copy 1

1994-1

# TAX REFORM ACT OF 1969

## HEARINGS

BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

NINETY-FIRST CONGRESS

FIRST SESSION

ON

## H.R. 13270

TO REFORM THE INCOME TAX LAWS

---

PART 1

---

SEPTEMBER 4 AND 5, 1969

---

STATEMENTS AND RECOMMENDATIONS OF THE DEPARTMENT OF THE TREASURY

---

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

33-865 O WASHINGTON : 1969

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price $3.75

## COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

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

JOHN J. WILLIAMS, Delaware
WALLACE F. BENNETT, Utah
CARL T. CURTIS, Nebraska
JACK MILLER, Iowa
LEN B. JORDAN, Idaho
PAUL J. FANNIN, Arizona
CLIFFORD P. HANSEN, Wyoming

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

# CONTENTS


Discussions between members of the Committee on Finance and the administration witnesses: — Page

- Russell B. Long (chairman) — 1–2, 495, 501–503, 544–545, 645, 663, 672, 682–688, 706–708, 757–767
- Clinton P. Anderson — 503–504, 678–679
- Albert Gore — 508–511, 628–630, 632–634, 643, 654, 696–702, 705, 711–716, 721–723
- Herman E. Talmadge — 672–677
- Eugene J. McCarthy — 677–678
- Vance Hartke — 513–517, 737–747
- J. W. Fulbright — 520–524, 640–646, 649, 747–757
- Fred R. Harris — 527–531
- Harry F. Byrd, Jr — 539–543, 647–652, 708–710
- John J. Williams — 504–508, 634–640, 688–696
- Wallace F. Bennett — 511–513, 645–647, 705–706, 716–718, 764
- Carl T. Curtis — 517–520, 652–658, 695, 717–737
- Jack Miller — 524–527, 630–631, 658–663, 702–708
- Len B. Jordan — 531–533, 679–682
- Paul J. Fannin — 533–539, 665–672
- Clifford P. Hansen — 543–544


## Witnesses


Hon. David M. Kennedy, Secretary of the Treasury, accompanied by:
- Charls E. Walker, Under Secretary of the Treasury;
- Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy; and
- John S. Nolan, Deputy Assistant Secretary of the Treasury for Tax Policy — 495
  - Prepared statement of Edwin S. Cohen — 547


## Additional Information


- Committee on Finance press release announcing tax reform hearings — 3
- Foundation ownership of improper business interests; excerpt from Treasury Department's general explanation of its tax reform proposals to the Ways and Means Committee — 726
- H.R. 13270 (text of the Tax Reform Act of 1969) — 127
- Income tax rates:
  - Married persons:
    - Existing law — 690
    - H.R. 13270 and Treasury proposal, 1972 — 690
  - Single persons:
    - Existing law — 691
    - Treasury proposal, 1972 — 692
  - Single persons over 35, House proposal — 692
  - Single persons under 35, House proposal — 691
- Private foundations, excerpt from Treasury Department report on — 729
- Revised tax law and tax-exempt securities—Amendment No. 141 to H.R. 13270, with explanation, submitted by Senator J. W. Fulbright — 523

Selected tables: Page
Assets of private foundations, 1930–68 ---- 709
Tax under present law and tax change under H.R. 13270 and the Treasury proposals assuming final incidence of the corporation income tax is borne:
50 percent by stockholders and 50 percent by consumers ---- 759
100 percent by individual stockholders ---- 759
100 percent by consumers ---- 759
Effect of current Treasury proposals on calendar year liabilities ---- 765
Calendar year liability of revenue estimates (Treasury proposals) ---- 766
Summary of H.R. 13270, prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance ---- 7
Unlimited charitable contributions deduction, Treasury position on ---- 658

## Appendix A

Technical memorandum of Treasury position on H.R. 13270 ---- 769

# TAX REFORM ACT OF 1969

---

**THURSDAY, SEPTEMBER 4, 1969**

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, D.C.*

The committee met, pursuant to notice, at 10:10 a.m., in room G-308, New Senate Office Building, Senator Russell B. Long (chairman) presiding.

Present: Senators Long, Anderson, Gore, Talmadge, Hartke, Fulbright, Harris, Byrd, Jr., of Virginia, Williams, Bennett, Curtis, Miller, Jordan of Idaho, Fannin, and Hansen.

## OPENING STATEMENT OF THE CHAIRMAN

The CHAIRMAN. This hearing will come to order.

Today the Committee on Finance begins the task of reform. The bill before us covers 368 pages of bewildering complexity and it has been described as the most significant tax reform legislation that Congress has ever undertaken. It involves more than $16 billion in revenues; $7 billion in tax increases, and $9 billion in tax cuts.

In one respect or another this bill would touch the lives and livelihood of every person in America. It would exert influences on our financial system and would leave its mark on our capital markets. Our churches, schools, and colleges would feel its impact. So would those responsible for the operation of our State and local governments.

Our major industries, without exception, will find higher taxes their legacy under the bill. Some of our industries—such as the natural resources industry and the homebuilding industry—would be affected by several features of the House bill.

Private foundations, whose existence stems from generous tax rules which not only reward donors for their contributions but also covers foundation incomes with a cloak of tax immunity, are a special target of this tax reform bill.

Individuals who today pay more taxes than they should will find their burdens lightened by the bill while those who pay less than they should will find a heavier burden to carry. The bill tightens up on the the loose ends and loosens up on the tight ends.

Truly, this is a significant bill. It contains much that is good. But those who seek a simple law, one that ordinary taxpayers and businessmen can read and determine how much tax they owe, will find little comfort in this bill. It is a mighty complicated bill, and its provisions are already confounding the best tax minds in the country.

Because of this complexity, I am making the request on the Treasury Department this morning that when the Committee on Finance goes into executive session on this bill that the Treasury Department furnish us with copies of the tax return forms and schedules as they would need to be modified to carry out the provisions of the bill.

The goal of this bill is tax justice. If we find the bill creates a greater injustice in some areas than it seeks to correct, then no doubt we will change the bill in that respect. Similarly, if we find desirable features which have been omitted from the bill, we will add them to it. This is the legislative procedure recited in the Constitution by those who founded our country. It is the only way by which the Senate can act in tax matters.

During the next 4½ weeks the committee will hear approximately 300 witnesses in public hearing. Some will favor the bill; others will oppose it—or some part of it. But in the process of listening to them and in discussing the issues raised by their testimony, the committee members will gain an insight—a "feel"—for what the bill does, how it works, who it affects, and why, that will guide us as we move from the public hearing phase of our work into closed-door executive sessions to mark up the bill.

I see here by the Treasury suggestions that in a note as indicated in page 19 of Assistant Secretary Cohen's statement a more detailed memorandum making further recommendations will not be available to the Committee on Finance until a later date. At such time they will be printed as a separate document and will be made available to the general public. It would seem to me that the technical memorandum should be available to us before public witnesses are heard.* Otherwise I do not understand how public witnesses can address themselves to the specifics, and I would hope that that can be made available to us by the time public witnesses appear, particularly those segments of those recommendations that have to do with what the particular public witnesses are testifying about.

I think it well to include at this point in the record material related to these hearings. Let us include our press release announcing these hearings, our staffs' summary of the bill, and the bill itself, H.R. 13270. While the bill is rather voluminous it will serve to provide a more complete record.

(The material referred to follows. Testimony begins on page 495.)

*The Treasury Department Technical Memorandum referred to was received by the Committee and printed as a separate document. It has also been included in this volume of hearings as appendix A.

## PRESS RELEASE

FOR IMMEDIATE RELEASE
August 12, 1969

COMMITTEE ON FINANCE
UNITED STATES SENATE
2227 New Senate Office Bldg.

### TAX REFORM HEARINGS
### COMMITTEE ON FINANCE

Honorable Russell B. Long, Chairman, Committee on Finance, announced today that on Thursday, September 4, 1969, the Committee would begin hearings on H. R. 13270, the Tax Reform Act of 1969. The hearing will begin at 10:00 a.m. on Thursday, September 4 in the Senate Auditorium, Room G-308, New Senate Office Building.

Administration Witness. -- He stated that the lead-off witness would be the Honorable David M. Kennedy, Secretary of the Treasury, who would testify on Thursday, September 4 and Friday, September 5.

Public Witnesses. -- He stated further that public witnesses testifying on tax reform would be scheduled beginning Monday, September 8, 1969, and continuing through Friday, October 3, 1969. Following the hearing, the Committee will begin closed-door mark-up sessions on the bill.

The Chairman noted that because of the particularly comprehensive nature of the House tax reform bill, an unusually large number of witnesses are expected at the hearing. For this reason, he stated that it would be necessary to very carefully control the time allotted for oral presentations before the Committee.

Legislative Reorganization Act. -- In this respect, the Chairman observed that the Legislative Reorganization Act of 1946, as amended, requires all witnesses appearing before the Committees of Congress --

> "to file in advance written statements of their proposed testimony, and to limit their oral presentations to brief summaries of their argument."

The statute also directs the staff of each Committee to prepare digests of all testimony for the use of Committee members.

Senator Long stated that in light of this statute and in view of the large number of witnesses who desire to appear before the Committee in the limited time available for the hearing, all witnesses who are scheduled to testify must comply with the following rules:

(1) All statements must be filed with the Committee at least two days in advance of the day on which the witness is to appear. If a witness is scheduled to testify on a Monday or a Tuesday, he must file his written statement with the Committee by the Friday preceding his appearance.

(2) All witnesses must include with their written statement a summary of the principal points included in the statement.

(3) The written statements must be typed on letter-size paper (not legal size) and at least 50 copies must be submitted to the Committee.

(4) Witnesses are not to read their written statements to the Committee, but are to confine their oral presentation to a summary of the points included in the statement.

Witnesses who fail to comply with these rules will forfeit their privilege to testify.

Consolidated Testimony. -- The Chairman also stated that the Committee urges all witnesses who have a common interest and a common position in a provision in the Tax Reform Act to consolidate their testimony and designate a single spokesman to present their common viewpoint orally to the Committee. He stated that this procedure would enable the Committee to receive a wider expression of views on the total bill than it might otherwise obtain. He praised witnesses who in the past have combined their statements in order to conserve the time of the Committee, and he urged very strongly that all witnesses exert a maximum effort to consolidate and coordinate their statements, not only to conserve the time of the Committee, but also to avoid repetitious testimony.

Staff Digests. -- The Chairman emphasized that the Committee staffs had been instructed to fully digest all statements submitted to the Committee so that every important point made by any witness would be called to the Committee's attention. He stated that these digests would be made available to the Committee members each morning before the witness involved actually appears before the Committee.

Schedule for Major Topics. -- Senator Long stated that the proposed schedule of the Committee called for testimony on major topics to begin on the date specified as follows:

Private Foundations - - - - - - - - - -Tuesday, September 9, 1969

Capital Gains and Losses - - - - - - -Tuesday, September 16, 1969

Minimum Income Tax, Allocation of Deductions, and State and Municipal Bond Interest - - - - - - - - -Tuesday, September 23, 1969

Natural Resources, Percentage Depletion, etc. - - - -Tuesday, September 30, 1969

He stressed, however, that this schedule was not intended to suggest that testimony on these major topics would be concluded in a single day.

Investment Tax Credit Repeal; Surtax Extension . -- The tax reform bill contains several provisions similar to those previously passed by the House in H. R. 12290. These relate to the repeal of the 7 percent investment tax credit, the extension of the 10 percent tax surcharge, the extension of the excise tax on automobiles and communications services, and the allowance of an amortization deduction for air and water pollution control facilities. The Chairman indicated that because the Committee on Finance had already taken five days of testimony (covering 530 pages of hearings) on those subjects, the Committee would not receive testimony with respect to those matters during the present hearing. He indicated that if the position stated by any witness at the earlier hearing on H. R. 12290 had changed since that time, the witness could communicate that fact to the Committee in a written statement.

He observed that H. R. 12290 also included a major amendment described as "the low income allowance," designed to eliminate tax on persons whose income was below or near the poverty level. Because the House of Representatives had made a major change in the low income allowance, the Chairman advised that the Committee would receive testimony on this provision, despite the fact that it had been subjected to hearings as part of H. R. 12290.

Requests to Testify; Witness List . -- Senator Long advised that witnesses desiring to testify during this tax reform hearing must make their request to testify to Tom Vail, Chief Counsel, Committee on Finance, 2227 New Senate Office Building, not later than Tuesday, August 26, 1969. He reported that it was particularly important that this hearing program be fixed in advance so that Senators and witnesses alike could prepare their own schedules. Toward this end he announced that the Committee would publish, by Wednesday, September 3, 1969, a complete listing by subject matter of all those scheduled to appear before the Committee.

Written Statements in Lieu of Appearance . -- The Chairman stated further that those persons who desire to submit a written statement to the Committee in lieu of a personal appearance should submit their statements not later than the day on which the Committee is to take testimony on the topic with which they are concerned. He stated that this would enable the written statements to appear in the printed hearing along with the oral statements on the same topics. He emphasized that these written statements would also be digested by the staff for presentation to the Committee during its closed-door sessions, and that they would receive the same careful consideration by the Committee as though they had been delivered orally.

P. R. # 20

# SUMMARY OF H.R. 13270, THE TAX REFORM ACT OF 1969

## (AS PASSED BY THE HOUSE OF REPRESENTATIVES)

---

PREPARED BY THE STAFFS

OF THE

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

AND THE

COMMITTEE ON FINANCE

---

(NOTE.—This document has not been reviewed by the committee.)

# CONTENTS

## PART I

### Outline Summary of Provisions


Page

I. Tax reform provisions .... 3
II. Extension of surcharge and excises, termination of investment credit, and certain amortization provisions (contained in H.R. 12290 but which have not yet passed the Senate, and which are in H.R. 13270) .... 7
III. Adjustments of tax burden for individuals .... 7


## PART 2

### Analysis of Provisions and Arguments For and Against


A. Private foundations .... 11
1. Tax on investment income .... 11
2. Prohibitions on self-dealing .... 12
3. Distributions of income .... 13
4. Stock ownership limitation .... 15
5. Limitations on use of assets .... 16
6. Other limitations .... 17
7. Disclosure and publicity requirements .... 18
8. Change of status .... 19
9. Changes in definitions .... 21
10. Private operating foundation definition .... 22
11. Hospitals .... 23
12. Effective dates .... 24
B. Other tax-exempt organizations .... 25
1. The "*Clay-Brown*" provision or debt-financed property .... 25
2. Extension of unrelated business income tax to all exempt organizations .... 26
3. Taxation of investment income of social, fraternal, and similar organizations .... 28
4. Interest, rent, and royalties from controlled corporations .... 29
5. Limitation on deductions of nonexempt membership organizations .... 29
6. Income from advertising .... 30
C. Charitable organizations .... 31
1. 50-percent charitable limitation deduction .... 31
2. Repeal of the unlimited deduction .... 32
3. Charitable contributions of appreciated property .... 33
4. Two-year charitable trust .... 35
5. Charitable contributions by estates and trusts .... 36
6. Gifts of the use of property .... 37
7. Charitable remainder trusts .... 37
8. Charitable income trust with noncharitable remainders .... 38
D. Farm losses .... 39
1. Gains from disposition of property used in farming where farm losses offset nonfarm income .... 39
2. Depreciation recapture .... 41
3. Holding period for livestock .... 42
4. Hobby losses .... 42

IV

Page

E. Limitation on deduction of interest ..... 43
F. Moving expenses ..... 45
G. Limit on tax preferences ..... 47
H. Allocation of deductions ..... 48
I. Income averaging ..... 50
J. Restricted stock plans ..... 51
K. Other deferred compensation ..... 52
L. Accumulation trusts, multiple trusts, etc ..... 54
M. Multiple corporations ..... 55
N. Corporate mergers ..... 57
  1. Disallowance of interest deduction in certain cases ..... 57
  2. Limitation on installment sales provision ..... 59
  3. Original issue discount ..... 60
  4. Convertible indebtedness repurchase premiums ..... 61
O. Stock dividends ..... 62
P. Foreign tax credit ..... 64
Q. Financial institutions ..... 66
  1. Commercial banks—Reserves for losses on loans ..... 66
  2. Mutual savings banks, savings and loan associations, etc ..... 67
  3. Treatment of bonds held by financial institutions ..... 70
  4. Foreign deposits in U.S. banks ..... 71
R. Depreciation allowed regulated industries ..... 72
  1. Accelerated depreciation ..... 72
  2. Earnings and profits ..... 73
S. Alternative capital gain rate for corporations ..... 75
T. Natural resources ..... 75
  1. Percentage depletion ..... 75
  2. Mineral production payments ..... 78
  3. Mining exploration expenditures ..... 80
  4. Treatment processes in the case of oil shale ..... 81
U. Capital gains and losses ..... 81
  1. Alternative tax ..... 81
  2. Capital losses of individuals ..... 82
  3. Collections of letters, memorandums, etc ..... 83
  4. Holding period of capital assets ..... 84
  5. Total distributions from qualified pension, etc., plans ..... 85
  6. Sales of life estates, etc ..... 87
  7. Certain casualty losses under section 1231 ..... 88
  8. Transfers of franchises ..... 89
V. Real estate depreciation ..... 90
W. Cooperatives ..... 92
X. Subchapter S corporations ..... 94
Y. Tax treatment of State and municipal bonds ..... 95
Z. Extension of tax surcharge and excise taxes; termination of investment credit ..... 96
  1. Extension of tax surcharge at 5-percent annual rate for first half of 1970 ..... 96
  2. Continuation of excise taxes on communication services and automobiles ..... 96
  3. Repeal of the investment credit ..... 97
  4. Amortization of pollution control facilities ..... 98
  5. Amortization of certain railroad rolling stock ..... 99
AA. Adjustment of tax burden for individuals ..... 100
  1. Increase in standard deduction ..... 100
  2. Low income allowance ..... 101
  3. Maximum tax on earned income ..... 102
  4. Intermediate tax rates; surviving spouse treatment ..... 103
  5. Individual income tax rates ..... 104
  6. Collection of income tax at source on wages ..... 105

# PART 3

## Statistical Material—Tables


| | | Page |
|---|---|---|
| 1. | The balancing of tax reform with tax relief under H.R. 13270 with modified rate reduction—Calendar year tax liability | 109 |
| 2. | Balancing of tax reform and tax relief—Calendar year tax liability | 109 |
| 3. | Individual income tax liability—Tax under present law and amount and percentage of change under reform and relief provisions when fully effective | 110 |
| 4. | Tax relief provisions affecting individuals and total for all reform and relief provisions affecting individuals, when fully effective, by adjusted gross income class, 1969 levels | 110 |
| 5. | Tax reform provisions affecting individuals, full year effect—By adjusted gross income class | 111 |
| 6. | Revenue estimates, tax reform, calendar year liability | 112 |
| 7. | Taxable returns under present law, number made nontaxable by relief provisions and number benefiting from rate reduction | 113 |
| 8. | Tax burdens under present law, under H.R. 13270, and percent tax change—Married couple with 2 dependents | 113 |
| 9. | Tax burdens under present law, under H.R. 13270, and percent tax change—Single person under 35 | 113 |
| 10. | Tax burdens under present law, under H.R. 13270, and percent tax change—Single person, 35 and over | 114 |
| 11. | Effect on H.R. 13270 on fiscal year receipts, 1970 and 1971 | 114 |

# PART 1

## OUTLINE SUMMARY OF PROVISIONS



33-865 O—69—pt. 1——2

# PART 1

## OUTLINE SUMMARY OF PROVISIONS

The provisions included in H.R. 13270 can be briefly summarized as follows:

### I. Tax Reform Provisions

1. *Private Foundations.*—The permissible activities of private foundations desiring to preserve the benefits of tax exemption, as well as the tax benefits to their contributors, are substantially tightened to prevent self-dealing between the foundations and their substantial contributors, to require the distribution of income for charitable purposes, to limit their holdings of private businesses, to give assurance that their activities are restricted as provided by the exemption provisions of the tax laws, and to be sure that investments of these organizations are not jeopardized by financial speculation. In addition, these private foundations are called upon to make a small contribution, 7½ percent of their investment income, toward the cost of government.

2. *Tax Exempt Organizations, Generally.*—The activities of exempt organizations generally are limited so that they cannot participate in debt-financed leaseback operations, wherein they, in effect, share their exemption with private businesses. Second, the unrelated business income tax is extended to virtually all tax-exempt organizations not previously covered by this tax, including churches. Third, the bill extends the regular corporate tax to the investment income of tax-exempt organizations set up primarily for the benefit of their members, such as social clubs, fraternal beneficiary societies, etc.

3. *Charitable Contributions.*—Charitable contribution deductions are substantially restructured. The general charitable deduction limitation is increased to 50 percent but the so-called unlimited charitable deduction is phased out over a 5-year period. The extra tax benefits derived from charitable contributions of appreciated property, are restricted in the case of gifts to private foundations, gifts of ordinary income property, gifts of tangible personal property, gifts of future interests, and in the case of so-called bargain sales. Also, the 2-year charitable trust rule is repealed and a number of changes are made limiting charitable contribution deductions where there are gifts of the use of property and in the case of charitable remainder and charitable income trusts.

4. *Farm Losses.*—The deduction of farm losses is restricted in the case of those with farm losses of $25,000 or more and with incomes of over $50,000 from nonfarm sources. Other provisions of the bill, primarily relating to farm operations, provide for the recapture of depreciation upon the sale of livestock, the extension of the holding period for livestock, and a revision of the treatment in the case of hobby losses.

5. *Interest Deductions.*—The deduction of interest on funds borrowed to carry investments is generally limited to investment income plus $25,000.

6. *Moving Expenses.*—Moving expense deductions are allowed when changing jobs for househunting trips, for temporary living expenses prior to locating a new home, and for the expenses of selling an old home or buying a new one.

7. *Limit on Tax Preferences.*—In those cases where tax preferences are not fully subject to tax, provision is made for a minimum tax on individuals having tax preferences in excess of their taxable income. The additional tax in this case is determined by adding to the regular income subject to tax, one-half of the tax preferences but only to the extent they exceed the regular income.

8. *Allocation of Deductions.*—Where taxpayers have substantial tax-free income, provision is made to allocate itemized personal deductions between this tax-free income and the individual's taxable income.

9. *Income Averaging.*—The income averaging provision of present law is substantially simplified and also made more generally available.

10. *Restricted Stock.*—In the case of so-called restricted stock plans, the interest in the property is taxed at the time of receipt, unless there is a substantial risk of forfeiture. In the latter event, the value of the property is taxed when the possibility of forfeiture is removed.

11. *Deferred Executive Compensation.*—Other deferred executive compensation is, in general, subject to tax rates as if taxed when earned, although the tax is not payable until the income is received.

12. *Multiple Trusts.*—In the case of accumulation trusts (including multiple trusts), the beneficiary, generally, is to be taxed on the distributions in substantially the same manner as if he had received these amounts of income when they were earned by the trust (taking into account any taxes paid by the trust on the income.)

13. *Corporate Mergers.*—In the case of corporate mergers, a number of changes are made. The principal change establishes tests to be used in determining when amounts cast in the form of "debt" have sufficient characteristics of "equity" to be denied the deduction of interest, where this so-called "debt" is used in the acquisition of other companies. Included among the other provisions is one which limits the availability of the installment method for reporting gains, where the debt can be readily traded on the market, and also where the installment payments are not spread relatively evenly over the period during which part of the debt is outstanding. Other restrictive changes are also made in the case of original issue discount and premiums paid on the repurchase by a corporation of its indebtedness which is convertible into its own stock.

14. *Multiple Corporations.*—Multiple surtax exemptions in the case of related corporations are withdrawn over an 8-year period.

15. *Stock Dividends.*—The rules applicable in determining when stock dividends become taxable are revised generally to provide for taxation where one group of stockholders, directly or indirectly, receives a disproportionate distribution in cash while the interests of the other shareholders in the corporation are increased.

16. *Foreign Tax Credit.*—The foreign tax credit is revised in two respects. First, it is provided that where losses of a corporation op-

erating abroad are offset against domestic income (either of the same corporation or as the result of filing a consolidated return), subsequent earnings from the foreign operations to the extent of one-half of these earnings remaining after foreign tax, are to be recaptured until the tax benefit for the domestic operations derived in the case of the initial offset of the foreign losses is recovered. Secondly, a separate limitation under the foreign credit is provided in certain cases with respect to foreign mineral income.

17. *Commercial Banks.*—The tax advantages of commercial banks, relating to special reserves for bad debt losses on loans and to capital gains treatment for bonds held in their banking business are withdrawn.

18. *Mutual Savings Banks and Savings and Loan Institutions.*—The tax treatment of mutual savings banks and savings and loan associations is revised to reduce a series of tax advantages presently available to these financial institutions.

19. *Depreciation in Case of Regulated Industries.*—Action is taken generally to limit the depreciation which may be taken in the case of certain regulated industries, to straight line depreciation unless the appropriate regulatory agency permits the company in question to take accelerated depreciation and "normalize" its tax reduction. However, in the case of existing property, no faster depreciation may be taken than is presently taken. Companies already on "flow through" may not change without permission of their regulatory agencies.

20. *Use of Depreciation in Computing Earning and Profits.*—In computing earnings and profits—which determine whether dividends are taxable or not—corporations are required to make the computation on the basis of straight line depreciation. As a result, this tax benefit cannot be passed on to stockholders.

21, *Capital Gains of Corporations.*—The alternative capital gains tax on corporations in increased from 25 to 30 percent.

22. *Depletion, etc.*—The percentage depletion rate for gas and oil wells is reduced from 27½ percent to 20 percent. Other depletion rates are comparably reduced (with five minor exceptions). Percentage depletion also is eliminated with respect to foreign oil and gas wells. Additionally, carved out production payments, as well as retained production payments (including ABC transactions) are treated as if they were loans, or the sale of property subject to a mortgage. The effect of this generally is to prevent such payments from artificially increasing the percentage depletion deduction and foreign tax credits or giving rise to income which can offset net operating losses. In addition, this eliminates the possibility of buying mineral property with money which is not treated as the taxable income of the buyer. Finally, recapture rules are applied to certain mining exploration expenditures to which the rules of present law are inapplicable.

23. *Capital Gains.*—Capital gain and loss treatment is revised in several respects. First, the alternative capital gains tax for individuals was repealed, with the result that in the case of those in the top tax brackets, the rates may rise to as much as 35 percent (or 32½ percent under the new rate structure provided by this bill); second, long-term capital losses of individuals are reduced by 50 percent before being

available as an offset against ordinary income; third, the offset against ordinary income in the case of husbands and wives filing separate returns is limited to $500 for each or to the same aggregate amount as if they filed a joint return; fourth, the sale of papers by a person whose efforts created them, or by a person for whom they were produced, is to give rise to ordinary income; fifth, the holding period for capital gains is increased from 6 months to 12 months; sixth, employers' contributions to pension plans when paid out as a part of a lump-sum distribution, is to be taxed as ordinary income; seventh, life interests are not to be accorded a cost basis when sold; eighth, casualty losses and gains are to be consolidated in determining whether they give rise to ordinary loss or to gain which is consolidated with other section 1231 gains or losses; and ninth, transfers of franchises are not to be treated as giving rise to capital gains if the transferor retains significant rights.

24. *Real Estate Depreciation.*—Real estate depreciation is revised in several respects. The 200-percent declining balance (or sum-of-the-years-digits) method is limited to new housing; other new real estate is limited to 150-percent declining balance depreciation; and all used property is limited to straight line depreciation. However, 5-year amortization is allowed for certain rehabilitation expenditures on low-cost rental housing. Finally, the so-called recapture rules of present law, in the case of real estate, are revised so that they apply to depreciation in excess of straight line depreciation. In other words, upon the sale of property, depreciation in excess of straight line will be recaptured at that time by converting the capital gain to ordinary income to the extent of this excess.

25. *Cooperatives.*—The tax treatment of cooperatives is revised to require patronage dividends and per-unit retains to be revolved out over a period of no more than 15 years. In addition, the required cash payout in any year, on either current or prior years' patronage, must equal at least 50 percent of the amount of the current year's patronage (taking into account the 20 percent which under present law must be paid in cash on the current patronage).

26. *Subchapter S Corporations.*—In the case of subchapter S corporations (that is, the corporations treated somewhat like partnerships) amounts set aside under qualified pension plans for shareholder-employee beneficiaries may not exceed 10 percent of the compensation paid or $2,500, whichever is smaller.

27. *State and Municipal Bonds.*—State and local governmental units are given an opportunity to issue taxable obligations and in turn receive from the Federal Government a payment equal to between 30 and 40 percent of the interest yield of the bond (on issues brought out after 5 years, the payment will be between 25 and 40 percent). Additionally, the interest on so-called arbitrage bonds of State and local governments are denied Federal income-tax exemption.

## II. Extension of Surcharge and Excises, Termination of Investment Credit, and Certain Amortization Provisions (Contained in H.R. 12290 but Which Have Not Yet Passed the Senate, and Which Are in H.R. 13270)

1. *Surcharge.*—The income-tax surcharge at a 5-percent rate is extended by this bill from January 1, 1970, through June 30, 1970.

2. *Excises.*—The present excise taxes on communications services and automobiles are extended for one more year and future reductions of these taxes are postponed.

3. *Investment Credit.*—The 7-percent investment credit is repealed.

4. *Pollution Control.*—Five-year amortization is provided for pollution control facilities.

5. *Railroad Rolling Stock.*—Seven-year amortization is provided for railroad rolling stock, other than locomotives.

## III. Adjustments of Tax Burden for Individuals

1. *Standard Deduction and Maximum Standard Deduction.*—Over a 3-year period the standard deduction is increased from 10 percent to 15 percent and the maximum standard deduction is increased from $1,000 to $2,000. This rate and amount are effective for 1972 and later years. In 1970 the percentage is 13 percent and the maximum, $1,400. In 1971 the percentage is 14 percent and the maximum, $1,700.

2. *Minimum Standard Deduction and Low-Income Allowance.*—The minimum standard deduction is increased to a level of $1,100, by adding to the present minimum what is called a low-income allowance. This amount is phased out for the income levels above the taxable levels. This phaseout, however, is used for only 1 year. After 1970 the full $1,100 allowance will be available for all taxpayers whose standard deduction without regard to the minimum is not in excess of $1,100.

3. *Top Rate on Earned Income.*—In the case of earned income, a maximum rate of tax of 50 percent is provided. This is a maximum marginal rate, with the result that no earned income will be taxed at a rate in excess of 50 percent.

4. *Tax Treatment of Single Persons.*—Single persons, 35 years of age or more, and persons whose spouse has died, are provided income tax rates which are halfway between those available to married couples and those previously available to these single persons. This intermediate tax rate treatment is the category formerly known as head-

of-household treatment. In addition, in the case of widows and widowers with dependent children, age 19 or less or attending school or college, full income splitting is to be available.

5. *Rates.*—In 1971 and 1972 tax rate reductions aggregating slightly over $2.2 billion in each year are provided. The 1972 rates provide slightly over a 5-percent reduction for those whose income levels are above the levels where the low-income allowance and increase in the standard deduction provide substantially greater reductions.

# PART 2

## ANALYSIS OF PROVISIONS AND ARGUMENTS FOR AND AGAINST

As requested by the Committee, the following summary includes arguments which might be raised in support of, or in opposition to, each provision contained in the House-passed bill. This listing of the arguments for and against the features of the House bill is not intended, and indeed it cannot be, all inclusive. The many different situations which the bill affects make it impossible to anticipate every attitude that might be expressed with respect to the bill. However, it is believed that the principal positions are reflected in the summary. The order in which the arguments are presented should not be interpreted as a ranking of their importance, nor should the phraseology indicate that the staffs have any position with respect to them.

# PART 2

## ANALYSIS OF PROVISIONS AND ARGUMENTS FOR AND AGAINST

### A. Private Foundations

#### 1. Tax on Investment Income

*Present law.*—Although present law subjects many exempt organizations to taxation on unrelated business income, investment income is specifically excepted from this tax.

*Problem.*—Heavily endowed foundations have substantial income that is not taxed. Questions have been raised as to why these private foundations should not pay some of the cost of government since they are able to pay. Also funds are needed for more and more extensive and vigorous enforcement of the tax laws relating to foundations. A user fee is needed to provide funds for this purpose.

*House solution.*—The bill imposes a tax of 7½ percent on a private foundation's net investment income (interest, dividends, rents and royalties) and its net capital gains. Deductions are allowed only for expenses paid or incurred in earning that income and for net capital losses. Taxes are not imposed upon their receipt of contributions or grants.

*Arguments For.*—(1) Since private foundations enjoy the benefits of Government as do other entities and individuals, they should bear some portion of the costs of Government, just as do other organizations and individuals.

(2) The administrative machinery necessary to insure that private foundations currently distribute their funds for proper charitable purposes is becoming more and more costly. This tax will defray a portion of that cost. It is a modest levy which will not hamper the operation of private foundations.

(3) Such a tax should encourage greater reliance upon the public than upon the one-time beneficence of one individual or family.

(4) Investment income of most other charitable organizations is not subject to tax (except for income from debt-financed acquisitions and investment income of social clubs, fraternal beneficiary societies, and certain employee insurance associations discussed below), and it is unfair to single out foundations for this special tax.

*Arguments Against.*—(1) Since the advent of our taxing statutes, the Government has recognized the special place that private foundations occupy in our society and has granted them tax-exempt status. This tax is an incursion into that philosophy and seriously undermines it.

(2) This tax will fall heavily upon those private foundations who have a profitable investment portfolio, and would reduce the fund that would be available for charitable purposes.

(3) The foundation that secures more current income for current charitable benefits will be liable for a greater tax than a foundation which does the minimum that the bill requires, and so the bill discourages good foundation management.

**2. Prohibitions on Self-Dealing**

*Present law.*—Under present law, no part of the net earnings of private foundations and other charitable organizations are permitted to inure to the benefit of private shareholders or individuals. Also, arm's-length standards are imposed with regard to loans, payments of compensation, preferential availability of services, substantial purchases or sales, and substantial diversions of income or corpus to (or from, as the case may be) creators (of trusts) and substantial donors and their families and controlled corporations. The only sanctions provided are loss of exemption for a minimum of one taxable year and loss of charitable contributions deductions under certain circumstances.

*Problem.*—Arm's-length standards have proved to require disproportionately large enforcement efforts, resulting in sporadic and uncertain effectiveness of the provisions. Moreover, the subjectivity involved in applying such standards has occasionally resulted in the courts refusing to uphold sanctions, especially when they are severe in relation to the offense. In other cases, the sanctions have practically no deterrent or punitive effect even where there is vigorous enforcement. Also, many benefits may be derived by those who control a private foundation even though they deal completely at arm's-length.

*House solution.*—The bill replaces the arm's-length standards with a list of specific prohibited self-dealing transactions. A violation of the provisions results in a tax on the self-dealer of 5 percent of the amount involved in the violation. If the self-dealing is not corrected within an appropriate time, then a tax of 200 percent of the amount involved is imposed upon the self-dealer. Similar taxes at lower rates are imposed upon the foundation manager who is knowingly involved in the self-dealing or who refuses to correct the self-dealing but the tax on the manager may not exceed $10,000. A third level of tax is available, as described below in Change of Status. The bill also requires that the foundation's governing instrument must prohibit it from engaging in the self-dealing transactions described in the Code.

*Arguments For.*—(1) The provisions of the present Internal Revenue Code which relate to self-dealing in private foundations have proved to be totally ineffective. Abuses have arisen where individual taxpayers have benefited by using the tax-exempt private foundation for their own purposes, rather than for the charitable purpose for which the foundation was ostensibly founded.

(2) The arms-length tests set forth in the present Internal Revenue Code are vague, and difficult to enforce. The result is that there is excessive litigation where, because of the difficulty in tracing the transaction involved, the Government is at a tremendous disadvantage.

(3) The fact that, in relation to the particular offense, present sanctions may be inordinately severe causes the courts, as well as the Internal Revenue Service, to refrain from invoking them even though there may be self-dealing. Under the bill the sanctions are properly proportioned to the amount involved in the improper transactions and are imposed upon the self-dealer rather than the foundation.

(4) The bill improves on the present law by including in the self-dealing provisions transactions between private foundations and Government officials.

(5) The highest fiduciary standards require as a practical matter that self-dealing be not engaged in, rather than that arm's-length standards be observed. These proposals are intended to impose the highest standard since experience has shown that lesser standards are too tempting to many donors and managers.

(6) The requirements as to foundation governing instruments will facilitate effective State enforcement of State common law and statutory regulation of funds dedicated to charitable purposes.

*Arguments Against*.—(1) Many innocent transactions will be subject to sanctions under the bill. Innocent transactions discovered years later may not be able to be effectively undone, especially where the foundation and the donor no longer have the property that was involved.

(2) The restrictions imposed upon dealings between the foundation and substantial contributors may well discourage persons from giving to private foundations if they have widespread business activities.

(3) In many cases, the first-level sanctions will be insufficient to deter self-dealing transactions which are deliberate and will be excessive in the case of self-dealing transactions that are inadvertent.

(4) The attribution rules are so broad that many private foundations will not be able to operate effectively because so many of those whom they would naturally deal with are or may be disqualified persons. In reply to this point it is noted that many of the present difficulties arise precisely because foundations "naturally" deal with their donors and their donors' businesses.

(5) This provision would prohibit fair and equitable transactions even where they benefit charity. In addition, it seems unfair to prevent a donor from dealing with his foundation on the same terms that the foundation would be willing to deal with an unrelated person.

(6) Rather than have any Federal prohibition on self-dealing, which is cumbersome and difficult to administer, the jurisdiction of the problem is better left to the State courts which have a wider range of remedies for dealing with the abuses, such as the removal of the fiduciaries, the mandatory distribution of income for charitable purposes, surcharge, and reformation.

### 3. Distributions of Income

*Present law*.—A private foundation loses its exemption if its aggregate accumulated income is unreasonable in amount or duration for its charitable purposes.

*Problem*.—Under present law, if a private foundation invests in assets that produce no current income, then it need make no distributions for charitable purposes, even though the donor has received full deductions for the value of the nonincome-producing property he has contributed. Also, current distributions are not required until the accumulated income becomes "unreasonable". Finally, the sanctions under present law (as described above under "self-dealing") tend to be either largely ineffective or else unduly harsh.

*House solution*.—The bill provides that a private foundation must distribute all its income currently (but not less than 5 percent of its

investment assets), and imposes graduated sanctions in the event of a failure to make timely distributions. However, provisions are made to set aside income for later distribution in certain circumstances and to carry forward "excess" distributions. Qualifying distributions include distributions to "public charities" and to private operating foundations, direct expenditures for charitable purposes, and expenditures for assets to be used for charitable purposes.

Income may be set aside for up to 5 years if approved in advance by the Internal Revenue Service, if such an arrangement is needed, as for example, to assure grants for continuing research or as part of a matching grant program. A tax of 15 percent of the undistributed amount is imposed where there has been a failure to distribute by the end of the taxable year after the income was received. If the distributions of the remainders are not made during the "correction period", then a tax of 100 percent is imposed.

*Arguments For.*—(1) These provisions are needed to insure that charity will begin promptly to receive benefits commensurate with the tax benefits available to donors and their foundations. The 5-year set-aside and carryover provisions should provide sufficient flexibility.

(2) The 5-percent minimum payout will reduce the incentive to use foundation assets to control businesses which do not pay substantial dividends.

(3) This provision would discard the "unreasonable accumulation" test contained in the present Internal Revenue Code. Under it, a private foundation can avoid making current distributions for the benefit of charity by investing in assets that produce no current income even though the donor may receive substantial tax benefits from his charitable contribution. Because it is difficult to determine subjectively when an accumulation has become unreasonable, the present law cannot be administered.

(4) Frequently under the present law the only available sanction for an unreasonable accumulation is the loss of exempt status which is ineffective and unduly harsh in many instances. The bill provides more appropriate sanctions designed to assure that current earnings will be distributed to charity.

(5) No private foundation should be permitted to use the tax laws to carve out a perpetual role in society without having to justify its continued existence to the contributing general public.

*Arguments Against.*—(1) The minimum 5-percent payout requirement will force foundations to engage in investment practices that will not permit them to grow commensurate with the rest of the economy.

(2) Foundation managers should be the sole judges of the best timing for the charitable use of foundation income.

(3) A foundation should not be required to distribute earned income currently if it is invested to produce a fair return. There are legitimate purposes for keeping a charitable fund intact for a long period of time, and this provision takes away fiduciary discretion in a major area of fiduciary responsibility.

(4) This provision might force an unwise corporate distribution to satisfy tax requirements and could well discourage many large donors from leaving substantial bequests to private foundations. Also, the necessity for an annual determination of the current fair market value

of foundation assets will breed litigation in areas where the investment asset is close-held and is not susceptible of an easy evaluation.

(5) This problem of accumulation is better attacked by allowing the foundations to control themselves or by placing authority for the administration of such matters in the State, rather than in the Federal Government.

## 4. Stock Ownership Limitation

*Present law.*—Present law does not deal directly with foundation ownership of business interests, although some cases have held that business involvement can become so great as to result in loss of exempt status.

*Problem.*—The use of foundations to maintain control of businesses appears to be increasing. Whether or not the foundation management is independent of donor control, incentive to control a business enterprise frequently detracts from incentive to produce and use funds for charitable purposes. Temptations are frequently difficult to measure and sanctions presently are applied only in rare cases.

*House solution.*—The bill limits to 20 percent the combined ownership of a corporation's voting stock which may be held by a foundation and all disqualified persons. If someone else can be shown to have control of the business, the 20-percent limit is raised to 35 percent. Existing excess holdings must be disposed of within 10 years (with interim requirements at 2 years and 5 years); excess holdings acquired by gift or bequest in the future generally must be disposed of within 5 years; exceptions are provided in the case of related businesses; and violations are subject to a series of graduated sanctions.

*Arguments For.*—(1) Where private foundations own substantial amounts of stock in corporations, there is a tendency to use the foundation's stockholdings to assert business control and to ignore the production of income by the foundation to be used for charitable purposes. The interests of the foundation's managers are diverted to the maintenance and improvement of the business and away from their charitable duties.

(2) Even where the ownership of a business by a private foundation does not cause the foundation managers to neglect their charitable duties, the corporate business may be run in such a way that it unfairly competes with other businesses whose owners must pay taxes on the income they realize.

(3) The divestiture requirements are sufficiently gradual (especially in the case of existing holdings) so as not to unreasonably disrupt the foundation's investment plans and also the worth of the security being divested. Even as to the future, 5 years should be sufficient where the excess holdings develop after knowledge of the new rules.

(4) Requiring divestiture is better than denying deductions because it permits a donor to give valuable assets to a foundation while allowing the foundation sufficient time to make the assets useful to it.

*Arguments Against.*—(1) This proposal will limit the diversity of foundations, will seriously inhibit their growth, and will prevent the creation of new private foundations.

(2) The fact that a donor derives some intangible benefit because the foundation controls his business does not alter the fact that he has made an irrevocable commitment to charity and as long as the prop-

erty is producing a fair return for charity, there should be no complaint. Any regulation in this area should not be on the foundation's ownership of other businesses, but should be on the use of funds realized from the operation of the other businesses.

(3) The other provisions of the law and the accompanying sanctions should correct the abuses resulting from foundation ownership of other businesses, making this provision unnecessary.

(4) Those whose fortunes consist largely of stock in single enterprises will be reluctant to contribute to private foundations since their only practical method of making a large grant will ultimately require loss of control over the business enterprise. In some cases, other social values may be served by protecting a business from the hazard of loss of control, as where a business has become vital to the economy of a community.

(5) The appropriate time for disposing of an investment asset should be left to the discretion of the foundation's managers and not be directed by the tax laws.

**5. Limitations on Use of Assets**

*Present law.*—A private foundation loses its exemption if its accumulated income is invested in such a manner as to jeopardize the carrying out of charitable purposes. No similar specific limitations apply to investment of assets.

*Problem.*—Under present law a private foundation manager may invest the assets (other than accumulated income) in warrants, commodity futures, and options, or may purchase on margin or otherwise risk the entire corpus of the foundation without being subject to any sanctions. (In one case a court held that a consistent practice of such investments constituted an operation of the foundation for a substantial non-exempt purpose, but the only sanction was loss of tax exemption, which did not really improve the status of charity.)

*House solution.*—The bill imposes upon all the assets of the foundation the same limitations presently applicable only to accumulated income. As a result, under this provision a foundation could not invest its corpus in a manner which would jeopardize the carrying out of its exempt purposes.

*Arguments For.*—(1) The rationale of the existing limitation applies to all the assets of a foundation. It is expected that the 100-percent tax on such jeopardizing investments will provide State officials with the necessary impetus for stronger regulatory supervision over the investment activities of private foundations.

(2) A tax measured by the amount of the improper investment is a better way of dealing with the problem than the present law's choice of either ignoring the impropriety or destroying the foundation's tax-exempt status.

*Arguments Against.*—(1) The restrictions placed on foundation management by these provisions would hamstring honest and competent trustees in dealing with the foundation's portfolio, and would limit investment flexibility.

(2) The abuse this provision seeks to prevent is not sufficiently widespread to require legislative action and in any event, the most effective way to deal with the problem is through substantive laws of the State or municipality.

(3) The jeopardy investment provision of present law has created few difficulties largely because it has rarely been enforced; it creates substantial difficulties of interpretation; and, these difficulties will be much magnified by making the present provision applicable to all the assets of the foundation.

**6. Other Limitations**

*Present law.*—Present law requires that no substantial part of the activities of a private foundation may consist of carrying on propaganda or otherwise attempting to influence legislation. It further provides that no such organization may "participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of any candidate for public office." The corresponding charitable contributions deduction provision prohibits substantial propaganda activities but does not deal specifically with the electioneering activities. Another provision prohibits the use of accumulated income to a substantial degree for nonexempt purposes.

*Problem.*—Under the present law's substantial lobbying provision, a large organization may safely engage in far more lobbying than a small organization. Also, many organizations make their views clear as to which candidates for public office ought to be supported, with confidence that the drastic remedy of loss of exemption will not be imposed. Heavily endowed organizations may engage in lobbying or electioneering and, if exempt status is lost, may continue to avoid tax on investment income by becoming exempt under other provisions of the law. The individual grant device is increasingly being used as a method for funding certain political viewpoints. Organizations that have been called to task for engaging in such activities have claimed that they have no responsibility for how their money is used once a grant has been made.

*House solution.*—The bill provides that private foundations are to be forbidden to spend money for lobbying, electioneering (including voter registration drives), grants to individuals (unless there are assurances that the grants are made on an objective basis), grants to other private foundations (unless the granting foundation accepts certain responsibilities as to the use of the funds by the donee organization), and for any other purpose which is not a charitable purpose. Improper expenditures will be subject to a tax of 100 percent of the amount paid or incurred. Activities will not be classified as prohibited "lobbying" if they consist only of making available the results of nonpartisan analysis or research. Also, a private foundation is permitted to appear before a legislative body with regard to matters that might affect the existence of the foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to it.

Voter registration drives will be permitted when conducted on a nonpartisan basis by broadly supported organizations active in at least 5 States, provided that contributions to the organization are not geographically limited as to use.

Grants may be made to individuals chosen in open competition or other nondiscriminatory programmatic basis. Grants may be made in the form of scholarships or fellowships or for a specific purpose. Grants to other private foundations (other than operating foundations) are prohibited unless the granting organization becomes responsible for

how the money is spent and for providing information to the Internal Revenue Service regarding the expenditures.

*Arguments For.*—(1) The present provision regarding the substantiality of improper lobbying, as indicated above, has the peculiar effect of permitting many organizations to engage in significant lobbying activities while others are, for practical purposes, completely forbidden to engage in such activities. This bill separates out the permissible activities from those which are not permissible and imposes the same sort of sanction on the large organization as it does on the small, the same sort of sanction on the heavily endowed organization as it does on the organization that depends upon current contributions.

(2) The bill corrects a defect in the present law through which foundations use their money to finance vacations abroad, trips between jobs for favored beneficiaries, and subsidies for the preparation of materials furthering specific political viewpoints.

(3) The bill accommodates both the interests of flexibility and responsibility, recognizing that the funds involved have already received substantial tax benefits by virtue of their being dedicated to charitable purposes. The foundations granting these funds are the stewards of public trusts and are no longer in the same posture as individuals who may dispose of their own money as they see fit.

*Arguments Against.*—(1) The provisions of the present law are adequate to take care of those isolated situations where private foundations engage in political activity. To impose further restrictions and sanctions would unduly restrict them in legitimate foundation activities.

(2) There is no substantial compelling evidence of abuse in the political activity or grant area relating to private foundations and, in any event, the problem should be met by State—not Federal—regulation.

(3) Private foundations have been increasingly involved in so-called action or social welfare programs. Prohibition of such activities at this time is viewed as an attack upon the causes, or as a punishment of the foundations.

(4) If private foundations are not permitted to "sell" the public as to their views on major social problems, then government will not be moved to act on those problems.

## 7. Disclosure and Publicity Requirements

*Present law.*—Private foundations must file annual information returns describing gross income, expenses, disbursements for exempt purposes, accumulations, balance sheet, and total amounts of contributions and gifts received. No specific sanctions are provided for failure to file a return except for certain criminal provisions applicable in extreme cases. Information required to be furnished on the information returns is open to the public.

*Problem.*—Existing law is not sufficient in most cases to provide the Internal Revenue Service with the information necessary to determine if the organization continues to be exempt and if it is liable for tax under the new rules for private foundations and the unrelated income and other provisions of this bill.

*House solution.*—The bill requires that information returns be filed annually by additional exempt organizations, that additional information as to donors and highly paid employees be included in the returns,

that sanctions of $10 per day be imposed for failure to file on time, and that certain information regarding violations must be furnished to appropriate State officials. In addition, the Service must make available, under regulations, information relevant to any determination under State law.

*Arguments For.*—(1) While the present law requires certain exempt organizations to file information returns and unrelated business income tax returns, the experience of the past two decades has indicated that these returns are inadequate to obtain information that is needed. This bill would require information on a more current basis, from more organizations, and would make the information available to more people, especially State officials, and to Congress for use in determining the need for further legislation.

(2) By requiring the names and addresses of all substantial contributors, directors, trustees, other management officials and highly compensated employees, this bill facilitates enforcement of the limitations imposed on self-dealing with "disqualified persons".

(3) The sanction of $10 per day should be more effective than the present vague possibility of criminal proceedings in the event of failure to file information returns.

*Arguments Against.*—(1) These provisions will compel private foundations to spend money on bookkeeping and accounting services that would otherwise be used for charitable purposes. This is especially undesirable in small foundations which do not have available large amounts of money and which rely on the ability of a few donors who may or may not have the ability to keep books and file detailed returns.

(2) The sanctions for failing to file a return are still too severe, especially since they are imposed on the foundation without any requirement that the Secretary notify the foundation before the sanction becomes operative.

(3) Privacy is unnecessarily invaded by the requirements of filing information regarding substantial contributors and payments to foundation officials. Payments of compensation to such officials are already sufficiently accounted for by the requirement to file withholding statements.

### 8. Change of Status

*Present law.*—Under present law, an organization is exempt if it meets the requirements of the Code, whether or not it has an "exemption certificate". Violation of the exemption provisions results in loss of exempt status, either prospectively or back to the time the violations first occurred.

*Problem.*—Many organizations do not make their existence known and thus receive tax benefits, both for themselves and their donors, without the Internal Revenue Service even being aware of their existence. In many cases, under existing law, loss of exempt status would be only a light burden. This is especially true where the foundation has already received the charitable contributions necessary to endow it and where it could retain its exemption as to its current income by qualifying for exemption under another provision of section 501(c).

*House solution.*—The bill requires new exempt organizations to notify the Internal Revenue Service if they claim to be exempt under section 501(c)(3). Existing and new organizations must notify the

Service if they claim to be other than private foundations. Exceptions may be provided by the Treasury Department to the extent appropriate without interfering with proper administration of the law.

If a private foundation seeks to change its status, or if the Internal Revenue Service determines that it has committed repeated willful violations (or a willful and flagrant violation) of the limitations imposed upon private foundations, then the organization must repay to the Government the aggregate income, estate, and gift tax benefits (with interest) that have flowed to the foundation and all its substantial donors since 1913 from the foundation's exempt status. However, this tax may be abated if the organization distributes all its assets to public charities or acts as a public charity itself for at least 5 years. The substantial contributors whose tax benefits must be taken into account are those who have contributed at least $5,000 to the private foundation in any one year or contributed more than anyone else to the foundation in any one year, or, in the case of a trust, have created the trust.

*Arguments For.*—(1) The Government ought to know what organizations receive tax benefits.

(2) A charity should not be permitted to deliberately cause loss of its exempt status in order to relieve itself of the law's limitations upon its activities, after it has already obtained substantial tax benefits.

(3) Required repayment of tax benefits (with interest) should make it highly unlikely that any organization which receives the benefits of such exempt status would take lightly its obligations to serve charitable purposes.

(4) The bill should greatly strengthen the position of State officials that seek to regulate the activities of private foundations, and, where necessary, conserve their assets and structures by causing the courts to replace the trustees or foundation managers who threaten to bring such a tax liability upon the foundation.

(5) The provision is needed to close a loophole through which existing private foundations already endowed with tax deductible contributions could change their character, secure tax-exempt status under another provision of the law, and yet escape the restrictive rules applied by the bill to private foundations.

(6) The bill properly requires organizations seeking to avoid the private foundation rules to clearly establish that they are not private foundations.

*Arguments Against.*—(1) It is harsh and unrealistic to require a foundation to repay tax benefits realized by contributors with respect to amounts they contributed to the foundation; determination of the amount of the tax benefit is an impossible task to impose on the foundation.

(2) It is impractical to require that all new exempt organizations must notify the Internal Revenue Service that they are claiming section 501(c)(3) exempt status. Such a requirement cannot be enforced with respect to such exempt organizations as Boy Scout troops, local Parent-Teacher Associations, and similar organizations.

(3) Views as to what constitutes proper forms of charity change with time. Those who have been entrusted with the task of directing a

foundation's activities should be given the flexibility to determine where the best advantages lie in the Internal Revenue Code as to carrying out of their entrusted functions.

(4) The sanction presented by the bill is so great that it would be unlikely that any court would be willing to enforce it.

### 9. Changes in Definitions

*Present law.*—"Private foundation", a term not found in present law, is often used to describe an organization, contributions to which may be deducted only up to 20 percent of an individual donor's adjusted gross income. Deductions of up to 30 percent of a donor's income may be taken for contributions to (1) churches, (2) schools, (3) hospitals, (4) fund-raisers for schools, (5) States and subdivisions, and (6) publicly supported charities.

*Problem.*—In general, the problems that gave rise to the statutory provisions of the bill discussed above appear to be especially prevalent in the case of organizations presently in the 20-percent group. However, it appears that certain organizations presently in the 20-percent category generally do not give rise to the problems which have led to the restrictions and limitations described above.

*House solution.*—The bill provides that a "private foundation" is any organization described in section 501(c)(3) other than:

(1) organizations, contributions to which may be deducted to the extent of 30 percent of an individual's income;

(2) certain types of broadly publicly supported organizations (including membership organizations);

(3) organizations which are organized and operated exclusively for the benefit of one or more organizations described in (1) or (2), and are controlled by one or more organizations, or operated in connection with one organization described in (1) or (2); and

(4) organizations which are organized and operated exclusively for testing for public safety.

The first and fourth categories are essentially the same as in present law. The second category includes a variety of organizations which receive substantial public support and whose income from endowments generally is quite limited. Among those to which this provision would apply are symphony societies, alumni associations, and the Boy Scouts of America. The remaining category includes religious organizations (other than churches), university presses, and certain organizations created and controlled by, and for, "(c)(3) organizations" which are not private foundations.

*Arguments For.*—(1) The objective definition of the term "private foundation" insures that the purposes of the bill can be carried out.

(2) The fact that organizations described above are not classified as "private foundations" does not to any significant extent present problems, since in general these organizations must justify their continued existence to the public and they usually spend for charitable purposes at least as much as their income (in many cases as much as their investment income plus contributions combined).

*Arguments Against.*—(1) Any arithmetic test necessarily means that two organizations, virtually identical in all respects, can receive

sharply different tax treatment because one just barely meets the test and escapes the private foundation rules, while the other just misses the test and falls subject to all of them. The bill would be quite arbitrary in its application.

(2) Limitations ought to be imposed upon all exempt organizations or upon none. To do otherwise, from this viewpoint, results in a discrimination which must not be allowed in the tax laws.

**10. Private Operating Foundation Definition**

*Present law.*—"Operating foundation", a term not found in present law, is sometimes used to describe the type of organization, contributions to which qualify for the unlimited charitable contribution deduction under present law but nevertheless do not qualify under the 30-percent deduction provision. (See Tax Treatment of Charitable Contributions, below.) In order to qualify for such treatment under present law, substantially more than half the organization's assets and substantially all its income must be used or expended directly for its exempt purposes or functions.

*Problem.*—Certain types of organizations which are included in the category of private foundations largely depend for their source of funds upon contributions from other private foundations. Although such organizations perform useful work, nevertheless, many of the problems giving rise to the limitations described above appear to be present in the case of these organizations.

*House solution.*—The bill provides that an "operating foundation," eligible to receive qualifying distributions from other private foundations (but otherwise subject to the limitations imposed upon private foundations) is an organization substantially all of the income of which is expended directly for the active conduct of its exempt purposes or functions, provided that either (1) substantially more than half its assets are devoted to such activities or to functionally related businesses or (2) substantially all its support (other than from endowments) is normally received from at least 5 independent exempt organizations and from the general public (but no more than 25 percent of its support may be received from any one such exempt organization).

These two categories of organizations relate generally to (1) museums and similar organizations and (2) special-purpose foundations, such as learned societies, associations of libraries, and organizations which have developed an expertise in certain substantive areas and which receive grants of funds and direct their research in those specified substantive areas.

*Arguments For.*—(1) Operating foundations make a significant contribution to the framework of American culture. The bill recognizes an operating foundation is carrying out its charitable purpose and properly permits private non-operating foundations to pay over their own income to it.

(2) The provision permitting private foundations to make grants to such institutions may be important to the preservation of major sources of learning.

*Arguments Against.*—(1) The bill is discriminatory because while it

allows a grant to be made to an operating foundation which is supported by at least five independent private foundations, it would not allow a grant to a foundation which received its support from one (or less than five) private foundations. An organization in the latter category which is engaged in worthy, and beneficial programs should also be treated as an operating foundation.

(2) Museums, etc., may range from the world-famous Smithsonian Institution to organizations which are little more than the whim of a wealthy person. Blanket exemptions for such organizations would point to a route for easy avoidance by private foundations generally.

(3) Operating foundations should not be subject to any of the limitations imposed upon private foundations generally. (In rebuttal, it is noted that this might provide too great an incentive for private foundations to avoid the limitations by creating operating foundations which they control.) It is contended by others that operating foundations ought to be subject to the same rules as private foundations.

**11. Hospitals**

*Present law.*—Hospitals qualify for exempt status and may receive deductible charitable contributions as "charitable" organizations.

*Problem.*—It has been contended by some agents that hospitals (unlike educational organizations, churches, and others) must provide some significant amount of charitable services on a no cost-or-loss basis in order to be exempt as "charitable" organizations.

*House solution.*—The bill provides that hospitals are to have the same status as churches and educational institutions for purposes of tax exemption, charitable contributions, and a variety of other matters. The other requirements for exemption—no inurement of profits to private individuals, operation and organization exclusively for exempt purposes, no substantial legislative activities, and no political electioneering activities—continue to apply to hospitals.

*Arguments For.*—(1) These provisions are necessary to eliminate challenges to the tax-exempt status of hospitals on the ground that the hospitals are accepting insufficient numbers of patients at no charge or at rates that are substantially below cost.

(2) By establishing hospitals as a separate exempt category and removing the indefinite test of to what extent a hospital must serve those who cannot pay, this bill removes the uncertainty surrounding the hospital's continued ability to draw necessary support from the public or from private foundations to accomplish its function .

(3) Hospitals perform a useful function of the sort that deserves treatment in section 501(c)(3) on the same basis as the other organizations specifically named in that provision.

(4) The present environment of governmental assistance to permit medical care to be made available to those otherwise unable to pay, appears to make obsolete the need for hospitals themselves to subsidize the providing of medical care to poor people. This is as true regarding hospitals as it is regarding schools and churches.

*Arguments Against.*—(1) In order to be tax exempt, hospitals historically have been required to render service to the poor whether or not there was an ability to pay for the services rendered. These provisions would do away with that requirement and many marginal income families that are now ineligible for payment of hospital care under Medicaid, and who do not have sufficient resources to pay for hospital treatment might be denied care now available to them. This is especially true in States that do not pay for hospital care of people who are eligible for general assistance under the welfare programs of the State. The bill will pose particular hardships on poor families priced out of hospital care by continually rising health costs and this will put greater pressure on Congress to expand the Medicaid program at the very time Congress is seeking to contract and moderate it.

(2) To the extent hospitals contend Medicare and Medicaid does not pay their full costs they would also contend that they are providing *charitable* services for those patients. If the bill were not changed these hospitals could refuse Medicare or Medicaid patients with impunity or could limit their services to such patients unless the Government met the hospitals' unilateral cost demands. Without the balancing effect of the present Internal Revenue Service position, government might be faced with the choice of either complying with such payment ultimatums or seeing millions of poor and aged citizens denied necessary care in community nonprofit hospitals.

(3) There is no substantial evidence that contributors to hospitals will decrease or stop their donations because the Internal Revenue Service is questioning the tax-exempt status of a hospital (or hospitals) on the ground that sufficient charitable services are not being rendered to the poor.

(4) The extent of free and "below cost" hospital care has diminished greatly with the advent of public programs such as Medicare and Medicaid. The pressure to provide free care has lessened to the extent that these multi-billion dollar programs and private hospital insurance are now paying for many of those whose bills previously went unpaid.

(5) The bill discards the charitable basis—the "community service to all" concept—on which tax exemption of hospitals is founded.

(6) If there is a legitimate complaint that Internal Revenue rulings are too vague on this point, a clarifying amendment establishing statutory standards is the appropriate remedy rather than the blanket approach of the House provision.

(7) Since the need for new legislative language has arisen because of uncertainties in administration, then the resolution of such uncertainties could be handled on an administrative basis.

**12. Effective Dates**

The provisions described above apply to taxable years beginning after December 31, 1969, except that additional time is permitted in the case of existing organizations to reform their governing instruments to conform to the new law as to business holdings and distributions of income. Also the 5-percent minimum distribution requirement will not apply, in the case of existing organizations, until taxable years beginning after December 31, 1971. However, any organization

that was a private foundation (under the rules of this bill) for its last taxable year ending before May 27, 1969, will be subject to the bill's requirements until it terminates its status as described previously in Change of Status.

## B. OTHER TAX-EXEMPT ORGANIZATIONS

### 1. The "Clay Brown" Provision or 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 includes 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.

*Problem.*—During the past several years weaknesses in the present provision relating to debt-financed property have been exploited in several different respects. As a result a large number of tax-exempt organizations have used their tax-exempt privileges to buy businesses and investments on credit, frequently at what is more than the market price, while contributing little or nothing themselves to the transaction other than their tax exemption.

In a typical *Clay Brown* situation a corporate business is sold to a charitable or educational foundation, which makes a small or no down payment and agrees to pay the balance of the purchase price out of profits from the property. The charitable or educational foundation liquidates the corporation, leases the business assets back to the seller, who forms a new corporation to operate the business. The newly formed corporation pays a large portion of its business profits as "rent" to the foundation, which then pays most of these receipts back to the original owner as installment payments on the initial purchase price.

In this manner in the *Clay Brown* case (1965 Supreme Court case), a business was able to realize increased after-tax income, and the exempt organization acquired the ownership of a business valued at $1.3 million without the investment of its own funds. In the recent (1969) *University Hill Foundation* case, the Tax Court upheld the acquisition of 24 businesses by the University Hill Foundation in the period 1945 to 1954. Other variants of the debt-financed property problem have also been used.

*House solution.*—The House 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. Also there is a special exception for the sale of annuities, and for debts insured by the

Federal Housing Administration to finance low and moderate income housing. For years before 1972, only indebtedness incurred on or after June 28, 1966, will be taken into account.

*Arguments For.*—(1) This provision would cure the defect in the present law which allows an exempt organization to acquire a going business for an inflated price, without the investment of its own funds, and pay the owners from the untaxed earnings of the business.

(2) The bill creates fair competition between tax-free and taxpaying organizations seeking to purchase a going business.

(3) The bill discourages an owner of a going business from seeking to sell it to a tax-free organization in an arrangement by which he in effect, converts his ordinary income from the operation of that business into a tax-favored capital gain.

(4) Tax-exempt organizations should be taxed on their debt-financed income because in such cases they are, in effect, using their tax-exempt status to "earn" income for them. It is suggested that the exemption was intended simply to remove from tax income on contributions from the general public, not as a tool for generating income without public contribution. In this regard, both the United States Catholic Conference and the National Council of Churches have expressed approval both of the objectives and the approach of the House bill.

*Arguments Against.*—(1) Other provisions of the bill extend the unrelated business income tax to organizations which previously were tax-exempt on income from a going business. Thus, they can no longer purchase a business with tax-free earnings, and this provision of the bill is now unnecessary.

(2) Rather than devise special rules for business purchased by tax-exempt organizations, the general rules of the bill governing debt-financed acquisitions could be applied.

(3) The House provisions go too far in that they apply to debt-financed cases whether or not the property is leased back to the sellers.

(4) This is an infringement on the tax-exempt status generally available for charitable organizations with respect to investment income

## 2. Extension of Unrelated Business Income Tax to All Exempt Organizations

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

(a) Charitable, educational, and religious organizations (other than churches or conventions of churches);

(b) Labor and agricultural organizations;

(c) Chambers of commerce, business leagues, real estate boards, and similar organizations;

(d) Mutual organizations which insure deposits in building and loan associations and mutual savings banks; and

(e) Employees' profit sharing trusts and trusts formed to pay (nondiscriminatory) supplemental unemployment compensation.

*Problem.*—In recent years, many of the exempt organizations not now subject to the unrelated business income tax—such as churches, social clubs, fraternal beneficiary societies, etc.—have begun to engage

in substantial commercial activity. Some churches, for example, are engaged in operating publishing houses, hotels, factories, radio and TV stations, parking lots, newspapers, bakeries, restaurants, etc. Furthermore, it is difficult to justify taxing a university or hospital which runs a public restaurant or hotel or other business and not tax a country club or lodge engaged in similar activity.

*House solution.*—The House 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, 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. (See discussion under Investment Income, below.) 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.

*Arguments For.*—(1) The bill eliminates unfair competition of tax-free organizations engaged in the same business as taxpaying organizations.

(2) The bill corrects an injustice by which some tax-exempt organizations are subjected to tax on their business income while others remain tax-free with respect to the same sort of business income.

(3) Unless the unrelated business income of all exempt organizations is taxed, the Federal revenues will suffer as more and more business moves from taxable to tax-exempt entities.

(4) Both the United States Catholic Conference and the National Council of Churches have indicated approval of the taxation of the unrelated business income of churches.

(5) The bill raises questions as to what activities will be related or unrelated in imposing this tax, whether intermittent activities such as football games held to raise funds for charitable purposes and activities primarily carried on for the benefit of members of the organizations are subject to tax. For the most part, these problems should be resolved on the basis of the present rulings and regulations although, because of the new types of organizations being brought under the tax, the regulations probably will require expansion to cover new types of situations.

*Arguments Against.*—(1) The provisions tax unrelated business income, even though there is no competition with a taxpaying entity.

(2) In taxing the investment income of organizations not heretofore subject to the unrelated income tax, such as a social club, little additional revenue would be provided but many of these clubs would be destroyed.

**3. 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 employees' beneficiary associations are exempt from income tax.

*Problem.*—Since the tax exemption for social clubs, fraternal beneficiary societies, and 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.

*House solution.*—The House bill provides for the taxation (at regular corporate rates) of the investment income and other unrelated income of social clubs, fraternal beneficiary associations, and employees' beneficiary associations. This will not apply, however, to such income of fraternal beneficiary associations and 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 other purpose, the amount taken out will be subject to tax in such year.

*Arguments For.*—(1) This provision is needed to close the loophole where certain exempt organizations which are comprised of individuals who join together for mutual benefit (such as a social club) receive untaxed income from investments and funnel the benefit to their members in the form of an increase in services or a reduction in the cost of services or membership fees.

(2) Continuing tax-exempt status for investment income in these situations distorts the original purpose of Congress in enacting the present law and it should be corrected.

*Arguments Against.*—(1) It is harsh and discriminatory to tax as unrelated busines income the investment income of these specific organizations while similar income received by other exempt organizations is not taxed.

(2) It is incorrect to assume that the benefit of the investment income in these organizations inures to the personal benefit of the members. In many cases the income is used for charitable or for other socially desirable purposes, and these efforts should not be thwarted.

(3) Congress traditionally has exempted from tax for so-called tax-exempt organizations any investment income received. To tax the investment income of these organizations represents an infringement of that traditional exemption.

**4. 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.

*Problem.*—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. While courts have occasionally disallowed some, or all, of the rent deduction, the issue is a difficult one for the Internal Revenue Service.

*House solution.*—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.

*Arguments For.*—(1) This provision eliminates the "gimmick" whereby a subsidiary corporation is set up by an exempt organization to operate a business which earns income and pays interest, rents and royalties to the exempt organization in amounts sufficient to wipe out any tax liability of the subsidiary corporation.

(2) Since the interest, rents and royalties are derived from the operation of an active business it would be wrong to allow the exempt organization to treat it as passive income, thwarting the intent of the Congress in enacting the unrelated business income tax.

*Arguments Against.*—(1) The bill is too broad and would tax as unrelated income all interest, rents, and royalties received by a tax-exempt organization from a controlled corporation without regard to the purpose or propriety of such payments.

(2) The bill would tax monies that would otherwise be used for charitable purposes.

(3) To tax rental, interest, or royalty income in such cases could result in a tax on investment income even though the payments to the tax-exempt organization were small relative to the value of the facilities or other property rented, borrowed, or subject to a royalty payment.

**5. 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, that 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.

*Problem.*—In some cases membership organizations, which also have business or investment income, serve their members at less than cost and offset this book loss against their business or investment income and as a result pay no income tax. In an important decision the courts held that a non-exempt water company was not subject to tax

when the "losses" in supplying its members water offset its investment income. Other courts have held to the contrary.

*House solution.*—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. Thus, no membership organization will be permitted to escape tax on business or investment income by using this income to serve its members at less than cost and deducting the book "loss."

*Arguments For.*—(1) To permit a membership organization to offset investment or business income against a loss arising from services provided to members is the same as if an individual were allowed to offset his personal or recreational expenses against his investment income.

(2) This provision is necessary to prevent exempt membership organizations from attempting to avoid the effect of the unrelated business income rule by giving up their exempt status and deducting the cost of providing services for members from its investment or nonmembership income.

*Argument Against.*—(1) There is nothing reprehensible about a non-exempt membership organization offsetting the expense of providing services to members against investment income or income derived from services to nonmembers. The Courts have upheld this approach.

(2) To deny an offset of membership losses and investment income is to tax a membership organization on income when it has no profit.

**6. Income From Advertising**

*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.

*Problem.*—While the House concluded that the regulations reached an appropriate result in specifying that in carrying on an advertising business in competition with other taxpaying advertising businesses, a tax should be paid, nevertheless, the statutory language on which the regulations were based was sufficiently unclear so that substantial litigation could have resulted from these regulations. To overcome this problem the regulations were placed in the tax law.

*House solution.*—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.

*Arguments For.*—(1) Advertising in a journal published by an exempt organization competes with tax-paying organizations that sell advertising, and this bill properly taxes the advertising income of the exempt organization.

(2) Activity such as advertising should not lose its identity as a trade or business because it is carried on within a larger scope of similar activities which may be related to the exempt purpose of the organization.

*Arguments Against.*—(1) Advertising in trade journals does not normally compete to any great extent with tax-paying corporations, publishing commercial magazines because it is usually of a technical nature, and attracts the attention only of those people interested in the professional aspects of the publication.

(2) This bill ignores the fact that it is difficult to separate technical comment (such as where technical benefits of a pharmaceutical product is described in an advertisement in a medical journal) from pure advertising.

(3) Many trade organizations depend on advertising income heavily, and the taxing of that income will seriously hamper their exempt endeavors.

## C. CHARITABLE CONTRIBUTIONS

### 1. 50 Percent Charitable Limitation Deduction

*Present law.*—Under present law, the charitable contributions deductions allowed individuals generally is limited to 30 percent of a taxpayer's adjusted gross income. In the case of gifts to certain private foundations, however, the deduction is limited to 20 percent of a taxpayer's adjusted gross income. (In addition, in limited circumstances, a taxpayer is allowed an unlimited charitable contributions deduction.)

*Problem.*—It has been suggested that it would be desirable to strengthen the incentive for charitable giving by increasing the present 30 percent limitation on the charitable contribution to 50 percent of a taxpayer's income. Moreover, it was hoped that this increase would offset any decreased incentive resulting from the repeal of the unlimited charitable contributions deduction (see page 32). In addition, the combination of these two actions means that charity (on a tax-free basis) can remain an equal partner with respect to an individual's income but cannot reduce an individual's tax base by more than one-half.

*House solution.*—The House bill increases the general 30 percent limitation on an individual's charitable contribution deduction to 50 percent. The 20 percent charitable contribution deduction limitation in the case of gifts to private foundations is not increased by the bill. Also, contributions of appreciated property would continue to be subject to the present 30 percent limitation. These changes apply to taxable years beginning after 1969.

*Arguments For.*—(1) It is more appropriate to have a general limitation of 50 percent with no unlimited charitable contribution deduction so that all taxpayers may be treated equally with respect to charitable giving.

(2) Limiting the additional contribution deduction to cases where no appreciation is involved will prevent any further increase in advantages arising from the omission of income given to charity from an individual's tax base.

*Arguments Against.*—(1) This provision benefits a particular class of taxpayers who already are able to take advantage of tax privileges that are not available to lower income taxpayers.

(2) The justification for increasing the limit was to provide a greater incentive to offset the disincentive resulting from a series of

restrictive charitable contribution suggestions which were rejected by the House. Since the bill does not contain these restrictions this "compensation" is unwarranted.

(3) From the standpoint of the educational institutions and public charities the increase to 50 percent in terms of total contributions they receive will not result in the very large contributions they could solicit under the unlimited charitable contribution deduction.

(4) Failing to make the additional contribution deduction available in the case of property which has appreciated in value will minimize the value of this additional deduction.

### 2. Repeal of the Unlimited Deduction

*Present law.*—The charitable contributions deduction for individuals generally is limited to 30 percent of the taxpayer's adjusted gross income. An exception to the 30 percent general limitation allows a taxpayer an unlimited charitable contributions deduction, if in 8 out of the 10 preceding taxable years the total of the taxpayer's charitable contributions plus income taxes paid exceeded 90 percent of his taxable income.

*Problem.*—It has been pointed out that the unlimited charitable contributions deduction has permitted a number of high-income persons to pay little or no tax on their income. It appears that the charitable contributions deduction is one of the two most important itemized deductions used by high-income persons, who pay little or no income tax, to reduce their tax liability.

*House solution.*—The unlimited charitable contributions deduction is to be eliminated for years beginning after 1974. During the interim period, an increasing limitation is to be placed on the amount by which the deduction can reduce the individual's taxable income. For taxable years beginning in 1970, the unlimited deduction is not to be allowed to reduce a person's taxable income in this manner to less than 20 percent of his adjusted gross income. This percentage is to be increased by 6 percentage points a year for the years 1971 through 1974. The bill also provides that the percentage of the taxpayer's income which must be given to charity or paid in income taxes each year in order to qualify for the unlimited deduction during this interim period is to be reduced to 80 percent in 1970. and is then to be reduced by 6 percentage points a year for the years 1971 through 1974.

*Arguments For.*—(1) It is not equitable to allow certain high-income persons to pay little or no income tax by means of the unlimited charitable contributions deduction, while most taxpayers are presently limited to a maximum charitable deduction of 30 percent of income each year (with a 5-year carryover of contributions in excess of 30 percent). Further, the qualification requirement for an unlimited deduction is related not to total economic income but only to "taxable" income, and some taxpayers have sufficient tax-free income and/or other deductions so that they may qualify and yet not actually have given up most of their economic income.

(2) Charitable contributions should not be allowed to reduce an individual's tax base by more than one-half. Thus, the repeal of the unlimited charitable deduction, combined with an increase in the general limitation from 30 percent of adjusted gross income to 50 percent

means that charity can remain an equal partner (but no more) with respect to an individual's income.

(3) This provision closes a "loophole" that has allowed a small number of high-income persons to pay little or no tax on their incomes which sometimes exceed $1 million a year.

(4) Because of the possibility of contributing highly appreciated property to charity for which the unlimited charitable contribution deduction is claimed, a high income taxpayer can contribute an amount sufficient to offset his income and place himself in a more favorable after-tax situation than if he had not made the charitable contribution; thus, the tax shelter is of greater benefit to the donor than the contribution is to charity. It is this tax-planning which motivates the gift—and not a desire to benefit charity.

*Arguments Against.*—(1) The relatively small gain in tax revenue ($25 million a year) would result in a large direct loss to philanthropic endeavors.

(2) The bill fails to recognize that persons who make a significant long-run commitment of a very large part of their income make a contribution to charitable activities that would be difficult to replace.

### 3. Charitable Contributions of Appreciated Property

*Present law.*—A taxpayer who contributes property which has appreciated in value to charity generally is allowed a charitable contributions deduction for the fair market value of the property at the time of contribution. Further, no income tax is imposed on the appreciation in value of the property at the time of the gift. In addition, if property is sold to a charity at a price below its fair market value—a so-called bargain sale—the proceeds of the 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 of the transaction. The seller is allowed a charitable contributions deduction for the difference between the fair market value of the property and the selling price (often at his cost or other basis).

*Problem.*—The combined effect of not taxing the appreciation in value and at the same time allowing a charitable contributions deduction for the fair market value of the property given is to produce tax benefits significantly greater than those available with respect to cash contributions. The tax saving which results from not taxing the appreciation in the case of gifts of long-term capital assets is the capital gains tax which would have been paid if the asset were sold. In the case of ordinary income type assets, however, this tax saving is at the taxpayer's top marginal tax rate. In either case, the tax saving from not taxing the appreciation in value is combined with the tax saving of the charitable deduction at the taxpayer's top marginal rate. As a result, in some cases it is possible for a taxpayer to realize a greater after-tax profit by making a gift of appreciated property than by selling the property, paying the tax on the gain, and keeping the proceeds.

In addition, in the case of a so-called bargain sale to a charity (often at the taxpayer's cost or other basis), the taxpayer is allowed a charitable deduction for the appreciation in excess of the sales price and no

33-865 O—69—pt. 1——4

tax is paid on this appreciation. In cases where the sales price is equal to the cost basis, the entire appreciation is deductible and escapes taxation.

*House solution.*—The bill in the case of certain charitable contributions of appreciated property takes this appreciation into account for tax purposes. This is true of gifts to a private foundation, other than a private operating foundation or one which within 1 year distributes an equivalent amount to, or for the use of, "public" charitable organizations or private operating foundaitons. Also, under the bill, appreciation in value is taken into account in the case of gifts of tangible personal property (such as paintings, art objects, and books), a future interest in property, and property which would give rise to ordinary income if sold. Where the appreciation is taken into account, the taxpayer has the option of reducing his deduction to the amount of his cost or other basis for the property, or taking a charitable deduction for the fair market value of the property but at the same time including the appreciation in value of the property in his income. These provisions relate to gifts of appreciated property made after 1969.

In the case of so-called bargain sales to charities—where a taxpayer sells property to a charitable organization for less than its fair market value (often at its cost basis)—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. This provision applies to sales made after May 26, 1969.

*Arguments For.*—(1) The charitable contributions deduction was not intended to provide greater—or even nearly as great—tax benefits in the case of gifts of property than would be realized if the property were sold. In gifts of appreciated property where the tax saving is so large, little, if any, charitable motivation may remain. In such cases, the Federal Government is almost the sole contributor to the charity.

(2) Concerning the specific types of appreciated property where the House bill requires appreciation to be taken into account for tax purposes, it is maintained that these types of property either result in the maximum tax benefit where the taxpayer is likely to be better off by making the contribution than by retaining the property (i.e., ordinary income property) or are very difficult to value and often result in overvalued claims for deductions (i.e., tangible personal property and future interests in property).

(3) With regard to gifts of appreciated property to private nonoperating foundations, it is thought that there is a high possibility that the property itself (or its equivalent value) will not actually be used for charitable purposes until some distant time in the future. This latter limitation may have the effect of increasing gifts of appreciated property to "public" charities, since those who are primarily interested in the tax benefits presumably would make their gifts of appreciated property to such charities.

(4) This provision partially closes the loophole whereby high-bracket taxpayers are able to realize a greater after-tax profit by making a gift of appreciated property to charity than they are by selling it, paying the tax on the gain, and keeping the proceeds.

(6) Because the donor received the beneficial enjoyment of giving his property to charity, it is appropriate to tax the appreciation in value of the property to him.

(7) The present system of allowing a contribution deduction for the fair market value of property without requiring that the appreciation be included in the donor's income has led to many abuses of the charitable contribution deduction involving gifts of paintings, statuary and similar art objects at artificially inflated prices calculated to produce the maximum tax benefit for the donor. The bill corrects this practice.

*Arguments Against.*—(1) This type of giving represents a major source of income to private educational institutions and colleges, and if it were eliminated Federal funds would be needed to support these colleges, raising constitutional questions regarding the use of Federal funds because of the traditional separation of Church and State.

(2) The result is much too complex and discriminatory in that gifts of the same type of property may receive different tax treatment, depending on the type of recipient.

(3) It does not appear to be appropriate to differentiate between types of property given to the same charitable organization—properties which may have identical fair market values in the hands of the taxpayer.

(4) Requiring the appreciation in value to be included in the tax base if the fair market value is claimed as a deduction for certain charitable gifts is a significant departure from the accepted practice of not taxing unrealized appreciation as "income."

### 4. Two-Year Charitable Trust

*Present law.*—Under present law, an individual may establish a trust for two years or more with the income from property placed in the trust being payable to charity. In such a case although the trust instrument provides that after the designated period of time the property is to be returned to him, the income from the trust property is not taxed to the individual. However, the individual does not receive a charitable contributions deduction in such a case.

*Problem.*—The special two-year charitable trust rule has the effect of permitting charitable contributions deductions in excess of the generally applicable percentage limitations on such deductions. For example with the 50 percent limitation on such deductions contained in the House bill, the maximum deductible contribution that could generally be made each year by an individual who had $100,000 of dividend income (but no other income) would be $50,000. However, if the individual transfered 60 percent of his stock to a trust with directions to pay the annual income ($60,000) to charity for two years and then return the property to him, the taxpayer would exclude the $60,000 from his own income each year. In effect, then, the individual has received a charitable contributions deduction equal to 60 percent of his income.

*House solution.*—The House bill eliminates the rule under which an individual is not taxed on the income from property which he transfers to a trust to pay the income to charity for a period of at least two years. This provision applies to transfers after April 22, 1969.

*Argument For.*—(1) This provision would prevent the avoidance of the limitations on the charitable contribution deduction through the device of a two-year charitable trust. In effect, the two-year trust rule is nothing more than a subterfuge for assigning income.

*Arguments Against.*—(1) There is little abuse connected with the two-year charitable trust rule and in many cases it leads to an ultimate gift of the total corpus to a charitable institution.

(2) The import of this provision is contrary to the objective of encouraging philanthropy highlighted by the provision which raises the ceiling on the charitable contribution deduction to 50 percent.

**5. Charitable Contributions by Estates and Trusts**

*Present law.*—Present law allows a nonexempt trust (or estate) a full deduction for any amount of gross income which it permanently sets aside for charitable purposes. There is no limitation on the amount of this deduction.

*Problem.*—To retain the deduction allowed by present law for nonexempt trusts for amounts set aside for charity (rather than paid to charity) was viewed as inconsistent with other changes made by the House bill in the treatment of charitable trusts.

Nonexempt trusts generally are subject to the same requirements and restrictions imposed on the private foundations since to the extent of the charitable interest their use achieves the same result. The current income distribution requirement generally applicable to foundations is not imposed on these nonexempt trusts, however, but the same result is achieved by denying the set-aside deduction to these trusts for their current income. In other words, to obtain the charitable deduction the nonexempt trusts must pay out their income currently for charity much in the same manner as private foundations are required to do.

In the case of a charitable remainder trust (i.e., a trust which provides that the income is to be paid to a noncharitable beneficiary for a period of time and the remainder interest is to go to charity) the House bill provides that if specified requirements are met, the trust is to be tax exempt. These requirements are designed to limit the allowance of a charitable deduction for the remainder interest upon creation of the trust to situations where there is a reasonable correlation between the amount of the deduction and the benefits that the charity will ultimately receive. Where these requirements are met, and the trust is thus accorded tax-exempt status, there is no need to allow the trust a deduction for amounts set aside for charity. To accord nonexempt trusts (with a remainder interest for charity) consistent treatment, it is necessary to deny them a deduction for amounts set aside for charity.

*House solution.*—The bill eliminates the set-aside deduction presently allowed nonexempt trusts. What were nonexempt trusts which meet the annuity or unitrust rules with respect to their remainder charitable interests are with respect to this interest treated as exempt trusts. This provision applies to amounts set aside after the enactment of the bill.

*Argument For.*—Allowing nonexempt trusts a deduction for amounts set aside for the future use of charity is not consistent with the other limitations placed by the bill on charitable trusts.

*Argument Against.*—The elimination of this deduction will discourage trusts from setting aside amounts for charity.

**6. Gifts of the Use of Property**

*Present law.*—Under existing law a taxpayer may claim a charitable deduction for the fair-rental value of property which he owns and gives to a charity to use for a specified time. In addition, he may exclude from his income the income which he would have received and been required to include in his tax base had the property been rented to other parties.

*Problem.*—By giving a charity the right to use property which he owns for a given period of time a taxpayer achieves a double benefit. For example, if an individual owns an office building, he may donate the use of 10 percent of its rental space to a charity for one year. He then reports for tax purposes only 90 percent of the income which he would otherwise have been required to report if the building were fully rented, and he claims a charitable deduction (equal to 10 percent of the rental value of the building) which offsets his already reduced rental income.

*House solution.*—The House bill provides that the charitable deduction is not to be allowed for contributions to charities of less than a taxpayer's entire interest in property. Therefore, no deduction will be allowed where a contribution is made of the right to use property for a period of time. In such a case, however, a taxpayer will be able to continue to exclude from his income the value of the right to use property so contributed. This provision applies with respect to gifts made after April 22, 1969.

*Argument For.*—It is appropriate to eliminate the double benefit which taxpayers have enjoyed with respect to contributions of the use of their property. This provides greater equity for taxpayers generally, in that many taxpayers do not have property which can be utilized in this manner.

*Arguments Against.*—(1) When an individual donates the use of property to a charitable organization he does not receive a double benefit because while, under the present law, he receives a deduction for the full rental value of the property he is not actually receiving any income from third parties while the property is being used by the charitable organization.

(2) The contribution of the use of property is a valuable gift, giving a charity exclusive control and possession for a period of time, and should be treated in the same manner as an outright gift of property.

**7. Charitable Remainder Trusts**

*Present law.*—Under present law an individual may make an indirect charitable contribution by transferring property to a trust and providing that the trust income is to be paid to private persons for a period of time with the remainder to go to a charity. Generally, a charitable contributions deduction is allowed for the remainder interest given to charity. The amount of the deduction is based on the present value of the remainder interest which is determined by using actuarial life expectancy tables and an assumed interest rate of 3½ per cent.

*Problem.*—Present rules allow a taxpayer to receive a charitable contribution deduction for a gift to charity of a remainder interest in

trust which is substantially in excess of the amount the charity may ultimately receive. This is because the assumptions used in calculating the value of the remainder interest may bear little relation to the actual investment policies of the trust. For example, the trust assets may be invested in high-income, high-risk assets. This enhances the value of the income interest but decreases the value of the charity's remainder interest. This factor, however, is not taken into account in computing the amount of the charitable contribution deduction.

*House solution.*—The bill limits the availability of a charitable contribution deduction in the case of a charitable gift of a remainder interest in trust to situations where there is a closer correlation between the amount to be received by charity and the amount of the deduction allowed on the creation of the trust. In general, a deduction is to be allowed only where the trust specifies the annual amount which is to be paid to the noncharitable income beneficiary either in dollar terms or as a fixed percentage of the value of the trust's assets (as determined each year).

The amount of the deduction allowed on the creation of the charitable remainder interest in trust, thus, would be computed on the basis of the actual relative interests of the noncharitable income and the charitable remainder beneficiaries in the trust property.

Generally, this provision applies to transfers in trust made after April 22, 1969 (except in the case of the estate tax where it applies with respect to persons dying after the enactment of the bill).

*Arguments For.*—(1) The limitations provided by this provision on the allowance of a charitable contribution deduction for gifts of remainder interests in trust will assure a better correlation between the deduction allowed and the benefit to charity. This is because the limitation will remove the present incentive to favor the noncharitable income beneficiary over the charitable remainder beneficiary by means of manipulating the trust's investments.

(2) The bill properly prevents the taking of a charitable contribution deduction for ostensible gifts of charitable remainder interests in trust where it is not probable that the gift will ultimately be received by the charity (such as where the charitable interest is only a contingent remainder interest) or where the trust permits invasion of the charitable share for the benefit of the non-charitable interest.

*Arguments Against.*—(1) This provision is not necessary because local laws which impose heavy responsibilities upon trustees and fiduciaries serve as sufficient assurance that trusts will be handled properly.

(2) The limitations restrict the flexibility presently available to persons who wish to make gifts to charity in the form of a remainder interest in trust. This smaller degree of flexibility might lead to an undue curtailment of this type of charitable gift.

**8. Charitable Income Trust With Noncharitable Remainders**

*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 contributions deduction for the value of the income interest given to charity. In addition, neither he nor the trust is taxed on the income earned by the trust which is given to charity.

*Problem.*—A taxpayer receives a double tax benefit where he is allowed a charitable deduction for the value of an income interest in trust given to charity and also is not taxed on the income earned by the trust.

*House solution.*—The bill generally provides that a charitable contribution deduction is not to be allowed where a person gives an income interest to charity in trust unless he is taxable on the trust income. Moreover, even in this case, the charitable deduction will not be allowed unless the charity's income interest is in the form of a guaranteed annuity or is a fixed percentage (payable annually) of the value of the trust property (as determined each year).

The bill also, in effect, provides for the recapture of the part of the charitable deduction previously received by a taxpayer where he ceases to be taxable on the trust income (i.e., that part of the deduction representing the income on which the taxpayer will not be taxed is recaptured).

The provision applies to transfers of property to trusts after April 22, 1969.

*Arguments For.*—(1) The bill is needed to prevent a taxpayer from taking a charitable contribution deduction for the present value of an income interest in trust, and at the same time failing to pay a tax on the income earned by the trust.

(2) It assures in cases where a deduction is allowed that the amount received by charity will bear a reasonable correlation to the amount of the deduction.

*Arguments Against.*—(1) This provision is not necessary because local laws which impose heavy responsibilities upon trustees and fiduciaries serve as sufficient assurance that the trusts will be handled properly.

(2) Since this provision restricts the charitable contribution deduction in certain cases, it is undesirable because it will therefore decrease contributions to charity.

## D. FARM LOSSES

### 1. Gains From Dispositions of Property Used in Farming Where Farm Losses Offset Nonfarm Income

*Present law.*—Under present law, income 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 accrual method of accounting and inventories 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 would have to capitalize. In addition, capital gains treatment quite often is available on the sale of farm assets.

*Problem.*—Although the special farm accounting rules were adopted to relieve farmers of bookkeeping burdens, these rules have been used by some high-income taxpayers who are not primarily engaged in farming to obtain a tax, but not an economic, loss which is then deducted from their high-bracket, nonfarm income. In addition, when these high-income taxpayers sell their farm investment, they often

receive capital gains treatment on the sale. The combination of the current deduction against ordinary income for farm expenses of a capital nature and the capital gains treatment available on the sale of farm assets produces significant tax advantages and tax savings for these high-income taxpayers.

*House solution.*—The bill generally provides that a gain on the sale of 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 the 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 a subsequent year.

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 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 rules (i.e., used inventories and capitalized capital expenses).

This provision applies to dispositions of farm property in years beginning after 1969.

*Arguments For.*—This provision will limit the tax advantages currently available in the case of farming operations by recapturing upon the sale of farm property the farm losses which the taxpayer had deducted from ordinary income. In addition, the provision would not affect the small bona fide farmer because of the high dollar limitations.

(2) The present farm tax accounting rules should not be allowed to continue because they have resulted in a tax abuse. By the use of these provisions, some high-income taxpayers have carried on limited farming activities (including racehorse breeding) as a sideline to obtain a tax loss which is deducted from their high-bracket nonfarm income.

(3) These losses are not economic losses but arise instead from the deducation of capital costs which, under the tax laws applicable to most other industries, would reduce capital gains instead of offsetting ordinary income.

(4) The tax abuse in this area has become so large that in recent years a growing body of investment firms have advertised that they would arrange a farm loss for persons in high tax brackets. The advertising emphasizes the fact that "after tax" dollars may be saved by the use of "tax losses" from farming operations. Thus, these provisions have created an industry which manufactures farm "tax losses" as their stock in trade.

(5) The Treasury Department has submitted statistics for 1964, 1965, and 1966 which clearly demonstrates that the average "farm loss" on an individual basis increases as the taxpayer's adjusted gross income increases.

*Arguments Against.*—(1) The proposed change would complicate bookkeeping and accounting records which are kept by farmers. Farmers forced to comply with the new provision would have their operational costs increased because of the outside professional help which they would have to retain.

(2) It would also discourage the flow of risk capital to rural areas. Generally, in line with this argument is the statement that objectives (improved livestock strains, crop experimentation, etc.) of the U.S. Department of Agriculture are being accomplished less expensively than the Government could do it itself.

(3) The limitations provided by this provision are too high, with the result that the provision will have little, if any, application in the case of many persons using the farm loss provisions as tax shelters.

(4) This provision would have relatively little effect on the hobby loss farmer, since this type of farmer generally would realize fewer gains on farm property that would bring the recapture rules into operation.

**2. Depreciation Recapture**

*Present law.*—Present law provides that when a taxpayer sells personal property used in a business, there is a recapture of the depreciation claimed on the property. In other words, the gain on the sale of the property is treated as ordinary income, rather than capital gain, to the extent of the depreciation previously claimed. These rules do not apply, however, to livestock.

*Problem.*—The effect of the exclusion of livestock from the depreciation recapture rule is to allow a taxpayer to convert ordinary income into capital gain with substantial tax savings. This occurs because the depreciation is deducted currently from ordinary income taxed at the regular rates, but the gain on the sale of the livestock is taxed only at the lower capital gains rates.

*House solution.*—The bill eliminates the exception for livestock from the depreciation recapture rules. Thus, gain on the sale of livestock will be treated as ordinary income, rather than as capital gain, to the extent of the previous depreciation deductions.

This provision applies to years after 1969, but only to the extent of the depreciation taken after 1969.

*Arguments For.*—(1) This provision is favored because it eliminates the present disparity of treatment, as far as depreciation recapture is concerned, between livestock and other types of property used in a business.

(2) Taxpayers should not be able to use the present depreciation deduction rules for livestock to convert income taxed at ordinary rates into income taxed at capital gains rates.

*Arguments Against.*—(1) Present tax laws should not be made more stringent against the farm industry at a time when it is undergoing severe economic problems.

(2) An extension of the complicated depreciation recapture rules to the farm industry runs counter to the established position of the Federal government since 1916 to provide simple tax rules for farmers.

### 3. Holding Period for Livestock

*Present law.*—Present law allows gain on the sale of livestock held for draft, breeding, or dairy purposes to be treated as a capital gain, if the animal has been held by the taxpayer for one year or more.

*Problem.*—A one-year holding period allows taxpayers to make short-term, tax-motivated investments in livestock. For example, a taxpayer can go into the livestock business to build up a breeding herd over a short period of time, currently deduct the expenses of raising the animals against his other income which is taxed in the high bracket, and then sell the entire herd at the lower capital gains rates.

*House solution.*—The bill extends the required holding period for livestock. Livestock will not qualify under the bill for capital gains treatment, unless the animal has been held by the taxpayer for at least one year after it normally would have been used for draft, breeding, or dairy purposes. The present one-year rule, in effect, still applies where an animal is purchased after it has reached the qualifying age.

The bill also extends this holding period requirement to livestock held for sporting purposes, such as horse racing.

This provision applies to livestock acquired after 1969.

*Arguments For.*—(1) The holding period for livestock, in order to qualify for the capital gain rate, should be increased because the present period is not long enough to resolve the question of whether the taxpayer is truly holding the animal for draft, breeding, or dairy purposes or whether he is holding it for sale in the ordinary course of business. The intentions of the taxpayer would be more clear if the taxpayer is required to hold the animal for at least one year after the animal has reached the age when it would normally have first been used for draft, breeding or dairy purposes.

(2) The bill correctly reserves capital gain classification until the taxpayer has clearly begun to hold such animals as capital assets.

(3) This provision is favored on the grounds that by extending the required holding period for livestock, it will lessen the attractiveness of short-term, tax-motivated investments in livestock.

*Arguments Against.*—(1) Present tax rules should not be made more stringent against the farm industry at a time when it is undergoing severe economic problems.

(2) Under present law the holding period for farm animals is one year, or twice the amount of the holding period required for other types of capital assets (six months). Although other provisions of the bill would increase the general holding period for capital assets to one year, this provision would discriminate against many raised farm animals by increasing the holding period for them, in some cases, to periods in excess of three years (three times the general period).

(3) Questions are raised as to whether the holding period provided by the bill is, in fact, sufficiently long to significantly decrease the present tax advantages of livestock operations (i.e., whether it is appreciably longer than the period for which a tax-motivated investor otherwise would hold livestock).

### 4. 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.

*Problem.*—This hobby loss provision generally has been of limited application because it usually is possible to break the required string of five loss years. In addition, where the provision has applied to disallow the deduction of a loss, the taxpayer has been faced in one year with a combined additional tax attributable to a five-year period.

*House solution.*—The bill replaces the present hobby loss provision with a rule which disallows the deduction of losses from an activity carried on by the taxpayer where the activity is not carried on with a reasonable expectation of profit. An activity would be presumed to have been carried on without this expectation of profit where the losses from the activity were greater than $25,000 in three out of five years.

This provision applies to years beginning after 1969.

*Arguments For.*—(1) This provision will provide a more effective and reasonable basis than does present law for distinguishing between situations involving a business activity carried on for profit and situations where taxpayers are merely attempting to utilize losses from an operation to offset other income.

(2) The hobby loss provision presently in the tax law has been of very limited application because taxpayers have been able to rearrange their income and deductions to avoid the 5-year requirement of the present law.

(3) Some court decisions have adopted procedural rules in the farming cases which have made it difficult to show that the loss which the taxpayer has incurred was the result of a "hobby" rather than the result of legitimate business activity.

*Arguments Against.*—(1) The bill fails to recognize that farming generally is a risky operation and that substantial losses are frequently incurred in early years.

(2) The discouragement of risk capital in this industry would impair animal husbandry, and the development of new and better crop strains and farming techniques.

(3) By restricting the application of the presumption that an activity is not carried on for profit to cases where the loss from the activity exceeds $25,000, the effectiveness of the provision in dealing with hobby loss situations may be unduly limited.

(4) This provision will result in farmers who experience losses (e.g., because of crop failures) being harassed by revenue agents seeking to apply this provision.

## E. LIMITATION ON DEDUCTION OF INTEREST

*Present law.*—Present law allows individual taxpayers an itemized deduction, without limitation, for all interest paid or accrued during the taxable year.

*Problem.*—The present deduction for interest allows taxpayers to voluntarily incur a substantial interest expense on funds borrowed to purchase growth stocks (or other investments initially producing low income) and to then use the interest deduction to shelter other income from taxation. Where a taxpayer's investment produces little or no

current income, the effect of allowing a current deduction for interest on funds used to make the investment is to allow the interest deduction to offset other ordinary income while the income finally obtained from the investments results in capital gains.

The principal reason why the 154 high-income nontaxable tax returns for 1966 paid no tax was the deduction allowed for "other interest" (that is, interest other than that on a home mortgage and other than interest incurred in connection with a business). In many of these cases, the interest deduction was substantially greater than the investment income and, thus, was used to shelter other income from taxation.

*House solution.*—The bill limits the deduction allowed individuals for interest on funds borrowed for investment purposes. The limitation does not apply to interest incurred in a trade or business. Under the limitation, a taxpayer's deduction for investment interest would be limited to the amount of his net investment income (dividends, interest, rents, etc.), plus the amount of his long-term capital gains, plus $25,000.

Investment interest in excess of $25,000 would first offset net investment income and then would offset long-term capital gain income (long-term gain offset in this manner would not be taken into account in computing the 50 percent capital gains deduction).

In the case of partnerships, these limitations apply at both the partnership and the partner levels.

A carryover for disallowed interest would be allowed under which the disallowed interest could be used to offset investment income (and capital gains) in subsequent years. The basic limitation, however, would be applicable in the subsequent years.

This provision applies to years beginning after 1969.

*Arguments For.*—(1) This provision would limit the use of the interest deduction in connection with funds borrowed for investment purpose as a means of offsetting noninvestment income, such as a salary. In other words, a taxpayer could not voluntarily incur a substantial interest expense in connection with what is initially a low income producing investment which eventually may result in capital gains and at the same time use the interest deduction to reduce his other taxable income.

(2) Interest on investment borrowing is a controllable expense as it is usually not necessary for a taxpayer to borrow substantial amounts for investment purposes and to incur the interest expense in connection with that borrowing. Accordingly, it is appropriate to place a limitation on the deduction for investment interest, matching the limitation on the deduction for controllable charitable contributions.

(3) A taxpayer who incurs current interest expense, substantially in excess of his current investment income, is interested not only in obtaining the resulting mismatching of income and the expense of earning that income but also in deducting the expense from ordinary income while realizing the income as a tax-favored capital gain.

(4) Examination of the tax returns, described by former Secretary of the Treasury, Joseph W. Barr, as reporting no income tax liability for many wealthy individuals for 1966, revealed that interest deductions were a principal contributing factor to their tax avoidance.

*Arguments Against.*—(1) The provision interferes with the long-standing principle behind the cash receipts and disbursements method of accounting that expenses are deducted when they are paid and income is taxed when it is received.

(2) Additional tax deductible record-keeping costs will be incurred to comply with this change.

(3) This limitation could adversely affect the stock or real estate markets where borrowed funds presently play an appreciable role. Additionally there are difficulties in distinguishing between investment interest and business interest which this provision may not adequately deal with. An example of this is the case where the taxpayer purchases 100 percent of the stock of a corporation. Although the limitation would appear to apply to this situation, it is questionable whether the purchase of the stock is made for investment purposes rather than for business purposes.

(4) This provision is unnecessarily harsh on legitimate investment transactions where good investment considerations, rather than tax considerations, are motivating factors.

## F. 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. The deductible expenses are those of transporting the taxpayer, members of his household and their belongings from the old residence to the new residence, including meals and lodging en route.

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.

Generally, the courts have held that reimbursements for moving expenses other than those which may be deducted are includible in gross income.

*Problem.*—Job-related moves often entail considerable expense in addition to the direct costs of moving the taxpayer, his family, and personal effects to the new job location. These additional expenses include certain costs of selling and purchasing residences, househunting trips to the new job location, and temporary living expenses at the new location while permanent housing is obtained.

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.

*House solution.*—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 househunting trips; (2) expenses for meals and lodging in the general location of the new job location for a period of up to 30 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 househunting 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. These provisions generally apply to years beginning after 1969.

*Arguments For.*—(1) It is appropriate to give more adequate recognition in the tax law to additional moving expenses which are incurred in connection with job-related moves. Moving expenses to a new job location may be viewed as a cost of earning income. From this, it may be argued that expenses reasonably incident to a job-related move should be deductible as are direct moving expenses under present law.

(2) The present law unreasonably discriminates in favor of "old" employees who are reimbursed for their moving expenses, on the one hand, as contrasted to "old" employees who are not reimbursed and "new" employes, whether or not they are reimbursed, on the other. This is so because individuals in the former category are not required to report their reimbursements and include them in income for tax purposes. (Of course, they get no deduction for their expenses.)

(3) Mobility of labor is highly desirable and the more complete deduction provisions for moving expenses in the bill fosters such mobility.

*Arguments Against.*—(1) The general philosophy of the income tax law is to deny a tax deduction for personal, family and living expenses, and for capital expenditures. The bill violates this general rule, enlarges the present moving expense deduction and makes it more of a precedent for allowance of still other personal family or living expenses.

(2) Mobility of labor, though desirable, is not motivated by a tax deduction. If a job offer in another location is attractive on its own, or if job opportunities are scare in the employee's present location, he will make a necessary move without a tax reward.

(3) Existing rules for "old" employees who are reimbursed by their employers for a move required by the employer—the only situation where tax relief is warranted—are adequate to prevent hardship where the move is beyond the employees' control.

(4) The allowance of a deduction for the additional moving expenses is primarily advantageous to the professional or managerial employee, who is most likely to move, as well as to incur substantially higher moving costs due to his more expensive mode of living.

(5) The dollar limitations on the additional moving expense deduction are unrealistically low.

## G. 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. Individuals whose income is secured mainly from tax-exempt State and local bond interest, for example, may exclude practically all their income from tax. Similarly, individuals may pay tax on only a fraction of their economic income, if they enjoy the benefits of accelerated depreciation on real estate. Individuals may also escape tax on a large part of their economic income if they can take advantage of the present special farm accounting rules or can deduct charitable contributions which include appreciation in value which has not been subject to tax.

*Problem.*—The present treatment, which imposes no limit on the portion of his income that an individual may exclude from tax, results in an unfair distribution of the tax burden. This treatment results in large variations in the tax burdens placed on individuals who receive different kinds of income. In general, high-income taxpayers, who get the bulk of their income from personal services, are taxed at high rates. On the other hand, those who get the bulk of their income from such sources as tax-exempt interest and capital gains or who can benefit from accelerated depreciation on real estate pay relatively low rates of tax. In fact, individuals with high incomes who can benefit from these provisions may pay lower average rates of tax than many individuals with modest incomes. In extreme cases, individuals may enjoy large economic incomes without paying any tax at all.

*House solution.*—The House bill provides a limit on tax preferences under which no more than 50 percent of the taxpayer's total income (adjusted gross income plus tax preference items) can be excluded from tax. The tax preference items to which this provision applies are: (1) tax-exempt interest on both new and old issues of State and local bonds (to be gradually taken into account over a 10-year period at a rate of one-tenth of the interest per year); (2) the excluded one-half of capital gains; (3) the untaxed appreciation in value of property for which a charitable contributions deduction is allowed; (4) the excess of depreciation claimed on real property over straight line depreciation; and (5) farm losses to the extent they result from the use of special farm accounting rules.

The limit on tax preferences applies only to taxpayers with at least $10,000 of tax preference items for the year. A 5-year carryover is provided for disallowed preferences. This provision applies to years beginning after 1969.

*Arguments For.*—(1) The limit on tax preference is based on the premise that individuals generally should be required to pay tax on at least one-half of their economic income.

(2) The limit on tax preferences has the advantage of making sure that individuals generally pay tax on a substantial part of their

income. It, therefore, serves as a second line of defense against the avoidance of income taxes, to back up the first line of defense against such avoidance offered by the remedial provisions in the House bill which limit the scope of specific tax preferences.

(3) The bill corrects the unfair discrimination in present law which favors those taxpayers who derive their income from the ownership of property as contrasted with those who earn their living from wages and salaries.

(4) The present law improperly encourages investment of capital in certain areas for tax consideration rather than good business reasons and violates the principle that taxes should have a neutral impact on economic decisions.

(5) Many individuals with large incomes benefit from tax preferences to the extent that they pay lower average rates of effective tax than many individuals with moderate incomes. This makes a mockery of a tax system based on the ability to pay.

*Arguments Against.*—(1) This limitation is an imperfect substitute for direct action on the preferential income tax provisions which cause today's tax injustice. Each particular item of tax preference should be considered on its own merits and should be adjusted accordingly.

(2) Enactment of a limit on tax preference complicates present law by imposing a new income tax system on top of our present system thereby compounding the complexity of the tax laws and adding considerable administrative difficulties to the existing system.

(3) This new approach could become the forerunner of a gross receipts tax on all taxpayers.

(4) The bill raises a constitutional question as to the power of Congress to tax income from State and local government obligations, particularly obligations already outstanding.

(5) The bill is inadequate; the excess of percentage depletion over cost depletion and the excess of intangible drilling and development expenses over the deductions allowed under straight line depreciation should be added to the list of tax preference items subject to the limit on tax preferences.

(6) The limit on tax preferences will discourage charitable gifts.

(7) If Congress has seen fit to provide a specific tax benefit, there is no reason why it should be denied to some merely on the ground that it, in combination with other items, represents a large proportion of that individual's income.

(8) Since this limit will not affect individuals until the sum of their tax preference income equals one-half of their total income, it will still be possible for some individuals to exclude substantial amounts of tax preference income from tax.

## H. ALLOCATION OF DEDUCTIONS

*Present law.*—Under present law an individual is permitted to charge his personal or itemized tax deductions entirely against his taxable income, without charging any part of these deductions to his tax-free income.

*Problem.*—The fact that an individual who receives tax-free income or special deductions can charge the entire amount of his personal deductions to his taxable income in effect gives him a double tax benefit. He not only excludes the tax-free income from his tax base but he also, by charging all his personal deductions against his taxable income, reduces his tax payments on this taxable income. As a result, individuals with substantial tax-free income and special deductions and large personal deductions can wipe out much or all of their tax liability on substantial amounts of otherwise taxable income.

*House solution.*—The House bill provides that an individual must allocate his personal deductions between his taxable income and his tax preference items, to the extent that the latter exceed $10,000.

For example, a taxpayer whose income is divided equally between his taxable income and his tax preference income is allowed to take only one-half his otherwise allowable personal deductions; the remaining half of such personal deductions are disallowed.[1]

The personal expenses which must be allocated include interest, taxes, personal theft and casualty losses, charitable contributions, and medical expenses.

The tax preference items taken into account for this purpose are the same as those included under the limit on tax preferences (see item G) except for certain modifications. Tax-exempt interest on State and local bonds issued before July 12, 1969, is not taken into account. In addition, unlike the limit on tax preferences, the allocation provision includes in the list of tax preference items the excess of intangible drilling expenses over the amount of the expenses which would have been recovered through straight line depreciation and the excess of percentage depletion over cost depletion.

Taxpayers apply the limit on tax preferences before allocating deductions. Any tax preferences included in taxable income as a result of the limit on tax preferences are treated as taxable income for purposes of allocating deductions.

The allocation provision applies to years beginning after 1969, except that in the first year to which it applies only one-half of the taxpayer's personal expenses must be allocated.

*Arguments For.*—(1) The allocation of deductions provision is supported on the grounds that personal deductions are in fact paid for out of an individual's entire economic income and not just his taxable income. For that reason the deduction should be allowed for these items only to the extent the income to which they relate is included in an individual's tax base.

(2) The allocation provision is specifically designed to minimize any possible unfavorable impact on State and local obligations since only interest on bonds issued in the future are taken into account and this interest income is brought in under the allocation provision only gradually over a 10-year period.

---

[1] This example, in order to illustrate the allocation in a simple manner, takes all tax preference income into account and, for allocation purposes, does not reduce such tax preference income by $10,000 as under the bill.

(3) This provision helps correct the unfair discrimination in present law which favors those taxpayers who derive their income from the ownership of property as contrasted with those who earn their living from wages and salaries.

(4) The provision recognizes the desirability of a tax system in which no individual can avoid his fair share of the tax burden.

(5) The present tax improperly encourages investment of funds in certain areas for tax considerations rather than good business reasons and violates the principle that taxes should have a neutral impact on economic decisions.

*Arguments Against.*—(1) The primary intent of the provision is to tax tax-preferred income rather than disallowing deductions, It would be better to consider the various tax-preference items individually and to take whatever corrective action is necessary directly on those items.

(2) Enactment of a system which allocates deductions on the basis of the relation between taxable and tax-preferred items of income complicates the tax laws and adds considerable administrative difficulties to the existing system.

(3) The bill raises a constitutional question as to the power of Congress to tax (even indirectly) income from State and local government obligations.

(4) Since most of the so-called "preferences" in today's law involves conscious decisions by Congress to encourage specific types of investments, those provisions should not now be heedlessly diluted under the guise of tax reform.

## I. INCOME AVERAGING

*Present law.*—Under 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 133⅓ percent of his average taxable income for the prior 4 years generally can be averaged and taxed at lower bracket rates than would otherwise apply. Certain types of income such as long-term capital gains, wagering income, and income from gifts are not eligible for averaging.

*Problem.*—The exclusion of certain types of income from income eligible for averaging complicates the tax return and makes in 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 133⅓ 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.

*House solution.*—The House bill extends income averaging to 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 33⅓ percent to 20 percent.

*Arguments For.*—(1) Permitting averaging for presently excluded income will result in simplification of the tax form and the averaging computation.

(2) In the case of capital gains, it is maintained that the 50 percent exclusion does not provide a form of averaging because it does not distinguish between taxpayers with fluctuating capital gains and those with constant capital gains, and therefore averaging for capital gains is appropriate.

(3) As the Internal Revenue Service has worked with the present income averaging provisions, it has become apparent that the administrative limitation of 133⅓ percent may be relaxed to do more equity for those cases where income averaging is appropriate.

*Arguments Against.*—(1) Income should be accounted annually. This provision enlarges the present opportunity for taxpayers to avoid full taxation.

(2) The items excluded from averaging were excluded for good reason. Capital gains already is given favorable treatment because only 50 percent of the gains is taxed. Income from wagering should not be eligible for averaging because the receipt of such income should not be encouraged. Income from gifts should not be eligible for averaging since it does not result from any effort on the part of the taxpayer.

(3) The 133⅓ percent requirement should not be reduced to 120 percent since this will allow averaging for unreasonably small increases in income.

(4) Liberalization of income averaging rules for persons who experience a substantial increase in their earnings should be deferred until income averaging rules are devised which will give relief to persons who experience a sharp decline in their earnings.

## J. RESTRICTED STOCK PLANS

*Present law.*—Present law does not contain any specific rules governing the tax treatment of restricted stock plans. Existing Treasury regulations generally provide that no tax is imposed when the employee receives the restricted stock. Tax is deferred until the time the restrictions lapse; at that time, only the value of the stock, determined at the time of transfer to the employee, is treated as compensation, provided the stock has increased in value. If the stock has decreased in value, then the lower amount at the time the restrictions lapse is considered to be compensation. Thus, under present regulations there is a deferral of tax with respect to this type of compensation and any increase in the value in the stock between the time it is granted and the time when the restrictions lapse is not treated as compensation.

*Problem.*—The present tax treatment of restricted stock plans is significantly more generous than the treatment specifically provided in the law for similar types of deferred compensation arrangements. An example of this disparity can be seen by comparing the situation where stock is placed in an employee's trust as opposed to the giving of restricted stock directly to the employee. In the employee trust situation, if an employer transfers stock to a trust for an employee and the trust provides that the employee will receive the stock at the end of 5 years if he is alive at that time, the employee would be treated as receiving, and would be taxed on, compensation in the amount of the value of the stock at the time of the transfer. However, if the employer, instead of contributing the stock to the trust, gives the stock directly to the employee subject to the restriction that it cannot be sold for 5 years, then the employee's tax is deferred until the end of the 5-year period. In the latter situation, the employee actually possesses the stock, and he can vote it and receive the dividends, yet his

tax is deferred. In the trust situation, he has none of these benefits, yet he is taxed at the time the stock is transferred to the trust.

*House solution.*—The House bill provides that a person who receives compensation in the form of property, such as stock, which is subject to a restriction generally is subject to tax on the value of the property at the time of receipt unless his interest is subject to a substantial risk of forfeiture. In this case, he is to be taxed when the risk of forfeiture is removed. The restrictions on the property are not taken into account in determining its value except in the case where the restriction by its terms will never lapse. Generally, this provision applies to property transferred after June 30, 1969.

*Arguments For.*—(1) The House bill provision is supported on the grounds that it eliminates the disparity of tax treatment between various forms of deferred compensation by bringing restricted stock plans within the rules that Congress set forth as being the appropriate means by which an employee could be given a shareholder's interest in the business.

(2) Restricted stock plans are essentially compensation to an executive for services rendered. They represent incentives to key employees, and in many cases represent a significant portion of a taxpayer's total compensation.

(3) The provision is needed to close a loophole through which highly compensated employees are paid part of their compensation under circumstances whereby tax can be put off until the employee is in a lower tax bracket.

(4) The stock option rules provide sufficient opportunity for employees to receive an interest in their employers' business, yet, these rules are undermined by the less stringent requirements of restricted stock plans.

*Arguments Against.*—(1) The tightening of the rules on restricted stock plans may discourage employees' stock ownership of their employers' business.

(2) The bill would immediately tax the receipt of property which, in many instances, cannot be sold or otherwise disposed of by the taxpayer to pay the tax.

(3) The bill, in the case of forfeitable stock would tax capital appreciation of the property as ordinary income.

(4) Restricted stock plans are not, in fact, deferred compensation arrangements, but rather are a means of allowing key employees to become shareholders in the business.

(5) It is necessary to have these preferred stock plans so as to obtain and retain key employees.

(6) These tax incentives increase the economic productivity of business; hence, the benefits to everyone concerned are increased.

(7) Little revenue appears to be involved; hence, there is no real benefit accruing from making a change.

## K. OTHER DEFERRED COMPENSATION

*Present law and problem.*—Under present law, the Internal Revenue Service has allowed substantial tax benefits to be obtained with respect to certain types of deferred compensation arrangements for key employees. These arrangements are not required to meet the qualifica-

tions prescribed in the tax law for qualified pension and profit-sharing plans, and they are often available only to highly paid employees. Generally, under these arrangements, employees are permitted to defer the receipt (and taxation) of part of their current compensation until retirement, when they presumably will be in lower income tax brackets.

The following example is typical of these arrangements: The employer and the employee enter into a 5-year employment contract which provides for a specified amount of current compensation and an additional specified amount of nonforfeitable deferred compensation. The deferred compensation is credited to a reserve account on the company books. It is accumulated and paid in equal annual installments in the first 10 years after the employee's retirement.

Deferral is available only with respect to unfunded arrangements. In the case of funded arrangements (that is, where the employee has an interest in property), the employee is taxed currently on the contribution (provided his rights are nonforfeitable) even though he cannot immediately receive it. There is no tax deferral, and the tax imposed on the additional compensation is determined by reference to the employee's current tax bracket.

*House solution.*—The bill provides that the tax on deferred compensation is to continue to be deferred until the time the compensation is received, but that a minimum tax is to be imposed on deferred compensation received in any year in excess of $10,000. Generally, this minimum tax is the total increase in tax which would have resulted if the deferred compensation had been included in the taxpayer's income in the years in which it was earned. This provision does not apply to any nondiscriminatory pension or profit-sharing plan (whether funded or unfunded). Generally, this provision applies only to the portion of deferred compensation payments attributable to years beginning after 1969.

*Arguments For.*—(1) This provision is supported on the basis that the employee who receives deferred compensation has received, in most cases, a valuable contractual right on which an immediate tax could be imposed, and the bill represents a reasonable compromise between immediate taxation and complete deferral. The payment of the tax is deferred until the compensation is actually received, but the original marginal rate is preserved as a minimum rate.

(2) The tax treatment of deferred compensation should not depend on whether the amount to be deferred is placed in trust or whether it is merely accumulated as a reserve on the books of the employer corporation, because an unfunded promise by a large, financially established corporation is probably as sufficiently sound as the amount of deferred compensation which is placed in trust. Usually these benefits are not available to the average employee-taxpayer.

(3) The possibility of shifting income from high-bracket years to low-bracket years after retirement is generally available only to high-bracket and managerial employees who are in a financial position to demand them—not to the average employee.

(4) Another provision of this bill reduces maximum tax on earned income to 50 percent. With this lower rate, the incentive to seek deferral is lessened and the special tax treatment of deferred compensation can be ended without harsh consequences.

*Arguments Against.*—(1) Deferred compensation arrangements benefit small and medium sized companies who face economic uncertainties and possible future financial difficulties. This type of arrangement enables management to have a financial interest in the business enterprise, while at the same time it allows the company to have the use of the funds involved.

(2) Income should be taxed at the tax rates which apply to the year in which the income is received.

(3) The primary benefit of deferred compensation is forward averaging; that is, the employee is able to level out his income by shifting earnings from peak years to retirement years when he expects his other income to be lower. Forward averaging is not tax avoidance and there is no reason to prevent it.

(4) This provision will be difficult to administer.

(5) Deferred compensation benefits should be preserved as an incentive to executives.

## L. ACCUMULATION TRUSTS, MULTIPLE TRUSTS, ETC.

*Present law.*—A trust that distributes all its income currently to its beneficiaries is not taxed on this income; instead the beneficiaries include these distributions in their income for tax purposes.

An accumulation trust (a trust where the trustee is either required, or is given discretion to accumulate income for future distributions to beneficiaries), however, is taxed on its accumulated income at individual rates. When this accumulated income is distributed 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 beneficiary in the year in which it was received by the trust. This throwback rule, however, only applies on the part of the distribution of accumulated income which represents income earned by the trust in the 5 years immediately prior to the distribution. In addition to this limitation, the throwback rule does not apply to certain types of distributions.

*Problem.*—The progressive tax rate structure for individuals is avoided when a grantor creates trusts which accumulate income taxed at low rates, and the income in turn is distributed at a future date with little or no additional tax being paid by the beneficiary. This result occurs because the trust itself is taxed on the accumulated income rather than the grantor or the beneficiary. This means that the income in question, instead of being added on top of the beneficiary's other income and taxed at his marginal tax rate, is taxed to the trust at the starting tax rate. The throwback rule theoretically prevents this result, but the 5-year limitation and the numerous exceptions substantially limit the effectiveness of the rule.

This avoidance device is compounded by the use of multiple trusts—the creation of more than one accumulation trust by the same grantor for the same beneficiary.

*House solution.*—The bill provides that in the case of accumulation trusts (including multiple trusts) the beneficiaries are to be taxed on distributions of accumulated income in substantially the same manner as if the income had been distributed to the beneficiaries when it was earned by the trust. The taxes paid by the trust on the income, in

effect, will be considered paid by the beneficiary for this purpose. A shortcut method of computing the tax on the distribution of accumulated income is provided under which the tax attributable to the distribution, in effect, is averaged over the number of years in which the income was earned by the trust. Distributions of income accumulated by a trust (other than a foreign trust created by a U.S. person) in years ending before April 23, 1964, are not subject to the new unlimited throwback rule. This provision applies to the distributions made after April 22, 1969.

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. This provision is to apply only in respect to property transferred in trust after April 22, 1969.

*Arguments For.*—(1) The bill prohibits the avoidance of the effect of the progressive tax rates where a grantor creates a trust or multiple trusts, which accumulate income, pay tax on such income at a much lower rate than would the beneficiary and then distribute it to him at a later date with little or no additional tax being paid by the beneficiary, even though he may be in a high tax bracket.

(2) Under the present law, the Internal Revenue Service has been unable to successfully resolve the problems presented by the use of multiple trusts. In some cases the courts have upheld the validity of such trusts.

(3) Accumulation trusts will be placed in substantially the same tax status as beneficiaries of trusts which distribute their income currently.

(4) This approach provides essentially the same treatment as has been applicable to foreign accumulation trusts created by U.S. persons since the pasage of the Revenue Act of 1962.

*Arguments Against.*—(1) These provisions would be extremely difficult to administer and enforce by the Internal Revenue Service and on the part of the trustees.

(2) The abuse in this area involves multiple trusts and it is harsh to correct it in a way that upsets the normal fiduciary use of accumulation trusts.

(3) This provision will result in harsh tax consequences in the case of accumulation trusts which were established for nontax reasons, such as to postpone the receipt of funds by the beneficiary until he had reached a responsible age.

## M. MULTIPLE CORPORATIONS

*Present law.*—There are several provisions in the code which are designed to aid small corporations. The most important of these provisions is the surtax exemption. As the result of the surtax exemption corporations are taxed at only 22 percent, instead of at 48 percent on the first $25,000 of taxable income.

Present law permits a controlled group of corporations to each obtain a $25,000 surtax exemption if each of the corporations pays an additional 6 percent tax on the first $25,000 of taxable income.[1] This

[1] The election to take multiple surtax exemptions and to pay the additional 6 percent tax is generally desirable where the group has a combined income of about $82,500 or more. Below this figure the allocation of a single surtax generally produces a lower tax.

generally reduces the tax savings of the surtax exemption from $6,500 to $5,000.

Other provisions in the code designed to aid small corporations include: (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; and (2) the provision which allows an additional first year depreciation deduction equal to 20 percent of the cost of the property (limited to $10,000 per year).

*Problem.*—Large corporate organizations have been able to obtain substantial benefits from these provisions by dividing income among a number of related corporations. Since these are not in reality "small businesses" it is difficult to see why they should receive tax benefits intended primarily for small business.

*House solution.*—The House bill provides that a group of controlled corporations may have only one of each of the special provisions designed to aid small corporations. A controlled group of corporations is limited to one $25,000 surtax exemption and $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. In addition, controlled corporations who elect to file consolidated returns, may deduct net operating losses for a taxable year ending on or after December 31, 1969, against the income of other members of such group. Present regulations allow such losses to be deductible only against the income of the corporation which sustained the losses.

The bill also broadens the definition of a controlled group of corporations.

*Arguments For.*—(1) Large economic units have been able to reap unintended tax benefits through the use of multiple corporations. Often the only reason for using multiple corporations is to take advantage of the surtax exemption or the $100,000 accumulated earnings credit. This may lead to uneconomic practice and a great waste of energy by taxpayers, their counsel, and the Internal Revenue Service. By structuring a large economic unit so as to generate no more than $25,000 of taxable income in each component corporation, the maximum marginal tax can be held at 28 percent instead of 48 percent, thus, avoiding tax of $5,000 for each corporation.

(2) Even where there are good business reasons for using multiple but related corporations they still should not be given the tax benefits designed for small business.

(3) This provision will prevent the artificial incorporation of many companies that actually perform the same or similar operations under one management.

(4) Under the present law, large businesses, such as various chain stores, are able to take advantage of the multiple surtax exemption while competing smaller businesses in local communities are not. This presents an element of unfair competition which the bill eliminates.

*Arguments Against.*—(1) The repeal of the multiple surtax exemption would discourage legitimate and normal expansion of growing businesses within a controlled group which is established for sound business purposes.

(2) Multiple corporate structures arise for bona fide business reasons and not for tax reductions. Such corporations are formed to limit public liability, to comply with State requirements and to "tailor" themselves to the particular business operation involved. The tax law should not penalize these legitimate purposes.

(3) A new venture is often unprofitable in the early operation. By placing the new venture in a separate corporation, the losses can be recouped faster via the $25,000 surtax exemption and the other benefits allowed.

(4) No competitive unfairness exists within the industries, some of whose members have traditionally been organized into separate corporations.

## N. CORPORATE MERGERS

### 1. 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.

*Problem.*—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 acquisitions 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. A number of the other factors which make the use of debt desirable are also the factors which tend to make a bond or debenture more nearly like equity than debt. For example, the fact that a bond is convertible into stock tends to make it more attractive since the convertibility feature will allow the bondholder to participate in the future growth of the company. The fact that debt is subordinated to other creditors of the corporation makes it more attractive to the corporation since it does not impair its general credit position.

Although it is possible to substitute debt for equity without a merger, this is much easier to bring about at the time of the merger. This is because, although stockholders ordinarily would not be willing to substitute debt for their stock holdings, they may be willing to do so pursuant to a corporate acquisition where they are exchanging their holdings in one company for debt in another (the acquiring) company.

In summary, in many cases the characteristics of an obligation issued in connection with a corporation acquisition make the interest

in the corporation which it represents more nearly like a stockholder's interest than a creditor's interest, although the obligation is labeled as debt.

*House solution.*—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 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.

This provision applies to interest on indebtedness incurred after May 27, 1969.

*Arguments For.*—(1) This provision helps stem the tide of conglomerate mergers, which have increased phenomenally in recent years and which pose a threat to our economic well-being, by denying the interest deduction with respect to certain types of indebtedness incurred by corporations in acquiring the stock of other entities.

(2) The corporate bonds and debentures used in conglomerate acquisitions have characteristics, such as convertibility and subordination, which delineate the interest in the corporation which they represent more as equity than as debt. This bill properly treats them as equity interests.

(3) Advantageous tax provisions have spurred the "urge to merge" with the result that the Federal Government bears a portion of the carrying costs of many conglomerate acquisitions. This provision withdraws one of those advantages.

*Arguments Against.*—(1) Mergers are part of the American business complex. They represent growth and, in many instances, rejuvenate businesses and management, and nurture higher degrees of efficiency and competence.

(2) Debentures and bond issues represent debt in the business community and they should not be characterized as equity interests for tax purposes.

(3) If Congress desires to inhibit the merger movement, it should make all reorganizations taxable events—regardless of whether they are voluntary or involuntary, horizontal, vertical or pure conglomerate. Congress should not limit its examination to the tax treatment of conglomerate mergers, but should also consider those sections of the Code

which permit hosts of corporate mergers to proceed unburdened by any taxation.

(4) The increasing amount of debt used for corporation acquisition purposes and the economic implications of the merger trend warrant a broader approach than that embodied in the bill (i.e., a broader disallowance of the interest deduction).

(5) If this rule is appropriate in the case of acquisitions it also is appropriate where similar "debt" is issued for other purposes.

**2. 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.

Although the Internal Revenue Service has not ruled as to whether the installment method of reporting gain is available where the seller receives debentures, it is understood that some tax counsel have advised that the method is so available.

*Problem.*—The allowance of the installment method of reporting gain where debentures are received by a seller of property may result in long-term tax deferral which nearly approaches nonrecognition, rather than installment reporting. In other words, the gain on the debentures need not be reported until they mature, which may not be until 15 or 20 years later.

Moreover, the allowance of the installment method where debentures or other readily marketable securities are received by the seller of property is not consistent with the purpose for which the installment provision was adopted. This method presumably was initially made available because of the view that where a seller received a debt obligation he did not have cash, or the equivalent of cash, on hand which would provide him with funds to pay the tax due on the gain. This problem, however, does not exist where the seller receives readily marketable securities.

Present law is also unclear as to the number of installments which are required if a transaction is to be eligible for the installment sales provision. 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.

*House solution.*—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 provided by the bill 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 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.

This provision applies to sales after May 27, 1969.

*Arguments For.*—(1) In view of the increase in merger activities in recent years, this provision is necessary, along with the other provisions relating to interest and original issue discounts, to withdraw tax incentives to merge.

(2) The limitations provided by this provision on the use of the installment sales method restrict the availability of the method to situations which are consistent with the purposes for which the installment method was adopted. In other words, a seller is treated as receiving cash when he receives something which is the equivalent of cash. In addition, a sale which involves a deferred payment, rather than installments, is not to be treated as an installment sale.

(3) The bill improves on the present law where ambiguity exists as to the number of installment payments which are required in order for a transaction to qualify for installment sale treatment. It sets forth the specific criteria to be followed.

*Arguments Against.*—(1) The present law relating to installment sales is clear enough to prevent any abuse. Where there is a transaction which provides for payment in installments, installment sales treatment should be allowed if it complies with the terms of the present law.

(2) The installment privilege should be available even where the debt instrument is readily marketable or where the payments are not spread relatively evenly over the period the debt is outstanding.

### 3. 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 amount of the discount is the difference between the issue price and the face amount of the bond.) 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. In addition, only that portion of the gain on the sale of the bond equal to the part of the original issue discount attributable to the period the taxpayer has held the bond is taxed at ordinary income rates.

The corporation issuing the bond, on the other hand, is allowed to deduct the original issue discount over the life of the bond.

*Problem.*—Present law 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. Although it is likely that the discount will be deducted by the corporation, it is probable that much of the ordinary income is not being reported by the bondholders.

*House solution.*—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.

The bill also clarifies present law by providing that original issue discount may arise when a bond is issued in exchange for stock or other property.

This provision does not apply to bonds issued by a government or a political subdivision.

This provision applies to bonds issued on or after May 28, 1969.

*Arguments For.*— The present law encourages the use of bonds to acquire another corporation because where original issue discount is involved, the tax treatment between the issuing corporation and the person acquiring the bond is nonparallel—both receive a tax benefit. This provision would eliminate the tax benefit to the bond holder, discouraging the use of bonds in corporate mergers.

(2) The provision minimizes the possibility that original issue discount will never be taxed to the bondholder.

*Arguments Against.*—(1) The present law is adequate in the treatment of original issue discount and this provision at best, is an artificial way to discourage corporate mergers.

(2) A bondholder should not be taxed on orginal issue discount until the time when he, in effect, receives it; namely, when the bond is redeemed or when he sells the bond.

### 4. 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 Revenue Service as a capital transaction analogous to a corporation's repurchase of its own stock for which no deduction is allowable. There is, however, a court case which holds to the contrary in that it allowed the deduction of the entire premium. In addition, court cases have been filed by taxpayers to test the validity of the Service's position on this matter.

*Problem.*—A corporation which repurchases its convertible indebtedness is, in part, repurchasing the right to convert the bonds into its stock. Since a corporation may not deduct the costs of purchasing its stock as a business expense, it would appear that the purchase of what, in effect, is the right to purchase its stock should be treated in the same manner.

*House solution.*—The bill provides that a corporation which repurchases its convertible indebtedness at a premium may deduct only that part of the premium which represents a cost of borrowing rather than being attributable to the conversion feature. Generally, the deduction

would be limited to a normal call premium for nonconvertible corporate debt except where the corporation can satisfactorily demonstrate that a larger amount of the premium is related to the cost of borrowing.

This provision generally applies to repurchases of convertible indebtedness after April 22, 1969.

*Arguments For.*—(1) This provision resolves the conflict between the Internal Revenue Service and the courts as to the amount of deductible interest expense allowable where a corporation repurchases its convertible indebtedness at a premium.

(2) This provision, in effect, treats a premium paid on the repurchase of convertible indebtedness as consisting of two elements, an interest cost and an amount paid for the right to purchase stock. It is appropriate to treat the amount paid for the right to purchase stock in the same manner as an amount paid for stock (i.e., no deduction is allowed for the amount).

*Argument Against.*—The premium, although it may not in its entirety be an interest expense, is an expense of carrying on a corporation's trade or business for which a deduction should be allowed.

## O. 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.

*Problem.*—In recent years, considerable ingenuity has been used in developing methods of capitalizing corporations in such a way that shareholders can be given the equivalent of an election to receive cash or stock, but at the same time permitting stockholders who choose stock dividends to receive them tax free. Typically, these methods involve the use of two classes of common stock, one paying cash dividends and the other stock dividends. 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.

*House solution.*—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 cause such a disproportionate distribution.

To counter the various devices by which the effect of a distribution of stock can be disguised, the bill gives the Treasury Department regulatory authority to treat as distributions changes in conversion ratios, redemptions, and other transactions that have the effect of disproportionate distributions.

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.

These provisions apply (subject to certain transitional rules) to distributions after January 10, 1969.

*Arguments For.*—(1) This provision is supported on the basis that if a corporation in effect were permitted to offer both growth stock and current income stock to investors, the taxation of dividends at ordinary income rates would be seriously undermined, and there would be a substantial loss of revenue, exceeding $1.5 billion a year. If this option were clearly permitted by statute, it is argued that most publicly held corporations would establish two classes of stock, one cash-dividend-paying stock and the other growth stock. The cash paying stock would tend to be held by exempt organizations and taxpayers in low tax brackets, and the growth stock would tend to be held by taxpayers in high brackets. The holders of the growth stock would normally realize their gains as capital gains (or without tax, if held until death).

(2) Giving investors the option to take taxable cash dividends or to permit earnings to accumulate without tax payment (but with a relative increase in the investor's equity interest) would provide them an option not available to those receiving earned income.

(3) By permitting corporations unlimited discretion to pattern their securities to fit various special situations, the present law facilitates the takeover of businesses and the growth of conglomerate enterprises.

(4) Existing regulations (promulgated January 10, 1969) fail to prevent all arrangements by which taxable cash dividends can be paid to some shareholders while others enjoy a tax-free increase in their proportionate ownership interest in the corporation.

*Arguments Against.*—(1) Stockholders should be allowed the choice of taking down taxable dividends or leaving the corporation's earnings to accumulate and thereby increasing their equity in the corporation. A corporation that gave investors this choice would find it easier to raise capital, both by broadening its appeal to investors and by decreasing the amount it pays out in dividends. Under present law, investors have the option to delay tax on investment earnings by investing in growth stocks that pay little or no dividends, although this choice is limited insofar as the corporation is concerned, since it must generally choose to offer its investors either growth or current income.

(2) The bill imposes a tax on common stockholders even in situations where their proportionate interests decline (or at least do not increase) because of the changing redemption or conversion rates attached to preferred stock.

## P. FOREIGN TAX CREDIT

*Present law.*—Under present law a U.S. taxpayer is allowed a foreign tax credit against his U.S. tax liability on foreign income. Generally, the amount of the credit is limited to the amount of U.S. tax on the foreign income.

There are two alternative formulations of the limitation on the foreign tax credit: the "per country" limitation and the "overall" limitation. Under the per country limitation, foreign taxes and income are considered on a country by country basis. Under the overall limitation, on the other hand, all foreign taxes and foreign income are aggregated.

Thus, under this limitation, foreign taxes in one country, in effect, can be averaged with lower foreign taxes in another foreign country.

*Problem.*—A. *Foreign Losses:*

The per country limitation allows a U.S. taxpayer with losses in a foreign country to, in effect, obtain a double tax benefit. Since the limitation is computed separately for each foreign country, the losses reduce U.S. tax on domestic income, rather than reducing the credit for taxes paid to other foreign countries (as would occur under the overall limitation). When the business operation in the loss country becomes profitable, the income, in effect, is likely not to be taxed by the United States because a foreign tax credit is allowed with respect to that income.

*Problem.*—B. *Foreign Tax-Royalties:*

Another problem which may arise under either limitation (but which primarily arises under the overall limitation) is the difficulty of distinguishing royalty payments from tax payments. This problem especially arises in cases where the taxing authority in a foreign country is also the owner of mineral rights in that country. Since royalty payments may not be credited against U.S. taxes, the allowance of a foreign tax credit for a payment which, although called a tax, is in fact a royalty, allows a taxpayer a larger credit than he should receive. Where the credit exceeds the U.S. tax on the income from the mineral production in the foreign country, the excess credit may be used to offset U.S. tax on income from other operations in that country, or on income from other foreign countries.

*House solution.*—The bill provides two additional limitations on the foreign tax credit.

A. *Foreign Losses:*

First, a taxpayer who uses the per country limitation, and who reduces his U.S. tax on U.S. income by reason of a loss from a foreign country, is to have the resulting tax benefit recaptured when income is subsequently derived from the country. This is accomplished by taxing subsequent income from that country until, in effect, the previous tax benefit is recaptured (i.e., until tax has been imposed on an amount of income equal to the amount of the loss previously deducted from

U.S. income). Generally, the amount of the benefit recaptured in any one year is limited to one-half the U.S. tax which would have been imposed on the income from the foreign country for that year, in the absence of the foreign tax credit. The amount of the tax benefit not recaptured in a year because of this limitation would be recaptured in subsequent years. The bill also applies the recapture rule where the taxpayer disposes of property which was used in the trade or business from which the loss arose. In this case, the amount of the loss not previously recaptured is included in income when the property is disposed of.

B. *Foreign Tax-Royalties:*

The bill also provides a separate foreign tax credit limitation in the case of foreign mineral income so that excess credits from this source cannot be used to reduce U.S. tax on other foreign income. In other words, the foreign tax credit allowed on mineral income from a foreign country will be limited to the amount of U.S. tax on that income. Excess credits may be carried over under the normal foreign tax credit carryover rules and credited against U.S. tax in other years on foreign mineral income. This separate limitation applies (1) where the foreign country from which the mineral income is derived requires the payment of a royalty with respect to the income producing property, (2) where that country has substantial mineral rights in the income producing property, or (3) where that country imposes higher taxes on mineral income than on other income. The purpose of these criteria is to isolate these cases in which it is likely that the taxes, at least in part, represent royalties. This separate limitation does not apply where a taxpayer's foreign mineral income for a year is less than $10,000.

The loss recapture rule applies to losses in years after 1969 and the separate foreign tax credit limitation on foreign mineral income applies to years beginning after the enactment of the bill.

A. *Foreign Losses:*

*Argument For.*—The foreign tax credit was designed to prevent the same income from being subjected to a double tax—once by the foreign country where the income was earned and a second time by this country; it was not intended to allow a double tax benefit, for example, where a foreign loss prevents the application of both foreign and domestic taxes on other domestic income. The amendment is needed to correct this loophole.

*Argument Against.*—This provision will tend to discourage new ventures by United States corporations in foreign countries.

B. *Foreign Tax-Royalties:*

*Arguments For.*—(1) Where a foreign government owns mineral deposits it makes little difference to the foreign government whether it demands royalties from the companies developing the deposits or assesses high taxes on the income they earn from those mineral deposits. For U.S. tax purposes, however, it is important that payments to a foreign government with respect to mineral deposits owned by that government be designated as a "tax" since foreign taxes are creditable against U.S. taxes while "royalties" are not. This amendment is needed to prevent these payments which may largely represent a "royalty" from being designated as "foreign taxes" in order to gain a U.S. tax advantage.

33-865 O—69—pt. 1——6

(2) The bill is desirable in that it recognizes the significant difficulties of ascertaining whether a payment labeled as a tax payment is, in fact, a tax or a royalty by limiting the major abuse which arises in this area, namely the use of excess foreign tax credits on mineral income to offset U.S. tax on other foreign income.

*Arguments Against.*—(1) A United States taxpayer with foreign mineral operations should not be penalized as compared to other U.S. taxpayers with other types of operations; if a foreign government imposes an income tax it should uniformly be treated as income tax for foreign tax credit purposes.

(2) Just because it is "difficult" to distinguish a true royalty and a tax is no reason to treat that portion of a "tax payment" made to a foreign government with respect to a mineral deposit it owns which is a true "tax" any less favorably than any other tax; by subjecting the entire payment to a separate limitation mineral taxes paid to a foreign government are discriminated against.

(3) The bill places further obstacles before U.S. companies competing with companies of other nations for the right to develop and control mineral production abroad; this hurts our balance of payments and can affect the share of worldwide oil reserves available to the free world.

(4) The general nature of the separate limitation on foreign mineral income may have the effect of denying a foreign tax credit for part of a tax payment even where no amount of the tax payment is, in fact, a royalty.

## Q. FINANCIAL INSTITUTIONS

### 1. Commercial Banks—Reserves for Losses on Loans

*Present law.*—Commercial banks, as a result of Revenue Ruling 65–92 (C.B. 1965–1, 112), now have the privilege of building up a bad debt reserve equal to 2.4 percent of outstanding loans not insured by the Federal Government. The 2.4-percent figure used for this purpose is roughly three times the annual bad-debt loss of commercial banks during the period 1928–47. In 1968, Revenue Ruling 68–630 (C.B. 1968–2, 84) clarified the loan base used for computing the allowable bad-debt reserve to include only those loans on which banks can suffer an economic loss.

*Problem.*—By allowing commercial banks to build up bad-debt reserves equal to 2.4 percent of uninsured outstanding loans, present law gives them much more favorable treatment than most other taxpayers. Section 166(c) of the Internal Revenue Code permits business taxpayers to take a deduction for a reasonable addition to a reserve for bad debts. Most taxpayers accumulate a bad-debt reserve equal to the ratio of the average year's losses to accounts receivable. The average loss is computed on the basis of losses for the current year and the 5 preceding years.

Commercial banks have the option of establishing their bad-debt reserves on the basis of their actual experience like other taxpayers. However, they generally elect to build up these reserves on the basis of the industrywide 2.4-percent figure permitted by Revenue Ruling 65–92. The extent of the favored tax treatment granted to commercial banks by this ruling is shown by the fact that if banks were subject to the same bad-debt reserve rules applying to taxpayers generally, they

would on the average be allowed to build up a bad-debt reserve of less than 0.2 percent of outstanding noninsured loans.

*House solution.*—The House bill provides that in the future the deduction allowed commercial banks for additions to bad debt reserves is to be limited to the amount called for on the basis of their own experience as indicated by losses for the current year and the 5 preceding years. Banks with bad debt reserves in excess of the amount allowable on the basis of their own experience (as of the close of the last taxable year beginning before July 11, 1969) will not be required to reduce these reserves. However, these banks will not be permitted to add to reserves until additions are justified on the basis of their own experience; and if such additions to reserves are not so justified they will be allowed in effect to deduct only actual bad-debt losses.

To provide an extra margin of safety to protect against the possibility of unusually large bad-debt losses, banks will be permitted to carry back net operating losses for 10 years instead of 3 years as under present law. In addition, commercial banks will be permitted, as under present law, to carry forward net operating losses for 5 years.

These provisions apply to years beginning after July 11, 1969.

*Arguments for.*—(1) The present bad debt reserves of commercial banks based on the 2.4-percent industrywide figure are in excess of the reserves needed in anything other than a catastrophic depression such as occurred in the early 1930's.

(2) The more generous loss carrybacks provided by the House bill should provide substantial protection to banks in the event of unusual losses.

(3) The administratively determined 2.4 percent formula is based generally on depression losses and ignores the many government policies since 1933, all designed to prevent a repetition of the financial chaos of that era. In light of these policies and in view of favorable banking experience since the depression, the present tax reduction for loss reserves is unreasonably generous.

*Arguments Against.*—(1) Banks should be encouraged to take every possible precaution, including the creation of adequate reserves, to assure depositors that their money is safe and that they will be able to protect against depression-scale losses. Without such assurance, confidence in the financial system could be threatened.

(2) Extension of the period for carrying bank losses back is no substitute for the strength and solvency which depression-related reserves convey, not only domestically, but in international financial circles as well.

**2. Mutual Savings Banks, Savings and Loan Associations, etc.**

*Present law.*—Mutual savings banks, savings and loan associations, and cooperative banks are permitted to compute additions to their bad-debt reserves on the basis of their actual experience or under one of two alternative formulas (specified by the 1962 Revenue Act), whichever produces the greatest addition to the reserve. The two alternative formulas provide for the deduction of (1) 60 percent of taxable income, or (2) 3 percent of qualifying real property loans. Under the 60-percent method, a mutual institution is permitted to deduct each year an amount equal to 60 percent of its taxable income (computed before any bad-debt deduction). Under the 3-percent

method, an institution is permitted to deduct an amount sufficient to bring the balance of the reserve for losses on qualifying real property loans to 3 percent of such loans outstanding at the close of the taxable year, plus an amount sufficient to bring the balance of the reserve for losses on other loans to a "reasonable" amount.

A savings and loan association and a cooperative bank are entitled to use these special reserve methods only if they meet a comprehensive set of investment standards, which were established by Congress in the 1962 act to insure that the tax benefits are available only to those institution primarily engaged in the business of home mortgage financing. Mutual savings banks, however, are not subject to any investment standards under these tax provisions and may use the special reserve methods regardless of the amount of their investments in home mortgage financing.

*Problem.*—In 1952 Congress repealed the exemption of these institutions from Federal income tax and subjected them to the regular corporate income tax. At that time, however, these institutions were allowed a special deduction for additions to bad-debt reserves which proved to be so large that they remained virtually tax exempt. In the Revenue Act of 1962, Congress sought to end this virtual tax exemption by providing the special alternative methods for these institutions in the computation of their bad-debt reserve. Although these methods are more restrictive than prior law, they still provide highly favorable treatment for the bad-debt reserves of these institutions.

It was expected that most of these institutions would compute their deduction under the 60-percent method, which requires the payment of some tax, while the 3-percent method would be an alternative primarily benefitting a limited number of new or rapidly growing institutions. In practice, about 90 percent of the savings and loan associations use the 60-percent method, but most mutual savings banks use the 3-percent method and as a result have been able to avoid substantially all Federal income taxes.

*House solution.*—The bill revises the treatment of mutual savings banks and savings and loan associations in a number of ways. It amends the special bad-debt reserve provisions by eliminating the 3 percent method and reducing the present 60 percent method to 30 percent gradually over a 10-year period.

The bill also revises the present investment standard applicable to savings and loan associations by liberalizing the composition of the qualifying assets and by applying the standard to mutual savings banks, as well as the other mutual institutions, as the basis on which the percentage for the special deduction method is determined. This new investment standard is a flexible one which reduces the percentage (applied against taxable income to compute the bad debt reserve deduction) depending on the percentage of the assets invested in the qualifying assets—residential real property loans, liquid reserves, and certain other assets. The full percentage (presently 60, to become 30) is to be allowed generally only if the institution has a prescribed percentage (82 percent for savings and loan associations and 72 percent for mutual savings banks) of its investments in qualifying assets. The percentage is proportionately reduced where an institution's qualifying assets are less than the prescribed percentage of total assets, but if less than 60 percent of its funds are in qualifying assets, the

percentage deduction method may not be used. The bill also allows these institutions to compute additions to their bad debt reserves on the basis of the 6-year moving average of their own experience (which is the new method provided by the bill for commercial banks), rather than on the basis of the percentage deduction method.

The bill also extends the net operating loss carryback for these institutions from 3 to 10 years, which allows the spreading of losses over 15 years (10 years back and 5 years forward), and provides for the same treatment of new institutions as is provided for new commercial banks. Generally, this provision applies to years beginning after July 11, 1969, although various transitional rules also are provided.

*Arguments For.*—(1) Since the House bill increased appreciably the effective rate of tax for commercial banks, a somewhat comparable increase in the effective tax rate for these institutions also is necessary. This is accomplished by (a) the repeal of the 3-percent method which has allowed mutual savings banks to remain virtually tax-free, and (b) the percentage reduction in the formula (from 60 to 30). Although raising the effective rate of tax, these changes will still leave a significant margin of tax advantage for them over commercial banks, preserving the inducement for them to continue investing in real estate mortgages.

(2) This and the other changes provide an assurance that significant tax will be paid in most cases on the retained earnings of these institutions, while at the same time providing reserves consistent with the proper protection of the institution and its policyholders in the light of the peculiar risks of long-term lending on residential real estate which is the principal function of these institutions.

(3) Although savings and loan associations are required (as a condition to favored tax deductions) to invest large amounts of their deposits in home-oriented mortgages, mutual savings banks are not similarly controlled as to their investments. By subjecting mutual savings banks to an investment standard (even one more generous than that applicable to savings and loan associations) the bill restricts preferential tax treatment to those instances where some preference still appears warranted.

(4) By extending the carryback for net operating losses from 3 to 10 years (allowing 15 years for such losses), the bill adequately provides for large unexpected losses.

*Arguments Against.*—(1) Congress recognized in 1962 the 60 percent deduction rule offered insufficient protection to member-depositors of rapidly growing mutual thrift institutions and so it provided the 3 percent rule as an appropriate alternative. The bill reverses this conscious Congressional decision.

(2) Mutual savings banks do not possess the same home mortgage background as savings and loan associations and prior Congresses have wisely left their investment practices disassociated from heavy involvement in home mortgages.

(3) The unique nature of real estate mortgages (very long term) makes it difficult to liquidate them in times of financial stress and this justifies the present loss reserve rules applicable with respect to these investments.

(4) These changes will adversely affect home mortgage financing, contrary to the intent of Congress, because increased taxes will mean less funds for loans, a lower return, and less protection for depositors. This will further retard an industry already hard hit by high interest rates.

(5) With the growth in the deposits of mutual savings banks, they need additional reserves to provide necessary protection for their depositors.

(6) The more generous investment standard will lead to heavier involvement in fewer properties, thereby exposing depositors to greater risks.

### 3. Treatment of Bonds Held by Financial Institutions

*Present law.*—Commercial banks and mutual savings institutions receive special tax treatment in regard to their transactions in bonds and other corporate and governmental evidences of indebtedness. Like other taxpayers, they can treat long-term gains from such transactions as long-term capital gains for tax purposes. However, unlike other taxpayers, they can treat capital losses from such transactions as ordinary losses and may deduct such losses without limit from ordinary income.

*Problem.*—The present nonparallel treatment of gains and losses on bond transactions by financial institutions appears to have inequitable results.

Transactions of financial institutions in corporate and government bonds and other evidences of indebtedness do not appear to be true capital transactions; they are more akin to transactions in inventory or stock in view of the size of the bank holdings of these items and the extent of their transactions in them. Moreover, financial institutions now maximize their tax advantages by arranging their transactions in bonds in the light of existing market conditions in order to realize gains in selected years and losses in other years. This enables them to report their gains as capital gains for tax purposes and their losses as ordinary losses chargeable against regular income. The result is to permit financial institutions to reduce their taxable liability and to receive preferential treatment over other taxpayers.

*House solution.*—The House bill provides parallel treatment for gains and losses derived by financial institutions on transactions in corporate and governmental bonds and other evidences of indebtedness. Under the bill, financial institutions are to treat net gains from these transactions as ordinary income instead of as capital gains but they will continue to treat net losses from such transactions as ordinary losses as under present law. This provision applies to taxable years beginning after July 11, 1969.

*Arguments For.*—(1) This provision removes the preferential treatment accorded to financial institutions over other taxpayers in regard to transactions in corporate and government bonds. It would have been possible to treat financial institutions exactly like other taxpayers with regard to such transactions—that is, treat the gains as capital gains and the losses as capital losses. However, it is understood that the financial institutions preferred the ordinary income tax treatment provided by the House bill to consistent capital gains treatment for their bond gains and losses, because they want to continue to have the protection offered by ordinary loss treatment on their bond losses.

(2) The bill prevents banks from so arranging their affairs as to realize gains from their securities when they have no other income, and to preserve losses on these securities until years in which they are profitable.

*Arguments Against.*—(1) The bill will further depress an already weak securities market by discouraging banks from buying and selling securities and this will have an adverse impact on Treasury revenues.

(2) The existing law reflects a wise policy of treating losses realized by financial institutions on governmental and corporate securities as ordinary losses while encouraging banks to invest in such securities (and thus create a market for government bonds) by offering capital gains treatment on potential profits; changing the existing law can only serve to narrow the market for governmental securities, making Federal debt management more difficult.

**4. Foreign Deposits in U.S. Banks**

*Present law.*—Present law provides special rules, for purposes of the income tax and the estate tax, for the treatment of U.S. bank deposits, and the interest thereon, of foreign persons.

In general the effect of these special rules is to exempt this type of interest income received by foreign persons from U.S. tax and to exempt the deposits from the estate tax. Under present law the special bank deposit rules are to cease to apply at the end of 1972. In other words, after 1972 the interest on these bank deposits otherwise would be subject to income tax and the bank deposits themselves would be subject to the estate tax.

*Problem.*—Congress provided, in 1966, that the special treatment accorded U.S. bank deposits of foreign persons should be terminated. It was believed, however, that an immediate elimination of the special rules might have a substantial adverse effect on the balance of payments. Accordingly, it was decided to postpone the elimination of the special rules until the end of 1972. In view of the continuing deficit in the balance of payments, it appears that our balance of payments situation might be adversey affected to a substantial degree if the special treatment were removed at the end of 1972.

*House solution.*—The bill provides that the special income tax and estate tax rules regarding U.S. bank deposits (including deposits with savings and loan associations and certain amounts held by insurance companies) of foreign persons are to continue to apply until the end of 1975.

*Arguments For.*—(1) Postponement of the termination date for the special bank deposits rule will forestall the possibility of an outflow of funds from the United States (in anticipation of the termination of the special status) and the resulting harmful effect on our balance of payments.

(2) The bill retains the long-term goal set by Congress in 1966 of eventually treating foreigners who deposit their money in U.S. banks in the same manner as U.S. citizens are treated with respect to their bank deposits, both under the income tax and the estate tax.

(3) The bill recognizes the desirability of continuing the present U.S. income tax exemption for interest paid on foreign-owned bank deposits—and the estate tax exemption with respect to the deposits—in order to encourage an inflow of foreign capital and thus help adjust our unfavorable balance of payments.

*Arguments Against.*—(1) The tax reform bill is designed to eliminate preferences in the tax law and make the tax burden more equal on all persons who have U.S. income and property; this feature of the bill runs counter to the objectives of tax reform and tax equity by continuing a pronounced preference in the tax law beyond the date when it would ordinarily end.

(2) Questions can be raised as to whether the termination of this special treatment, in fact, will have an appreciable adverse effect on the balance of payments.

## R. DEPRECIATION ALLOWED REGULATED INDUSTRIES

### 1. Accelerated Depreciation

*Present law.*—Regulated industries may make the same elections as other taxpayers regarding depreciation of their business property. About half the regulatory agencies require utilities that use accelerated depreciation to "flow through" the resulting reduction in Federal income taxes currently to income. (Where the utility is earning the maximum allowed by law or regulations, this results in flowing through the tax reduction to the utility's current customers.) Other agencies permit the utilities they regulate to "normalize" the deferred tax liabilities resulting from accelerated depreciation. (This involves the utillity retaining the current tax reduction and using this money in lieu of capital that would otherwise have to be obtained from equity investments or borrowing.) Some agencies insist that utilities subject to their jurisdiction use accelerated depreciation for tax purposes and, in a few rate cases, such agencies have treated the utilities they regulate as though they used accelerated depreciation (and flowed through the resulting tax reduction), even though the utilities may have in fact used straight-line depreciation.

*Problem.*—The trends of recent years are shifts from straight line to acclerated depreciation and shifts from normalization to flow-through, often against the will of the taxpayer utilities. In general, flow through to customers doubles the revenue loss involved in shifting from straight-line to accelerated depreciation. It is understood that continuation of these trends would shortly lead to revenue losses of approximately $1.5 billion. Consideration of legislative action in this area is complicated by the fact that many utilities do not have effective monopolies while others do; many utilities are in growing industries while others are losing ground; many utilities compete (to the extent they face any competition) only with other regulated utilities while others compete with businesses not subject to governmental rate regulation.

*House solution.*—The bill provides that, in general, utilities brought under these provisions will be "frozen" as to their depreciation practices. As to existing property: if straight-line depreciation is presently being taken, then no faster depreciation may be used; if the taxpayer is taking accelerated depreciation and is normalizing, then accelerated depreciation can continue to be taken only if the taxpayer continues to normalize; no change is required if the taxpayer is now on flow-through. As to new property: a taxpayer presently on straight line or presently on accelerated depreciation with normalization will be per-

mitted to take accelerated depreciation only if the tax benefits are normalized in the manner described above (otherwise such taxpayers must take only straight line depreciation); no change is made if the taxpayer is now on flow-through insofar as the same kind of property is involved. The bill also does not change the power of the agency, in the case of normalization, to exclude the normalized tax reduction from the base upon which the company's maximum permitted profits are computed. These rules apply to property used predominantly in the trade or business of the furnishing or sale of: electrical energy, water, sewage disposal services, gas through a local distribution system, telephone services (other than those provided by COMSAT), or transportation of gas, oil (including shale oil), or petroleum products by pipeline, if the rates are regulated by a utilities commission or similar agency.

The changes apply to taxable years ending after July 22, 1969.

*Arguments For.*—(1) The bill substantially forestalls the entire revenue loss that continuation of existing trends would have made almost inevitable. It does so in a way that (with very few exceptions) will require no increase in utility rates because of the tax laws, since by and large, it merely takes the various regulatory situations as it finds them and freezes those situations.

(2) Although regulatory commissions have adopted widely varying rules relating to the depreciation policies, this change will assure uniform tax rules for all affected utilities in the future.

*Arguments Against.*—(1) The change will deny to some utility taxpayers the tax benefits of accelerated depreciation which are available to other taxpayers. The denial would be inconsistent and discriminatory.

(2) The bill is discriminatory against rate-payers to the extent that utilities under present law may adopt accelerated depreciation on their investments and "flow-through" the tax deferral to these ratepayers.

(3) This change infringes upon the authority of the various Federal and State commissions to regulate the accounts, financial reports, and rates of the various utilities which they are charged to supervise.

(4) Regulated utilities should be limited to straight line depreciation since they must expand services in accordance with their customers' needs and are protected from competition.

(5) All utilities should be permitted to elect accelerated depreciation with normalization, as a method for meeting competition by means that accord with generally preferred accounting standards.

### 2. Earnings and Profits

*Present law.*—A dividend is defined as a distribution of property by a corporation to its shareholders out of earnings and profits. If a distribution exceeds the corporation's earnings and profits, then the excess is a "tax-free dividend" (not currently taxable to the shareholder) which reduces his cost basis in the stock (increasing capital gain or reducing capital loss if the stock is sold by him). Earnings and profits in general are computed by reference to the method of depreciation used in computing the corporation's taxable income and so are reduced by the amount of depreciation deducted by the corporation on its return.

*Problem.*—Tax-free dividends (in effect, resulting in current avoidance of tax at ordinary income rates in exchange for possible postponed tax at long-term capital gains rates) appear to be increasing in a number of industries. Especially among utilities, a number of companies are regularly making such distributions. It was indicated that in 1968 private power companies alone made such tax-free distributions totaling approximately $260 million. Statistical information is not readily available in the real estate industry on this point, but it is understood that substantial amounts of corporate distributions in this industry are also tax-free. Availability of these tax benefits is generally unrelated to the purposes of accelerated depreciation and is of greatest value to individuals in high tax brackets.

*House solution.*—The bill provides that, for the purpose of computing its earnings and profits, a corporation is to deduct depreciation on the straight line method, or on a similar method providing for ratable deductions of depreciation over the useful life of the asset. This provision would not affect the amount of depreciation that can be deducted in determining the corporation's Federal income tax.

This provision applies to earnings and profits for taxable years beginning after June 30, 1972.

*Arguments For.*—(1) This provision is supported on the ground that it is expected to put an end to the increasing practice of distributing tax-free dividends. It will not affect the corporations' tax liabilities but can affect the tax liabilities of the shareholders. It should end the use of this unintended substantial benefit to high-bracket taxpayers, which use is generally unrelated to the purposes for which accelerated depreciation deductions are made available to corporations.

(2) This rule regarding depreciation is essentially the same as what is currently required in the case of percentage depletion (where cost depletion is used for earnings and profits computations).

*Arguments Against.*—(1) The ability to distribute "tax-free dividends" is part of the structure of many corporations, and change in this regard will result in substantial reduction in the market price of those corporations' shares. It is noted, in reply, that three years are provided for market adjustments before the change takes effect.

(2) Accelerated depreciation is unlike prcentage depletion in that it merely allocates the same amount of deductions over a different period of time—consequently, the earnings and profits treatment of percentage depletion should not be used as a model for the treatment of accelerated depreciation.

(3) Earnings and profits, for purposes of determining dividend distributions, should be computed by the same accounting rules used in determining income tax of the corporation. Eventually the amount of earnings and profit of a corporation from a particular investment should be the same whether the method of depreciation is an accelerated method or the straight-line method. The increase in the accumulated earning and profits in the latter years of the corporation should make up for the decreased earnings from the property in the earlier years.

## S. ALTERNATIVE CAPITAL GAIN RATE FOR CORPORATIONS[1]

*Present law.*—Corporations that have an excess of net long-term capital gains over net short-term capital losses may use the "alternative tax," which taxes the entire excess net long-term capital gain at 25 percent. Since the corporate tax structure is not graduated (as in the case for individuals) but is computed on the basis of a normal tax of 22 percent of taxable income and a surtax of 26 percent of that part of the taxable income which exceeds $25,000, usually only those corporations with taxable incomes in excess of $25,000 (on which the tax rate would be 48 percent, apart from the effect of the surcharge) use the alternative tax.

*Problem.*—The House bill eliminates the alternative tax for individuals, thereby raising their maximum capital gain rates. Accordingly, it appears appropriate to raise the corporate alternative tax rate to a greater percentage of the regular corporate tax rate. In addition, since corporations are not subject to graduted tax rates they usually do not encounter the problems of having bunched income, which has accrued over more than a one year period, taxed in one year at steeply graduated rates, which is one of the reasons for providing special tax treatment to capital gains.

*House solution.*—The bill increases the alternative tax rate which is applied to a corporation's net long-term capital gains from 25 to 30 percent. This provision applies to sales and other dispositions after July 31, 1969.

*Arguments For.*—(1) A corporation's capital gains, in comparison with those of an individual, are more in the nature of business income which is not essentially different from the corporation's other income.

(2) Because other changes in this bill provide that the alternative tax for individuals will be raised, in effect, to a maximum rate of 35 percent (scaling down later to 32.5 percent), a comparable adjustment should be made in the corporate tax on capital gains.

*Arguments Against.*—(1) This provision results in an economically undesirable redistribution of income from the corporate sector of the economy where it might be used for investment, to the individual sector where it might be used for consumption. This is so because the increase in revenues from this charge is used to provide tax relief to individuals.

(2) The 30 percent rate appears to be an arbitrary rate which was not developed from a study of corporate statistics.

## T. NATURAL RESOURCES

### 1. Percentage Depletion

*Present law.*—At present, percentage depletion is granted to a wide range of minerals. The depletion rates are 27½ percent for oil and gas wells; 23 percent for sulfur, uranium, and an extended list of minerals; 15 percent for metal mines, rock asphalt, vermiculite, and certain types of clay; 10 percent for coal and a limited group of other minerals; 7½ percent for clay, shale, and slate used for specified purposes; and 5 percent for such items as gravel, peat, and sand, and cer-

[1] Witnesses did not testify to this change in the law during the Ways and Means Committee hearings.

tain minerals from brine wells. In addition, a 15-percent rate applies to a final category which contains an extended series of minerals and also includes all other minerals unless sold for riprap, ballast road material, rubble, concrete aggregates, or for similar purposes. Percentage depletion is not granted in the case of soil, sod, dirt, turf, water, or mosses or minerals from sea water, the air, or similar inexhaustible sources.

Percentage depletion generally applies to the specified items regardless of whether the pertinent property is located in the United States or abroad. However, except for sulfur and uranium, the 23-percent percentage depletion rate applies only to deposits in the United States, and foreign deposits of the other minerals in this category are eligible for percentage depletion at the 15 percent rate.

The percentage depletion allowance is limited to a maximum of 50 percent of the taxable income from the property, computed before any allowance for depletion. In any case where depletion based upon cost is higher than percentage depletion, the higher amount is allowed as a deduction.

*Problem.*—Percentage depletion was adopted in 1926 when the prior allowances based on discovery value in the case of oil and gas proved difficult to administer and produced varying results. At that time, it was recognized that percentage depletion could permit taxpayers to recover amounts in excess of their investment. However, this was deemed justified on the ground it would have the beneficial effect of stimulating exploration for and discovery of new reserves of vitally needed oil and gas.

It has been charged that if percentage depletion rates are viewed as a needed stimulant at the present time they are higher than is needed to achieve the desired beneficial effect on reserves.

The application of percentage depletion allowances to income from oil and gas wells located in foreign countries has also been subject to criticism. It is charged that insofar as percentage depletion is intended primarily to encourage the exploration and discovery of new domestic wells, the granting of percentage depletion to income from foreign deposits results in a loss of revenue without commensurate advantages.

*House solution.*—The House bill affects percentage depletion in two ways. First, the various percentage depletion rates are reduced as follows:

[In percent]

| | Present rate | Rate provided by bill |
|---|---|---|
| Oil and gas wells (domestic) | 27½ | 20 |
| Sulfur and uranium, and specified minerals from domestic deposits | 23 | 17 |
| Gold, silver, oil shale, copper and iron ore from domestic deposits | 15 | 15 |
| Remaining minerals now at 15 percent | 15 | 11 |
| Asbestos, coal, sodium chloride, etc | 10 | 7 |
| Clay, shale and slate for specified uses | 7½ | 5 |
| Gravel, sand, and other minerals now at 5 percent | 5 | 4 |

As can be seen from this table, the bill provides for substantial reductions in percentage depletion rates for most items. However, some

items—namely, gold, silver, oil shale, copper and iron ore—are to remain at the present 15 percent rate in the case of deposits in the United States.

Second, the bill provides that percentage depletion is not to be allowed for foreign oil and gas wells. These changes in percentage depletion allowances are effective for taxable years beginning after July 22, 1969.

*Arguments For.*—(1) The appropriate level of percentage depletion rates depends on a number of factors including the effect on incentives to discover new reserves, equity considerations involving the payment by each taxpayer of his fair share of taxes, and revenue considerations. This provision is supported on the ground that the new percentage depletion rates represent a better balance than now exists between all these objectives.

(2) Percentage depletion is symbolic of a preference-prone tax structure that discriminates against persons whose incomes are wholly or principally from fully taxable wages and salaries. To leave it unchanged would invite the breakdown of our voluntary, self-assessment system of taxation.

(3) The oil companies today do not pay a fair share of the Federal tax burden, largely because of percentage depletion.

(4) If stimulation of discovery and development of oil deposits to make the United States self-sufficient and independent of questionable supplies of foreign oil is a goal of percentage depletion, then the bill enhances that goal by doing away with percentage depletion on foreign oil.

*Arguments Against.*—(1) Oil and gas producers now pay heavy severance taxes to the States so that some measure of relief under the Federal income tax is appropriate.

(2) Receipts from withdrawals of oil, gas and mineral reserves are akin to receipts from the sale of a capital asset and should be given relief just as capital gains are given relief by being taxed at a special rate.

(3) Removal of percentage depletion from foreign oil and gas wells will not produce any significant additional revenue for the United States. This is because the foreign countries in which the wells are located will raise their taxes until the foreign tax credits allowed against U.S. tax absorb the increase in the U.S. tax resulting from the removal of percentage depletion.

(4) It is not percentage depletion rates in general that raise the charge of preferential treatment; rather, it is the specific 27½ percent rate applicable to oil and gas. By cutting the rates applicable to virtually all minerals the House bill unfairly portrays the entire mineral industry as the beneficiary of undeserved tax largess.

(5) Doing away with percentage depletion on foreign oil ignores the role the United States oil companies play in funnelling foreign oil earnings back to this country to benefit our suffering balance of payments. Similarly, it ignores the significance of expanding U.S. influence over oil reserves and keeping them available for the free world and out of Communist domination.

(6) Proved oil reserves today are declining at a rapid rate in this country, and there is insufficient new exploration. What the industry needs is more, not less, stimulation to seek new deposits.

(7) The true measure of an industry's profitability and tax burden is determined by reference to its gross income, not its net income, which is how most critics of the oil industry analyze it. Viewed in relation to its gross income the oil industry is less profitable, and more heavily taxed, than the average of other industries.

**2. 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 A–B–C transaction.

A carved-out production payment is created when the owner of a mineral property sells—or carves out—a portion of his future production. A carved-out production payment is usually sold for cash and, quite often, to a financial institution. Under present law, the amount received by the seller of the carved-out production payment generally is considered ordinary income subject to depletion in the year in which received. The purchaser of the production payment treats the payments received as income subject to the allowance for depletion (almost always cost depletion) and thus generally pays no tax on those amounts (except for that portion of the payments which is in the nature of interest). The amounts utilized to pay the production payment are excluded from income by the owner of the property during the payout period, but the expenses attributable to producing the income are deducted by him in the year they are incurred.

A retained production payment is created when the owner of a mineral interest sells the working interest, but reserves a production payment for himself. Under present law the owner of the retained production payment receives income for which percentage depletion may be taken during the payout period, or period during which he receives a part of the production (or a payment based on production). The purchaser of the working interest excludes the amounts used to satisfy the production payment during the payout period, but (until recently) deducted the cost of producing the minerals subject to the production payment.

The so-called A–B–C transaction is the same as a retained production payment case, except that after selling the working interest, the initial owner then sells the "retained production payment." Thus, in an A–B–C transaction, the owner of the mineral property, A, sells it to a second person, B, and reserves a production payment (bearing interest) for a major portion of the purchase price. He then sells the production payment to a third party, C, which is usually a financial institution, or, perhaps, a tax-exempt organization.

*Problem.*—It is charged that the use of carved-out production payments constitutes a problem because they are being employed 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, it is charged that 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.

*House solution.*—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). Thus, the proceeds received by the seller upon a sale of a production payment would not be taxable to him. However, as income is derived from the property subject to the carve out, that income would be taxable to the owner of the property, subject to the depletion allowance. The cost of producing minerals used to satisfy carved-out production payments would be deductible when incurred.

This treatment is not to apply to a production payment carved out for exploration or development of a mineral property if, 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). Accordingly, the income derived from the property which is used to satisfy the payment would be taxable to the owner of the mineral property subject, of course, to the allowance for depletion. In addition, the production costs attributable to producing the minerals used to satisfy the production payment would be deductible by the owner of the working interest in the year incurred.

Generally this provision applies to production payments created after April 21, 1969.

*Arguments For.*—(1) In each of the three situations (the carved-out production payment, the retained production payment, and the ABC transaction, the transaction is similar in fact, to a loan transaction with the loan secured by a mortgage on the property and the "borrower" not personally liable for the loan.

(2) The use of production payments produce tax benefits that are in excess of the advantages Congress intended, in the case of the depletion deduction, the foreign tax credit, and the net operating loss carryover.

(3) Production payments enable taxpayers to avoid the 50 percent limitation on percentage depletion by accelerating the time when they realize income from the mineral property without also moving up the expenses related to the production of the minerals pledged to pay off the production payment. The bill will prevent this avoidance of the limitation.

*Arguments Against.*—(1) Mineral production payment transactions are not loans and to treat them as such distorts the generally accepted concepts of the terms "loan and mortgage." A production payment, it is argued, creates only a property right, and not a debtor-creditor relationship or the rights of a mortgage.

(2) To change the tax treatment of production payments would adversely affect the collateral securing existing loans and would further restrict the ability of the independent producers to finance their operations with the proceeds of new loans.

**3. Mining 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.

*Problem.*—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. No reason is seen for this difference in treatment.

*House solution.*—The bill provides that the general recapture rules of present law are to apply to mining exploration expenditures (made after July 22, 1969) 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.

*Arguments For.*—(1) A current deduction for exploration expenditures and, in addition, depletion on the property when the producing stage is reached should not be allowed on the same property.

(2) The bill continues the present privilege which taxpayers have of deducting foreign (and oceanographic) exploration expenditures subject to the same limitations as at present.

(3) The present law lacks uniformity in the tax treatment of exploration expenses in that mining companies which choose to deduct these expenses in excess of $400,000 (and present law permits the taxpayer to elect to deduct greater amounts) are subject to a recapture of all their exploration expenses as the mine becomes profitable, while those which choose to limit their exploration expense deduction to $400,000 would not be subject to the recapture. The bill provides uniform rules in this area by applying the recapture to *all* exploration expenses where the mines become profitable.

*Arguments Against.*—(1) The bill ignores the basis on which the existing law is predicated. Until 1966 exploration expense deductions were limited to $400,000, but in that year Congress eliminated the limit (on an optional basis) principally to benefit the large companies and the special recapture rule was a *quid pro quo* for the higher de-

duction. Extension of the recapture rule to all exploratilon expenses now, in effect, makes small mining companies pay for the benefit extended to the large companies in 1966.

(2) Since some companies are willing to limit exploration expenditure deductions to $400,000, they should not be subjected to the recapture rules.

**4. Treatment Processes in the Case of Oil Shale**

*Present law.*—The depletion allowance for oil shale under present law is applicable only to the value of the rock itself—which has little if any value. Liquid oil from wells, on the other hand have considerable value.

*Problem.*—The industry will never develop in its use of oil shale until oil from shale receives more nearly the same percentage depletion allowance as oil produced from a well.

*House solution.*—The bill extends the point at which percentage depletion is computed in the case of oil shale to after extraction from the ground, through crushing, loading into the retort, and retorting, but not to hydrogenation, or any refining process or any other process subsequent to retorting.

*Argument For.*—Oil from shale should receive similar treatment to that given to oil produced from a well, that is on the value of liquid oil.

*Argument Against.*—This provision will allow percentage depletion to be taken on certain manufacturing processes performed in reducing oil shale to oil. The cut-off point should be at the completion of the mining from the ground.

## U. CAPITAL GAINS AND LOSSES

**1. Alternative Tax**

*Present law.*—One-half of an individual's net long-term capital gains are included in taxable income and, accordingly, are taxed at regular tax rates. The alternative tax—a maximum of 25 percent on net long-term capital gains—is applied when an individual's marginal tax rate exceeds 50 percent. For married couples filing a joint return, the alternative tax is applied when other taxable income is greater than $52,000. For single persons, the alternative tax is applied when other taxable income exceeds $26,000.

*Problem.*—The incentive for many high income taxpayers to convert their income into capital gain is greater than for taxpayers subject to lesser rates because to the extent they do so the alternative tax rate for capital gains decreases their effective tax rate by more than one-half. This effect is associated with the extent that the taxpayer's income is greater than the level where the 50 percent marginal tax rate is effective.

*House solution.*—The bill eliminates the alternative tax rate for net long-term capital gains for individuals. The provision applies to sales and other dispositions made after July 25, 1969.

*Arguments For.*—(1) It is appropriate to remove the alternative capital gains rate to lessen the incentive for individuals to plan the conversion or ordinary income into capital gains.

(2) The alternative tax on capital gains benefits only the super-rich—those whose marginal income tax rate exceeds 50 percent—by

allowing them to, in effect, deduct more than 50 percent of their capital gain. The bill properly corrects this situation by assuring the same tax treatment for all capital gain income without regard to the individual's tax bracket.

(3) The alternative tax rate is at variance with the intent of the progressive rate structure which underlies our income tax laws. The bill more closely reflects the goal of taxing individuals according to their ability to pay.

(4) The alternative tax, because it is set at a maximum of 25 percent, operates to create an excessively large difference between the tax rate paid on capital gains and that paid on ordinary income by taxpayers in higher tax brackets.

*Arguments Against.*—(1) More liberal capital gains treatment is needed to spur the assumption of risk of enterprise and the responsibilities of ownership. For this reason, the alternative tax rate should be decreased rather than increased.

(2) An increase in the amount of the capital gain tax will reduce capital transactions, thereby reducing revenues to the Treasury at the very time other provisions of the bill are raising taxes.

(3) The effective tax rate for individuals with high taxable incomes may be increased by as much as 40 percent above present rates (from 25 percent to 35 percent).

**2. 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. (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.)

When 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.

*Problem.*—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 one 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 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 noncom-

BEST AVAILABLE COPY

munity 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. (In addition, they must have equal incomes or the loss offset may be more than offset by a difference in tax as a result of this variation in income.)

*House solution.*—The House 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. These provisions apply to years beginning after July 25, 1969.

*Arguments For.*—(1) Taxpayers who are able to manage their investments to realize their gains and losses in different years are able to take advantage of the present disparity in treatment of gains and losses. Thus, they are able to take the 50 percent deduction for net-long-term capital gains in one year and to also take a full deduction for long-term capital losses in another year.

(2) The present treatment of capital losses also results in a special benefit to spouses who file separate returns to enable each to deduct up to $1,000 of those losses from ordinary income. This advantage is automatic for persons in community property states, whereas spouses living in non-community property states must either hold property in joint tenacy or own separate property before they may obtain this advantage. In addition, married persons in non-community property states who file separate returns must be willing to forego the split-income rates applicable to joint returns while couples in community property states do not lose this advantage even though separate returns are filed.

(3) Present law discriminates against taxpayers whose investments are not readily marketable in favor of those taxpayers who can more freely manipulate sales of their investments to maximum advantage.

*Arguments Against.*—(1) An individual with a capital loss has suffered a loss in the full amount, and it is unfair to deny him the full benefit of this loss.

(2) If only a portion of an individual's net capital loss can be offset against his other income, the individual will be less willing to incur the risk of investment in new ventures and the economy will suffer.

(3) The bill fails to achieve consistency in treatment between capital gains and capital losses because while capital gains are taxed in full, only $1000 of capital losses may be deducted from ordinary income annually. This provision of the bill should be deferred until the entire treatment of capital losses can be explored.

### 3. Collections of Letters, Memorandums, Etc.

*Present law.*—Present law excludes copyrights and literary, musical, or artistic compositions (or similar property) from the definition of a capital asset, if they are held by the person whose efforts created the property (or by a person who acquired the property as a gift from the person who created it). Thus, gain arising from the sale of such a book, artistic work, or similar property is treated as ordinary income, rather than as capital gain. However, since collections of letters, memorandums, etc. (including those prepared for the individual) are

not excluded from the definition of a capital asset, gains from the sale of such property are accorded capital gains treatment.

*Problem.*—The rationale underlying the present law treatment of artistic works and similar property in the hands of the person who created them, in effect, is that the person is engaged in the business of creating the artistic work or similar property. In view of this, the gain arising from the sale of the property is treated as ordinary income, rather than as a gain from the sale of a capital asset.

It is difficult to see why this treatment should not extend to collections of letters, memorandums, etc., created by the person or prepared for or given to him. In the one case a person who writes a book and then sells it is treated as receiving ordinary income on the sale of the product of his personal efforts; in the one case, one who sells a letter or memorandum written by, or for, him is treated as receiving capital gain on the sale even though the product he is selling is, in effect, the result of his personal efforts.

*House solution.*—The House bill excludes letters, memorandums, and similar property from the definition of a capital asset, if they are held by a person whose efforts created the property or for whom the property was prepared or produced (or if received as a gift from such a person). Thus, the gain on a sale of these letters or memorandums would be treated as ordinary income, rather than as a capital gain. This provision applies to sales and other dispositions after July 25, 1969.

*Argument For.*—Collections of papers and letters are essentially similar to a literary or artistic composition which has been created by the personal efforts of the taxpayer. Both types of works should be classified in a similar manner for purposes of income taxation. It is logical to consider income from both these types of personal effort as income arising from the sale of property in the "ordinary course of a trade or business."

*Arguments Against.*—(1) Since other forms of earnings by an individual in some cases result in capital gains there is no reason for changing the treatment of such collections of letters, memorandums, etc., held by the person who created them, or for whom they were prepared or produced.

(2) If this kind of property is to be taxed it should be taxed as a capital gain in recognition of the fact that their value is attributable to work performed over a period longer than a single year.

**4. Holding Period of Capital Assets**

*Present law.*—Capital gains on assets held longer than 6 months are considered long-term gains. In the case of individuals, 50 percent of the excess of net long-term capital gains over net short-term capital losses is included in income. In the case of corporations, the excess is taxed at a maximum rate of 25 percent (30 percent under the bill) rather than at the regular 48 percent corporate rate.

*Problem.*—The distinction between the treatment of long and short term gains is based on the belief that gains which accrue over long

periods of time should not be taxed as ordinary income and that special treatment should be provided for investment, as opposed to speculative gains. The 6-month holding period does not appear to be an adequate implementation of either of these concepts. It affords special treatment to gains which accrue over a period of less than a year and it does not appear to adequately distinguish between speculative and investment gains.

*House solution.*—The House 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. This provision applies to taxable years beginning after July 25, 1969.

*Arguments For.*—(1) Lengthening the holding period to one year is necessary to restore the original concept of the capital gains tax—that is, that these gains accruing over a period longer than one taxable year should not be "bunched" together and subjected to the graduated tax rates generally applicable to income normally received on an annual basis.

(2) A person who holds an investment for little more than six months is primarily interested in obtaining speculative gains from short-term market fluctuations which may be taxed at favorable rates. In contrast, the person who holds an investment for a long time probably is interested fundamentally in the income aspects of his investment, and in its long-term appreciation in value. The available evidence suggests that assets held for a period between six months and one year tend to be speculative. Further, a study made in 1962, of gains from corporate stock transactions revealed that almost 90 percent of all capital gains in that year arose from sales occurring after one year of possession. By fixing the holding period at one year the bill reflects all these considerations.

*Arguments Against.*—(1) Lengthening the holding period would cause investors in securities to postpone the sale of these securities. This, in turn, would seriously reduce the liquidity of the various securities markets and would reduce, as well, the Federal revenues from capital gains.

(2) Many persons believe that any lengthening of the holding period should be accompanied by a decrease in the maximum capital gain rate which would apply to such a gain.

### 5. Total Distributions 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, 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 self-employed persons) receives his total accrued benefits in a distribution within 1 taxable year on account of separation from service or death, the distribution is taxed as a capital gain, rather than 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 gains rate, rather than at ordinary income rates.

*Problem.*—The capital gains 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 gains treatment afforded lump-sum distributions from qualified pension plans allows employees to receive substantial amounts of deferred compensation at a much more favorable tax rate than other compensation received for services rendered. Moreover, it appears that the more significant benefits accrue to taxpayers with adjusted gross incomes in excess of $50,000, and that a number of lump-sum distributions of $800,000 to over $1,000,000 have been made.

*House solution.*—The bill limits the extent to which capital gains treatment will be allowed for lump-sum distributions from qualified employees' trusts made within 1 taxable year. Capital gains treatment is to be limited to the amount of the total distribution in excess of employer contributions made during plan years beginning after 1969. Thus, amounts attributable to employer contributions made during plan years beginning after 1969 will be treated as ordinary income. This applies also to the amount of employer contributions of employer securities to the plan.

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.

*Argument For.*—It is appropriate to treat at least the amount of the employer contributions to a pension trust (including contributions of employer stock) as ordinary income, since it is deferred compensation for services rendered over the period of employment which otherwise would be taxed as ordinary income. The bunched-income problem of treating this portion of the distribution as ordinary

income is alleviated by the special 5-year averaging provision of the bill.

*Arguments Against.*—(1) Opponents to any limitation on capital gains treatment of lump-sum pension distributions contend that the entire amount should continue to be taxed at capital gains rates, as they maintain that the fact that these amounts accrue over many years qualifies the distribution for special tax treatment.

(2) In the case of employer securities, the tax treatment of retirement plans involving these securities should be left unchanged because it is possible to consider an employee's participation in such a plan as if he had purchased the securities himself. Any change will be detrimental to the interests of the employees who have had the expectation of receiving capital gains treatment when they retire.

(3) The House bill does not go far enough in solving a basic tax inequity as a result of the tax advantage granted to lump-sum pension distributions in comparison with ordinary income treatment of all other pension distributions. There is other income in the lump-sum distribution which should appropriately be taxed as ordinary income, such as the dividends received on the trust accumulations.

(4) The present law properly taxes as a capital gain amounts received in one taxable year which are attributable to many taxable years.

**6. Sales of Life Estates, Etc.**

*Present law.*—Under present law, when a life estate and remainder interest in property are acquired by gift, by bequest, or through inheritance, the basis of the property is divided between the life estate and the remainder. The owner of the life interest is not permitted to deduct any portion of his basis over the life of his interest and thereby to reduce for tax purposes the amount of income he receives from his interest. However, where the life tenant sells his right to receive future income, his basis in the property may be used to reduce the gain he receives on the sale. The purchaser of the life estate is allowed to amortize his basis (his purchase price) and, therefore, is able to offset it against the income he receives from it.

*Problem.*—This treatment of life estates has the effect of allowing a large portion, and in some cases, almost all of the income from a life estate or similar interest to avoid taxation in those situations where the life tenant sells his interest. This is because the life tenant is not taxed on his income to the extent of his basis and, in addition, the purchaser of this interest is not taxed on most of the income from it because he is allowed to reduce that income by amortization deductions for the purchase price which he pays for the interest. In addition, in some cases the seller's basis has exceeded the amount he received upon its sale, and he has been permitted to take a deductible loss.

*House solution.*—The bill provides that the entire amount received on the sale or other disposition of a life (or term-of-years) interest in property, or an income interest in a trust (which was acquired by gift, bequest, inheritance, or by a transfer in trust), is to be taxable, rather than only the excess of the amount received over the seller's basis for his interest. This provision applies to sales or other dispositions after July 25, 1969.

The House bill, however, does not change present law where a life interest is disposed of as part of a single transaction in which the entire fee interest is transferred (e.g., where a life tenant and remainderman simultaneously join in a sale of the entire property interest) to any person or persons. In such a case, the gain realized by the life tenant is to be measured by the excess of the proceeds received on the disposition over his adjusted basis in the property.

*Argument For.*—The present tax law has the effect of allowing a large part, and in some cases almost all, of the income from a life estate to avoid taxation in those situations where the life tenant sells his interest. The life tenant is not taxed on the income he receives from the sale because he will usually have a tax basis equal to, or almost equal to, the sales price. This is regarded as particularly undesirable by those who view such transactions as an anticipatory assignment of income rather than as the sale of a property interest.

*Argument Against.*—A sale of a property interest is involved and therefore it is appropriate in measuring the amount of gain to reduce the proceeds by the amount of the life tenant's basis.

**7. Certain Casualty Losses Under Section 1231**

*Present law.*—Generally, under present law (sec. 1231(a) of the code), 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.

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 section 1231.

*Problem.*—The exception to the general section 1231 rule has lead 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.

*House solution.*—The bill modifies the treatment of casualty losses and casualty gains under section 1231. 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. Although it was intended that casualty losses and casualty gains on capital assets which are personal assets, such as a personal residence or a nonbusiness automobile, were to be subject to this special rule, they were not included through a drafting error.

The bill also clarifies the fact that uninsured casualty losses on personal assets are subject to the basic section 1231 provisions.

This provision applies to years beginning after July 25, 1969.

*Argument For.*—This provision eliminates the present unrealistic distinction under section 1231 between insured and partially insured casualty losses. In addition, it eliminates the possibility that a business taxpayer can deduct an uninsured casualty loss on business property in full from ordinary income, when he also has a larger casualty gain on insured business property which would be treated as a capital gain.

*Argument Against.*—The bill fails to recognize the objective behind the original adoption of present law in the Technical Amendments Act of 1958—that is, that taxpayers who self-insure their property should be able to deduct their losses in full (without any type of reduction) against ordinary income in the year of the loss in a manner similar to taxpayers who insure their property with insurance companies, and who are able to deduct their insurance premiums against ordinary income (without any reduction) as they are paid.

### 8. Transfers of Franchises

*Present law.*—Questions have arisen under present law as to whether the transfer of a franchise is to be treated as an outright sale or as a mere license, and whether franchisors are selling franchises in the ordinary course of business. Depending upon how these questions are resolved, the franchisor will receive ordinary income or capital gains treatment on the gain he realizes on the transfer of a franchise. At present, these problems must be resolved under general tax principles, and this has produced different results: i.e., capital gains in some situations and ordinary income treatment in others, despite factual similarities in the interests in the franchises transferred.

*Problem.*—On several occasions the Tax Court has held that the transfer of subfranchises was not a sale for tax purposes and that all gains therefrom were to be taxed as ordinary income. This position of the Tax Court has been accepted generally by two Circuit Courts of Appeals; however, three other circuit courts have found sales to exist in similar transactions and have allowed franchisors capital gains treatment. Since present law does not specifically deal with the tax treatment of the transfer of a franchise, and since this has resulted in a 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 a sale of a franchise constitutes the sale of a capital asset) there appears to be a need for legislation in this area.

*House solution.*—The House bill denies a franchisor capital gains treatment on the transfer of a franchise if he retains any significant power, right, or continuing interest with respect to the subject matter of the franchise.

In the event the franchise agreement includes significant conditions or restrictions which are subject to the franchisor's approval on a continuing basis, this power to exercise continuing, active, operational

control over the subfranchise will constitute the franchisor's retention of a significant power, right, or continuing interest. Moreover, if the franchisor's conduct constitutes participation in the commercial or economic activities of the subfranchise then this conduct will be regarded as a retention of a significant power, right, or continuing interest. The rule provided by the bill, however, does not apply with respect to amounts received or accrued in connection with a transfer of a franchise which is attributable to the transfer of all substantial rights to a patent, trademark, or trade name, to the extent the amounts are separately identified and are reasonable in amount. These rules will apply to transfers made after July 25, 1969.

*Argument For.*—The substantial growth of franchising throughout the United States in recent years, and the split of authority among the courts with respect to the proper tax treatment to be accorded the transfer of a franchise, necessitates the adoption of more definite guidelines in this area so that where a franchisor does not part with all his interest in a franchise then the transfer will not be entitled to capital gains treatment.

*Argument Against.*—On the other hand, it is argued that most transfers of franchises are more like sales than licenses and, accordingly should continue to receive capital gains treatment.

## V. 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" and even that amount is reduced after 20 months, at the rate of 1 percent per month, until 120 months, after which nothing is recaptured.

*Problem.*—The present tax treatment of real estate has been used by some high income 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. Moreover, because accelerated depreciation usually produces a deduction in excess of the actual decline in the usefulness of property, economically profitable real estate operations are normally converted into substantial tax losses, sheltering from

income tax such economic profits and permitting avoidance of income tax on the owner's other ordinary income, such as salary and dividends. Later the property can be sold and the excess of the sale price over the remaining basis can be treated as a capital gain to the extent that the recapture provisions do not apply. By holding the property for 10 years before sale, moreover, the taxpayer can arrange to have all the gain resulting from excess depreciation (which was offset against ordinary income) taxed as a capital gain without the recapture provisions coming into play. The tax advantages from such operations increase as a taxpayer's income moves into the higher tax brackets.

Because of the present tax situation, when investment is solicited in a real estate venture it has become the practice to promise a prospective investor substantial tax losses which can be used to diminish the tax on his income from other sources. Thus, there is, in effect, substantial dealing in "tax losses" produced by depreciable real property.

*House solution.*—The House bill revises real estate depreciation allowances to limit the opportunities to use the present treatment as a tax shelter and yet, at the same time, to maintain tax incentives to build low income housing where the need is great.

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 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.

*Arguments For.*—(1) This provision strikes a good balance between the need to curtail the availability of the real estate provisions as a tax shelter and the need to provide adequate incentives for the building of low income housing. Since the provision allows the most accelerated methods of real estate depreciation to be used for new residential housing, it continues the encouragement to build the residential housing needed to meet present housing shortages. On the other hand, by limiting new real estate other than residential housing to the 150-percent declining balance method, by limiting used buildings to straight line depreciation, and by strengthening the recapture provisions, the bill reduces the potential base of real estate as a tax shelter.

(2) Many economically profitable real estate operations produce substantial "tax losses" because of accelerated depreciation deductions

which are used to avoid income tax on the taxpayer's other income, such as salary and dividends, and in many cases result in the conversion of ordinary income into capital gain.

(3) Reducing depreciation deductions for slum and ghetto housing while continuing accelerated depreciation for new housing will make investments in slum housing less attractive and lead to its earlier demolition and replacement with modern housing, thus achieving a socially desirable goal.

(4) Recapturing real estate depreciation taken in excess of straight line depreciation at ordinary income tax rates not only simplifies this area of the tax law, but also it more closely recognizes that the larger deductions taken for depreciation reduced ordinary income (even though the property itself actually did not decrease in value) and should not now be allowed as a capital gain.

*Arguments Against.*—(1) There should be no change in the present tax treatment of real estate because of the pressing need to encourage the construction of more housing to eliminate the present housing shortages. This situation tends to imply that tax incentives have been deficient rather than excessive.

(2) Accelerated depreciation is a particularly appropriate incentive to real estate development in that it provides greater capital recovery during the uncertain earlier years when real property has to prove itself as a good or bad investment.

(3) The present recapture rules were carefully tailored to the peculiar requirements of the real estate industry and no case of favoritism has been established.

## W. COOPERATIVES [1]

*Present law.*—In determining taxable income under present law, cooperatives are permitted a deduction (or exclusion) for patronage dividends paid in money or in qualified patronage allocations. They also are permitted a deduction (or exclusion) for qualified per-unit retain certificates (that is, certificates issued to patrons to reflect the retention by the cooperative of a portion of the proceeds of the marketing of products for the patrons).

A patronage allocation, or per-unit retain certificate, is qualified—and therefore not taken into account by the cooperative—only if the patron consents to take it into account currently as income (or as a reduction in price in the case of purchases from the cooperative). Thus, in general, a cooperative is not taxed on patronage allocations or per-unit retains only if they are taxable to patrons. In the case of qualified patronage dividends, present law requires that 20 percent must be paid in money so that the patron will have all or part of the money to pay the tax.

*Problem.*—Qualified patronage allocations and qualified per-unit retains may be considered as amounts distributed by the cooperative to its patrons and reinvested in the cooperative as capital. However, the patron often does not have an independent choice between investing them in the cooperative or retaining them for his own use. This

[1] Witnesses did not testify to this change in the law during the Ways and Means Committee hearings.

choice is frequently made by the members as a group, and it may govern the use of a patron's funds even though he is not a member, or became a member after the cooperative's practices in this regard were established. Nevertheless, he is taxed as though he had full dominion over the entire patronage allocation or per-unit retain. Moreover, although most cooperatives revolve out these funds—on which the patron has already paid the tax—within 4 to 15 years, some cooperatives retain them indefinitely.

*House solution.*—Under the bill cooperatives are to be required to revolve out patronage dividends and per-unit retains within 15 years from the time the written notice of allocation is made or the per-unit retain certificate is issued. In addition, the percentage of patronage allocations which must be paid out currently in cash, or by qualified check, is increased from 20 percent to 50 percent. The additional 30 percent may be paid with respect to the current allocation or in redemption of prior allocations. The increase in the required payout is phased in ratably over a 10-year period. These provisions apply to taxable years beginning after 1969.

*Arguments For.*—(1) By requiring the cooperative to pay to the patron all of the patronage dividends or per-unit retains within 15 years, the bill assures the patron that he will eventually receive the patronage income on which he has been taxed. It is often argued, in fact, that the patron should receive this money earlier.

(2) Farmers today have little dominion over the treatment of patronage dividends despite the fact that they must pay tax on them as if they did. The bill will give them full control over one-half of the patronage dividend immediately with assurances that the remaining one-half (retained by the cooperative) will be paid out to them in 15 years. This greater control over the income on which they are taxed makes the tax more equitable.

(3) By requiring cooperatives to pay out more of their income currently the amounts they can retain tax-free for expansion of facilities in competition with fully tax-paying businesses is lessened. This is a desirable way of limiting the tax-free growth of business enterprises.

*Arguments Against.*—(1) The House bill fails to recognize the significance of the present rules whereby the patron in effect is given an option to accept the patronage dividend and pay a tax on it. Those rules were carefully devised to assure a single tax would always be collected on the earnings of cooperative enterprises and the bill does nothing to improve on present law in this respect.

(2) The bill ignores the role farm cooperatives play in improving the incomes of farmers by providing them with alternative methods of marketing their crops or of acquiring farm equipment, machinery and supplies at reasonable prices.

(3) There is no showing that the present balance between farm cooperatives and regular businesses should be upset to the detriment of the cooperative movement.

(4) The requirements for an early payout of patronage dividends and retains will impair the working capital of the cooperative, since these amounts represent, in effect, the cooperative's equity capital and serve as a base to support its borrowings.

# X. SUBCHAPTER S CORPORATIONS

*Present law.*—Subchapter S of the Internal Revenue Code was enacted in 1958 to provide tax relief for small business corporations (those with 10 or fewer shareholders) by allowing them to elect not to be taxed as a corporation, but instead to have the income or loss of the corporation taxed directly to the shareholders in a pattern roughly similar to that of partnership taxation. 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.

*Problem.*—The H.R. 10 limitations on retirement income plans described above (do not apply to corporations and so may be avoided by a proprietor or the partners of a partnership by forming a corporation, electing subchapter S treatment, and then becoming employees of the corporation. By the same token, a business that had incorporated without contemplating a subchapter S election can avoid the burden of the corporate tax while retaining its broad corporate retirement plans.

*House solution.*—The House 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. This provision applies to taxable years of subchapter S corporations beginning after 1969.

*Argument For.*—If an enterprise wants to incorporate for business purposes, but wants to be taxed in a manner similar to a partnership, then it should be subject to the same H.R. 10 limitations as partnerships in the case of pension plan contributions it makes on behalf of its owner-employees.

*Arguments Against.*—(1) Subchapter S corporations are in fact corporations; the subchapter S election doesn't entitle them to partnership taxation but rather to tax treatment in a manner similar to the partnership rules, and these special rules do not provide all the benefits of partnership taxation.

(2) H.R. 10 limitations are too restrictive and should be revised in a more reasonable manner possibly on a comparable basis with the corporate plans.

(3) The process of revising all the existing plans presents an unbearable burden.

(4) This change in the law should await a Congressional review of

the overall treatment of pension plan contributions and benefits, including the Treasury Department study of 1965.

## Y. TAX TREATMENT OF STATE AND MUNICIPAL BONDS [1]

*Present law.*—Interest payments on obligations of State and local governments generally are exempt from Federal income tax, an exemption that has been provided ever since the Federal income tax was adopted in 1913.

*Problem.*—The tax savings for individuals and corporations from the purchase of tax-exempt bonds has been greater than the differential between the interest yields on tax-exempt and taxable bonds. As a result, it has been estimated that the interest savings to State and local governments was $1.3 billion in 1968, but the tax revenue loss of the Federal Government was $1.8 billion.

In addition some State and local governments have issued arbitrage bonds whose proceeds are invested in Treasury bonds which pay a higher interest yield than the issuer's tax-exempt yield. The issuer retains the differential between the interest yields as an addition to its revenues.

*House solution.*—State and local governments are given the voluntary election to issue taxable bonds. If they make this choice, the Federal Government will pay between 25 and 40 percent of the interest on the bond (between 30 and 40 percent through the end of 1974). The Secretary of the Treaury will determine and publish the percentage for the Federal payment before the first day of each calendar quarter, and the percentage will apply for the entire life of all taxable bonds issued during that quarter. The Federal payments will be made under a permanent appropriation no later than the time when the issuing government must pay the interest on its bonds. This provision applies to issues made in calendar quarters that begin after the date of enactment.

Federal income tax exemption would no longer apply to arbitrage bonds issued after July 11, 1969.

*Arguments For.*—(1) The election to issue taxable bonds is voluntary on the part of State and local governments, and the Federal Government automatically makes the interest payments if they so elect. Since this provision is voluntary on the part of States and local governments none need elect it unless it works to their advantage.

(2) The Federal Government will have no powers of review over the purpose for which the bonds are issued or the capacity of the issuing government to repay its debt and, as a result, there will be no Federal control of the program.

(3) Because of the higher yield on the taxable bonds, the market for State and local bonds will be broadened.

(4) The Federal subsidy provided by the bill will be offset—possibly more than offset—by increased taxes as the portion of the interest on the bond paid by State municipal governments moves from nontaxable to taxable status.

(5) The provision would help eliminate the stimulus present tax exemption exerts on wealthy individuals to purchase State and local government obligations for tax reasons, thereby diverting their investments from areas more economically justified.

---

[1] See also discussion under Limit on Tax Preferences, page 47, and Allocation of Deductions, page 48.

*Arguments Against.*—(1) The provision opens the way to complete repeal of the State and local tax exemption.

(2) It does not avoid the constitutional question as to whether Congress has the power to tax the income from State and local obligations; if the Constitution prohibits the Federal Government from taxing these obligations the Constitution cannot be made inapplicable at the election of a State or municipal government. The provision is a further incursion of the Federal Government into the affairs of State and local governments and in this respect it runs counter to the goal of decentralized government.

(3) It is argued that commercial banks which are the most significant purchasers of tax-exempt bonds may reduce their purchases when the issues are taxable in light of other provisions in the bill that increase the effective rate of taxation on commercial bank net income.

## Z. EXTENSION OF TAX SURCHARGE AND EXCISE TAXES; TERMINATION OF INVESTMENT CREDIT

### 1. Extension of Tax Surcharge at 5-Percent Annual Rate for First Half of 1970.

*Present law.*—The Revenue and Expenditure Control Act of 1968 adopted a 10-percent surcharge on the tax liabilities of individuals and business corporations in order to dampen inflationary pressures and keep the economy under control. The 10-percent surcharge expired as of June 30, 1969. H.R. 9951 extended the 10-percent surcharge for the period from July 1, 1969, through December 31, 1969.

*Problem.*—The extension of the surcharge until the end of calendar year 1969 provided by H.R. 9951 will help combat the inflationary pressures which are rampant in the economy. However, these inflationary pressures are now so strong that some extension of the surcharge through the first half of 1970 may be necessary in order to finish the job of bringing the economy under control. The gross national product is still rising sharply, the consumer price index and the wholesale price index have risen at an annual rate of over 6-percent since the end of last year and our financial and money markets are showing marked signs of strain.

*House solution.*—The House bill provides that the surcharge on the tax liabilities of individuals and corporations which, under H.R. 9951, is scheduled to expire on December 31, 1969, shall be continued at a 5-percent annual rate for the period from January 1, 1970, until June 30, 1970. Since this 5-percent surcharge will be applicable only for the first half of 1970, the surcharge for the entire year 1970 will be 2½-percent for a calendar-year taxpayer.

*Note.*—This provision was included in H.R. 12290, the bill to repeal the 7 percent investment tax credit, to extend the 10 percent income tax surcharge, and for other purposes. It was approved by the Committee on Finance when the Committee ordered that bill reported in July. For that reason no position for or against it is stated.

### 2. Continuation of Excise Taxes on Communication Services and Automobiles

*Present law.*—The excise tax on passenger automobiles presently is 7 percent and the excise tax on local and toll telephone services and teletypewriter exchange services presently is 10 percent. Both rates

are scheduled to decline to 5 percent on January 1, 1970, 3 percent on January 1, 1971, 1 percent on January 1, 1972, and to be repealed on January 1, 1973.

*Problem.*—It appears inappropriate to reduce these excise taxes during a period of serious inflationary pressures when the Federal Government has imposed an income tax surcharge and is applying other forms of fiscal and monetary restraints to control the inflationary pressures.

*House solution.*—The scheduled reductions which were to begin on January 1, 1970, are delayed for 1 year. As a result, the 5 percent excise tax rates will become effective on January 1, 1971, the 3 percent rate on January 1, 1972, and the 1 percent rate on January 1, 1973, and the repeal of these excise taxes will take effect on January 1, 1974.

*Note.*—This provision was included in H.R. 12290, the bill to repeal the 7 percent investment tax credit, to extend the 10 percent income tax surcharge, and for other purposes. It was approved by the Committee on Finance when the Committee ordered that bill reported in July. For that reason no position for or against it is stated.

**3. Repeal of the Investment Credit**

*Present law.*—Present law provides a 7-percent tax credit (3 percent for public utility property) for qualified investment in: (1) tangible personal property; (2) other property (not including buildings and structural components) which is an integral part of manufacturing or production, or a research or storage facility; and (3) elevators and escalators.

To qualify, the property must be depreciable and have a useful life of four years or more. New property fully qualifies for the credit. Up to $50,000 of used property can be taken into account in any year.

Property with a useful life of from four to six years qualifies for the credit to the extent of one-third of its cost. Property with a useful life of six to eight years, qualifies to the extent of two-thirds of the investment. If the property has a useful life of eight years or more, the full amount qualifies.

The amount of the investment credit taken in any year may not exceed the first $25,000 of tax liability plus 50 percent of the tax liability in excess of $25,000. Investment credits which, because of this limitation, cannot be used in the current year may be carried back to the three prior years and carried forward to the succeeding 7 taxable years.

*Problem.*—The investment credit does not appear to be suited to present conditions. The credit was designed to provide a tax inducement for businessmen to modernize their equipment and expand productive capacity. Since 1962, business has invested almost $400 billion in new plant and equipment, and it would appear that there is no reason to grant a tax inducement for new investment now.

The current outlook is that plant and equipment expenditures will reach record levels in 1969. The most recent Commerce Department—SEC survey indicates that such expenditures will reach $72.2 billion in 1969—12.5 percent more than was spent for this purpose in 1968. Much of this investment results from the present inflationary psychology which induces businessmen to increase plant and equipment spending beyond normal levels in an attempt to avoid higher costs in later years.

33-865 O—69—pt. 1——8

In such a situation, business investment should not be stimulated. Instead, such investment should be moderated in order to contain an overactive economy and reduce inflationary pressures.

The investment credit cannot be turned on and off quickly to adjust to current economic conditions. In 1966, the credit was suspended temporarily in order to reduce the inflationary impact of large investment expenditures; but the investment credit continued to have an expansionary impact on some investments beyond the cutoff date as a result of transition provisions and carryovers of unused credits. In other cases, there was distortion in the investment process because businessmen postponed normal investments in anticipation of the time when the credit would be restored.

*House solution.*—The House bill provides for the permanent repeal of the investment credit in the case of property acquired, or the construction of which is begun, after April 18, 1969. The bill also provides an exception to this general rule under which the credit is to continue to be available for property constructed or acquired under a binding contract entered into before April 19, 1969. A number of other transition rules are also provided by the bill under which the credit will continue to be available in situations where, although a binding contract is not involved, a substantial portion of the property in question had been acquired, constructed, or contracted for prior to April 19, 1969. The transition rules in the bill are generally the same as those provided in the legislation which temporarily suspended the investment credit in 1966.

The bill also provides for the "phaseout" of the investment credit in the case of property placed in service after 1970 (which generally would be eligible for the credit under a transition rule). Under this "phaseout," the credit is to be reduced by one-tenth of one percentage point for each full calendar month after November 1970 and the date the property is placed in service. In addition, no credit will be allowable for property placed in service after 1974.

The bill also places a limit on the extent to which taxpayers may carry over unused investment credits to 1969 and subsequent years. As of the end of 1968 these unused investment credits amounted to an estimated $2 billion. Under the limitation provided by the bill, the credit taken in a year after 1968, attributable to carryovers, cannot exceed 20 percent of the aggregate amount of unused investment credits otherwise available as carryovers to the year in question (or to any prior year after 1968 if the carryovers to that year are higher than in the current year). This limitation is in addition to the general 50 percent of the tax liability limitation on the amount of credit which may be claimed in a year. The bill also retains the present length of the carryover periods (3 years back and 7 years forward).

*Note.*—This provision was included in H.R. 12290, the bill to repeal the 7 percent investment tax credit, to extend the 10 percent income tax surcharge, and for other purposes. It was approved by the Committee on Finance when the Committee ordered that bill reported in July. For that reason no position for or against it is stated.

**4. Amortization of Pollution Control Facilities**

*Present law.*—Under present law, a taxpayer may claim an investment credit with respect to pollution control facilities to the extent

they involve property of a type generally eligible for the investment credit.

*Problem.*—There is a present need for industry to install facilities that will remove pollutants and contaminants from air and water discharged after use in production processes. Since termination of the investment credit will remove to some extent the financial offsets to the costs of these facilities, an alternative form of incentive may be viewed as desirable.

*House solution.*—The bill provides that a taxpayer will be allowed to amortize over a period of 60 months any new certified air or water pollution control facility that is identifiable as a separate treatment facility. The amortization deduction would be taken in place of the regular depreciation deduction. The amortization deduction generally would be available only for a pollution control facility that is constructed after 1965 and that is certified by the appropriate State and Federal Authorities as being in conformity with relevant programs and requirements for the abatement or control of air or water pollution. The amortization is to be available for taxable years ending after 1968.

*Note.*—This provision was included in H.R. 12290, the bill to repeal the 7 percent investment tax credit, to extend the 10 percent income tax surcharge, and for other purposes. It was approved by the Committee on Finance when the Committee ordered that bill reported in July. For that reason no position for or against it is stated.

**5. Amortization of Certain Railroad Rolling Stock**

*Present law.*—A taxpayer may claim an investment credit with respect to railroad rolling stock to the extent they are property of a type for which the investment credit generally is available. Under present depreciation guidelines, the useful life of rolling stock is 14 years.

*Problem.*—The railroad industry generally has been in poor financial condition for many years. The investment credit made a substantial contribution to the modernization of railroad equipment and in increasing railroad efficiency by improving the ability of the railroads to finance the acquisition of new equipment.

*House solution.*—Domestic common carrier railroads subject to regulation by the Interstate Commerce Commission may elect to amortize all railroad rolling stock (except locomotives) over a period of 84 months. (The bill erroneously provides for 7-year depreciation, instead of amortization). The provision applies to eligible rolling stock that is constructed or acquired and put into original use after July 31, 1969.

*Arguments For.*—(1) Amortization is an appropriate incentive because it permits a rapid recovery of the costs involved and does not extend a return in excess of actual total costs.

(2) Amortization is preferable to accelerated depreciation because it permits a complete write-off of the equipment without adjustment for salvage value.

(3) Amortization is preferable to depreciation because it does not entail adjustment for the restrictions required by the "reserve ratio test" in the depreciation guidelines.

(4) On the other hand, the amortization provision does not extend to companies which purchased railroad rolling stock eligible for the investment credit and leased the equipment to railroads.

(5) Since it appears the 7-percent investment tax credit will be repealed without industry exemptions, some other form of stimulus—such as amortization—must replace it or the railroads will be unable to attract capital needed to modernize and expand their rolling stock.

*Arguments Against.*—(1) Repealing the 7-percent investment tax credit and replacing it with amortization is just substituting one tax preference for another.

(2) If there is freight to be hauled, the profit motive is all the incentive needed to assure that the necessary rolling stock will be acquired.

(3) The depreciation practices of the railroad industry are already among the most complex of any industry, and this provision compounds the complexity without adding greatly to the cash flow they presently can generate through accelerated depreciation.

## AA. ADJUSTMENT OF TAX BURDEN FOR INDIVIDUALS

### 1. Increase in Standard Deduction

*Present law.*—Under present law, a taxpayer in computing taxable income may itemize his deductions, or may take the larger of the minimum standard deduction or the 10 percent standard deduction. The minimum standard deduction is $200 plus $100 for each exemption, and the regular standard deduction is 10 percent of adjusted gross income. Both forms of the standard deduction are limited to $1,000 ($500 in the case of a married individual filing a separate return).

*Problem.*—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. Since that time, higher medical costs, higher interest rates, higher State and local taxes, increased home-ownership, and more expensive homes have encouraged more and more taxpayers to itemize their deductions. In addition, itemization has been encouraged by rising incomes which have moved more and more taxpayers beyond the $10,000 income level where the $1,000 standard deduction ceiling first becomes applicable. The effect of higher incomes and increased expenses has been to decrease the proportion of returns using the standard deduction from 82 to 58 percent.

*House solution.*—The House bill increases the 10-percent standard deduction and $1,000 ceiling to 15 percent with a $2,000 ceiling in three stages: in 1970 to 13 percent with a $1,400 ceiling, in 1971 to 14 percent with a $1,700 ceiling, and in 1972 to 15 percent with a $2,000 ceiling. The increase was made in three stages to avoid an excessive revenue loss in 1970 and 1971.

*Arguments For.*—(1) The 15-percent standard deduction with a $2,000 ceiling will result in substantial simplification. This combined with the $1,100 low-income allowance also contained in the bill will cause a total of 11.8 million or 37 percent of all itemizers to

switch to the standard deduction. The proportion of returns using the standard deduction as a result of the low-income allowance and the higher standard deduction taken together will be nearly 74 percent.

(2) This higher standard deduction also will provide a tax reduction to a substantial number of taxpayers. By itself, the 15 percent, with a $2,000 ceiling will reduce taxes by $2.4 billion for 33.7 million returns or more than 53 percent of taxable returns. After the low-income allowance of $1,100, it will provide a tax reduction of $1.4 billion for approximately 16.7 million returns or 29 percent of the returns which remain taxable after the low-income allowance.

(3) In 1944, when the standard deduction was first added to the tax law, 82.2% of the individual tax returns filed used the standard deduction in lieu of itemizing. However, by 1965 only 58.8% of the returns filed used this deduction. The bill will help to restore the use of the standard deduction to the 1944 levels.

(4) The provision will reduce the number of income tax returns which will need to be audited by the Internal Revenue Service.

*Arguments Against.*—(1) If the standard deduction is liberalized, tax incentives for making contributions to charity will be reduced for many taxpayers.

(2) The standard deduction permits two taxpayers, in the same family circumstances and with the same adjusted gross income, to pay the same tax even though these two taxpayers incur substantially different amounts of itemizable expenses. Raising the standard deduction will, of course, increase this inequity.

(3) Other provisions of the bill provide rate reductions to all individual taxpayers. The increase in the amount of the standard deduction will, in effect, provide additional reduction of tax liability to many of the same individuals and amounts to a doubling of tax benefits.

(4) The 15-percent standard deduction with a $2,000 ceiling involves too great a revenue loss. Furthermore, it is noted that the doubling of the ceiling (from $1,000 to $2,000) provides larger percentage tax decreases to taxpayers in the $10,000 to $15,000 income range than to any other group.

**2. Low-Income Allowance**

*Present law.*—The minimum standard deduction is $200 plus $100 for each personal exemption up to a total of $1,000.

*Problem.*—Inflationary price increases have had their most severe impact in the erosion of the already inadequate purchasing power of the poor. In addition, recent studies of the economic conditions of the poor by the Department of Health, Education, and Welfare have indicated, even with the present minimum standard deduction, many persons with incomes below the poverty level are subject to tax and, in addition, substantial tax burdens are imposed on those with incomes immediately above the poverty levels.

*House solution.*—The bill replaces the minimum standard deduction with a low income allowance of $1,100 for each taxpayer. The level of taxation for each taxpayer, thus, will begin where adjusted gross income exceeds the $1,100 low income allowance plus the number of personal exemptions the taxpayer may claim. The low income allowance will be available for 1970 and later years.

In 1970 only, the bill provides a phaseout 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 adjusted gross income exceeds the nontaxable income level. The phaseout is repealed after calendar year 1970.

*Note.*—This provision was included in H.R. 12290, the bill to repeal the 7 percent investment tax credit, to extend the 10 percent income tax surcharge, and for other purposes. It was approved by the Committee on Finance when the Committee ordered that bill reported in July. For that reason no position for or against it is stated.

However it is observed that the phaseout of the low-income allowance is deleted with respect to years after 1970, raising the cost of the allowance by $2 billion.

### 3. 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.

*Problem.*—The present tax rates with a maximum of 70 percent seem unrealistically high especially in the case of earned income. They appear to have some disincentive effect and motivate taxpayers to use and develop methods of tax avoidance. 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. The high rates also take what can be considered an excessive portion of the income of those who are unable to shelter their earned income from the full impact of these rates.

*House solution.*—The House-passed 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 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.

*Argument For.*—(1) While it is not feasible to reduce the tax rates in excess of 50 percent to 50 percent for all types of income at the present time because of the revenue cost, a reduction in the tax rates applicable to earned income to a maximum of 50 percent should substantially reduce the pressure to use and develop tax loopholes. Since the disincentive effect of high tax rates on effort is greatest in the case of earnings, it is most efficient to focus the 50 percent limit on earned income.

(2) High tax rates on *earned* income (wages, salaries, and fees) reduces personal initiative because the high bracket taxpayer receives only a small marginal amount of "after tax" income for any additional work.

*Arguments Against.*—(1) This provision is a "loophole for those persons without loopholes." The income tax base should be broadened with the rates on that tax base made substantially lower.

(2) There is no reason for lowering the tax rate if the "ability to pay" theory of a progressively graduated income tax structure is accepted.

(3) The main objection to the maximum rate of 50 percent on earned income is that it limits the top rate of 50 percent to one type of income instead of making rate reduction generally applicable. For example, instead of a 65 percent top rate for unearned income and a 50 percent top rate for earned income it might be argued that it would be preferable to make the top rate 60 percent for all types of income.

**4. Intermediate Tax Rates: Surviving Spouse Treatment**

*Present law.*—Since the Revenue Act of 1948, married couples filing joint returns have had the option of being taxed under the split-income provision. This, in effect, taxes a married couple as if it were composed of two single individuals each with one-half the couple's combined income. This 50–50 split of income between the spouses for tax purposes generally produces a lower tax than any other division of income since the application of the graduated tax rates separately to each of the two equal parts comprising the couple's income keeps the total income in lower tax brackets.

Single people generally do not have a comparable income splitting privilege. As a result they pay higher taxes than married couples at the same income levels.

In 1951, a head-of-household provision was enacted to grant partial income-splitting to widows, widowers, and single persons with dependents in their households. Individuals who qualify under this provision are allowed approximately one-half of the income-splitting benefits given to married couples. These heads of household use a different tax rate schedule which, at any given level of income, produces a tax liability about halfway between the tax paid by a married couple filing a joint return and a single individual.

Beginning in 1954 surviving spouses with dependent children were permitted to use the joint return tax rates with full income splitting for two taxable years following the year of death of the husband or wife.

*Problem.*—Widows, widowers, and unmarried individuals who do not support dependents in a household cannot qualify for head-of-household treatment under present law. As a result, such individuals are taxed as single individuals and do not receive the income-splitting benefits accorded to heads of households (that is, one-half the income-splitting benefits granted to married couples filing joint returns). It is argued that this treatment places unduly heavy tax burdens on mature single individuals, widows and widowers. Such individuals more often than not have to incur the expense of maintaining a household; and in any event, it is maintained, they should receive some income splitting in order to be treated fairly compared with married couples. Moreover, for widows and widowers present law is said to be harsh in that it withdraws all the benefits of income splitting after their spouse dies despite the fact that they may continue to have relatively heavy living expenses.

*House solution.*—The House bill extends the benefits of income splitting to specified groups of individuals whose taxes are deemed to be too heavy under present law.

Under the bill, widows and widowers, regardless of age, and unmarried individuals age 35 and over are to be taxed at rates which are halfway between the rates available to married couples and those previously available to single persons. This intermediate tax rate treatment was formerly known as head-of-household treatment. This provision applies to years beginning after 1970.

The bill also provides that a widow, or widower, with a dependent child in the household is to receive the full income splitting benefits available to married couples for as long as she or he continues to support the child in her or his household and is entitled to a dependency exemption for the child (rather than just two years after the person's spouse has died as at present). Generally, this treatment will be available where the child is age 19 or less or is attending school or college. This provision applies to years beginning after 1969.

*Arguments For.*—(1) The House provision extends relief to large numbers of mature single individuals and surviving spouses whose taxes are now relatively heavy compared with those paid by married couples at the same income levels. This is favored by those who generally believe that the split-income provision grants excessive tax reductions to married couples and places too heavy burdens on single people generally.

(2) Surviving spouses with a dependent child continue to have the full obligations of a married couple toward their children after their spouses die. Therefore, they should continue to receive full income-splitting.

*Arguments Against.*—(1) The selection of age 35 as the age at which individuals should receive a more favorable tax treatment is arbitrary. Many single individuals, of that age or older, with considerably different economic situations will be receiving the same tax treatment while those of slightly different ages but similar incomes will be taxed differently.

(2) A more favorable result for the Treasury—but one producing equity for single persons—would be reached if income splitting for married taxpayers were repealed instead of extending split income tax relief to certain single individuals.

(3) The provision is adverse to marriage because two individuals eligible for the intermediate tax rates (which confer one-half the full income-splitting benefits accorded married couples) could find their combined tax liabilities increased as a result of marriage. However, there is some question whether marriage is significantly affected by such tax considerations.

**5. Individual Income Tax Rates**

*Present law.*—Present law tax rates range from 14 percent to 70 percent on taxable income in excess of $100,000 for a single taxpayer and $200,00 for a joint return (see the rate schedule, p. 105).

*Problem.*—The present tax rates are considered by many to be too high. They take an excessive portion of the income from those subject to the full impact of the rates. Such high rates also encourage many taxpayers to shelter their income from the top rates by using tax avoidance techniques which have frequently developed into tax loopholes.

*House solution.*—The House bill reduces all tax rates by at least one percentage point and reduces the top bracket rate from 70 percent to 65 percent. In all brackets this is a tax reduction of 5 percent or more. The reduction is to take place in two stages because of the

revenue loss: half in 1971, and the full reduction in 1972. (See the rate schedule below).

INDIVIDUAL INCOME TAX RATE SCHEDULE UNDER PRESENT LAW AND UNDER H.R. 13270 FOR CALENDAR YEARS 1971 AND 1972

| Taxable income bracket | | Tax rate (percent) | | |
|---|---|---|---|---|
| Single person not eligible for intermediate rates | Married (Joint) | Present law | House bill | |
| | | | 1971 | 1972 |
| $000 to $500 | $000 to $1,000 | 14 | 13.5 | 13 |
| $500 to $1,000 | $1,000 to $2,000 | 15 | 14.5 | 14 |
| $1,000 to $1,500 | $2,000 to $3,000 | 16 | 15.5 | 15 |
| $1,500 to $2,000 | $3,000 to $4,000 | 17 | 16.5 | 16 |
| $2,000 to $4,000 | $4,000 to $8,000 | 19 | 18.5 | 18 |
| $4,000 to $6,000 | $8,000 to $12,000 | 22 | 21.5 | 21 |
| $6,000 to $8,000 | $12,000 to $16,000 | 25 | 24 | 23 |
| $8,000 to $10,000 | $16,000 to $20,000 | 28 | 27.5 | 27 |
| $10,000 to $12,000 | $20,000 to $24,000 | 32 | 31 | 30 |
| $12,000 to $14,000 | $24,000 to $28,000 | 36 | 35 | 34 |
| $14,000 to $16,000 | $28,000 to $32,000 | 39 | 38 | 37 |
| $16,000 to $18,000 | $32,000 to $36,000 | 42 | 41 | 40 |
| $18,000 to $20,000 | $36,000 to $40,000 | 45 | 43.5 | 42 |
| $20,000 to $22,000 | $40,000 to $44,000 | 48 | 46 | 44 |
| $22,000 to $26,000 | $44,000 to $52,000 | 50 | 48.5 | 47 |
| $26,000 to $32,000 | $52,000 to $64,000 | 53 | 51 | 49 |
| $32,000 to $38,000 | $64,000 to $76,000 | 55 | 52.5 | 50 |
| $38,000 to $44,000 | $76,000 to $88,000 | 58 | 55 | 52 |
| $44,000 to $50,000 | $88,000 to $100,000 | 60 | 57 | 54 |
| $50,000 to $60,000 | $100,000 to $120,000 | 62 | 60 | 58 |
| $60,000 to $70,000 | $120,000 to $140,000 | 64 | 62 | 60 |
| $70,000 to $80,000 | $140,000 to $160,000 | 66 | 63 | 60 |
| $80,000 to $90,000 | $160,000 to $180,000 | 68 | 64.5 | 61 |
| $90,000 to $100,000 | $180,000 to $200,000 | 69 | 65 | 61 |
| $100,000 to $120,000 | $200,000 to $240,000 | 70 | 66 | 62 |
| $120,000 to $150,000 | $240,000 to $300,000 | 70 | 66.5 | 63 |
| $150,000 to $200,000 | $300,000 to $400,000 | 70 | 67 | 64 |
| $200,000 and over | $400,000 and over | 70 | 67.5 | 65 |

*Arguments For.*—(1) It is appropriate to redistribute the tax burden by closing loopholes and eliminating preferences on the one hand, and lowering tax rates on the other.

(2) Tax reduction is justified on the grounds that present rates are unrealistic and have been instrumental in encouraging the development of tax avoidance devices and tax shelters. Lower tax rates reduce the incentive to use and devise methods of avoiding tax and reduce the disproportionate influence of tax considerations on economic decisions, both socially desirable goals.

*Arguments Against.*—(1) Tax rates should not be reduced (even on a prospective basis) during a period when inflation is so strong, and further extension of the income tax surcharge is being considered to combat it.

(2) One objection to the reduction of all tax rates is that the revenue cost is $4.5 billion. This amount unbalances the reform and relief program in contrast to the rate schedule in the bill as reported by the Ways and Means Committee. That rate schedule roughly balanced the revenue gain from tax reform and the revenue loss from tax relief.

### 6. Collection of Income Tax at Source on Wages

*Present law.*—Present law provides withholding tables and a percentage withholding method which incorporates the $600 personal exemption, the minimum standard deduction, the 10 percent standard deduction, and the tax rates.

*House solution.*—The withholding rates and tables incorporate the changes made in the minimum standard deduction (the low income allowance), the 10 percent standard deduction, and the tax rates.

# PART 3

## STATISTICAL MATERIAL—TABLES

(107)

# PART 3

## STATISTICAL MATERIAL—TABLES

TABLE 1.—THE BALANCING OF TAX REFORM WITH TAX RELIEF UNDER H.R. 13270 WITH MODIFIED RATE REDUCTION—CALENDAR YEAR TAX LIABILITY

[In millions of dollars]

| | 1970 | 1971 | 1972 | 1974 | 1979 |
|---|---|---|---|---|---|
| Tax reform program | +1,640 | +2,050 | +2,180 | +2,600 | +3,555 |
| Repeal of investment credit | +2,500 | +3,000 | +3,000 | +3,100 | +3,300 |
| Tax reform and repeal of investment credit | +4,140 | +5,050 | +5,180 | +5,700 | +6,855 |
| Income tax relief | −1,692 | −6,787 | −9,273 | −9,273 | −9,273 |

Note: The tax surcharge extension ($3,100,000,000 liability for 1970) and the excise tax extension ($1,170,000,000' $800,000,000, $800,000,000, and $400,000,000 for 1970 through 1973, respectively) are not included above because of their impermanent character.

TABLE 2.—BALANCING OF TAX REFORM AND TAX RELIEF—CALENDAR YEAR TAX LIABILITY

[In millions of dollars]

| | 1970 | 1971 | 1972 | 1974 | 1979 |
|---|---|---|---|---|---|
| Tax reform program | +1,640 | +2,050 | +2,180 | +2,600 | +3,555 |
| Repeal of investment credit | +2,500 | +3,000 | +3,000 | +3,100 | +3,300 |
| Tax reform and repeal of investment credit | +4,140 | +5,050 | +5,180 | +5,700 | +6,855 |
| Income tax relief: | | | | | |
| Low income allowance | −625 | −625 | −625 | −625 | −625 |
| Removal of phaseout on low income allowance | | −2,027 | −2,027 | −2,027 | −2,027 |
| Increase in standard deduction [1] | −867 | −1,086 | −1,373 | −1,373 | −1,373 |
| Rate reduction | | −2,249 | −4,498 | −4,498 | −4,498 |
| Maximum 50-percent rate on earned income | −200 | −150 | −100 | −100 | −100 |
| Intermediate tax treatment for certain single persons, etc | | −650 | −650 | −650 | −650 |
| Total reductions | −1,692 | −6,787 | −9,273 | −9,273 | −9,273 |

[1] 1970: 13 percent, $1,400 ceiling; 1971: 14 percent, $1,700 ceiling; 1972: 15 percent, $2,000 ceiling.

Note: The tax surcharge extension ($3,100,000,000 liability for 1970) and the excise tax extension ($1,170,000,000, $800,000,000, $800,000,000 and $400,000,000, for 1970 through 1973, respectively) are not included above because of their impermanent character.

(109)

TABLE 3.—INDIVIDUAL INCOME TAX LIABILITY—TAX UNDER PRESENT LAW AND AMOUNT AND PERCENTAGE OF CHANGE UNDER REFORM AND RELIEF PROVISIONS WHEN FULLY EFFECTIVE

| AGI class | Tax under present law (millions) | Increase (+) decrease (−), from reform and relief provisions (taking into account committee amendment) Amount (millions) | Percentage | Percentage tax decrease under original rate schedule | Additional percentage point reduction from modified rate schedule |
|---|---|---|---|---|---|
| $0 to $3,000 | $1,169 | −$775 | −66.3 | −64.0 | 2.3 |
| $3,000 to $5,000 | 3,320 | −1,049 | −31.6 | −27.3 | 4.3 |
| $5,000 to $7,000 | 5,591 | −996 | −17.8 | −12.3 | 5.5 |
| $7,000 to $10,000 | 11,792 | −1,349 | −11.4 | −6.5 | 4.9 |
| $10,000 to $15,000 | 18,404 | −1,932 | −10.4 | −6.0 | 4.4 |
| $15,000 to $20,000 | 9,184 | −775 | −8.4 | −5.4 | 3.0 |
| $20,000 to $50,000 | 13,988 | −976 | −7.0 | −5.1 | 1.9 |
| $50,000 to $100,000 | 6,650 | −365 | −5.5 | −5.0 | .5 |
| $100,000 and over | 7,686 | +324 | +4.2 | +4.2 | |
| Total | 77,884 | −7,893 | −10.1 | −7.0 | 3.1 |

TABLE 4.—TAX RELIEF PROVISIONS AFFECTING INDIVIDUALS AND TOTAL FOR ALL REFORM AND RELIEF PROVISIONS AFFECTING INDIVIDUALS, WHEN FULLY EFFECTIVE, BY ADJUSTED GROSS INCOME CLASS, 1969 LEVELS

[In millions of dollars]

| AGI class | Reform provisions | Low income allowance | Elimination of phaseout | 15-percent $2,000 standard deduction | General rate reductions | Maximum tax on earned income | Intermediate tax treatment | Total relief provisions | Total, all provisions |
|---|---|---|---|---|---|---|---|---|---|
| 0 to $3,000 | +16 | −552 | −202 | | −27 | | −10 | −791 | −775 |
| $3,000 to $5,000 | −3 | −72 | −788 | | −141 | | −45 | −1,046 | −1,049 |
| $5,000 to $7,000 | +3 | −1 | −594 | | −329 | | −75 | −999 | −996 |
| $7,000 to $10,000 | +7 | | −335 | −228 | −663 | | −130 | −1,356 | −1,349 |
| $10,000 to $15,000 | +28 | | −83 | −789 | −975 | | −111 | −1,958 | −1,932 |
| $15,000 to $20,000 | +23 | | −16 | −231 | −496 | | −55 | −798 | −775 |
| $20,000 to $50,000 | +90 | | −8 | −117 | −806 | | −135 | −1,066 | −976 |
| $50,000 to $100,000 | +137 | | −1 | −7 | −420 | −20 | −54 | −502 | −365 |
| $100,000 and over | +1,081 | | | −1 | −841 | −80 | −35 | −757 | +324 |
| Total | +1,380 | −625 | −2,027 | −1,373 | −4,498 | −100 | −650 | −9,273 | −7,893 |

TABLE 5.—TAX REFORM PROVISIONS AFFECTING INDIVIDUALS, FULL YEAR EFFECT—BY ADJUSTED GROSS INCOME CLASS

[In millions of dollars]

| Adjusted gross income class (thousands) | Eliminate alternative tax rate[1] on long-term gains | 6- to 12-month gains included at 100 percent[1] | Capital loss limitation | Pension plan provision | Life estates provision | Averaging including capital gains and 120 percent | Deferred compensation | Charitable deductions | Interest deduction | Reduce percentage depletion | Accumulation trust | Moving expenses | Farm losses | Real estate | Tax-free dividends | Limited tax preference | Allocation | Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 0 to $3 | | +$1 | +$5 | (2) | | (2) | (2) | | | +$1 | (2) | −$1 | | (2) | (2) | +$10 | (2) | +$16 |
| $3 to $5 | | +2 | +3 | +$1 | | (2) | (2) | | | +1 | (2) | −11 | | (2) | (2) | +1 | (2) | −3 |
| $5 to $7 | | +2 | +5 | +2 | | (2) | (2) | | | +2 | +1 | −13 | | (2) | +$11 | +3 | (2) | +3 |
| $7 to $10 | | +5 | +9 | +3 | | (2) | (2) | | | +2 | +1 | −23 | | +$5 | +2 | +3 | (2) | +7 |
| $10 to $15 | | +10 | +15 | +9 | | −$5 | (2) | | | +5 | +3 | −29 | | +10 | +3 | +3 | +$2 | +26 |
| $15 to $20 | | +10 | +8 | +6 | | −30 | (2) | | | +5 | +3 | −10 | | +10 | +3 | +15 | +3 | +23 |
| $20 to $50 | +$1 | +35 | +16 | +17 | (2) | −110 | (2) | | | +19 | +16 | −11 | | +45 | +17 | +10 | +35 | +98 |
| $50 to $100 | +11 | +30 | +4 | +10 | +$5 | −105 | +$20 | | | +13 | +17 | −2 | +$5 | +50 | +19 | +10 | +65 | +137 |
| $100 and over | +348 | +55 | (2) | +22 | +5 | −50 | +5 | +$20 | +$20 | +22 | +29 | (2) | +20 | +140 | +35 | +30 | +365 | +1,081 |
| Total | +360 | +150 | +65 | +70 | +10 | −300 | +25 | +20 | +20 | +70 | +70 | −100 | +25 | +260 | +80 | +85 | +470 | +1,380 |

[1] Assumes ½ of effect as compared with no change in realization.

[2] Less than $500,000.

TABLE 6.—REVENUE ESTIMATES, TAX REFORM, CALENDAR YEAR LIABILITY[1]

[In millions of dollars]

| | 1970 | 1971 | 1972 | 1974 | 1979 |
|---|---|---|---|---|---|
| Corporate capital gains | 175 | 175 | 175 | 75 | 175 |
| Foundations—investment income tax | 65 | 70 | 75 | 85 | 100 |
| Unrelated business income | 5 | 5 | 5 | 5 | 20 |
| Contributions | 5 | 10 | 20 | 20 | 20 |
| Farm losses | (2) | 5 | 10 | 10 | 20 |
| Moving expenses | −100 | −100 | −100 | −100 | −100 |
| Railroad depreciation | (2) | −5 | −20 | −70 | −100 |
| Amortization of air and water pollution | −40 | −130 | −230 | −380 | −400 |
| Corporate mergers, etc | 10 | 20 | 25 | 40 | 70 |
| Multiple corporations | 20 | 45 | 75 | 135 | 235 |
| Accumulation trusts | 50 | 70 | 70 | 70 | 70 |
| Income averaging | −300 | −300 | −300 | −300 | −300 |
| Deferred compensations: | | | | | |
| Restricted stock | (2) | (2) | (2) | (2) | (2) |
| Other deferred compensation | (2) | (2) | 5 | 10 | 25 |
| Stock dividends | (2) | (2) | (2) | (2) | (2) |
| Subchapter S | (2) | (2) | (2) | (2) | (2) |
| Tax-free dividends | | | | 80 | 80 |
| Financial institutions: | | | | | |
| Commercial banks: | | | | | |
| Reserve | 250 | 250 | 250 | 250 | 250 |
| Capital gain | 50 | 50 | 50 | 50 | 50 |
| Mutual thrift: | | | | | |
| Reserve—savings and loan associations | 10 | 25 | 35 | 60 | 125 |
| Mutual | (2) | 5 | 10 | 15 | 35 |
| Municipals | (2) | (2) | (2) | (2) | (2) |
| Capital gains: | | | | | |
| Capital loss provisions | 50 | 50 | 55 | 60 | 65 |
| 6 months-1 year holding | 100 | 150 | 150 | 150 | 150 |
| Pension plans | (2) | 5 | 10 | 25 | 50 |
| Casualty loss | (2) | (2) | (2) | (2) | (2) |
| Sale of papers | (2) | (2) | (2) | (2) | (2) |
| Life estates | 10 | 10 | 10 | 10 | 10 |
| Franchises | (2) | (2) | (2) | (2) | (2) |
| Removal of alternate rate | 300 | 300 | 300 | 300 | 300 |
| Natural resources: | | | | | |
| Production payment | 100 | 110 | 125 | 150 | 200 |
| Cut percentage depletion | 400 | 400 | 400 | 400 | 400 |
| Foreign depletion[3] | 25 | 10 | (2) | (2) | (2) |
| Foreign income: | | | | | |
| Loss carryover | 35 | 35 | 35 | 35 | 35 |
| Restriction on mineral credits | 30 | 30 | 30 | 30 | 30 |
| Individual interest deduction | 20 | 20 | 20 | 20 | 20 |
| Regulated utilities[4,5] | 80 | 140 | 185 | 260 | 310 |
| Cooperatives | (2) | (2) | (2) | (2) | (2) |
| Limit on tax preferences (LPT) | 40 | 50 | 60 | 70 | 85 |
| Allocation | 205 | 420 | 425 | 440 | 460 |
| Real estate: | | | | | |
| Used property | 15 | 40 | 65 | 150 | 250 |
| New nonhousing | (2) | 60 | 170 | 435 | 900 |
| Capital gain, recapture | 5 | 15 | 25 | 50 | 125 |
| Rehabilitation | −15 | −50 | −100 | −200 | −330 |
| Preliminary total | 1,640 | 2,050 | 2,180 | 2,600 | 3,555 |
| Plus investment credit | 2,500 | 3,000 | 3,000 | 3,100 | 3,300 |
| Total | 4,140 | 5,050 | 5,180 | 5,700 | 6,855 |

[1] Except as indicated these estimates are all at current levels, the time differences being solely to show the phasein.
[2] Less than $2,500,000.
[3] Potentially, a larger gain appears possible. The figure shown assumes this will be offset in the beginning by carryovers of unused credits and in the later years by increased foreign taxes.
[4] Assumes growth.
[5] Excludes change to 150 percent for construction of public utilities, 1971, $10,000,000; 1972, $30,000,000; 1974 $50,000,000; and 1979, $80,000,000.

BEST AVAILABLE COPY

TABLE 7.—TAXABLE RETURNS UNDER PRESENT LAW, NUMBER MADE NONTAXABLE BY RELIEF PROVISIONS AND NUMBER BENEFITING FROM RATE REDUCTION

[Number of returns in thousands]

| AGI class | Taxable under present law | Made nontaxable by low-income allowance and 15 percent $2,000 standard deduction | Remaining taxable—benefit from modified rate reduction |
|---|---|---|---|
| 0 to $3,000 | 10,083 | 5,398 | 4,685 |
| $3,000 to $5,000 | 9,562 | 389 | 9,173 |
| $5,000 to $7,000 | 8,779 | 41 | 8,738 |
| $7,000 to $10,000 | 13,815 | 8 | 13,807 |
| $10,000 to $15,000 | 13,062 | 7 | 13,055 |
| $15,000 to $20,000 | 3,852 | 2 | 3,850 |
| $20,000 to $50,000 | 2,594 | | 2,594 |
| $50,000 to $100,000 | 340 | | 340 |
| $100,000 and over | 95 | | 95 |
| Total | 63,152 | 5,845 | 57,307 |

TABLE 8.—TAX BURDENS UNDER PRESENT LAW,[1] UNDER H.R. 13270,[2] AND PERCENT TAX CHANGE (ASSUMES NONBUSINESS DEDUCTIONS OF 10 PERCENT OF INCOME)

| Adjusted gross income (wages and salaries) | Married couple with 2 dependents | | | Adjusted gross income (wages and salaries) | Married couple with 2 dependents | | |
|---|---|---|---|---|---|---|---|
| | Present tax law | H.R. 13270 tax | Percent tax change | | Present tax law | H.R. 13270 tax | Percent tax change |
| $3,000 | [3] $0 | [4] $0 | 0 | $12,500 | [5] $1,567 | [5] $1,347 | −14.0 |
| $3,900 | [5] 276 | [4] 0 | −100.0 | $15,000 | [5] 2,062 | [7] 1,846 | −10.5 |
| $4,000 | [5] 140 | [6] 65 | −53.6 | $17,000 | [5] 2,566 | [7] 2,366 | −7.8 |
| $5,000 | [5] 290 | [6] 200 | −31.0 | $20,000 | [5] 3,180 | [7] 2,988 | −6.1 |
| $7,500 | [5] 687 | [6] 576 | −16.2 | $25,000 | [5] 4,412 | [5] 4,170 | −5.5 |
| $10,000 | [5] 1,114 | [6] 958 | −14.0 | | | | |

[1] Does not include 10-percent surcharge.
[2] Uses provisions effective for tax year 1972.
[3] Uses minimum standard deduction of $900.
[4] Uses minimum standard deduction of $1,100.
[5] Itemizes deductible nonbusiness expenses.
[6] Uses 15-percent standard deduction.
[7] Uses $2,000 limit on 15-percent standard deduction.

TABLE 9.—TAX BURDENS UNDER PRESENT LAW,[1] UNDER H.R. 13270,[2] AND PERCENT TAX CHANGE (ASSUMES NONBUSINESS DEDUCTIONS OF 10 PERCENT OF INCOME)

| Adjusted gross income (wages and salaries) | Single person under 35 (not a widow or widower) | | | Adjusted gross income (wages and salaries) | Single person under 35 (not a widow or widower) | | |
|---|---|---|---|---|---|---|---|
| | Present tax law | H.R. 13270 tax | Percent tax change | | Present tax law | H.R. 13270 tax | Percent tax change |
| $900 | [3] $0 | [4] $0 | 0 | $10,000 | [6] $1,742 | [6] $1,507 | −13.5 |
| $1,700 | [3] $115 | [4] 0 | −100.0 | $12,500 | [7] 2,398 | [6] 2,078 | −13.3 |
| $3,000 | [5] 329 | [6] $180 | −45.3 | $15,000 | [7] 3,154 | [6] 2,806 | −11.0 |
| $4,000 | [5] 500 | [6] 344 | −31.2 | $17,500 | [7] 3,666 | [6] 3,383 | −7.8 |
| $5,000 | [6] 671 | [6] 524 | −21.9 | $20,000 | [7] 4,918 | [8] 4,650 | −5.4 |
| $7,500 | [6] 1,168 | [6] 1,023 | −12.4 | $25,000 | [7] 6,962 | [7] 6,566 | −6.0 |

[1] Does not include 10-percent surcharge.
[2] Uses provisions effective for tax year 1972.
[3] Uses minimum standard deduction of $900.
[4] Uses minimum standard deduction of $1,100.
[5] Uses 10-percent standard deduction.
[6] Uses 15-percent standard deduction.
[7] Itemizes deductible nonbusiness expenses.
[8] Uses $2,000 limit on 15-percent standard deduction.

TABLE 10.—TAX BURDENS UNDER PRESENT LAW,[1] UNDER H.R. 13270,[2] AND PERCENT TAX CHANGE (ASSUMES NONBUSINESS DEDUCTIONS OF 10 PERCENT OF INCOME)

| Adjusted gross income (wages and salaries) | Single person, 35 and over (widow or widower at any age) | | | Adjusted gross income (wages and salaries) | Single person, 35 and over (widow or widower at any age) | | |
|---|---|---|---|---|---|---|---|
| | Present tax law | H.R. 13270 tax | Percent tax change | | Present tax law | H.R. 13270 tax | Percent tax change |
| $900 | [3] $0 | [4] $0 | 0 | $10,000 | [5] $1,742 | [6] $1,399 | −19.7 |
| $1,700 | [3] $115 | [4] $0 | −100.0 | $12,500 | [7] $2,398 | [6] $1,906 | −20.5 |
| $3,000 | [3] $329 | [4] $175 | −46.8 | $15,000 | [7] $3,154 | [8] $2,532 | −19.7 |
| $4,000 | [5] $500 | [4] $331 | −33.8 | $17,500 | [7] $3,[illegible] | [8] $3,250 | −18.7 |
| $5,000 | [5] $671 | [4] $501 | −25.3 | $20,000 | [7] $4,918 | [8] $4,042 | −17.8 |
| $7,500 | [5] $1,168 | [4] $957 | −18.1 | $25,000 | [7] $6,982 | [7] $5,643 | −19.2 |

[1] Does not include 10-percent surcharge.
[2] Uses provisions effective for tax year 1972.
[3] Uses minimum standard deduction of $300.
[4] Uses minimum standard deduction of $1,100.
[5] Uses 10-percent standard deduction.
[6] Uses 15-percent standard deduction.
[7] Itemizes deductible nonbusiness expenses.
[8] Uses $2,000 limit on 15-percent standard deduction.

TABLE 11.—EFFECT OF H.R. 13270 ON FISCAL YEAR RECEIPTS, 1970 AND 1971

[In billions]

| | Fiscal year 1970 | Fiscal year 1971 |
|---|---|---|
| Tax reform provisions: | | |
| Corporation | +$0.4 | +$1.1 |
| Individual | +.3 | +.6 |
| Total, tax reform provisions | +.7 | +1.7 |
| Tax relief provisions: | | |
| Corporation | −0 | −.1 |
| Individual | −.7 | −3.6 |
| Total, tax relief provisions | −.7 | −3.7 |
| Other provisions: | | |
| Repeal of investment credit: | | |
| Corporation | +$0.9 | +$1.9 |
| Individual | +.4 | +.6 |
| Total, repeal of investment credit | +1.3 | +2.6 |
| Extend tax surcharge: | | |
| Corporation | +.3 | +.7 |
| Individual | +1.7 | +.4 |
| Total, surcharge extension | +2.0 | +1.1 |
| Extend excise taxes | +.5 | +1.1 |
| Total, other provisions | +3.8 | +4.8 |
| Total | +3.8 | +2.8 |

91st CONGRESS
1st Session

# H. R. 13270

IN THE SENATE OF THE UNITED STATES

August 8, 1969

Read twice and referred to the Committee on Finance

# AN ACT

To reform the income tax laws.

1 *Be it enacted by the Senate and House of Representa-*
2 *tives of the United States of America in Congress assembled,*

3 **SECTION 1. SHORT TITLE, ETC.**

4 (a) Short Title.—This Act may be cited as the "Tax
5 Reform Act of 1969".

6 (b) Table of Contents.—


TITLE I—TAX EXEMPT ORGANIZATIONS

Subtitle A—Private Foundations

Sec. 101. Private foundations.

Subtitle B—Other Tax Exempt Organizations

Sec. 121. Tax on unrelated business income.


II

TITLE II—INDIVIDUAL DEDUCTIONS

SUBTITLE A—CHARITABLE CONTRIBUTIONS

Sec. 201. Charitable contributions.

SUBTITLE B—FARM LOSSES, ETC.

Sec. 211. Gain from disposition of property used in farming where farm losses offset nonfarm income.
Sec. 212. Livestock.
Sec. 213. Hobby losses.

SUBTITLE C—INTEREST

Sec. 221. Interest.

SUBTITLE D—MOVING EXPENSES

Sec. 231. Moving expenses.

TITLE III—OTHER ADJUSTMENTS PRIMARILY AFFECTING INDIVIDUALS

SUBTITLE A—LIMIT ON TAX PREFERENCES AND ALLOCATION OF DEDUCTIONS

Sec. 301. Limit on tax preferences for individuals, estates, and trusts.
Sec. 302. Allocation of deductions.

SUBTITLE B—INCOME AVERAGING

Sec. 311. Income averaging.

SUBTITLE C—RESTRICTED PROPERTY

Sec. 321. Restricted property.

SUBTITLE D—OTHER DEFERRED COMPENSATION

Sec. 331. Deferred compensation.

SUBTITLE E—ACCUMULATION TRUSTS, MULTIPLE TRUSTS, ETC.

Sec. 341. Treatment of excess distributions by trusts.
Sec. 342. Trust income for benefit of a spouse.

TITLE IV—ADJUSTMENTS PRIMARILY AFFECTING CORPORATIONS

SUBTITLE A—MULTIPLE CORPORATIONS

Sec. 401. Multiple corporations.

SUBTITLE B—DEBT-FINANCED CORPORATE ACQUISITIONS AND RELATED PROBLEMS

Sec. 411. Interest on indebtedness incurred by corporations to acquire stock or assets of another corporation.
Sec. 412. Installment method.
Sec. 413. Bonds and other evidences of indebtedness.
Sec. 414. Limitation on deduction of bond premium upon repurchase.

3

## TITLE IV—ADJUSTMENTS PRIMARILY AFFECTING CORPORATIONS—Continued

### Subtitle C—Stock Dividends

Sec. 421. Stock dividends.

### Subtitle D—Foreign Tax Credit

Sec. 431. Foreign tax credit reduction in case of foreign losses.
Sec. 432. Separate limitation on foreign tax credit with respect to foreign mineral income.

### Subtitle E—Financial Institutions

Sec. 441. Reserve for losses on loans; net operating loss carrybacks.
Sec. 442. Mutual savings banks, etc.
Sec. 443. Treatment of bonds, etc., held by financial institutions.
Sec. 444. Foreign deposits in United States banks.

### Subtitle F—Depreciation Allowed Regulated Industries; Earnings and Profits Adjustment for Depreciation

Sec. 451. Public utility property.
Sec. 452. Effect on earnings and profits.

### Subtitle G—Alternative Capital Gain Rate for Corporations

Sec. 461. Increase of rate.

## TITLE V—ADJUSTMENTS AFFECTING INDIVIDUALS AND CORPORATIONS

### Subtitle A—Natural Resources

Sec. 501. Natural resources.

### Subtitle B—Capital Gains and Losses

Sec. 511. Repeal of alternative capital gains tax for individuals.
Sec. 512. Capital losses of individuals.
Sec. 513. Letters, memorandums, etc.
Sec. 514. Holding period of capital assets.
Sec. 515. Total distributions from qualified pension, etc., plans.
Sec. 516. Other changes in capital gains treatment.

### Subtitle C—Real Estate Depreciation

Sec. 521. Depreciation of real estate.

### Subtitle D—Cooperatives

Sec. 531. Cooperatives.

### Subtitle E—Subchapter S Corporations

Sec. 541. Qualified pension, etc., plans of small business corporations.

TITLE VI—STATE AND LOCAL OBLIGATIONS

Sec. 601. Interest on certain governmental obligations.
Sec. 602. United States to pay fixed percentage of interest yield on taxable issues.

TITLE VII—EXTENSION OF TAX SURCHARGE AND EXCISE TAXES; TERMINATION OF INVESTMENT CREDIT

Sec. 701. Extension of tax surcharge.
Sec. 702. Continuation of excise taxes on communications services and on automobiles.
Sec. 703. Termination of investment credit.
Sec. 704. Amortization of pollution control facilities.
Sec. 705. Depreciation of certain railroad rolling stock.

TITLE VIII—ADJUSTMENT OF TAX BURDEN FOR INDIVIDUALS

Sec. 801. Low income allowance; increase in standard deduction.
Sec. 802. Fifty-percent maximum rate on earned income.
Sec. 803. Intermediate tax rates; surviving spouse treatment.
Sec. 804. Tax rates.
Sec. 805. Collection of income tax at source on wages.

1 (c) AMENDMENT OF 1954 CODE.—Except as otherwise
2 expressly provided, whenever in this Act an amendment or
3 repeal is expressed in terms of an amendment to, or repeal of,
4 a section or other provision, the reference shall be considered
5 to be made to a section or other provision of the Internal
6 Revenue Code of 1954.

# 7 TITLE I—TAX EXEMPT
# 8 ORGANIZATIONS

## 9 Subtitle A—Private Foundations

### 10 SEC. 101. PRIVATE FOUNDATIONS.

11 (a) IN GENERAL.—Subchapter F of chapter 1 (relat-
12 ing to exempt organizations) is amended by redesignating
13 parts II, III, and IV as parts III, IV, and V, respectively,
14 and by inserting after part I the following new part:

1 "PART II—PRIVATE FOUNDATIONS

"Sec. 506. Tax on private foundation investment income.
"Sec. 507. Tax on termination of private foundation status.
"Sec. 508. Special rules with respect to section 501(c)(3) organizations.
"Sec. 509. Private foundation defined.

2 "SEC. 506. TAX ON PRIVATE FOUNDATION INVESTMENT
3 INCOME.

4 "(a) IMPOSITION OF TAX.—There is hereby imposed
5 for each taxable year on the net investment income of every
6 private foundation (as defined in section 509) a tax equal
7 to 7½ percent of such income.

8 "(b) NET INVESTMENT INCOME DEFINED.—

9 "(1) IN GENERAL.—For purposes of subsection
10 (a), the net investment income is the amount by
11 which (A) the gross investment income and the net
12 capital gain, exceed (B) the deductions allowed by
13 paragraph (3) and the net capital loss.

14 "(2) GROSS INVESTMENT INCOME.—For purposes
15 of paragraph (1), the term 'gross investment income',
16 means the gross amount of income from interest, divi-
17 dends, rents, and royalties, but not including any such
18 income to the extent included in computing the tax
19 imposed by section 511.

20 "(3) DEDUCTIONS.—For purposes of paragraph
21 (1), there shall be allowed as a deduction all the ordi-
22 nary and necessary expenses paid or incurred for the

1 production or collection of gross investment income or
2 for the management, conservation, or maintenance of
3 property held for the production of such income.

4 "(4) CAPITAL GAINS AND LOSSES.—For purposes
5 of paragraph (1), in determining net capital gain or
6 loss—

7 "(A) The basis of property held by the private
8 foundation on December 31, 1969, and continuously
9 thereafter to the date of its disposition shall be
10 deemed to be not less than the fair market value of
11 such property on December 31, 1969.

12 "(B) There shall be taken into account only
13 the sale or other disposition of property used for the
14 production of interest, dividends, rents, and royal-
15 ties, and property used for the production of in-
16 come included in computing the tax imposed by
17 section 511 (except to the extent gain or loss from
18 the sale or other disposition of such property is taken
19 into account for purposes of such tax).

20 **"SEC. 507. TAX ON TERMINATION OF PRIVATE FOUNDA-**
21 **TION STATUS.**

22 "(a) GENERAL RULE.—There is hereby imposed on
23 each organization which is referred to in subsection (d) or
24 (e) of section 508 a tax equal to the lower of—

25 "(1) the amount which the private foundation

1 substantiates by adequate records or other corroborating
2 evidence as the aggregate tax benefit resulting from the
3 section 501 (c) (3) status of such foundation, or
4 "(2) the value of the net assets of such foundation.
5 "(b) AGGREGATE TAX BENEFIT.—
6 "(1) IN GENERAL.—For purposes of subsection
7 (a), the aggregate tax benefit resulting from the section
8 501 (c) (3) status of any private foundation is the sum
9 of—
10 "(A) the aggregate increases in tax under
11 chapters 1, 11, and 12 (or the corresponding pro-
12 visions of prior law) which would have been im-
13 posed with respect to all substantial contributors
14 to the foundation if deductions for all contributions
15 made by such contributors to the foundation after
16 February 28, 1913, had been disallowed, and
17 "(B) the aggregate increases in tax under
18 chapter 1 (or the corresponding provisions of prior
19 law) which would have been imposed with respect
20 to the income of the private foundation for taxable
21 years beginning after December 31, 1912, if (i) it
22 had not been exempt from tax under section 501 (a)
23 (or the corresponding provisions of prior law), and
24 (ii) in the case of a trust, deductions under section
25 642 (c) (or the corresponding provisions of prior

1 law) had been limited to 20 percent of the taxable
2 income of the trust (computed without the benefit
3 of section 642 (c) but with the benefit of section
4 170 (b) (1) (B)), and
5 "(C) interest on the increases in tax deter-
6 mined under subparagraphs (A) and (B) from the
7 first date on which each such increase would have
8 been due and payable to the date on which the pri-
9 vate foundation ceases to be a section 501 (c) (3)
10 organization.
11 "(2) SUBSTANTIAL CONTRIBUTOR.—For purposes
12 of paragraph (1), the term 'substantial contributor'
13 means—
14 "(A) any person who (by himself or with his
15 spouse) contributed more than $5,000 to the private
16 foundation in any one calendar year (or bequeathed
17 more than $5,000 to the private foundation), and
18 "(B) any person who (by himself or with his
19 spouse) contributed or bequeathed the greatest
20 amount to the foundation in any one calendar year.
21 In the case of a trust, such term also includes the creator
22 of such trust.
23 "(3) REGULATIONS.—For purposes of this sec-
24 tion, the determination as to whether and to what ex-
25 tent there would have been any increase in tax shall

1 be made in accordance with regulations prescribed by
2 the Secretary or his delegate.
3 "(c) VALUE OF ASSETS.—For purposes of subsection
4 (a), the value of the net assets shall be determined at which-
5 ever time such value is higher: (1) the first day on which
6 action is taken by the private foundation which culminates
7 in its ceasing to be a section 501 (c) (3) organization, or
8 (2) the day on which it ceases to be a section 501 (c) (3)
9 organization.
10 "(d) LIABILITY IN CASE OF TRANSFERS OF ASSETS
11 FROM PRIVATE FOUNDATION.—For purposes of determin-
12 ing liability for the tax imposed by subsection (a) in the
13 case of assets transferred by the private foundation, such
14 tax shall be deemed to have been imposed on the first day on
15 which action is taken by the private foundation which cul-
16 minates in its ceasing to be a section 501 (c) (3) organiza-
17 tion.
18 "(e) ABATEMENT OF TAXES.—The Secretary or his
19 delegate may abate the unpaid portion of the assessment
20 of any tax imposed by subsection (a), or any liability in
21 respect thereof, if the private foundation—
22 "(1) has operated as a section 501 (c) (3) orga-
23 nization which meets the requirements of paragraph (1),
24 (2), or (3) of section 509 (a) for a continuous period

1 of at least 60 calendar months beginning after Decem-
2 ber 31, 1969, or
3 "(2) distributes all of its net assets to one or more
4 organizations specified in section 170(b)(1)(B) each
5 of which has been in existence and met the requirements
6 of section 170(b)(1)(B) for a continuous period of
7 at least 60 calendar months.
8 "(f) DISALLOWANCE OF CERTAIN CHARITABLE, ETC.,
9 DEDUCTIONS.—
10 "(1) GIFT OR BEQUEST TO PRIVATE FOUNDATION
11 OR SECTION 4947 TRUST.—No gift or bequest made to
12 an organization described in section 509(a) or a trust
13 described in section 4947(a), which is liable for the
14 tax imposed by subsection (a) or section 4947(b)(1),
15 shall be allowed as a deduction under section 170, 545
16 (b)(2), 642(c), 2055, 2106(a)(2), or 2522, if such
17 gift or bequest is made—
18 "(A) by any person after notification is made
19 under subsection (d) or (e) of section 508 or under
20 section 4947(b)(1), or
21 "(B) by a substantial contributor (as defined
22 in subsection (b)(2)) in his taxable year which
23 includes the first day on which action is taken by
24 such organization or trust which culminates in the
25 imposition of tax under subsection (a) or section
26 4947(b)(1) and any subsequent taxable year.

1 "(2) EXCEPTION.—Paragraph (1) shall not apply
2 if the tax imposed by subsection (a) or section 4947
3 (b) (1) is abated by the Secretary or his delegate under
4 subsection (e) or section 4947 (b) (5).

5 "SEC. 508. SPECIAL RULES WITH RESPECT TO SECTION
6 501(c)(3) ORGANIZATIONS.

7 "(a) NEW ORGANIZATIONS MUST NOTIFY SECRETARY
8 THAT THEY ARE APPLYING FOR RECOGNITION OF SEC-
9 TION 501 (c) (3) STATUS.—An organization organized after
10 May 26, 1969, shall not be treated as an organization de-
11 scribed in section 501 (c) (3) which is exempt from taxa-
12 tion under section 501 (a) unless it has notified the Secre-
13 tary or his delegate, at such time and in such manner as the
14 Secretary or his delegate may by regulations prescribe, that
15 it is applying for recognition of such status.

16 "(b) PRESUMPTION THAT ORGANIZATIONS ARE PRI-
17 VATE FOUNDATIONS.—Any organization (including an or-
18 ganization in existence on May 26, 1969) which is described
19 in section 501 (c) (3) and which does not notify the Secre-
20 tary or his delegate, at such time and in such manner as
21 the Secretary or his delegate may by regulations prescribe,
22 that it is not a private foundation shall be presumed to be
23 a private foundation.

24 "(c) EXCEPTIONS.—The Secretary or his delegate may
25 by regulations exempt (to the extent and subject to such

1 conditions as may be prescribed in such regulations) from
2 the provisions of subsection (a) or (b) or both—
3 "(1) churches (or conventions or associations of
4 churches);
5 "(2) educational organizations which normally
6 maintain a regular faculty and curriculum and normally
7 have a regularly enrolled body of pupils or students in
8 attendance at the place where their educational activities
9 are regularly carried on; and
10 "(3) any other class of organizations where the
11 Secretary or his delegate determines that full compli-
12 ance with the provisions of subsections (a) and (b)
13 is not necessary to the efficient administration of the
14 provisions of this title relating to private foundations.
15 "(d) VOLUNTARY TERMINATION OF STATUS AS PRI-
16 VATE FOUNDATION.—Any private foundation may termi-
17 nate its status as such by notifying the Secretary or his dele-
18 gate (at such time and in such manner as the Secretary or
19 his delegate may by regulations prescribe) of its plan to
20 accomplish such termination and by complying with sub-
21 section (a) or (e) of section 507 (relating to tax on termi-
22 nation of private foundation status).
23 "(e) REQUIREMENT OF TERMINATION.—If—
24 "(1) the Secretary or his delegate notifies any

1 organization that he is invoking this subsection with
2 respect to such organization, and
3 "(2) with respect to such organization, there have
4 been either willful repeated acts (or failures to act),
5 or a willful and flagrant act (or failure to act), giving
6 rise to liability for tax under chapter 42,
7 then such organization shall be liable for the tax imposed by
8 section 507. In the case of any organization which has com-
9 plied with subsection (a) or (e) of section 507, the status
10 of such organization as a private foundation shall be termi-
11 nated.
12 "(f) FUTURE STATUS OF ORGANIZATION.—In the case
13 of any organization which has complied with subsection (a)
14 or (e) of section 507 by reason of subsection (d) or (e)
15 of this section, for purposes of the provisions of this title
16 relating to private foundations for all periods beginning after
17 it has completed compliance with section 507 such organiza-
18 tion shall be treated as a newly created organization.
19 "(g) GOVERNING INSTRUMENTS.—
20 "(1) GENERAL RULE.—A private foundation shall
21 not be treated as an organization described in section
22 501(c)(3) which is exempt from taxation under sec-
23 tion 501(a) unless its governing instrument includes
24 provisions the effects of which are—

1 "(A) to require its income for each taxable
2 year to be distributed at such time and in such
3 manner as not to subject the foundation to tax under
4 section 4942, and
5 "(B) to prohibit the foundation from engaging
6 in any act of self-dealing (as defined in section
7 4941(d)), from retaining any excess business hold-
8 ings (as defined in section 4943(c)), from making
9 any speculative investments in such manner as to
10 subject the foundation to tax under section 4944,
11 and from making any taxable expenditures (as de-
12 fined in section 4945(b)).
13 "(2) SPECIAL RULES FOR EXISTING FOUNDA-
14 TIONS.—In the case of any organization organized before
15 January 1, 1970—
16 "(A) it shall not cease to be treated as an
17 organization described in section 501(c)(3) be-
18 cause of a failure to comply with paragraph (1),
19 and
20 "(B) paragraph (1) shall apply only to tax-
21 able years beginning after December 31, 1971; ex-
22 cept that if it is impossible to reform the governing
23 instrument (by amendment, judicial proceeding, or
24 otherwise) by December 31, 1971, to meet the re-
25 quirements of paragraph (1), paragraph (1) shall

1 not apply until it is possible to meet such require-
2 ments.
3 "SEC. 509. PRIVATE FOUNDATION DEFINED.
4 "(a) GENERAL RULE.—For purposes of this title, the
5 term 'private foundation' means an organization described in
6 section 501 (c) (3) other than—
7 "(1) an organization described in section 170 (b)
8 (1) (B);
9 "(2) an organization which—
10 "(A) normally receives more than one-third of
11 its support in each taxable year from any combina-
12 tion of—
13 "(i) gifts, grants, contributions, or mem-
14 bership fees, or
15 "(ii) gross receipts from admissions, sales
16 of merchandise, performance of services, or
17 furnishing of facilities, in an activity which is
18 not an unrelated trade or business (within the
19 meaning of section 513), not including such re-
20 ceipts from any person in any taxable year
21 which are in excess of 1 percent of the organiza-
22 tion's support in such taxable year,
23 from any person other than a disqualified person (as
24 defined in section 4946) with respect to the orga-

1 nization, or from any organization described in
2 section 170 (b) (1) (B), and
3 "(B) normally receives not more than one-
4 third of its support in each taxable year from gross
5 investment income (as defined in section 506 (b)
6 (2));
7 "(3) an organization which—
8 "(A) is organized, and at all times thereafter
9 is operated, exclusively for the benefit of, to perform
10 the functions of, or to carry out the purposes of one
11 or more organizations described in paragraph (1)
12 or (2),
13 "(B) is operated, supervised, or controlled by
14 one or more organizations, or in connection with
15 one organization, described in paragraph (1) or
16 (2), and
17 "(C) is not controlled directly or indirectly by
18 one or more disqualified persons (as defined in sec-
19 tion 4946) other than foundation managers and
20 other than one or more organizations described in
21 paragraph (1) or (2); and
22 "(4) an organization which is organized and oper-
23 ated exclusively for testing for public safety.
24 "(b) CONTINUATION OF PRIVATE FOUNDATION
25 STATUS.—If an organization is a private foundation (within

1 the meaning of subsection (a)) for its last taxable year end-
2 ing before May 27, 1969, such organization shall, for pur-
3 poses of this title, be treated as a private foundation for each
4 succeeding taxable year unless its status as such is terminated
5 under section 508."
6 (b) AMENDMENT OF SUBTITLE D.—Subtitle D (relat-
7 ing to miscellaneous excise taxes) is amended by adding at
8 the end thereof the following new chapter:

9 "CHAPTER 42.—PRIVATE FOUNDATIONS

"Sec. 4941. Taxes on self-dealing.
"Sec. 4942. Taxes on failure to distribute income.
"Sec. 4943. Taxes on excess business holdings.
"Sec. 4944. Investments which jeopardize charitable purpose.
"Sec. 4945. Taxes on taxable expenditures.
"Sec. 4946. Definitions and special rules.
"Sec. 4947. Application of taxes to certain nonexempt trusts.

10 "SEC. 4941. TAXES ON SELF-DEALING.
11 "(a) INITIAL TAXES.—
12 "(1) ON SELF-DEALER.—There is hereby imposed
13 a tax on each act of self-dealing between a disqualified
14 person and a private foundation. The rate of tax shall
15 be equal to 5 percent of the amount involved with re-
16 spect to the act of self-dealing for each year (or part
17 thereof) in the taxable period. The tax imposed by this
18 paragraph shall be paid by any disqualified person who
19 participates in the act of self-dealing. In the case of a
20 government official (as defined in section 4946(c)), a

1 tax shall be imposed by this paragraph only if such dis-
2 qualified person participates in the act of self-dealing
3 knowing that it is such an act.

4 "(2) ON FOUNDATION MANAGER.—In any case
5 in which a tax is imposed by paragraph (1), there
6 is hereby imposed on the participation of any foundation
7 manager in an act of self-dealing between a disqualified
8 person and a private foundation, knowing that it is such
9 an act, a tax equal to 2½ percent of the amount
10 involved with respect to the act of self-dealing for each
11 year (or part thereof) in the taxable period. The tax
12 imposed by this paragraph shall be paid by any founda-
13 tion manager who participated in the act of self-dealing.

14 "(b) ADDITIONAL TAXES.—

15 "(1) ON SELF-DEALER.—In any case in which an
16 initial tax is imposed by subsection (a) (1) on an
17 act of self-dealing by a disqualified person with a private
18 foundation and the act is not corrected within the cor-
19 rection period, there is hereby imposed a tax equal to
20 200 percent of the amount involved. The tax imposed
21 by this paragraph shall be paid by any disqualified per-
22 son who participated in the act of self-dealing.

23 "(2) ON FOUNDATION MANAGER.—In any case
24 in which an additional tax is imposed by paragraph (1),
25 if a foundation manager refused to agree to any part of

1 the correction, there is hereby imposed a tax equal to
2 50 percent of the amount involved. The tax imposed
3 by this paragraph shall be paid by any foundation man-
4 ager who refused to agree to part or all of the correction.
5 "(c) SPECIAL RULES.—For purposes of subsections
6 (a) and (b)—
7 "(1) JOINT AND SEVERAL LIABILITY.—If more
8 than one person is liable under any paragraph of sub-
9 section (a) or (b) with respect to one act of self-dealing,
10 all such persons shall be jointly and severally liable under
11 such paragraph with respect to such act.
12 "(2) $10,000 LIMIT FOR MANAGEMENT.—With
13 respect to any one act of self-dealing, the maximum
14 amount of the tax imposed by subsection (a)(2) shall
15 not exceed $10,000, and the maximum amount of the tax
16 imposed by subsection (b)(2) shall not exceed $10,000.
17 "(d) SELF-DEALING.—
18 "(1) IN GENERAL.—For purposes of this section,
19 the term 'self-dealing' means any direct or indirect—
20 "(A) sale or exchange, or leasing, of property
21 between a private foundation and a disqualified
22 person;
23 "(B) lending of money or other extension of
24 credit between a private foundation and a disqualified
25 person;

1 "(C) furnishing of goods, services, or facilities
2 between a private foundation and a disqualified
3 person;
4 "(D) payment of compensation (or payment
5 or reimbursement of expenses) by the private foun-
6 dation to a disqualified person;
7 "(E) transfer to, or use by, a disqualified per-
8 son of the income or assets of the private foundation;
9 and
10 "(F) agreement by the private foundation to
11 make any payment of money or other property to a
12 government official (as defined in section 4946 (c)),
13 other than an agreement to employ such individual
14 for any period after the termination of his
15 government service if such individual is terminating
16 his government service within a 90-day period.
17 "(2) SPECIAL RULES.—For purposes of paragraph
18 (1)—
19 "(A) the transfer of real or personal property
20 by a disqualified person to the private foundation
21 shall be treated as a sale or exchange if the property
22 is subject to a mortgage or similar lien which the
23 foundation assumes or if it is subject to a mortgage
24 or similar lien which a disqualified person placed

1 on the property within the 10-year period ending
2 on the date of the transfer;
3 "(B) the lending of money by a disqualified
4 person to a private foundation shall not be an act
5 of self-dealing if the loan is without interest or
6 other charge and if the proceeds of the loan are
7 used exclusively for purposes specified in section
8 501 (c) (3);
9 "(C) the furnishing of goods, services, or fa-
10 cilities by a disqualified person to a private founda-
11 tion shall not be an act of self-dealing if the furnish-
12 ing is without charge and if the goods, services, or
13 facilities so furnished are used exclusively for pur-
14 poses specified in section 501 (c) (3);
15 "(D) the furnishing of goods, services, or fa-
16 cilities by a private foundation to a disqualified
17 person shall not be an act of self-dealing if such
18 furnishing is made on a basis no more preferential
19 than that on which such goods, services, or facilities
20 are made available to the general public;
21 "(E) except in the case of a government of-
22 ficial (as defined in section 4946 (c)), the payment
23 of compensation (and the payment or reimburse-
24 ment of expenses) by a private foundation to a dis-

1 qualified person for personal services which are rea-
2 sonable and necessary to carrying out the exempt
3 purpose of the private foundation shall not be an act
4 of self-dealing if the compensation (or payment or
5 reimbursement) is not excessive;
6 "(F) any transaction between a private founda-
7 tion and a corporation which is a disqualified person
8 (as defined in section 4946), pursuant to any liqui-
9 dation, merger, redemption, recapitalization, or other
10 corporate adjustment or reorganization, shall not
11 be an act of self-dealing if all of the securities of
12 the same class as that held by the foundation are
13 subject to the same terms and such terms provide
14 for receipt by the foundation of no less than fair
15 market value; and
16 "(G) only in the case of a government official
17 (as defined in section 4946(c)), paragraph (1)
18 shall not apply to—
19 "(i) prizes and awards which are subject
20 to the provisions of section 74(b), if the re-
21 cipients of such prizes and awards are selected
22 from the general public,
23 "(ii) scholarships and fellowship grants
24 which are subject to the provisions of section
25 117(a) and are to be used for study at an edu-

1 cational institution described in section 170(b)
2 (1)(B)(ii),
3 "(iii) any annuity or other payment
4 (forming part of a stock-bonus, pension, or
5 profit-sharing plan) by a trust which is a quali-
6 fied trust under section 401,
7 "(iv) any annuity or other payment under
8 a plan which meets the requirements of section
9 404(a)(2),
10 "(v) any contribution or gift (other than
11 a contribution or gift of money) to, or services
12 or facilities made available to, any such indi-
13 vidual, if the aggregate value of such contribu-
14 tions, gifts, services, and facilities to, or made
15 available to, such individual during any calen-
16 dar year does not exceed $25,
17 "(vi) any payment made under chapter
18 32 of title 5, United States Code, or
19 "(vii) traveling expenses (including
20 amounts expended for meals and lodging) for
21 travel from any point in the United States to
22 another point in the United States, not to ex-
23 ceed 125 percent of the maximum amounts
24 authorized to be paid by the United States for
25 like travel.

1 "(e) OTHER DEFINITIONS.—For purposes of this sec-
2 tion—
3 "(1) TAXABLE PERIOD.—The term 'taxable period'
4 means, with respect to any act of self-dealing, the
5 period beginning with the date on which the act of self-
6 dealing occurs and ending on whichever of the follow-
7 ing is the earlier: (A) the date of mailing of a notice of
8 deficiency with respect to the tax imposed by subsection
9 (a) (1) under section 6212, or (B) the date on which
10 correction of the act of self-dealing is completed.
11 "(2) AMOUNT INVOLVED.—The term 'amount
12 involved' means, with respect to any act of self-dealing,
13 the greater of the amount of money and the fair market
14 value of the other property given or the amount of money
15 and the fair market value of the other property received;
16 except that, in the case of services described in subsection
17 (d) (2) (E), the amount involved shall be only the
18 excess compensation. For purposes of the preceding sen-
19 tence, the fair market value—
20 "(A) in the case of the taxes imposed by sub-
21 section (a), shall be determined as of the date on
22 which the act of self-dealing occurs; and
23 "(B) in the case of the taxes imposed by sub-
24 section (b), shall be the highest fair market value
25 during the correction period.

1 "(3) CORRECTION.—The terms 'correction' and
2 'correct' mean, with respect to any act of self-dealing,
3 undoing the transaction to the extent possible, but in
4 any case placing the private foundation in a financial
5 position not worse than that in which it would be if the
6 disqualified person were dealing under the highest fidu-
7 ciary standards.
8 "(4) CORRECTION PERIOD.—The term 'correction
9 period' means, with respect to any act of self-dealing,
10 the period beginning with the date on which the act of
11 self-dealing occurs and ending 90 days after the date of
12 mailing of a notice of deficiency with respect to the tax
13 imposed by subsection (b) (1) under section 6212, ex-
14 tended by—
15 "(A) any period in which a deficiency cannot
16 be assessed under section 6213 (a), and
17 "(B) any other period which the Secretary or
18 his delegate determines will be conducive to bring-
19 ing about correction of the act of self-dealing.
20 "SEC. 4942. TAXES ON FAILURE TO DISTRIBUTE INCOME.
21 "(a) INITIAL TAX.—There is hereby imposed on the
22 undistributed income of a private foundation for any taxable
23 year, which has not been distributed before the first day of
24 the second (or any succeeding) taxable year following such
25 taxable year (if such first day falls within the taxable

1 period), a tax equal to 15 percent of the amount of such
2 income remaining undistributed at the beginning of such
3 second (or succeeding) taxable year. This section shall not
4 apply to a private foundation which is an operating founda-
5 tion (as defined in subsection (j) (3)) for the taxable year.

6 "(b) ADDITIONAL TAX.—In any case in which an
7 initial tax is imposed under subsection (a) on the undis-
8 tributed income of a private foundation for any taxable
9 year, if any portion of such income remains undistributed
10 at the close of the correction period, there is hereby imposed
11 a tax equal to 100 percent of the amount remaining undis-
12 tributed at such time.

13 "(c) UNDISTRIBUTED INCOME.—For purposes of this
14 section, the term 'undistributed income' means, with respect
15 to any private foundation for any taxable year as of any
16 time, the amount by which—

17 "(1) the distributable amount for such taxable
18 year, exceeds

19 "(2) the qualifying distributions made before such
20 time out of such distributable amount.

21 "(d) DISTRIBUTABLE AMOUNT.—For purposes of this
22 section, the term 'distributable amount' means, with respect
23 to any foundation for any taxable year, whichever of the
24 following amounts is the higher: (1) the minimum invest-
25 ment return, or (2) the adjusted net income.

1 "(e) MINIMUM INVESTMENT RETURN.—
2 "(1) IN GENERAL.—For purposes of subsection
3 (d), the minimum investment return for any private
4 foundation for any taxable year is the amount determined
5 by multiplying—
6 "(A) the aggregate fair market value of all
7 assets of the foundation other than those being
8 used (or held for use) directly in carrying out the
9 foundation's exempt purpose reduced by acquisition
10 indebtedness (as defined in section 514 (c) (1))
11 with respect to such property, by
12 "(B) the applicable percentage for such year,
13 as determined under paragraph (3).
14 "(2) VALUATION.—For purposes of paragraph
15 (1) (A), the fair market value of securities for which
16 market quotations are readily available shall be deter-
17 mined on a monthly basis. For all other assets, the fair
18 market value shall be determined at such times and in
19 such manner as the Secretary or his delegate shall by
20 regulations prescribe.
21 "(3) APPLICABLE PERCENTAGE.—For purposes of
22 paragraph (1) (B), the applicable percentage for tax-
23 able years beginning in 1970 is 5 percent. The appli-
24 cable percentage for any taxable year beginning after

1 1970 shall be determined and proclaimed by the Secre-
2 tary or his delegate and shall bear a relationship to 5
3 percent which the Secretary or his delegate determines
4 to be comparable to the relationship which the money
5 rates and investment yields for the calendar year im-
6 mediately preceding the beginning of the taxable year
7 bear to the money rates and investment yields for the
8 calendar year 1969.
9 "(f) ADJUSTED NET INCOME.—
10 "(1) DEFINED.—For purposes of subsection (d),
11 the term 'adjusted net income' means the excess (if
12 any) of—
13 "(A) the gross income for the taxable year
14 (determined with the modifications provided by
15 paragraph (2)), over
16 "(B) the sum of—
17 "(i) the deductions (determined with the
18 modifications provided by paragraph (3))
19 which would be allowed to a corporation sub-
20 ject to the tax imposed by section 11 for the
21 taxable year, plus
22 "(ii) the amount of the tax imposed by sec-
23 tion 511 for such year, plus
24 "(iii) the amount of the tax imposed by
25 section 506 for such year.

1 "(2) INCOME MODIFICATIONS.—The modifications
2 referred to in paragraph (1)(A) are as follows:
3 "(A) section 103 (relating to interest on
4 certain governmental obligations) shall not apply,
5 and
6 "(B) capital gains and losses from the sale or
7 other disposition of property shall be taken into ac-
8 count only in an amount equal to any net short-
9 term capital gain for the taxable year.
10 "(3) DEDUCTION MODIFICATIONS.—The modifi-
11 cations referred to in paragraph (1)(B)(i) are as
12 follows:
13 "(A) no deduction shall be allowed other than
14 all the ordinary and necessary expenses paid or in-
15 curred for the production or collection of gross in-
16 come or for the management, conservation, or main-
17 tenance of property held for the production of such
18 income, and
19 "(B) section 265 (relating to expenses and
20 interest relating to tax-exempt interest) shall not
21 apply.
22 "(4) TRANSITIONAL RULE.—For purposes of para-
23 graph (2)(B), the basis of property held by the private
24 foundation on December 31, 1969, and continuously
25 thereafter to the date of its disposition shall be deemed

1 to be not less than the fair market value of such prop-
2 erty on December 31, 1969.
3 "(g) QUALIFYING DISTRIBUTIONS DEFINED.—
4 "(1) IN GENERAL.—For purposes of this section,
5 the term 'qualifying distribution' means—
6 "(A) any amount paid out to accomplish one
7 or more purposes described in section 170(c)(2)
8 (B), other than any contribution to (i) an organi-
9 zation controlled (directly or indirectly) by one or
10 more disqualified persons (as defined in section
11 4946) with respect to the foundation, (ii) a pri-
12 vate foundation which is not an operating foundation
13 (as defined in subsection (j)(3)), or (iii) an
14 organization which would be a private foundation
15 if it were a domestic organization, or
16 "(B) any amount paid out to acquire an asset
17 used (or held for use) directly in carrying out one
18 or more purposes described in section 170(c)
19 (2)(B).
20 "(2) CERTAIN SET-ASIDES.—Subject to such terms
21 and conditions as may be prescribed by the Secretary or
22 his delegate, an amount set aside for a specific project
23 which comes within one or more purposes described in
24 section 170(c)(2)(B) may be treated as a qualifying
25 distribution, but only if, at the time of the set-aside, the

1 private foundation establishes to the satisfaction of the
2 Secretary or his delegate that—
3 "(A) the amount will be paid out for the spe-
4 cific project within 5 years, and
5 "(B) the project is one which can be better
6 accomplished by such set-aside than by immediate
7 paying out of funds.
8 For good cause shown, the period for paying out the
9 amount set aside may be extended by the Secretary or his
10 delegate.
11 "(h) TREATMENT OF QUALIFYING DISTRIBUTIONS.—
12 "(1) IN GENERAL.—Except as provided in para-
13 graph (2), any qualifying distribution made during a
14 taxable year shall be treated as made—
15 "(A) first out of the undistributed income of
16 the immediately preceding taxable year (if the pri-
17 vate foundation was subject to the tax imposed by
18 this section for such preceding taxable year) to the
19 extent thereof,
20 "(B) second out of the undistributed income
21 for the taxable year to the extent thereof, and
22 "(C) then out of corpus.
23 For purposes of this paragraph, distributions shall be
24 taken into account in the order of time in which made.

1 "(2) CORRECTION OF DEFICIENT DISTRIBUTIONS
2 FOR PRIOR TAXABLE YEARS, ETC.—In the case of any
3 qualifying distribution which (under paragraph (1)) is
4 not treated as made out of the undistributed income of
5 the immediately preceding taxable year, the taxpayer
6 may elect to treat any portion of such distribution as
7 made out of the undistributed income of a designated
8 prior taxable year or out of corpus. The election shall
9 be made by the taxpayer at such time and in such
10 manner as the Secretary or his delegate shall by regu-
11 lations prescribe.

12 "(i) ADJUSTMENT OF DISTRIBUTABLE AMOUNT
13 WHERE DISTRIBUTIONS DURING PRECEDING 5-YEAR
14 PERIOD HAVE EXCEEDED INCOME.—If, for the 5 taxable
15 years immediately preceding the taxable year—

16 "(1) the aggregate qualifying distributions treated
17 (under subsection (h)) as made out of the undistributed
18 income for such preceding taxable years or as made out
19 of corpus (except to the extent section 170(e)(3)(B)
20 applies) during such preceding taxable years, exceed

21 "(2) the distributable amounts for such preceding
22 taxable years,

23 then, for purposes of this section (other than subsection (h))
24 the distributable amount for the taxable year shall be re-
25 duced by an amount equal to such excess.

1 "(j) OTHER DEFINITIONS.—For purposes of this sec-
2 tion—
3 "(1) TAXABLE PERIOD.—The term 'taxable period'
4 means, with respect to the undistributed income for any
5 taxable year, the period beginning with the taxable
6 year and ending on the date of mailing of a notice of
7 deficiency with respect to the tax imposed by subsection
8 (a) under section 6212.
9 "(2) CORRECTION PERIOD.—The term 'correction
10 period' means, with respect to any foundation for any
11 taxable year, the period beginning with the taxable year
12 and ending 90 days after the date of mailing of a notice
13 of deficiency (with respect to the tax imposed by
14 subsection (b)) under section 6212, extended by—
15 "(A) any period in which a deficiency cannot
16 be assessed under section 6213 (a), and
17 "(B) any other period which the Secretary or
18 his delegate determines is reasonable and necessary
19 to permit a distribution of undistributed income
20 under this section.
21 "(3) OPERATING FOUNDATION.—For purposes of
22 this section, the term 'operating foundation' means any
23 organization—
24 "(A) substantially all of the income of which

1 is expended directly for the active conduct of the
2 activities constituting the purpose or function for
3 which it is organized and operated, and
4 "(B) (i) substantially more than half of the
5 assets of which are devoted directly to such activi-
6 ties or devoted to functionally related activities de-
7 scribed in section 4943 (d) (4) or both, or
8 "(ii) substantially all of the support (other
9 than gross investment income as defined in section
10 506 (b) (2)) of which is normally received from 5
11 or more exempt organizations which are not de-
12 scribed in section 4946 (a) (1) (H) with respect
13 to each other or the recipient foundation, or from
14 the general public, and not more than 25 percent of
15 the support of which is normally received from any
16 one such exempt organization.
17 "SEC. 4943. TAXES ON EXCESS BUSINESS HOLDINGS.
18 "(a) INITIAL TAX.—
19 "(1) IMPOSITION.—There is hereby imposed on
20 the excess business holdings of any private foundation
21 in a business enterprise during any calendar year which
22 ends during the taxable period a tax equal to 5 percent
23 of the value of such excess holdings.
24 "(2) SPECIAL RULES.—The tax imposed by para-
25 graph (1)—

1 "(A) shall be imposed on the last day of the
2 calendar year, but
3 "(B) with respect to the private foundation's
4 holdings in any business enterprise, shall be deter-
5 mined as of that day during the year when the
6 foundation's excess holdings in such enterprise were
7 the greatest.
8 "(b) ADDITIONAL TAX.—In any case in which an
9 initial tax is imposed under subsection (a) with respect to
10 the holdings of a private foundation in any business enter-
11 prise, if, at the close of the correction period with respect
12 to such holdings the foundation still has excess business
13 holdings in such enterprise, there is hereby imposed a tax
14 equal to 200 percent of such excess business holdings.
15 "(c) EXCESS BUSINESS HOLDINGS.—For purposes of
16 this section—
17 "(1) IN GENERAL.—The term 'excess business
18 holdings' means, with respect to the holdings of any
19 private foundation in any business enterprise, the amount
20 of stock or other interest in the enterprise which the
21 foundation would have to dispose of to a person other
22 than a disqualified person in order for the remaining
23 holdings of the foundation in such enterprise to be per-
24 mitted holdings.

1 "(2) PERMITTED HOLDINGS IN A CORPORATION.—
2 "(A) IN GENERAL.—The permitted holdings
3 of any private foundation in an incorporated busi-
4 ness enterprise are—
5 "(i) 20 percent of the voting stock, re-
6 duced by
7 "(ii) the percentage of the voting stock
8 owned by all disqualified persons.
9 In any case in which all disqualified persons to-
10 gether do not own more than 20 percent of the vot-
11 ing stock of an incorporated business enterprise, non-
12 voting stock held by the private foundation shall
13 also be treated as permitted holdings.
14 "(B) 35 PERCENT RULE WHERE THIRD PER-
15 SON HAS EFFECTIVE CONTROL OF ENTERPRISE.—
16 If—
17 "(i) the private foundation and all dis-
18 qualified persons together do not own more than
19 35 percent of the voting stock of an incorporated
20 business enterprise, and
21 "(ii) it is established to the satisfaction of
22 the Secretary or his delegate that effective con-
23 trol of the corporation is in one or more persons
24 who are not disqualified persons with respect
25 to the foundation,

1 then subparagraph (A) shall be applied by sub-
2 stituting 35 percent for 20 percent.
3 "(C) 2 PERCENT DE MINIMIS RULE.—A pri-
4 vate foundation shall not be treated as having excess
5 business holdings in any corporation in which it
6 (together with all other private foundations which
7 are described in section 4946(a)(1)(H)) owns
8 not more than 2 percent of the voting stock and
9 not more than 2 percent in value of all outstanding
10 shares of all classes of stock.
11 "(3) PERMITTED HOLDINGS IN PARTNERSHIPS,
12 ETC.—The permitted holdings of a private foundation
13 in any business enterprise which is not incorporated
14 shall be determined under regulations prescribed by the
15 Secretary or his delegate. Such regulations shall be con-
16 sistent in principle with paragraph (2), except that—
17 "(A) in the case of a partnership or joint
18 venture, 'profits interest' shall be substituted for
19 'voting stock', and 'capital interest' shall be substi-
20 tuted for 'nonvoting stock',
21 "(B) in the case of a proprietorship, there
22 shall be no permitted holdings, and
23 "(C) in any other case, 'beneficial interest'
24 shall be substituted for 'voting stock'.

1 "(4) 10-YEAR PERIOD TO DISPOSE OF PRESENT
2 HOLDINGS.—
3 "(A) In applying this section, any interest in
4 a business enterprise which a private foundation
5 holds on May 26, 1969, if the private foundation
6 on such date has excess business holdings, shall
7 (while held by the foundation) be treated as held
8 by a disqualified person (rather than by the private
9 foundation) during the 10-year period beginning
10 on such date.
11 "(B) Subparagraph (A) shall cease to apply
12 with respect to such business holdings unless, at the
13 close of the 2-year period beginning on May 26,
14 1969, the private foundation has disposed of at
15 least one-tenth of such excess business holdings in
16 such enterprise to a person other than a disqualified
17 person. The preceding sentence shall not apply
18 if—
19 "(i) such disposition would create severe
20 hardship for the foundation or such business en-
21 terprise (including a severe depressive effect on
22 the value of any interest in such enterprise),
23 and
24 "(ii) it is established to the satisfaction of
25 the Secretary or his delegate that, during the re-

1 tention of such one-tenth interest, control of
2 such interest will be exercised by persons other
3 than the foundation, or disqualified persons (as
4 defined in section 4946) with respect thereto,
5 or a plan has been adopted to assure that the
6 value of any interest in such enterprise will not
7 be jeopardized.

8 "(C) Subparagraph (A) shall cease to apply
9 with respect to such business holdings unless, at
10 the close of the 5-year period beginning on May 26,
11 1969—

12 "(i) the private foundation has disposed
13 of at least one-third of such excess business
14 holdings in such enterprise to a person other
15 than a disqualified person, and

16 "(ii) the private foundation and all dis-
17 qualified persons have less than a 50 percent
18 voting stock interest (or less than a 50 per-
19 cent profits interest in the case of any unin-
20 corporated enterprise) in such business enter-
21 prise.

22 "(D) Any period prescribed in subparagraph
23 (A), (B), or (C) for the disposition of excess
24 business holdings shall be suspended during the
25 pendency of any judicial proceeding by the private

1 foundation which is necessary to reform its govern-
2 ing instrument to allow disposition of such holdings.
3 "(5) 10-YEAR PERIOD TO DISPOSE OF HOLDINGS
4 ACQUIRED BY WILL.—Paragraph (4) shall apply to any
5 interest in a business enterprise which a private founda-
6 tion acquires under the terms of a will executed on or
7 before July 28, 1969, which are in effect on such date
8 and at all times thereafter, except that 'the date of ac-
9 quisition by will' shall be substituted for 'May 26, 1969'
10 wherever it appears in paragraph (4).
11 "(6) 5-YEAR PERIOD TO DISPOSE OF GIFTS, BE-
12 QUESTS, ETC.—Except as provided in paragraph (5),
13 if, after May 26, 1969, there is a change in the holdings
14 in a business enterprise (other than by purchase by the
15 private foundation or by a disqualified person) which
16 causes the private foundation to have—
17 "(A) excess business holdings in such enter-
18 prise, the interest of the foundation in such enter-
19 prise (immediately after such change) shall (while
20 held by the foundation) be treated as held by a dis-
21 qualified person (rather than by the foundation)
22 during the 5-year period beginning on the date of
23 such change in holdings; or
24 "(B) an increase in excess business holdings
25 in such enterprise (determined without regard to

1 subparagraph (A)), subparagraph (A) shall
2 apply, except that the excess holdings immediately
3 preceding the increase therein shall not be treated,
4 solely because of such increase, as held by a dis-
5 qualified person (rather than by the foundation).
6 "(d) DEFINITIONS; SPECIAL RULES.—For purposes of
7 this section—
8 "(1) BUSINESS HOLDINGS.—In computing the
9 holdings of a private foundation, or a disqualified person
10 (as defined in section 4946) with respect thereto, in any
11 business enterprise, any stock or other interest owned.
12 directly or indirectly, by or for a corporation, partner-
13 ship, estate, or trust shall be considered as being owned
14 proportionately by or for its shareholders, partners, or
15 beneficiaries.
16 "(2) TAXABLE PERIOD.—The term 'taxable period'
17 means, with respect to any excess business holdings of a
18 private foundation in a business enterprise, the period
19 beginning on the first day on which there are such excess
20 holdings and ending on the date of mailing of a notice of
21 deficiency with respect to the tax imposed by subsection
22 (a) under section 6212 in respect of such holdings.
23 "(3) CORRECTION PERIOD.—The term 'correction
24 period' means, with respect to excess business holdings of

1 a private foundation in a business enterprise, the period
2 ending 90 days after the date of mailing of a notice of
3 deficiency (with respect to the tax imposed by subsec-
4 tion (b)) under section 6212, extended by—
5 "(A) any period in which a deficiency cannot
6 be assessed under section 6213 (a), and
7 "(B) any other period which the Secretary
8 or his delegate determines is reasonable and neces-
9 sary to permit orderly disposition of such excess
10 business holdings.
11 "(4) FUNCTIONALLY RELATED BUSINESS.—The
12 term 'business enterprise' does not include a trade or
13 business—
14 "(A) which is not an unrelated trade or busi-
15 ness as defined in section 513, or
16 "(B) which is carried on within a larger aggre-
17 gate of similar activities or within a larger complex
18 of other endeavors which is related (aside from the
19 need of such organization for income or funds or the
20 use it makes of the profits derived) to the exempt
21 purposes of the organization.
22 **"SEC. 4944. INVESTMENTS WHICH JEOPARDIZE CHARI-**
23 **TABLE PURPOSE.**
24 "(a) TAX ON THE PRIVATE FOUNDATION.—If a pri-
25 vate foundation invests any amount in such a manner as to

1 jeopardize the carrying out of any of its exempt purposes,
2 there is hereby imposed on the making of such investment
3 a tax equal to 100 percent of the amount so invested. The
4 tax imposed by this subsection shall be paid by the private
5 foundation.

6 "(b) TAX ON THE MANAGEMENT.—In any case in
7 which a tax is imposed under subsection (a), there is hereby
8 imposed on any foundation manager who participates in the
9 making of such investment knowing that it is jeopardizing
10 the carrying out of any of the foundation's exempt purposes,
11 a tax equal to 50 percent of the amount so invested. Where,
12 under the preceding sentence, more than one foundation
13 manager is liable for a tax with respect to the same invest-
14 ment, the liability of such managers for tax under this sub-
15 section shall be joint and several.

16 "SEC. 4945. TAXES ON TAXABLE EXPENDITURES.

17 "(a) GENERAL RULE.—

18 "(1) TAX ON THE PRIVATE FOUNDATION.—There
19 is hereby imposed on each taxable expenditure a tax
20 equal to 100 percent of the amount thereof. The tax im-
21 posed by this paragraph shall be paid by the private
22 foundation.

23 "(2) TAX ON FOUNDATION MANAGER.—There
24 is hereby imposed on any foundation manager who
25 agrees to the making of an expenditure, knowing

1 that it is a taxable expenditure, a tax equal to 50
2 percent of the amount thereof. Where, under the
3 preceding sentence, more than one foundation man-
4 ager is liable for a tax with respect to the same
5 expenditure, the liability of such managers for tax
6 under this paragraph shall be joint and several.
7 "(b) TAXABLE EXPENDITURE.—For purposes of this
8 section, the term 'taxable expenditure' means any amount
9 paid or incurred by a private foundation—
10 "(1) to carry out propaganda, or otherwise attempt
11 to influence legislation,
12 "(2) to influence the outcome of any public elec-
13 tion (including voter registration drives carried on by
14 or for such foundation),
15 "(3) as a grant to an individual for travel, study,
16 or other similar purposes by such individual, unless
17 such grant satisfies the requirements of subsection (e),
18 "(4) as a grant to another organization (other than
19 an organization described in paragraph (1), (2), or (3)
20 of section 509 (a)), unless the private foundation exer-
21 cises expenditure responsibility with respect to such
22 grant in accordance with subsection (f), or
23 "(5) for any purpose other than for a purpose
24 specified in section 501 (c) (3).
25 "(c) CERTAIN ACTIVITIES EXPRESSLY INCLUDED

1 WITHIN SUBSECTION (b) (1).—For purposes of subsec-
2 tion (b) (1), the term 'taxable expenditures' includes (but
3 is not limited to)—

4 "(1) any attempt to influence legislation through
5 an attempt to affect the opinion of the general public
6 or any segment thereof, and

7 "(2) any attempt to influence legislation through
8 private communication with any member or employee
9 of a legislative body, or with any other person who may
10 participate in the formulation of the legislation,

11 other than through making available the results of non-
12 partisan analysis or research. Paragraph (2) of this subsec-
13 tion shall not apply to any amount paid or incurred in con-
14 nection with an appearance before, or communication to,
15 any legislative body with respect to a possible decision of
16 such body which might affect the existence of the private
17 foundation, its powers and duties, its tax-exempt status, or
18 the deduction of contributions to such foundation.

19 "(d) NONPARTISAN ACTIVITIES CARRIED ON BY CER-
20 TAIN ORGANIZATIONS.—Subsection (b) (2) shall not apply
21 to any amount paid or incurred by an organization—

22 "(1) which is exempt from taxation under section
23 501 (c) (3),

24 "(2) the principal activity of which is nonpartisan
25 political activity in 5 or more States,

1 "(3) substantially all of the income of which is ex-
2 pended directly for the active conduct of the activities
3 constituting the purpose or function for which it is
4 organized and operated,
5 "(4) substantially all of the support (other than
6 gross investment income as defined in section 506(b)
7 (2)) of which is normally received from 5 or more
8 exempt organizations which are not described in section
9 4946(a)(1)(H) with respect to each other or the
10 recipient foundation, or from the general public, and not
11 more than 25 percent of the support of which is normally
12 received from any one such exempt organization, and
13 "(5) contributions to which for voter registration
14 drives are not subject to conditions that they may be
15 used only in specified States, possessions of the United
16 States, or political subdivisions or other areas of any of
17 the foregoing, or the District of Columbia.
18 Subsection (b)(4) shall not apply to any grant to an or-
19 ganization which meets the requirements of the preceding
20 sentence.
21 "(e) INDIVIDUAL GRANTS.—Subsection (b)(3) shall
22 not apply to an individual grant awarded on an objective and
23 nondiscriminatory basis pursuant to a procedure approved
24 in advance by the Secretary or his delegate, if it is demon-
25 strated to the satisfaction of the Secretary or his delegate

1 that it constitutes a scholarship or fellowship grant at an edu-
2 cational institution described in section 170(b)(1)(B)
3 (ii) or that the purpose of the grant is to achieve a specific
4 objective, produce a report or other similar product, or im-
5 prove or enhance a literary, artistic, musical, scientific, or
6 other similar capacity, skill, or talent.

7 "(f) EXPENDITURE RESPONSIBILITY.—The expendi-
8 ture responsibility referred to in subsection (b)(4) means
9 that the private foundation is fully responsible—

10 "(1) to see that the grant is spent solely for the
11 purpose for which made,

12 "(2) to obtain full and complete reports from
13 the grantee on how the funds are spent, and to verify
14 the accuracy of such reports, and

15 "(3) to make full and detailed reports with respect
16 to such expenditures to the Secretary or his delegate.

17 **"SEC. 4946. DEFINITIONS AND SPECIAL RULES.**

18 "(a) DISQUALIFIED PERSON.—

19 "(1) IN GENERAL.—For purposes of this chapter,
20 the term 'disqualified person' means, with respect to a
21 private foundation, a person who is—

22 "(A) a substantial contributor to the founda-
23 tion,

24 "(B) a foundation manager (within the mean-
25 ing of subsection (b)(1)),

33-865 O—69—pt. 1——12

1 "(C) an individual who—

2 "(i) owns more than 20 percent of the
3 total combined voting power of a corporation,
4 or

5 "(ii) is a general partner in a partnership,
6 or

7 "(iii) holds more than 20 percent of the
8 beneficial interest of a trust or unincorporated
9 enterprise,

10 which is a substantial contributor to the foundation,

11 "(D) a member of the family (within the
12 meaning of section 341 (d)) of any person described
13 in subparagraph (A), (B), or (C),

14 "(E) a corporation of which persons described
15 in subparagraph (A), (B), (C), or (D) own
16 more than 35 percent of the total combined voting
17 power,

18 "(F) a partnership in which persons described
19 in subparagraph (A), (B), (C), or (D) own
20 more than 35 percent of the profits interest,

21 "(G) a trust or estate in which persons de-
22 scribed in subparagraph (A), (B), (C), or (D)
23 hold more than 35 percent of the beneficial interest,

24 "(H) only for purposes of section 4943, a
25 private foundation—

1 "(i) which is effectively controlled (di-
2 rectly or indirectly) by the same person or
3 persons who control the private foundation in
4 question, or
5 "(ii) substantially all of the contributions
6 to which were made (directly or indirectly) by
7 the same person or persons described in sub-
8 paragraph (A), (B), or (C), or members of
9 their families (within the meaning of subpara-
10 graph (D)), who made (directly or indirect-
11 ly) substantially all of the contributions to the
12 private foundation in question, and
13 "(I) only for purposes of section 4941, a gov-
14 ernment official (as defined in subsection (c)).
15 "(2) SUBSTANTIAL CONTRIBUTORS.—For purposes
16 of paragraph (1), the term 'substantial contributor'
17 means a person who is described in section 507 (b) (2).
18 "(3) STOCKHOLDINGS.—For purposes of para-
19 graphs (1) (C) (i) and (1) (E), there shall be taken
20 into account indirect stockholdings which would be taken
21 into account under section 267 (c).
22 "(b) FOUNDATION MANAGER.—For purposes of this
23 chapter, the term 'foundation manager' means, with respect
24 to any private foundation—

1 "(1) an officer, director, or trustee of a foundation
2 (or an individual having powers or responsibilities sim-
3 ilar to those of officers, directors, or trustees of a foun-
4 dation), and
5 "(2) with respect to any act (or failure to act),
6 the employees of the foundation having authority or re-
7 sponsibility with respect to such act (or failure to act).
8 "(c) GOVERNMENT OFFICIAL.—For purposes of sub-
9 section (a) (1) (I) and section 4941, the term 'government
10 official' means, with respect to an act of self-dealing described
11 in section 4941, an individual who, at the time of such act,
12 holds any of the following offices or positions (other than as
13 a 'special Government employee', as defined in section 202
14 (a) of title 18, United States Code):
15 "(1) an elective public office in the executive or
16 legislative branch of the Government of the United
17 States,
18 "(2) an office in the executive or judicial branch
19 of the Government of the United States, appointment
20 to which was made by the President,
21 "(3) a position in the executive, legislative, or
22 judicial branch of the Government of the United
23 States—
24 "(A) which is listed in schedule C of rule VI
25 of the Civil Service Rules, or

1 "(B) the compensation for which is equal to
2 or greater than the lowest rate of compensation pre-
3 scribed for GS–16 of the General Schedule under
4 section 5332 of title 5, United States Code,
5 "(4) a position under the House of Representa-
6 tives or the Senate of the United States held by an
7 individual receiving gross compensation at an annual
8 rate of $15,000 or more,
9 "(5) an elective or appointive public office in the
10 executive, legislative, or judicial branch of the Govern-
11 ment of a State, possession of the United States, or
12 political subdivision or other area of any of the fore-
13 going, or of the District of Columbia, held by an in-
14 dividual receiving gross compensation at an annual rate
15 of $15,000 or more, or
16 "(6) a position as personal or executive assistant
17 or secretary of any of the foregoing.
18 **"SEC. 4947. APPLICATION OF TAXES TO CERTAIN NON-**
19 **EXEMPT TRUSTS.**
20 "(a) APPLICATION OF TAX.—
21 "(1) IN GENERAL.—The taxes imposed by section
22 506 (relating to tax on private foundation investment in-
23 come) and this chapter shall apply to any trust which
24 is not exempt from tax under section 501 (a), all of the
25 unexpired interests of which are devoted to one or more

1 of the purposes described in section 170(c)(2)(B),
2 and for which a deduction was allowable under section
3 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or
4 2522.

5 "(2) LIMITATION TO CHARITABLE PORTION.—In
6 the case of a trust which is not exempt from tax under
7 section 501(a), not all of the unexpired interests of
8 which are devoted to one or more of the purposes de-
9 scribed in section 170(c)(2)(B), and which has
10 amounts in trust for which a deduction was allowable
11 under section 170, 545(b)(2), 642(c), 2055, 2106
12 (a)(2), or 2522, the taxes imposed by section 4941
13 (relating to taxes on self-dealing), section 4943 (relat-
14 ing to taxes on excess business holdings), section 4944
15 (relating to investments which jeopardize charitable pur-
16 pose), and section 4945 (relating to taxes on taxable
17 expenditures) shall apply as if such trust were a private
18 foundation. This subsection shall not apply with respect
19 to—

20 "(A) any amounts payable under the terms
21 of such trust to income beneficiaries, unless section
22 170(b)(1)(H) applies, or

23 "(B) any amounts in trust for which a deduc-
24 tion was not allowable under section 170, 545(b)
25 (2), 642(c), 2055, 2106(a)(2), or 2522, if such

1 amounts are segregated from amounts for which
2 such deduction was allowable.
3 "(3) For purposes of subsection (a) (2) (B), a
4 trust with respect to which amounts are segregated shall
5 separately account for the various income, deduction,
6 and other items properly attributable to each of such
7 segregated amounts.
8 "(b) ADDITIONAL TAX.—
9 "(1) AMOUNT OF TAX.—There is hereby imposed
10 upon a trust described in subsection (a) which is noti-
11 fied by the Secretary or his delegate that he is invoking
12 this subsection as to it, and with respect to which there
13 have been either willful repeated acts (or failures to
14 act), or a willful and flagrant act (or failure to act), giv-
15 ing rise to liability for tax under this chapter, a tax equal
16 to the lower of—
17 "(A) the amount which such trust substanti-
18 ates by adequate records or other corroborating evi-
19 dence as the aggregate tax benefit described in para-
20 graph (2), or
21 "(B) the value of the net assets of such trust
22 (limited by the value of assets segregated for charity
23 in accordance with subsection (a) (2) (B)).
24 "(2) AGGREGATE TAX BENEFIT.—For purposes of

1 subsection (b) (1), the aggregate tax benefit is the sum
2 of—
3 "(A) the aggregate increases in tax under
4 chapters 1, 11, and 12 (or the corresponding provi-
5 sions of prior law) which would have been imposed
6 with respect to all substantial contributors (as de-
7 fined in section 507 (b) (2)) to the trust if deduc-
8 tions for all contributions made by such contributors
9 to the trust after February 28, 1913, had been dis-
10 allowed, and
11 "(B) the aggregate increases in tax under
12 chapter 1 (or the corresponding provisions of prior
13 law) which would have been imposed with respect
14 to the income of the trust for taxable years begin-
15 ning after December 31, 1912, if deductions under
16 section 642 (c) (or the corresponding provisions of
17 prior law) had been limited to 20 percent of the
18 taxable income of the trust (computed without the
19 benefit of section 642 (c) but with the benefit of
20 section 170 (b) (1) (B)), and
21 "(C) interest on the increases in tax deter-
22 mined under subparagraphs (A) and (B) from the
23 first date on which each such increase would have
24 been due and payable to the date on which the trust
25 pays the tax imposed by this subsection.

1 "(3) SPECIAL RULE.—For purposes of paragraph
2 (2), the value of the net assets shall be determined at
3 whichever time such value is higher:
4 "(A) the first day on which action is taken
5 by the trust which culminates in the imposition of
6 tax under this subsection, or
7 "(B) the day on which the tax prescribed by
8 this subsection is imposed.
9 "(4) LIABILITY IN CASE OF TRANSFERS OF ASSETS
10 FROM TRUSTS.—For purposes of determining liability
11 for the tax imposed by this subsection in the case of as-
12 sets transferred by the trust, such tax shall be deemed
13 to have been imposed on the first day on which action
14 is taken by the trust which culminates in the imposition
15 of tax under this subsection.
16 "(5) ABATEMENT OF TAX WHERE ASSETS ARE
17 DISTRIBUTED TO PUBLIC CHARITIES.—The Secretary
18 or his delegate may abate the unpaid portion of the
19 assessment of any tax imposed by this subsection, or any
20 liability with respect thereto, if the trust distributes all
21 of its net assets (limited by the value of assets segregated
22 for charity in accordance with subsection (a) (2) (B))
23 to one or more organizations specified in section 170(b)
24 (1) (B) each of which has been in existence and met

1 the requirements of section 170 (b) (1) (B) for a con-
2 tinuous period of at least 60 calendar months.
3 "(c) SPECIAL RULE.—For purposes of this section,
4 'nonexempt trust' shall be substituted for 'private founda-
5 tion' in sections 506, 507 (b) (2), 4941, 4942, 4943, 4944,
6 4945, and 4946.
7 "(d) REGULATIONS.—The Secretary or his delegate
8 shall prescribe such regulations as may be necessary to carry
9 out the purposes of this section."
10 (c) ASSESSABLE PENALTIES FOR REPEATED, OR
11 WILLFUL AND FLAGRANT, ACTS UNDER CHAPTER 42.—
12 Subchapter B of chapter 68 (relating to assessable penalties)
13 is amended by adding at the end thereof the following new
14 section:
15 "SEC. 6684. REPEATED LIABILITY FOR TAX UNDER
16 CHAPTER 42.
17 "If any person becomes liable for tax under any section
18 of chapter 42 (relating to private foundations) by reason of
19 any act or failure to act which is not due to reasonable cause
20 and either—
21 "(1) such person has theretofore been liable for
22 tax under such chapter, or
23 "(2) such act or failure to act is both willful and
24 flagrant,

1 then such person shall be liable for a penalty equal to the
2 amount of such tax."
3 (d) INFORMATION RETURNS OF EXEMPT ORGANIZA-
4 TIONS.—
5 (1) IN GENERAL.—Section 6033 (a) (relating to
6 information returns by exempt organizations) is amended
7 to read as follows:
8 "(a) ORGANIZATIONS REQUIRED TO FILE.—
9 "(1) IN GENERAL.—Every organization exempt
10 from taxation under section 501 (a) shall file an annual
11 return, stating specifically the items of gross income, re-
12 ceipts, and disbursements, and such other information for
13 the purpose of carrying out the internal revenue laws as
14 the Secretary or his delegate may by forms or regulations
15 prescribe, and shall keep such records, render under oath
16 such statements, make such other returns, and comply
17 with such rules and regulations as the Secretary or his
18 delegate may from time to time prescribe; except that,
19 in the discretion of the Secretary or his delegate, any or-
20 ganization described in section 401 (a) may be relieved
21 from stating in its return any information which is re-
22 ported in returns filed by the employer which established
23 such organization.
24 "(2) EXCEPTIONS FROM FILING.—The Secretary

1 or his delegate may relieve any organization required
2 under paragraph (1) to file an information return from
3 filing such a return where he determines that such filing
4 is not necessary to the efficient administration of the in-
5 ternal revenue laws."
6 (2) ADDITIONAL INFORMATION.—Section 6033
7 (b) (relating to certain organizations described in
8 section 501 (c) (3)) is amended—
9 (A) by striking out in paragraph (3) "out
10 of income",
11 (B) by striking out paragraphs (4), (5),
12 (6), and (8), and by redesignating paragraph (7)
13 as paragraph (4), and
14 (C) by adding after paragraph (4) (as re-
15 designated) the following new paragraphs:
16 "(5) the total of the contributions and gifts re-
17 ceived by it during the year, and the names and ad-
18 dresses of all substantial contributors,
19 "(6) the names and addresses of its foundation
20 managers (within the meaning of section 4946 (b) (1))
21 and highly compensated employees, and
22 "(7) the compensation and other payments made
23 during the year to each individual described in para-
24 graph (6)."
25 (3) PENALTY FOR LATE FILING OF CERTAIN IN-

1 FORMATION RETURNS.—Section 6652 (relating to fail-
2 ure to file certain information returns) is amended by
3 relettering subsection (d) as subsection (e) and in-
4 serting immediately after subsection (c) the following
5 new subsection:
6 "(d) RETURNS BY EXEMPT ORGANIZATIONS AND BY
7 CERTAIN TRUSTS.—
8 "(1) PENALTY ON ORGANIZATION OR TRUST.—In
9 the case of a failure to file a return required under sec-
10 tion 6033 (relating to returns by exempt organizations)
11 and section 6034 (relating to returns by certain trusts)
12 on the date and in the manner prescribed therefor (de-
13 termined with regard to any extension of time for filing),
14 unless it is shown that such failure is due to reasonable
15 cause, there shall be paid (on notice and demand by the
16 Secretary or his delegate and in the same manner
17 as tax) by the exempt organization or trust failing
18 so to file, $10 for each day during which such failure
19 continues, but the total amount imposed hereunder on
20 any organization for failure to file any return shall not
21 exceed $5,000.
22 "(2) PENALTY ON MANAGERS.—The Secretary or
23 his delegate may make written demand upon an orga-
24 nization failing to file under paragraph (1) specifying
25 therein a reasonable future date by which such filing shall

1 be made, and if such filing is not made on or before such
2 date, and unless it is shown that failure so to file is due
3 to reasonable cause, there shall be paid (on notice
4 and demand by the Secretary or his delegate and in
5 the same manner as tax) by the person failing so to
6 file, in addition to the penalty prescribed in paragraph
7 (1), a penalty of $10 for each day after the expiration
8 of the time specified in the written demand during
9 which such failure continues, but the total amount im-
10 posed hereunder on all persons for such failure to file
11 shall not exceed $5,000. If more than one person is liable
12 under this paragraph for a failure to file, all such
13 persons shall be jointly and severally liable with respect
14 to such failure. The term 'person' as used herein means
15 any officer, director, trustee, employee, member, or other
16 individual who is under a duty to perform the act in
17 respect of which the violation occurs."
18 (e) PUBLICITY OF INFORMATION REQUIRED BY
19 CERTAIN EXEMPT ORGANIZATIONS.—Section 6104 (re-
20 lating to publicity of information required from certain ex-
21 empt organizations and certain trusts) is amended by insert-
22 ing immediately after subsection (b), the following new
23 subsection:
24 "(c) PUBLICATION TO STATE OFFICIALS.—
25 "(1) GENERAL RULE.—In the case of any organi-

1 zation which is exempt from taxation under section
2 501 (a), or has applied for recognition of exemption
3 under such section on or after May 26, 1969, the Secre-
4 tary or his delegate at such times and in such manner as
5 he may by regulations prescribe shall—
6 "(A) notify the appropriate State officer of a
7 refusal to recognize exemption or the operation of
8 such organization in a manner which does not meet,
9 or no longer meets, the requirements of its ex-
10 emption,
11 "(B) notify the appropriate State officer of the
12 mailing of a notice of deficiency of tax under sec-
13 tion 507 or chapter 42, and
14 "(C) at the request of such appropriate State
15 officer, make available for inspection and copying
16 such returns, filed statements, records, reports, and
17 other information, relating to a determination under
18 subparagraph (A) or (B) as are relevant to any
19 determination under State law.
20 "(2) APPROPRIATE STATE OFFICER.—For pur-
21 poses of this section, the term 'appropriate State officer'
22 means the State attorney general, State tax officer, or
23 any other State official charged with overseeing charit-
24 able organizations."

1 (f) PETITION TO TAX COURT; DEFICIENCY PROCE-
2 DURES MADE APPLICABLE.—
3 (1) Section 6211 (a) (definition of a deficiency)
4 is amended—
5 (A) by striking out "and gift taxes" and in-
6 serting in lieu thereof "gift, and excise taxes,",
7 (B) by striking out "subtitles A and B," and
8 inserting in lieu thereof "subtitles A and B, and
9 chapter 42,", and
10 (C) by striking out "subtitles A or B" and
11 inserting in lieu thereof "subtitle A or B or chap-
12 ter 42".
13 (2) Section 6212 (c) (1) (relating to further de-
14 ficiency letters restricted) is amended by striking out
15 "or" before "of estate tax" and by inserting after "the
16 same decedent," the following: "or of chapter 42 tax
17 with respect to any act (or failure to act) to which
18 such petition relates,".
19 (3) Section 6213 (relating to restrictions appli-
20 cable to deficiencies; petition to Tax Court) is amended
21 by relettering subsection (e) as subsection (f) and in-
22 serting immediately after subsection (d) the following
23 new subsection:
24 "(e) SUSPENSION OF FILING PERIOD FOR CERTAIN
25 CHAPTER 42 TAXES.—The running of the time prescribed

1 by subsection (a), for filing a petition in the Tax Court with
2 respect to the taxes imposed by section 4941 (relating to
3 taxes on self-dealing), 4942 (relating to taxes on failure to
4 distribute income), or 4943 (relating to taxes on excess
5 business holdings) shall be suspended for any period during
6 which the Secretary or his delegate has extended the time
7 allowed for making correction under section 4941 (e) (4),
8 4942 (j) (2), or 4943 (d) (3)."
9 (g) LIMITATIONS ON ASSESSMENT AND COLLEC-
10 TION.—
11 (1) Section 6501 is amended by adding at the end
12 thereof the following new subsection:
13 "(n) SPECIAL RULE FOR CHAPTER 42 TAXES.—For
14 purposes of any tax imposed by chapter 42 (other than sec-
15 tion 4942), the return referred to in this section shall be the
16 return filed by the private foundation for the year in which
17 the act (or failure to act) giving rise to liability for such tax
18 occurred. For purposes of section 4942 (relating to taxes on
19 failure to distribute income), such return is the return filed
20 by the private foundation for the taxable year in which a
21 distribution of undistributed income under section 4942 is
22 required to be made."
23 (2) Section 6501 (c) is amended by adding the
24 following new paragraph at the end thereof:
25 "(7) TERMINATION OF PRIVATE FOUNDATION

33-865 O—69—pt. 1——13

1 STATUS.—In the case of a tax on termination of private
2 foundation status under section 507, such tax may be
3 assessed, or a proceeding in court for the collection of
4 such tax may be begun without assessment, at any time."
5 (3) Section 6503 (relating to suspension of running
6 of period of limitation) is amended by relettering sub-
7 section (h) as subsection (i) and inserting immediately
8 after subsection (g) the following new subsection:
9 "(h) SUSPENSION PENDING CORRECTION.—The run-
10 ning of the period of limitations provided in sections 6501
11 and 6502 on the making of assessments or the collection
12 by levy or a proceeding in court in respect of any tax im-
13 posed by chapter 42 or section 507 shall be suspended for
14 any period during which the Secretary or his delegate has
15 extended the time for making correction under section 4941
16 (e) (4), 4942 (j) (2), or 4943 (d) (3)."
17 (h) LIMITATIONS ON CREDITS OR REFUNDS.—Section
18 6511 (relating to limitations on credits or refunds) is
19 amended by relettering subsection (f) as subsection (g) and
20 inserting immediately after subsection (e) the following
21 new subsection:
22 "(f) SPECIAL RULE FOR CHAPTER 42 TAXES.—For
23 purposes of any tax imposed by chapter 42, the return re-
24 ferred to in subsection (a) shall be the return specified in
25 section 6501 (n)."

1 (i) CIVIL ACTION FOR REFUND.—Section 7422 (re-
2 lating to civil actions for refund) is amended by relettering
3 subsection (g) as subsection (h) and by inserting immedi-
4 ately after subsection (f) the following new subsection:
5 "(g) SPECIAL RULES FOR CERTAIN EXCISE TAXES
6 IMPOSED BY CHAPTER 42.—
7 "(1) RIGHT TO BRING ACTIONS.—With respect to
8 any act (or failure to act) giving rise to liability under
9 section 4941, 4942, or 4943, payment of the full amount
10 of tax imposed under section 4941 (a) (relating to initial
11 taxes on self-dealing), section 4942 (a) (relating to
12 initial tax on failure to distribute income), section 4943
13 (a) (relating to initial tax on excess business holdings),
14 section 4941 (b) (relating to additional taxes on self-
15 dealing), section 4942 (b) (relating to additional tax on
16 failure to distribute income), or section 4943 (b)
17 (relating to additional tax on excess business holdings)
18 shall constitute sufficient payment in order to maintain
19 an action under this section with respect to such act.
20 "(2) LIMITATION ON SUIT FOR REFUND.—No suit
21 may be maintained under this section for the credit or
22 refund of any tax imposed under section 4941, 4942, or
23 4943 with respect to any act (or failure to act) giving
24 rise to liability for tax under such sections, unless no

1 other suit has been maintained for credit or refund, and
2 no petition has been filed in the Tax Court with respect
3 to a deficiency of tax, for any other tax imposed under
4 such sections with respect to such act (or failure to act).

5 "(3) FINAL DETERMINATION OF ISSUES.—For pur-
6 poses of this section, any suit for the credit or refund
7 of any tax imposed under section 4941, 4942, or 4943
8 with respect to any act (or failure to act) giving rise to
9 liability for tax under such sections, shall constitute a
10 suit to determine all questions with respect to any other
11 tax imposed with respect to such act (or failure to act)
12 under such sections, and failure by the parties to such
13 suit to bring any such question before the Court shall
14 constitute a bar to such question.

15 (j) TECHNICAL, CONFORMING, AND CLERICAL
16 AMENDMENTS.—

17 (1) Section 101(b)(2)(B)(iii) (relating to non-
18 forfeitable rights) is amended by striking out "section
19 503(b) (1), (2), or (3)" and inserting in lieu there-
20 of "section 170(b)(1)(B) (ii) or (iii) or which is a
21 religious organization (other than a trust)".

22 (2) Section 170(c)(2)(B) (relating to the defi-
23 nition of charitable contributions) is amended by in-
24 serting after "animals" the phrase ", or for the provid-
25 ing of hospital care".

1 (3) Section 170 (c) (4) (relating to contributions
2 to fraternal societies) is amended by inserting after
3 "animals" the phrase ", or for the providing of hospital
4 care".
5 (4) Section 170 (i) (1) (relating to disallowance
6 of deductions in certain cases) (as redesignated) is
7 amended by striking out "section 503 (e)" and inserting
8 in lieu thereof "section 507 (f)".
9 (5) Section 501 (a) (relating to exemption from
10 taxation) is amended by striking out "502, 503, or
11 504" and inserting in lieu thereof "502 or 503".
12 (6) Section 501 (b) (relating to tax on unrelated
13 business income) is amended to read as follows:
14 "(b) TAX ON UNRELATED BUSINESS INCOME AND
15 CERTAIN OTHER ACTIVITIES.—An organization exempt
16 from taxation under subsection (a) shall be subject to tax to
17 the extent provided in parts II and III of this subchapter,
18 but (notwithstanding parts II and III of this subchapter)
19 shall be considered an organization exempt from income taxes
20 for the purpose of any law which refers to organizations
21 exempt from income taxes."
22 (7) Section 501 (c) (3) (relating to the definition
23 of exempt organizations) is amended by inserting after
24 "animals" the phrase ", or for the providing of hospital
25 care,".

1 (8) Section 501 (c) (16) (relating to list of ex-
2 empt organizations) is amended by striking out "part
3 III" and inserting in lieu thereof "part IV".
4 (9) Section 501 (e) (relating to cooperative hos-
5 pital service organizations) is amended by striking out
6 in the last sentence thereof "section 503 (b) (5)." and
7 inserting in lieu thereof "section 170 (b) (1) (B) (iii).".
8 (10) Section 503 (a) (1) (relating to general rule)
9 is amended to read as follows:
10 "(1) GENERAL RULE.—
11 "(A) An organization described in section 501
12 (c) (17) shall not be exempt from taxation under
13 section 501 (a) if it has engaged in a prohibited
14 transaction after December 31, 1959.
15 "(B) An organization described in section 401
16 (a) shall not be exempt from taxation under section
17 501 (a) if it has engaged in a prohibited transaction
18 after March 1, 1954."
19 (11) Section 503 (a) (2) (relating to taxable years
20 affected by denial of exemption) is amended by striking
21 out "section 501 (c) (3) or (17)" and inserting in lieu
22 thereof "section 501 (c) (17)".
23 (12) Section 503 (d) (relating to future status of
24 organizations denied exemption) is amended by striking

1 out "section 501 (c) (3) or (17)" and inserting in lieu
2 thereof "section 501 (c) (17)".
3 (13) Section 503 (g) (relating to special rule for
4 loans) is amended by striking out "subsection (c) (1),"
5 and inserting in lieu thereof "subsection (b) (1),".
6 (14) Section 503 (h) (relating to special rules
7 relating to lending by section 401 (a) and section 501
8 (c) (17) trusts to certain persons) is amended—
9 (A) by striking out in the title thereof "SPE-
10 CIAL RULES RELATING TO LENDING BY SECTION
11 401(a) AND SECTION 501(C)(17) TRUSTS TO CERTAIN
12 PERSONS.—", and inserting in lieu thereof "SPECIAL
13 RULES.—",
14 (B) by striking out "subsection (c) (1)," and
15 inserting in lieu thereof "subsection (b) (1),",
16 (C) by striking out "acquired by a trust de-
17 scribed in section 401 (a) or section 501 (c) (17)",
18 and
19 (D) by striking out in paragraph (3) "subsec-
20 tion (c)" and inserting in lieu thereof "subsection
21 (b)".
22 (15) Section 503 (i) (relating to loans with re-
23 spect to which employers are prohibited from pledging
24 certain assets) is amended—

1 (A) by striking out "Subsection (c) (1)" and
2 inserting in lieu thereof "Subsection (b) (1)", and
3 (B) by striking out "subsection (h)" and in-
4 serting in lieu thereof "subsection (e)".
5 (16) Section 503 (j) (1) (relating to prohibited
6 transactions) is amended by striking out "subsection
7 (c)" and inserting in lieu thereof "subsection (b)".
8 (17) Section 503 (relating to requirements of ex-
9 emption) is amended by striking out subsections (b),
10 (e), and (f) and by redesignating subsections (c),
11 (d), (g), (h), (i), and (j) (as amended) as sub-
12 sections (b), (c), (d), (e), (f), and (g), respectively.
13 (18) Section 504 (relating to denial of exemption)
14 is repealed.
15 (19) Section 542 (a) (2) (relating to stock own-
16 ership requirement) is amended—
17 (A) by striking out in the second sentence
18 "503 (b)" and inserting in lieu thereof "section
19 401 (a), 501 (c) (17), or 509 (a)", and
20 (B) by amending the third sentence to read as
21 follows: "The preceding sentence shall not apply in
22 the case of an organization or trust organized or cre-
23 ated before July 1, 1950, if at all times on or after
24 July 1, 1950, and before the close of the taxable
25 year such organization or trust has owned all of the

1 common stock and at least 80 percent of the total
2 number of shares of all other classes of stock of the
3 corporation."
4 (20) Section 663 (a) (2) (relating to charitable,
5 etc., distributions) is amended by striking out "section
6 681" and inserting in lieu thereof "sections 681 and
7 507 (f)".
8 (21) Section 681 (b) and (c) (relating to oper-
9 ations of trusts and accumulated income) is repealed.
10 (22) Section 681 (d) (relating to cross reference)
11 is redesignated as subsection (b), and as so redesignated
12 is amended by striking out "section 503 (e)" and in-
13 serting in lieu thereof "section 507 (f)".
14 (23) Section 2039 (c) (3) (relating to exemption
15 of annuities under certain trusts and plans) is amended
16 by striking out "section 503 (b) (1), (2), or (3),"
17 and inserting in lieu thereof "section 170 (b) (1) (B)
18 (ii) or (vi), or which is a religious organization (other
19 than a trust),".
20 (24) Section 2055 (a) (relating to general rule for
21 transfers for public, charitable, and religious uses) is
22 amended by—
23 (A) inserting in paragraph (2) after "ani-
24 mals" the phrase ", or for the providing of hospital
25 care", and

1 (B) inserting in paragraph (3) after "ani-
2 mals" the phrase ", or for the providing of hospital
3 care".
4 (25) Section 2106(a) (2) (A) (relating to gen-
5 eral rule for transfers for public, charitable, and religious
6 uses) is amended by—
7 (A) inserting in clause (ii) after "animals"
8 the phrase ", or for the providing of hospital care",
9 and
10 (B) inserting in clause (iii) after "animals"
11 the phrase ", or for the providing of hospital care".
12 (26) Section 2517(a) (3) (relating to general
13 rule for certain annuities under qualified plans) is
14 amended by striking out "section 503(b) (1), (2), or
15 (3)," and inserting in lieu thereof "section 170(b) (1)
16 (B) (ii) or (vi), or which is a religious organization
17 (other than a trust),".
18 (27) Section 2522 (relating to charitable and sim-
19 ilar gifts) is amended by:
20 (A) inserting in subsection (a) (2) after
21 "animals" the phrase ", or for the providing of
22 hospital care",
23 (B) inserting in subsection (a) (3) after
24 "animals" the phrase ", or for the providing of
25 hospital care",

1 (C) inserting in subsection (b)(2) after
2 "animals" the phrase ", or for the providing of
3 hospital care",
4 (D) inserting in subsection (b)(3) after
5 "animals" the phrase ", or for the providing of
6 hospital care", and
7 (E) inserting in subsection (b)(4) after
8 "animals" the phrase ", or for the providing of
9 hospital care".
10 (28) Section 4057(b) (relating to the definition
11 of nonprofit educational organization) is amended by
12 striking out "section 503(b)(2)" and inserting in lieu
13 thereof "section 170(b)(1)(B)(ii)".
14 (29) Section 4221(d)(5) (relating to the defini-
15 tion of nonprofit educational organization) is amended
16 by striking out "section 503(b)(2)" and inserting in
17 lieu thereof "section 170(b)(1)(B)(ii)".
18 (30) Section 4253(h) (relating to nonprofit hos-
19 pitals) is amended by striking out "section 503(b)
20 (5)" and inserting in lieu thereof "section 170(b)(1)
21 (B)(iii)".
22 (31) Section 4294(b) (relating to the definition
23 of nonprofit educational organization) is amended by
24 striking out "section 503(b)(2)" and inserting in lieu
25 thereof "section 170(b)(1)(B)(ii)".

1 (32) Section 5214 (a) (3) (A) (relating to pur-
2 poses for withdrawal of distilled spirits from bonded
3 premises free of tax or without payment of tax) is
4 amended by striking out "section 503 (b) (2)" and in-
5 serting in lieu thereof "section 170 (b) (1) (B) (ii)".
6 (33) Section 6033 (b) (7) (relating to certain
7 balance sheet items on returns by exempt organizations)
8 is amended by striking out "and".
9 (34) Section 6034 (relating to returns by certain
10 trusts) is amended by striking out all of such section be-
11 fore paragraph (1) of subsection (a) and inserting in
12 lieu thereof the following:
13 "SEC. 6034. RETURNS BY TRUSTS DESCRIBED IN SECTION
14 4947(a) OR CLAIMING CHARITABLE DEDUC-
15 TIONS UNDER SECTION 642(c).
16 "(a) GENERAL RULE.—Every trust described in sec-
17 tion 4947 (a) or claiming a charitable, etc., deduction under
18 section 642 (c) for the taxable year shall furnish such infor-
19 mation with respect to such taxable year as the Secretary
20 or his delegate may by forms or regulations prescribe as
21 necessary to carry out the provisions of the internal revenue
22 laws, including—".
23 (35) Section 6034 (a) (1) (relating to returns by
24 certain trusts) is amended by striking out "(showing
25 separately the amount of such deduction which was paid

1 out and the amount which was permanently set aside
2 for charitable, etc., purposes during such year)".

3 (36) Section 6104(b) (relating to inspection of
4 annual information returns) is amended by striking
5 out "sections 6033(b) and 6034," and inserting in lieu
6 thereof "sections 6033 and 6034,".

7 (37) Section 6161(b) (relating to the amount
8 determined as a deficiency when granting an extension
9 of time) is amended—

10 (A) by striking out in paragraph (1) "chap-
11 ter 1 or 12," and inserting in lieu thereof "chapter
12 1, 12, or 42,", and

13 (B) by striking out "chapter 1," the last time
14 it appears and inserting in lieu thereof "chapter 1
15 or 42,".

16 (38) Section 6201(d) (relating to deficiency pro-
17 ceedings) is amended by striking out "and gift taxes",
18 and inserting in lieu thereof "gift, and chapter 42 taxes".

19 (39) Section 6211(b)(2) (relating to the term
20 "rebate") is amended by striking out "subtitles A or B"
21 and inserting in lieu thereof "subtitle A or B or chapter
22 42".

23 (40) Section 6212(a) (relating to notice of defi-
24 ciency) is amended by striking out "subtitles A or B"

1 and inserting in lieu thereof "subtitle A or B or chapter
2 42".
3 (41) Section 6212(b)(1) (relating to address for
4 notice of deficiency) is amended—
5 (A) by striking out in the title thereof "AND
6 GIFT TAXES" and inserting in lieu thereof "AND
7 GIFT TAXES AND TAXES IMPOSED BY CHAPTER
8 42",
9 (B) by striking out "subtitle A or chapter
10 12," and inserting in lieu thereof "subtitle A, chap-
11 ter 12, or chapter 42,", and
12 (C) by inserting "chapter 42," after "chapter
13 12," the last place it appears.
14 (42) Section 6213(a) (relating to restrictions ap-
15 plicable to deficiencies; petition to Tax Court) is
16 amended by inserting "or chapter 42" after "subtitle
17 A or B".
18 (43) Section 6214 (relating to determinations by
19 the Tax Court) is amended by relettering subsection
20 (c) as subsection (d) and by inserting after subsection
21 (b) the following new subsection:
22 "(c) TAXES IMPOSED BY SECTION 507 OR CHAPTER
23 42.—The Tax Court, in redetermining a deficiency of any
24 tax imposed by section 507 or chapter 42 for any period,
25 act, or failure to act, shall consider such facts with relation

1 to the taxes under chapter 42 for other periods, acts, or
2 failures to act as may be necessary correctly to redetermine
3 the amount of such deficiency, but in so doing shall have no
4 jurisdiction to determine whether or not any other tax has
5 been overpaid or underpaid."

6 (44) Section 6214(d) (as relettered) is amended
7 by inserting ", chapter 42," after "chapter".

8 (45) Section 6344(a)(1) (relating to certain
9 cross references) is amended by inserting "and taxes
10 imposed by chapter 42," after "gift taxes,".

11 (46) Section 6503(a)(1) (relating to issuance of
12 statutory notice of deficiency) is amended by striking
13 out "and gift taxes" and inserting in lieu thereof "gift,
14 and chapter 42 taxes".

15 (47) Section 6512(a) (relating to effect of peti-
16 tion of Tax Court) is amended—

17 (A) by striking out "and gift taxes" and insert-
18 ing in lieu thereof "gift, and chapter 42 taxes", and

19 (B) by striking out "or of estate tax in respect
20 of the taxable estate of the same decedent," and in-
21 serting in lieu thereof "of estate tax in respect of the
22 taxable estate of the same decedent, or of tax im-
23 posed by chapter 42 with respect to any act (or
24 failure to act) to which such petition relates,".

1 (48) Section 6512(b)(1) (relating to jurisdiction
2 to determine overpayment determined by Tax Court) is
3 amended by striking out "or of estate tax in respect of
4 the taxable estate of the same decedent," and inserting in
5 lieu thereof "of estate tax in respect of the taxable estate
6 of the same decedent, or of tax imposed by chapter 42
7 with respect to any act (or failure to act) to which such
8 petition relates,".
9 (49) Section 6601(d) (relating to suspension of
10 interest in certain cases) is amended—
11 (A) by striking out in the title thereof "AND
12 GIFT TAX CASES." and inserting in lieu thereof
13 "GIFT, AND CHAPTER 42 TAX CASES.", and
14 (B) by striking out "and gift taxes" and insert-
15 ing in lieu thereof "gift, and chapter 42 taxes".
16 (50) Section 6653(c)(1) (relating to definition
17 of overpayment) is amended—
18 (A) by striking out in the title thereof "AND
19 GIFT TAXES." and inserting in lieu thereof "GIFT,
20 AND CHAPTER 42 TAXES.", and
21 (B) by striking out "and gift taxes" the last
22 time it appears and inserting in lieu thereof "gift,
23 and chapter 42 taxes".
24 (51) Section 6659(b) (relating to procedure for
25 assessing certain additions to tax) is amended by strik-

1 ing out "and gift taxes" and inserting in lieu thereof
2 "gift, and chapter 42 taxes".
3 (52) Section 6676(b) (relating to deficiency pro-
4 cedures not to apply) is amended by striking out "and
5 gift taxes" and inserting in lieu thereof "gift, and chapter
6 42 taxes".
7 (53) Section 6677(b) (relating to deficiency pro-
8 cedures not to apply) is amended by striking out "and
9 gift taxes" and inserting in lieu thereof "gift, and chapter
10 42 taxes".
11 (54) Section 6679(b) (relating to deficiency pro-
12 cedures not to apply) is amended by striking out "and
13 gift taxes" and inserting in lieu thereof "gift, and chapter
14 42 taxes".
15 (55) Section 6682(b) (relating to deficiency pro-
16 cedures not to apply) is amended by striking out "and
17 gift taxes" and inserting in lieu thereof "gift, and chap-
18 ter 42 taxes".
19 (56) Section 7422(e) (relating to stay of pro-
20 ceeding in civil actions for refund) is amended by strik-
21 ing out "or gift tax" the first time it appears and insert-
22 ing in lieu thereof "gift tax, or tax imposed by chapter
23 42".
24 (57) The table of parts for subchapter F of chapter
25 1 is amended to read as follows:

1 "Subchapter F—Exempt Organizations

"Part I. General rule.
"Part II. Private foundations.
"Part III. Taxation of business income of certain exempt organizations.
"Part IV. Farmers' cooperatives.
"Part V. Shipowners' protection and indemnity associations."

2 (58) The table of chapters for subtitle D is amended
3 by adding at the end thereof the following new item:

"Chapter 42. Private foundations."

4 (59) The table of sections for subchapter B of
5 chapter 68 is amended by adding at the end thereof
6 the following new item:

"Sec. 6684. Repeated liability for tax under chapter 42."

7 (k) Effective Dates.—
8 (1) In general.—Except as otherwise provided
9 in this subsection, the amendments made by this section
10 shall apply for taxable years beginning after Decem-
11 ber 31, 1969.
12 (2) Section 4941.—Section 4941 shall not apply
13 to—
14 (A) any transaction between a private founda-
15 tion and a corporation which is a disqualified per-
16 son (as defined in section 4946), pursuant to the
17 terms of securities of such corporation in existence
18 at the time acquired by the foundation, if such se-

1 curities were acquired by the foundation before
2 May 27, 1969;
3 (B) the sale of property which is owned by a
4 private foundation on May 26, 1969, to a disquali-
5 fied person, if such foundation is required to dispose
6 of such property in order not to be liable for tax
7 under section 4943 (relating to taxes on excess busi-
8 ness holdings), and it receives in return an amount
9 which equals or exceeds the fair market value of
10 such property; and
11 (C) the use of property in which a private
12 foundation and a disqualified person have a joint
13 or common interest, if the interests of both in such
14 property were acquired before May 27, 1969.
15 (3) SECTION 4942.—In the case of organizations
16 organized before May 27, 1969, section 4942 shall—
17 (A) for taxable years beginning before Jan-
18 uary 1, 1972, apply without regard to the minimum
19 investment return provision (as defined in section
20 4942(e) as added by this Act); and
21 (B) not apply to an organization to the extent
22 its income is required to be accumulated pursuant to
23 the mandatory terms (as in effect on May 27, 1969,

1 and at all times thereafter) of an instrument
2 executed before May 27, 1969, with respect to the
3 transfer of income producing property to such orga-
4 nization, except that section 4942 shall apply to such
5 organization if the organization would have been
6 denied exemption if section 504 (a) had not been
7 repealed by this Act, or would have had its deduc-
8 tions under section 642 (c) limited if section 681 (c)
9 had not been repealed by this Act. In applying
10 the preceding sentence, in addition to the limitations
11 contained in section 504 (a) or 681 (c) before its
12 repeal, section 504 (a) (1) or 681 (c) (1) shall be
13 treated as not applying to income attributable to
14 property transferred to an organization before Jan-
15 uary 1, 1951, if the transfer was irrevocable on such
16 date and if such income is required to be accumu-
17 lated pursuant to the mandatory terms (as in effect
18 on such date and at all times thereafter) of an in-
19 strument relating to such transfer executed before
20 such date.
21 With respect to taxable years beginning after December
22 31, 1971, subparagraph (B) shall apply only with
23 respect to taxable years for which it is impossible for
24 such organization to reform its governing instrument

1 (by amendment, judicial proceeding, or otherwise) to
2 meet the requirements of section 508 (g) (1) (A).
3 (4) SECTION 4943.—Subject to the provisions of
4 paragraph (5), section 4943 shall not apply with re-
5 spect to—
6 (A) an organization created by an inter-vivos
7 trust which was irrevocable on December 31, 1939,
8 and which, together with all disqualified persons (as
9 defined in section 4946) with respect thereto, owned
10 on July 28, 1969, not more than 55 percent of the
11 stock of a corporation, the common stock of which
12 was traded on a public stock exchange at all times
13 after 1960, or
14 (B) an organization incorporated before De-
15 cember 31, 1944, which owns stock in a business
16 enterprise 95 percent of the gross income of which
17 (for the 10-year period ending on December 31,
18 1969) was derived from dividends, interest, royal-
19 ties, income in the nature of royalties, and capital
20 gains, and which, for each taxable year beginning
21 after December 31, 1969, makes qualifying dis-
22 tributions (within the meaning of section 4942 (g)
23 (1) and (2)) of substantially more than half of

1 its income for educational purposes described in
2 section 170 (c) (2) (B).
3 For purposes of subparagraph (B), income in the nature
4 of royalties means income of a corporation derived from
5 the sale of any product under a contract between such
6 corporation and a buyer of such product designating
7 such buyer as the corporation's exclusive customer of
8 such product within a specified geographical area, or
9 from charges or costs passed on to such customer at cost,
10 if such corporation does not manufacture, produce, physi-
11 cally receive, or deliver or maintain inventories in such
12 product, and income of a corporation received in settle-
13 ment of a dispute concerning, or in lieu of the exercise
14 of, its right to sell a product within a specified geographi-
15 cal area.
16 (5) SPECIAL RULE.—An organization is within the
17 meaning of paragraph (4) only if—
18 (A) at least 80 percent of its net income in
19 each of the last 4 taxable years ending on or before
20 December 31, 1969, is derived from the stock in a
21 business enterprise described in subparagraph (A)
22 or (B) of paragraph (4),
23 (B) no donor to such organization of the stock
24 in a business enterprise described in subparagraph
25 (A) or (B) of paragraph (4), or a member of

1 his family (as defined in section 341(d)), is a
2 foundation manager (as defined in section
3 4946(b)) with respect thereto or a member of
4 the board of directors or other managing body of
5 such business enterprise on July 28, 1969, and
6 (C) it does not purchase any stock or other
7 interest in such business enterprise after July 28,
8 1969, and it does not acquire any stock or other
9 interest in any other business enterprise which
10 would constitute excess business holdings if the
11 organization were subject to the provisions of
12 section 4945.
13 (6) SECTION 4947.—Section 4947(a)(2) shall
14 not apply with respect to amounts transferred in trust
15 before May 27, 1969.

16 ## Subtitle B—Other Tax Exempt
17 ## Organizations

18 **SEC. 121. TAX ON UNRELATED BUSINESS INCOME.**
19 (a) ORGANIZATIONS SUBJECT TO TAX.—
20 (1) CORPORATE RATES.—Section 511(a)(2)(A)
21 (relating to certain organizations subject to tax on unre-
22 lated business income at corporate rates) is amended to
23 read as follows:
24 "(A) ORGANIZATIONS DESCRIBED IN SECTIONS
25 401(a) AND 501(c).—The taxes imposed by para-

1 graph (1) shall apply in the case of any organiza-
2 tion (other than a trust described in subsection (b)
3 or an organization described in section 501 (c) (1))
4 which is exempt, except as provided in this part or
5 part II (relating to private foundations), from tax-
6 ation under this subtitle by reason of section 501
7 (a)."
8 (2) INDIVIDUAL RATES.—Section 511 (b) (2) (re-
9 lating to charitable, etc., trusts subject to tax on un-
10 related business income) is amended to read as follows:
11 "(2) CHARITABLE, ETC., TRUSTS SUBJECT TO
12 TAX.—The tax imposed by paragraph (1) shall apply
13 in the case of any trust which is exempt, except as pro-
14 vided in this part or part II (relating to private founda-
15 tions), from taxation under this subtitle by reason of
16 section 501 (a) and which, if it were not for such exemp-
17 tion, would be subject to subchapter J (sec. 641 and
18 following, relating to estates, trusts, beneficiaries, and
19 decedents)."
20 (b) DEFINITION OF UNRELATED BUSINESS TAXABLE
21 INCOME.—
22 (1) IN GENERAL.—Section 512 (a) (relating to
23 definition of unrelated business taxable income) is
24 amended to read as follows:
25 "(a) DEFINITION.—For purposes of this title—

1 "(1) GENERAL RULE.—Except as otherwise pro-
2 vided in this subsection, the term 'unrelated business
3 taxable income' means the gross income derived by any
4 organization from any unrelated trade or business (as
5 defined in section 513) regularly carried on by it, less
6 the deductions allowed by this chapter which are directly
7 connected with the carrying on of such trade or business,
8 both computed with the modifications provided in sub-
9 section (b).

10 "(2) SPECIAL RULE FOR FOREIGN ORGANIZA-
11 TIONS.—In the case of an organization described in sec-
12 tion 511 which is a foreign organization, the unrelated
13 business taxable income shall be—

14 "(A) its unrelated business taxable income
15 which is derived from sources within the United
16 States and which is not effectively connected with
17 the conduct of a trade or business within the United
18 States, plus

19 "(B) its unrelated business taxable income
20 which is effectively connected with the conduct of
21 a trade or business within the United States.

22 "(3) SPECIAL RULES APPLICABLE TO ORGANIZA-
23 TIONS DESCRIBED IN SECTION 501(c) (7), (8), (9), OR (10).—

24 "(A) GENERAL RULE.—In the case of an or-
25 ganization described in section 501(c) (7), (8),

1 (9), or (10), the term 'unrelated business taxable
2 income' means the gross income (excluding any ex-
3 empt function income), less the deductions allowed
4 by this chapter which are directly connected with
5 the production of the gross income (excluding ex-
6 empt function income), both computed with the
7 modifications provided in paragraphs (6), (10),
8 (11) and (12) of subsection (b).

9 "(B) EXEMPT FUNCTION INCOME.—For pur-
10 poses of subparagraph (A), the term 'exempt
11 function income' means the gross income from dues,
12 fees, charges, or similar amounts paid by members
13 of the organization as consideration for providing
14 such members or their guests goods, facilities, or
15 services in furtherance of the purposes constituting
16 the basis for the exemption of the organization to
17 which such income is paid. In the case of an organi-
18 zation described in section 501(c) (8), (9), or
19 (10), the term 'exempt function income' also in-
20 cludes all income (other than an amount equal to
21 the gross income derived from any unrelated trade
22 or business regularly carried on by such organiza-
23 tion computed as if the organization were subject to
24 paragraph (1)), which is permanently committed—

1 "(i) for a purpose specified in section
2 170(c)(4), or
3 "(ii) to providing for the payment of life,
4 sick, accident, or other benefits under section
5 501(c)(8)(B), (9), or (10).
6 If during the taxable year, an amount which is
7 attributable to income so permanently committed
8 is used for a purpose other than that described in
9 clause (i) or (ii), such amount shall be included,
10 under subparagraph (A), in unrelated business tax-
11 able income for the taxable year.
12 "(C) APPLICABILITY TO CERTAIN CORPORA-
13 TIONS DESCRIBED IN SECTION 501(c)(2).—In the
14 case of a corporation described in section 501(c)
15 (2), the income of which is payable to an organiza-
16 tion described in section 501(c) (7), (8), (9), or
17 (10), the rules of subparagraphs (A) and (B)
18 shall apply as if such corporation were the organiza-
19 tion to which the income were payable, and in com-
20 puting exempt function income amounts paid by
21 the organization to which such corporation's income
22 is payable as well as by members of such organiza-
23 tion shall be taken into account."

1 (2) MODIFICATIONS.—

2 (A) DEBT-FINANCED PROPERTY.—Section
3 512(b)(4) (relating to modifications with re-
4 spect to business leases) is amended to read as
5 follows:

6 "(4) Notwithstanding paragraph (1), (2), (3),
7 or (5), in the case of debt-financed property (as de-
8 fined in section 514) there shall be included, as an item
9 of gross income derived from an unrelated trade or
10 business, the amount ascertained under section 514(a)
11 (1), and there shall be allowed, as a deduction, the
12 amount ascertained under section 514(a)(2)."

13 (B) LIMIT ON SPECIFIC DEDUCTION.—Section
14 512(b)(12) (relating to allowance of specific de-
15 duction) is amended to read as follows:

16 "(12) Except for purposes of computing the net op-
17 erating loss under section 172 and paragraph (6), there
18 shall be allowed a specific deduction of $1,000."

19 (C) SPECIAL RULES FOR CERTAIN ORGANIZA-
20 TIONS.—Section 512(b) (relating to modifications
21 in determining unrelated business taxable income) is
22 further amended by adding at the end thereof the
23 following:

24 "(15) Notwithstanding paragraph (1), (2), or
25 (3), amounts of interests, annuities, royalties, and rents

1 derived from an organization of which the organization
2 deriving such amounts has control (as defined in section
3 368(c)) shall be included as an item of gross income
4 (whether or not the activity from which such amounts
5 are derived represents a trade or business or is regularly
6 carried on), and there shall be allowed all deductions
7 directly connected with such amounts.

8 "(16) Except as provided in paragraph (4), in the
9 case of a church, or convention or association of church-
10 es, for taxable years beginning before January 1, 1976,
11 there shall be excluded all gross income derived from a
12 trade or business and all deductions directly connected
13 with the carrying on of such trade or business if such
14 trade or business was carried on by such organization or
15 its predecessor before May 27, 1969."

16 (D) TECHNICAL AMENDMENT.—Section 512
17 (b) (relating to exceptions, additions, and limita-
18 tions in determining unrelated business taxable in-
19 come) is amended by striking out so much thereof
20 as precedes paragraph (1) and inserting in lieu
21 thereof the following:

22 "(b) MODIFICATIONS.—The modifications referred to in
23 subsection (a) are the following:"

24 (3) RELATED AMENDMENT.—

25 (A) Part IX of subchapter B of chapter 1

1 (relating to items not deductible) is amended by
2 adding at the end thereof the following:
3 "SEC. 278. DEDUCTIONS INCURRED BY CERTAIN MEMBER-
4 SHIP ORGANIZATIONS IN TRANSACTIONS
5 WITH MEMBERS.
6 "(a) GENERAL RULE.—In the case of a social club or
7 other membership organization which is operated primarily
8 to furnish services or goods to members and which is not
9 exempt from taxation, deductions for the taxable year in
10 furnishing services, insurance, goods, or other items of value
11 to members shall be allowed only to the extent of income
12 derived during such year from members or transactions with
13 members.
14 "(b) EXCEPTIONS.—Subsection (a) shall not apply to
15 any organization which for the taxable year is subject to
16 taxation under subchapter H or L."
17 (B) The table of sections for part IX of sub-
18 chapter B of chapter 1 is amended by adding at the
19 end thereof the following:

"Sec. 278. Deductions incurred by certain membership organizations in transactions with members."

20 (4) LOCAL EMPLOYEE ASSOCIATION.—Section 513
21 (a) (2) (relating to exception to definition of unrelated
22 trade or business) is amended by striking out "em-
23 ployees; or" and inserting in lieu thereof the following:

1 "employees, or, in the case of a local association of em-
2 ployees described in section 501 (c) (4), organized be-
3 fore May 27, 1969, is the selling by the organization of
4 items normally sold through vending machines, through
5 food dispensing facilities, or by snack bars, for the con-
6 venience of its members at their usual places of employ-
7 ment; or".

8 (5) VOLUNTARY EMPLOYEES' BENEFICIARY AS-
9 SOCIATIONS.—Section 501 (c) (9) (relating to certain
10 voluntary employees' beneficiary associations) is amend-
11 ed to read as follows:

12 "(9) Voluntary employees' beneficiary associations
13 providing for the payment of life, sick, accident, or other
14 benefits to the members of such association or their de-
15 pendents, if no part of their net earnings inures (other
16 than through such payments) to the benefit of any pri-
17 vate shareholder or individual."

18 (c) ACTIVITIES INCLUDED AS UNRELATED TRADE OR
19 BUSINESS.—Section 513 (relating to unrelated trade or
20 business) is amended by striking out subsection (c) and
21 inserting in lieu thereof the following new subsection:

22 "(c) ADVERTISING, ETC., ACTIVITIES.—For purposes
23 of this section, the term 'trade or business' includes any activ-
24 ity which is carried on for the production of income from

1 the sale of goods or the performance of services. For pur-
2 poses of the preceding sentence, an activity does not lose
3 identity as a trade or business merely because it is carried
4 on within a larger aggregate of similar activities or within a
5 larger complex of other endeavors which may, or may not,
6 be related to the exempt purposes of the organization."

7 (d) UNRELATED DEBT-FINANCED INCOME.—

8 (1) IN GENERAL.—Section 514 (relating to busi-
9 ness leases) is amended by striking out so much thereof
10 as precedes subsection (b) and inserting in lieu thereof
11 the following:

12 "SEC. 514. UNRELATED DEBT-FINANCED INCOME.

13 "(a) UNRELATED DEBT-FINANCED INCOME AND
14 DEDUCTIONS.—In computing under section 512 the unre-
15 lated business taxable income for any taxable year—

16 "(1) PERCENTAGE OF INCOME TAKEN INTO AC-
17 COUNT.—There shall be included with respect to each
18 debt-financed property as an item of gross income de-
19 rived from an unrelated trade or business an amount
20 which is the same percentage (but not in excess of 100
21 percent) of the total gross income derived during the
22 taxable year from or on account of such property as
23 (A) the average acquisition indebtedness (as defined in
24 subsection (c) (7)) for the taxable year with respect
25 to the property is of (B) the average amount (deter-

1 mined under regulations prescribed by the Secretary or
2 his delegate) of the adjusted basis of such property dur-
3 ing the period it is held by the organization during such
4 taxable year.
5 "(2) PERCENTAGE OF DEDUCTIONS TAKEN INTO
6 ACCOUNT.—There shall be allowed with respect to each
7 debt-financed property, as a deduction to be taken into
8 account in computing unrelated debt-financed income,
9 an amount determined by applying (except as provided
10 in the last sentence of this subsection) the percentage
11 derived under paragraph (1) to the sum determined
12 under paragraph (3). The percentage derived under
13 this paragraph shall not be applied with respect to the
14 deduction of any capital loss resulting from the carryover
15 under section 1212 of unused losses in prior taxable
16 years.
17 "(3) DEDUCTIONS ALLOWABLE.—The sum referred
18 to in paragraph (2) is the sum of the deductions under
19 this chapter which are directly connected with the debt-
20 financed property or the income therefrom, except that
21 if the debt-financed property is of a character which is
22 subject to the allowance for depreciation provided in sec-
23 tion 167, the allowance shall be computed only by use of
24 the straight-line method.

1 "(b) DEFINITION OF DEBT-FINANCED PROPERTY.—
2 "(1) IN GENERAL.—The term 'debt-financed prop-
3 erty' means any property which is held to produce
4 income and with respect to which there is an acquisition
5 indebtedness (as defined in subsection (c)) at any time
6 during the taxable year (or, if the property was disposed
7 of during the taxable year, with respect to which there
8 was an acquisition indebtedness at any time during the
9 12-month period ending with the date of such disposi-
10 tion), except that such term does not include—
11 "(A) any property all the use of which is
12 related (aside from the need of the organization for
13 income or funds) to the exercise or performance by
14 such organization of its charitable, educational, or
15 other purpose or function constituting the basis for
16 its exemption under section 501 (or, in the case of
17 an organization described in section 511(a)(2)
18 (B), to the exercise or performance of any purpose
19 or function designated in section 501(c)(3));
20 "(B) except in the case of income excluded
21 under section 512(b)(5), any property all the
22 income from which is taken into account in com-
23 puting the gross income of any unrelated trade or
24 business;
25 "(C) any property all the income from which

1 is excluded by reason of the provisions of paragraph
2 (7), (8), or (9) of section 512(b) in computing
3 the gross income of any unrelated trade or business;
4 or

5 "(D) any property all the use of which is in
6 any trade or business described in paragraph (1),
7 (2), or (3) of section 513(a).

8 "(2) SPECIAL RULES WHEN LAND IS ACQUIRED
9 FOR EXEMPT USE WITHIN 10 YEARS.—

10 "(A) NEIGHBORHOOD LAND.—If an organiza-
11 tion acquires real property for the principal purpose
12 of using the land (commencing within 10 years of
13 the time of acquisition) in the manner described in
14 paragraph (1)(A) and at the time of acquisition
15 the property is in the neighborhood of other prop-
16 erty owned by the organization which is used in such
17 manner, the real property acquired for such future
18 use shall not be treated as debt-financed property so
19 long as the organization does not abandon its intent
20 to so use the land within the 10-year period. The
21 preceding sentence shall not apply for any period
22 after the expiration of the 10-year period, and shall
23 apply after the first 5 years of the 10-year period
24 only if the organization establishes to the satisfaction

1 of the Secretary or his delegate that it is reasonably
2 certain that the land will be used in the described
3 manner before the expiration of the 10-year period.
4 "(B) OTHER CASES.—If the first sentence of
5 subparagraph (A) is inapplicable only because—
6 "(i) the acquired land is not in the neigh-
7 borhood referred to in subparagraph (A), or
8 "(ii) the organization (for the period after
9 the first 5 years of the 10-year period) is unable
10 to establish to the satisfaction of the Secretary or
11 his delegate that it is reasonably certain that the
12 land will be used in the manner described in
13 paragraph (1) (A) before the expiration of the
14 10-year period,
15 but the land is converted to such use by the organi-
16 zation within the 10-year period, the real property
17 (subject to the provisions of subparagraph (D))
18 shall not be treated as debt-financed property for
19 any period before such conversion. For purposes of
20 this subparagraph, land shall not be treated as used
21 in the manner described in paragraph (1) (A) by
22 reason of the use made of any structure which was
23 on the land when acquired by the organization.
24 "(C) LIMITATIONS.—Subparagraphs (A) and
25 (B)—

1 "(i) shall apply with respect to any struc-
2 ture on the land when acquired by the orga-
3 nization, or to the land occupied by the structure,
4 only if (and so long as) the intended future use
5 of the land in the manner described in para-
6 graph (1) (A) requires that the structure be
7 demolished or removed in order to use the land
8 in such manner;

9 "(ii) shall not apply to structures erected
10 on the land after the acquisition of the land; and

11 "(iii) shall not apply to property subject
12 to a lease which is a business lease as (defined
13 in subsection (f)).

14 "(D) REFUND OF TAXES WHEN SUBPARA-
15 GRAPH (B) APPLIES.—If an organization for any tax-
16 able year has not used land in the manner to satisfy
17 the actual use condition of subparagraph (B) before
18 the time prescribed by law (including extensions
19 thereof) for filing the return for such taxable year,
20 the tax for such year shall be computed without
21 regard to the application of subparagraph (B), but
22 if and when such use condition is satisfied, the pro-
23 visions of subparagraph (B) shall then be applied
24 to such taxable year. If the actual use condition of
25 subparagraph (B) is satisfied for any taxable year

1 after such time for filing the return, and if credit or
2 refund of any overpayment for the taxable year
3 resulting from the satisfaction of such use condition
4 is prevented at the close of the taxable year in
5 which the use condition is satisfied, by the operation
6 of any law or rule of law (other than chapter 74,
7 relating to closing agreements and compromises),
8 credit or refund of such overpayment may neverthe-
9 less be allowed or made if claim therefor is filed
10 before the expiration of 1 year after the close of
11 the taxable year in which the use condition is satis-
12 fied. Interest on any overpayment for a taxable year
13 resulting from the application of subparagraph (B)
14 after the actual use condition is satisfied shall be
15 allowed and paid at the rate of 4 percent per annum
16 in lieu of 6 percent per annum.

17 "(E) SPECIAL RULE FOR CHURCHES.—In ap-
18 plying this paragraph to a church or convention or
19 association of churches, in lieu of the 10-year period
20 referred to in subparagraphs (A) and (B) a 15-
21 year period shall be applied, and subparagraphs
22 (A) and (B) (ii) shall apply whether or not the
23 acquired land meets the neighborhood test.

24 "(c) ACQUISITION INDEBTEDNESS.—

25 "(1) GENERAL RULE.—The term 'acquisition in-

1 debtedness' means, with respect to any debt-financed
2 property, the unpaid amount of—
3 "(A) the indebtedness incurred by the orga-
4 nization in acquiring or improving such property;
5 "(B) the indebtedness incurred before the ac-
6 quisition or improvement of such property if such
7 indebtedness would not have been incurred but for
8 such acquisition or improvement; and
9 "(C) the indebtedness incurred after the ac-
10 quisition or improvement of such property if such
11 indebtedness would not have been incurred but for
12 such acquisition or improvement and the incurrence
13 of such indebtedness was reasonably foreseeable at
14 the time of such acquisition or improvement,
15 except that in the case of any taxable year beginning
16 before January 1, 1972, any indebtedness incurred before
17 June 28, 1966, shall not be taken into account. In
18 the case of an organization (other than a church or con-
19 vention or association of churches) such indebtedness
20 incurred before June 28, 1966, shall be taken into ac-
21 count if such indebtedness constitutes business lease
22 indebtedness (as defined in subsection (g)).
23 "(2) PROPERTY ACQUIRED SUBJECT TO MORT-
24 GAGE, ETC.—
25 "(A) GENERAL RULE.—Where property (no

1 matter how acquired) is acquired subject to a mort-
2 gage or other similar lien, the amount of the in-
3 debtedness secured by such mortgage or lien shall
4 be considered as an indebtedness of the organization
5 incurred in acquiring such property even though the
6 organization did not assume or agree to pay such in-
7 debtedness.

8 "(B) EXCEPTIONS.—Where property subject
9 to a mortgage is acquired by an organization by
10 bequest or devise, the indebtedness secured by the
11 mortgage shall not be treated as acquisition indebt-
12 edness during a period of 10 years following the date
13 of the acquisition. If an organization acquires prop-
14 erty by gift subject to a mortgage which was placed
15 on the property more than 5 years before the gift,
16 which property was held by the donor more than 5
17 years before the gift, the indebtedness secured by
18 such mortgage shall not be treated as acquisition in-
19 debtedness during a period of 10 years following
20 the date of such gift. This subparagraph shall not
21 apply if the organization, in order to acquire the
22 equity in the property by bequest, devise, or gift,
23 assumes and agrees to pay the indebtedness secured
24 by the mortgage, or if the organization makes any

1 payment for the equity in the property owned by
2 the decedent or the donor.
3 "(3) EXTENSION OF OBLIGATIONS.—An extension,
4 renewal, or refinancing of an obligation evidencing a pre-
5 existing indebtedness shall not be treated, for the pur-
6 pose of this section, as the creation of a new indebtedness.
7 "(4) INDEBTEDNESS INCURRED IN PERFORMING
8 EXEMPT PURPOSE.—The term 'acquisition indebted-
9 ness' does not include indebtedness the incurrence of
10 which is inherent in the performance or exercise of the
11 purpose or function constituting the basis of the organiza-
12 tion's exemption, such as the indebtedness incurred by
13 a credit union (exempt from tax under section 501 (c)
14 (14)) in accepting deposits from its members.
15 "(5) ANNUITIES.—The term 'acquisition indebted-
16 ness' does not include an obligation to pay an annuity
17 which—
18 "(A) is the sole consideration (other than a
19 mortgage to which paragraph (2) (B) applies)
20 issued in exchange for property if, at the time of the
21 exchange, the value of the annuity is less than
22 90 percent of the value of the property received
23 in the exchange,
24 "(B) is payable over the life of one individual

1 in being at the time the annuity is issued, or over
2 the lives of two individuals in being at such time,
3 and

4 "(C) is payable under a contract which—

5 "(i) does not guarantee a minimum amount
6 of payments or specify a maximum amount of
7 payments, and

8 "(ii) does not provide for any adjustment
9 of the amount of the annuity payments by ref-
10 erence to the income received from the trans-
11 ferred property or any other property.

12 "(6) CERTAIN FEDERAL FINANCING.—The term
13 'acquisition indebtedness' does not include an obligation,
14 to the extent that it is insured by the Federal Housing
15 Administration, to finance the purchase, rehabilitation,
16 or construction of housing for low and moderate income
17 persons.

18 "(7) AVERAGE ACQUISITION INDEBTEDNESS.—The
19 term 'average acquisition indebtedness' for any taxable
20 year with respect to a debt-financed property means the
21 average amount determined under regulations prescribed
22 by the Secretary or his delegate, of the acquisition in-
23 debtedness during the period the property is held by the
24 organization during the taxable year, except that for
25 the purpose of computing the percentage of any gain

1 or loss to be taken into account on a sale or other dis-
2 position of debt-financed property, such term means the
3 highest amount of the acquisition indebtedness with re-
4 spect to such property during the 12-month period end-
5 ing with the date of the sale or other disposition.

6 "(d) BASIS OF DEBT-FINANCED PROPERTY ACQUIRED
7 IN CORPORATE LIQUIDATION.—If the property was acquired
8 in a complete or partial liquidation of a corporation in ex-
9 change for its stock, the basis of the property, for the pur-
10 poses of this subtitle, shall be the same as it would be in the
11 hands of the transferor corporation, increased by the amount
12 of gain recognized to the transferor corporation upon such
13 distribution and by the amount of any gain to the organiza-
14 tion which was included, on account of such distribution,
15 in its unrelated debt-financed income.

16 "(e) ALLOCATION RULES.—Where debt-financed prop-
17 erty is held for purposes described in subsection (b) (1)
18 (A), (B), (C), or (D) as well as for other purposes,
19 proper allocation shall be made with respect to basis, in-
20 debtedness, and income and deductions. The allocations and
21 exclusions required by this section shall be made in accord-
22 ance with regulations prescribed by the Secretary or his
23 delegate to the extent proper to carry out the purposes of
24 this section."

1 (2) RELATED AMENDMENTS.—
2 (A) Section 48 (a) (4) (relating to definition
3 of section 38 property) is amended by adding at the
4 end thereof the following new sentence: "If the
5 property is debt-financed property (as defined in
6 section 514 (c)) the basis or cost of such property
7 for purposes of computing qualified investment
8 under section 46 (c) shall include only that per-
9 centage of the basis or cost which is the same per-
10 centage as is used under section 514 (b), for the
11 year the property is placed in service, in comput-
12 ing the amount of gross income to be taken into
13 account during such taxable year with respect to
14 such property."
15 (B) The second sentence of section 681 (a)
16 (relating to limitation on charitable deduction of
17 taxable trusts) is amended by striking out the
18 words "certain leases" and inserting in lieu thereof
19 "certain property acquired with borrowed funds".
20 (C) Section 1443 (relating to withholding
21 of tax on payments to foreign tax-exempt organiza-
22 tions) is amended by striking out "rents" and in-
23 serting in lieu thereof "income".
24 (3) TECHNICAL AND CONFORMING AMEND-
25 MENTS.—

1 (A) Subsections (b), (c), and (d) of section
2 514 (relating to business leases) are relettered as
3 subsections (f), (g), and (h), respectively.
4 (B) New subsection (f) (1) (old subsection
5 (b) (1), relating to general rule for definition of
6 business lease) is amended by striking out "subsec-
7 tion (c)" and inserting in lieu thereof "subsection
8 (g)".
9 (C) The table of sections for part III of sub-
10 chapter F of chapter 1 (as redesignated by section
11 101 (a) of this Act) is amended by striking out

"Sec. 514. Business leases."

12 and inserting in lieu thereof the following:

"Sec. 514. Unrelated debt-financed income."

13 (e) Returns.—
14 (1) In general.—Subpart B of part III of sub-
15 chapter A of chapter 61 is amended by adding at the
16 end thereof the following new section:
17 "SEC. 6050. RETURNS RELATING TO CERTAIN TRANSFERS
18 TO EXEMPT ORGANIZATIONS.
19 "(a) General Rule.—On or before the 90th day after
20 the transfer of income producing property, the transferor shall
21 make a return in compliance with the provisions of subsection
22 (b) if the transferee is known by the transferor to be an
23 organization referred to in section 511 (a) or (b) and the

1 property (without regard to any lien) has a fair market value
2 in excess of $50,000.
3 "(b) FORM AND CONTENTS OF RETURNS.—The return
4 required by subsection (a) shall be in such form and shall
5 set forth, in respect of the transfer, such information as the
6 Secretary or his delegate prescribes by regulations as neces-
7 sary for carrying out the provisions of the income tax laws."
8 (2) TECHNICAL AMENDMENT.—The table of sec-
9 tions for subpart B of part III of subchapter A of chap-
10 ter 61 is amended by adding at the end thereof the
11 following:

"Sec. 6050. Returns relating to certain transfers to exempt organizations."

12 (f) RESTRICTION ON EXAMINATION OF CHURCHES.—
13 Section 7605 (relating to time and place of examination)
14 is amended by adding at the end thereof the following new
15 subsection:
16 "(c) RESTRICTION ON EXAMINATION OF CHURCHES.—
17 No examination of the books of account of a church or con-
18 vention or association of churches shall be made to determine
19 whether such organization may be engaged in the carrying
20 on of an unrelated trade or business or may be otherwise en-
21 gaged in activities which may be subject to tax under part
22 III of subchapter F of chapter 1 of this title (sec. 511 and
23 following, relating to taxation of business income of exempt

1 organizations) unless the Secretary or his delegate (such
2 officer being no lower than a principal internal revenue officer
3 for an internal revenue region) believes that such organiza-
4 tion may be so engaged and so notifies the organization in
5 advance of the examination."

6 (g) EFFECTIVE DATE.—The amendments made by this
7 section shall apply to taxable years beginning after December
8 31, 1969.

# 9 TITLE II—INDIVIDUAL DEDUCTIONS

## 10 Subtitle A—Charitable Contributions

### 11 SEC. 201. CHARITABLE CONTRIBUTIONS.

12 (a) LIMITATIONS.—

13 (1) INDIVIDUALS.—Section 170(b) (1) (relating
14 to limitations on individuals) is amended to read as
15 follows:

16 "(1) INDIVIDUALS.—

17 "(A) GENERAL RULE.—In the case of an in-
18 dividual, the deduction provided in subsection (a)
19 shall be limited as provided in the succeeding sub-
20 paragraphs of this paragraph.

21 "(B) SPECIAL RULE.—Any charitable con-
22 tribution to—

23 "(i) a church or a convention or associa-
24 tion of churches,

1 "(ii) an educational organization which
2 normally maintains a regular faculty and cur-
3 riculum and normally has a regularly enrolled
4 body of pupils or students in attendance at the
5 place where its educational activities are regu-
6 larly carried on,
7 "(iii) an organization the principal pur-
8 poses or functions of which are the providing of
9 medical or hospital care or medical education or
10 medical research, if the organization is a hos-
11 pital, or if the organization is a medical research
12 organization directly engaged in the continuous
13 active conduct of medical research in conjunc-
14 tion with a hospital and during the calendar
15 year in which the contribution is made such
16 organization is committed to spend such con-
17 tributions for such research before January 1
18 of the fifth calendar year which begins after
19 the date such contribution is made,
20 "(iv) an organization which normally re-
21 ceives a substantial part of its support (exclu-
22 sive of income received in the exercise or
23 performance by such organization of its char-
24 itable, educational, or other purpose or function
25 constituting the basis for its exemption under

1 section 501 (a)) from the United States or any
2 State or political subdivision thereof or from
3 direct or indirect contributions from the general
4 public, and which is organized and operated
5 exclusively to receive, hold, invest, and admin-
6 ister property and to make expenditures to or
7 for the benefit of a college or university which
8 is an organization referred to in clause (ii) of
9 this subparagraph and which is an agency or
10 instrumentality of a State or political subdivi-
11 sion thereof, or which is owned or operated by
12 a State or political subdivision thereof or by an
13 agency or instrumentality of one or more States
14 or political subdivisions,

15 "(v) a governmental unit referred to in
16 subsection (c) (1), or

17 "(vi) an organization referred to in sub-
18 section (c) (2) which normally receives a sub-
19 stantial part of its support (exclusive of income
20 received in the exercise or performance by such
21 organization of its charitable, educational, or
22 other purpose or function constituting the basis
23 for its exemption under section 501 (a)) from
24 a governmental unit referred to in subsection

1 (c) (1) or from direct or indirect contributions
2 from the general public,
3 shall be allowed to the extent that the aggregate of
4 such contributions does not exceed 30 percent of the
5 taxpayer's contribution base.
6 "(C) GENERAL LIMITATION.—The total de-
7 ductions under subsection (a) for any taxable year
8 shall not exceed 20 percent of the taxpayer's con-
9 tribution base. For purposes of this subparagraph,
10 the deduction under subsection (a) shall be com-
11 puted without regard to any deduction allowed
12 under subparagraph (B) but shall take into ac-
13 count any charitable contributions described in sub-
14 paragraph (B) which are in excess of the amount
15 allowable as a deduction under subparagraph (B).
16 "(D) UNLIMITED DEDUCTION FOR CERTAIN
17 INDIVIDUALS.—The limitation in subparagraph (C)
18 shall not apply in the case of an individual for a tax-
19 able year beginning before January 1, 1975, if
20 in such taxable year and in 8 of the 10 preceding
21 taxable years, the amount of the charitable contri-
22 butions, plus the amount of income tax (determined
23 without regard to chapter 2, relating to tax on self-
24 employment income) paid during such year in
25 respect of such year or preceding taxable years,

1 exceeds the transitional deduction percentage (de-
2 termined under subparagraph (F)) of the tax-
3 payer's taxable income for such year, computed
4 without regard to—
5 "(i) this section,
6 "(ii) section 151 (allowance of deductions
7 for personal exemption), and
8 "(iii) any net operating loss carryback to
9 the taxable year under section 172.
10 In lieu of the amount of income tax paid during any
11 such year, there may be substituted for that year
12 the amount of income tax paid in respect of such
13 year, provided that any amount so included in the
14 year in respect of which payment was made shall
15 not be included in any other year.
16 "(E) PARTIAL REDUCTION OF UNLIMITED DE-
17 DUCTION.—In the case of an individual, if the limi-
18 tations in subparagraph (C) do not apply because
19 of the application of subparagraph (D), the amount
20 otherwise allowable as a deduction under subsection
21 (a) shall be reduced by the amount by which the
22 taxpayer's taxable income computed without re-
23 gard to this subparagraph is less than the transitional
24 income percentage (determined under subparagraph

1 (G)) of the taxpayer's adj.. ted gross income.
2 However, in no case shall a taxpayer's deduction
3 under this section be reduced below the amount al-
4 lowable as a deduction under this section without the
5 applicability of subparagraph (D).
6 "(F) TRANSITIONAL DEDUCTION PERCENT-
7 AGE.—For purposes of applying subparagraph (D),
8 the term 'transitional deduction percentage' means—
9 "(i) in the case of a taxable year beginning
10 before 1970, 90 percent, and
11 "(ii) in the case of a taxable year begin-
12 ning in—

| | |
|---|---|
| 1970 | 80 percent |
| 1971 | 74 percent |
| 1972 | 68 percent |
| 1973 | 62 percent |
| 1974 | 56 percent. |

13 "(G) TRANSITIONAL INCOME PERCENTAGE.—
14 For purposes of applying subparagraph (E), the
15 term 'transitional income percentage' means, in the
16 case of a taxable year beginning in—

| | |
|---|---|
| 1970 | 20 percent |
| 1971 | 26 percent |
| 1972 | 32 percent |
| 1973 | 38 percent |
| 1974 | 44 percent. |

17 "(H) DENIAL OF DEDUCTION IN CASE OF
18 CERTAIN TRANSFERS IN TRUST.—No deduction shall
19 be allowed under this section for the value of any

1 interest in income from property transferred after
2 April 22, 1969, to a trust unless—
3 "(i) the interest is in the form of a guaran-
4 teed annuity or the trust instrument specifies
5 that the interest shall receive a fixed percentage
6 yearly of the fair market value of the trust
7 property (determined yearly) and the grantor
8 is treated as the owner of such interest for pur-
9 poses of applying section 671, or
10 "(ii) a deduction would be allowed under
11 this section for the donor's entire interest in such
12 property.
13 If the donor ceases to be treated as the owner of
14 such an interest for purposes of applying section 671,
15 at the time the donor ceases to be so treated, the
16 donor shall for purposes of this chapter be con-
17 sidered as having received an amount of income
18 equal to the amount of any deduction he received
19 under this section for the contribution reduced by
20 the discounted value of all amounts of income earned
21 by the trust and taxable to him before the time
22 at which he ceases to be treated as the owner of the
23 interest. Such amounts of income shall be discounted
24 to the date of the contribution. The Secretary or his

1 delegate shall prescribe such regulations as may be
2 necessary to carry out the purposes of this subpara-
3 graph.

4 "(I) DENIAL OF DEDUCTION IN CASE OF PAY-
5 MENTS BY CERTAIN TRUSTS.—In any case where a
6 deduction is allowed under this section for the value
7 of an interest in income from property transferred
8 after April 22, 1969, to a trust, no deduction shall be
9 allowed under this section to the grantor or any other
10 person for the amount of any contribution made by
11 the trust with respect to such income interest.

12 "(J) SPECIAL LIMITATION ON CONTRIBU-
13 TIONS OF APPRECIATED PROPERTY.—

14 "(i) In the case of appreciated property
15 to which subsection (e) does not apply, the
16 total deduction for contributions of such prop-
17 erty under subsection (a) for any taxable year
18 shall not exceed 30 percent of the taxpayer's
19 contribution base. For purposes of the percent-
20 age limitations in subparagraphs (B) and (C),
21 such contributions shall be allowable as a deduc-
22 tion only to the extent that the amount of such
23 contributions plus any other contributions under
24 such subparagraphs does not exceed such
25 limitations.

1 "(ii) For purposes of paragraph (5), if
2 the amount of charitable contributions described
3 in subparagraph (B) which consists of appreci-
4 ated property (to which clause (i) applies) ex-
5 ceeds 30 percent of the taxpayer's contribution
6 base for a contribution year, the excess shall be
7 carried over the same as any other amount car-
8 ried over under paragraph (5) whether or not
9 the taxpayer's charitable contributions described
10 in subparagraph (B) exceed 50 percent of his
11 contribution base. The amount of any carryover
12 under paragraph (5) of property to which
13 clause (i) applies shall be added to contribu-
14 tions of appreciated property in future contri-
15 bution years for purposes of determining the 30-
16 percent limitation in clause (i) for a future
17 year and computing any further carryover under
18 paragraph (5).
19 "(iii) For purposes of this subparagraph,
20 the term 'appreciated property' means property
21 which has a fair market value (at the time of
22 the contribution) which exceeds the taxpayer's
23 adjusted basis in such property.
24 "(iv) The Secretary or his delegate shall

1 prescribe such regulations as may be necessary
2 to carry out the purposes of this subparagraph."
3 (2) CARRYOVERS.—Section 170(b)(5) (relating
4 to carryover of certain excess contributions by individ-
5 uals) is amended by striking out that portion of sub-
6 paragraph (A) which precedes clause (ii) and insert-
7 ing in lieu thereof the following:
8 "(A) In the case of an individual, if the amount
9 of charitable contributions described in paragraph
10 (1)(B) payment of which is made within a tax-
11 able year (hereinafter in this paragraph referred
12 to as the 'contribution year') beginning before Jan-
13 uary 1, 1970, exceeds 30 percent of the taxpayer's
14 adjusted gross income for such year (computed with-
15 out regard to any net operating loss carryback to
16 such year under section 172), or within a contribu-
17 tion year beginning after December 31, 1969, ex-
18 ceeds 50 percent of the taxpayer's contribution base
19 for such year, such excess shall be treated as a
20 charitable contribution described in paragraph (1)
21 (B) paid in each of the 5 succeeding taxable
22 years in order of time, but, with respect to any such
23 succeeding taxable year, only to the extent of the
24 lesser of the two following amounts:
25 "(i) for taxable years beginning before

1 January 1, 1970, the amount by which 30 per-
2 cent of the taxpayer's adjusted gross income for
3 such succeeding taxable year (computed with-
4 out regard to any net operating loss carryback
5 to such succeeding taxable year under section
6 172), or for taxable years beginning after De-
7 cember 31, 1969, the amount by which 50 per-
8 cent of the taxpayer's contribution base for such
9 succeeding taxable year, exceeds the sum of the
10 charitable contributions described in paragraph
11 (1) (B) payment of which is made by the tax-
12 payer within such succeeding taxable year
13 (determined without regard to this subpara-
14 graph) and the charitable contributions de-
15 scribed in paragraph (1) (B) payment of
16 which was made in taxable years (beginning
17 after December 31, 1963) before the contribu-
18 tion year which are treated under this sub-
19 paragraph as having been paid in such succeed-
20 ing taxable year; or"
21 (3) FURTHER LIMITATIONS.—Section 170(b)
22 (relating to limitation on amount of deduction for chari-
23 table contributions) is amended by adding at the end
24 thereof the following new paragraphs:
25 "(6) CONTRIBUTION BASE DEFINED.—For pur-

1 poses of this section, the term 'contribution base' means
2 adjusted gross income (computed without regard to any
3 net operating loss carryback to the taxable year under
4 section 172) increased by the allowable tax preferences
5 as determined under section 277 (c) (2).
6 "(7) DISALLOWANCE OF DEDUCTION IN CERTAIN
7 CASES.—No deduction shall be allowed under this sec-
8 tion—
9 "(A) for a contribution to or for the use of an
10 organization described in section 501 (c) (3) (re-
11 lating to exempt organizations) unless the organi-
12 zation—
13 "(i) is exempted from the requirements of
14 section 508 (a) and (b) (relating to special
15 rules with respect to section 501 (c) (3) orga-
16 nizations) pursuant to subsection (c) thereof,
17 or
18 "(ii) complies with section 508 (a), (b),
19 and (g), or
20 "(B) for a transfer in trust (other than one to
21 which the provisions of subparagraph (A) of this
22 paragraph apply) unless the governing instrument
23 of the trust includes provisions, the effects of which
24 are to prohibit the trust from—
25 "(i) engaging in any act of self-dealing
26 (as defined in section 4941 (d)),

1 "(ii) retaining any excess business hold-
2 ings (as defined in section 4943 (c)),
3 "(iii) making any speculative investments
4 in such manner as to subject the trust to tax
5 under section 4944, and
6 "(iv) making any taxable expenditures
7 (as defined in section 4945 (b)).
8 "(8) DENIAL OF DEDUCTION IN CASE OF CONTRI-
9 BUTION OF PARTIAL INTEREST IN PROPERTY.—In a case
10 where a taxpayer makes a charitable contribution of less
11 than his entire interest in property to, and not in trust
12 for, an organization described in subsection (c), a deduc-
13 tion shall be allowed under this section only to the extent
14 that the value of the interest contributed would be
15 allowed as a deduction under this section if such interest
16 had been transferred in trust. For purposes of this para-
17 graph, the charitable contribution by a taxpayer of the
18 right to use property shall be treated as a charitable con-
19 tribution of less than the taxpayer's entire interest in such
20 property."
21 (4) CONFORMING AMENDMENTS.—
22 (A) Subsections (b) (5) (A) (ii) and (g) of
23 section 170 are each amended by striking out "170
24 (b) (1) (A)" each place it appears and inserting
25 in lieu thereof "170 (b) (1) (B)".

1 (B) Section 170(g)(1) is amended by strik-
2 ing out "subsection (b)(1)(C)" each place it
3 appears and inserting in lieu thereof "subsection
4 (b)(1)(D)".
5 (C) Sections 512(b)(11), 545(b)(2), and
6 556(b)(2) are each amended by striking out "170
7 (b)(1)(A) and (B)" each place it appears and
8 inserting in lieu thereof "170(b)(1)(B) and
9 (C)".
10 (b) POLITICAL ACTIVITIES.—Section 170(c)(2)(D)
11 (relating to definition of charitable contributions) is amended
12 to read as follows:
13 "(D) no substantial part of the activities of
14 which is carrying on propaganda, or otherwise at-
15 tempting, to influence legislation, and which does
16 not participate in, or intervene in (including the
17 publishing or distributing of statements), any po-
18 litical campaign on behalf of any candidate for
19 public office."
20 (c) CHARITABLE CONTRIBUTIONS OF APPRECIATED
21 PROPERTY.—
22 (1) IN GENERAL.—Section 170(e) (relating to
23 special rule for charitable contributions of certain prop-
24 erty) is amended to read as follows:
25 "(e) CONTRIBUTIONS OF APPRECIATED PROPERTY.—

1 "(1) GENERAL RULE.—In the case of a charitable
2 contribution of property to which paragraph (2) ap-
3 plies or a charitable contribution of any property di-
4 rectly or indirectly to or for the use of an organization
5 to which paragraph (3) applies, if (at the time of the
6 contribution) the fair market value of the property ex-
7 ceeds the taxpayer's adjusted basis (for purposes of
8 determining gain) in the property, the taxpayer shall
9 elect (at such time and in such manner as the Secre-
10 tary or his delegate by regulations prescribes) to treat
11 either:
12 "(A) the fair market value of the property, or
13 "(B) such adjusted basis of the property,
14 as the amount of the charitable contribution to be taken
15 into account under subsection (a).
16 "(2) CERTAIN APPRECIATED PROPERTY.—Para-
17 graph (1) shall apply to charitable contributions of—
18 "(A) property any portion of the gain on
19 which, if the property were sold for its fair market
20 value at the time of the contribution, would have
21 constituted or been treated as a gain other than a
22 gain from the sale or exchange of a capital asset
23 held for more than 12 months,
24 "(B) tangible personal property, and
25 "(C) a future interest in property.

1 For purposes of the preceding sentence, a fixture which
2 is intended to be severed from real property shall be
3 treated as tangible personal property.
4 "(3) CERTAIN ORGANIZATIONS.—Paragraph (1)
5 shall apply to charitable contributions to a private founda-
6 tion (as defined in section 509 (a)) unless—
7 "(A) it is an operating foundation (as defined
8 in section 4942 (j) (3)), or
9 "(B) not later than the close of the organiza-
10 tion's first year after its taxable year in which such
11 contributions are received, such organization makes
12 a qualifying distribution (as defined in section 4942
13 (g)) which is treated (in accordance with section
14 4942 (h)) as a distribution out of corpus in an
15 amount equal to 100 percent of all such contribu-
16 tions.
17 Subparagraph (B) shall not apply to a contribution to
18 an organization described in subparagraph (B) unless
19 the taxpayer obtains adequate records or sufficient
20 evidence from the organization showing that the orga-
21 nization made the distributions as required therein.
22 "(4) ALLOCATION OF BASIS.—In the case of a
23 charitable contribution of less than the taxpayer's entire
24 interest in the property contributed, the taxpayer's ad-
25 justed basis in such property shall be allocated between

1 the interest contributed and any interest not contributed
2 in accordance with regulations prescribed by the Secre-
3 tary or his delegate.

4 "(5) CROSS REFERENCE.—

"For treatment of gain in a case where the taxpayer elects to treat the fair market value of property as the amount to be taken into account, see section 83."

5 (2) GIFTS TREATED AS SALE.—Part II of subchap-
6 ter B of chapter 1 of such Code (relating to items spe-
7 cifically included in gross income) is amended by adding
8 at the end thereof the following new section:

9 "SEC. 83. CERTAIN GIFTS TO CHARITY TREATED AS SALES
10 OF PROPERTY.

11 "(a) COMPUTATION AND RECOGNITION OF GAIN.—
12 If a taxpayer—
13 "(1) has made a charitable contribution of property,
14 and
15 "(2) has elected to treat the fair market value of
16 the property as the amount of the charitable contribu-
17 tion pursuant to section 170(e),
18 the contribution shall be treated for purposes of this subtitle
19 as a sale (at the time of the contribution) of the property
20 to the donee for an amount equal to the fair market value
21 of such property, and the gain on such sale shall be
22 recognized.

1 "(b) LIMITATION.—In the case of a charitable con-
2 tribution to an organization to which section 170(e)(1)
3 does not apply of property—
4 "(1) which is described in section 170(e)(2)
5 (A), and
6 "(2) to which subparagraphs (B) and (C) of sec-
7 tion 170(e)(2) do not apply,
8 only that portion of the gain which would not be treated as
9 gain from the sale of a capital asset held for more than 12
10 months shall be recognized.
11 "(c) ADJUSTMENTS TO BASIS.—The basis of the prop-
12 erty acquired by gift to which this section applies shall be
13 the donor's adjusted basis (for purposes of determining gain)
14 increased by the amount of any gain recognized by the
15 donor on the contribution under this section."
16 (3) CLERICAL AMENDMENT.—The table of sec-
17 tions for part II of subchapter B of chapter 1 is amended
18 by adding at the end thereof the following item:

"Sec. 83. Certain gifts to charity treated as sales of property."

19 (d) BARGAIN SALES TO CHARITABLE ORGANIZA-
20 TIONS.—Section 1011 (relating to adjusted basis for deter-
21 mining gain or loss) is amended—
22 (1) by striking out "The" at the beginning and
23 inserting in lieu thereof:

1 "(a) GENERAL RULE.—The", and

2 (2) by adding at the end thereof the following

3 new subsection:

4 "(b) BARGAIN SALE TO A CHARITABLE ORGANIZA-

5 TION.—If a deduction is allowable under section 170 (relat-

6 ing to charitable contributions) by reason of a sale, then the

7 adjusted basis for determining the gain from such sale shall

8 be that portion of the adjusted basis which bears the same

9 ratio to the adjusted basis as the amount realized bears to

10 the fair market value of the property."

11 (c) SPLIT-INTEREST TRUSTS.—Section 170 is amended

12 by redesignating subsections (h) and (i) as subsections (i)

13 and (j), respectively, and by inserting after subsection (g)

14 the following new subsection:

15 "(h) LIMITATION ON CONTRIBUTIONS OF REMAINDER

16 INTEREST IN PROPERTY PLACED IN TRUST.—

17 "(1) GENERAL RULE.—In the case of property

18 transferred in trust, no deduction shall be allowed un-

19 der this section for the value of a contribution of a re-

20 mainder interest unless the trust is a charitable remain-

21 der annuity trust or charitable remainder unitrust de-

22 scribed in section 664(d).

23 "(2) EXCEPTION.—This subsection shall not ap-

33-865 O—69—pt. 1——17

1 ply in a case where the value of all interests in property
2 transferred in trust are deductible under subsection (a)."
3 (f) CHARITABLE CONTRIBUTIONS BY ESTATES AND
4 TRUSTS.—
5 (1) IN GENERAL.—Subsection (c) of section 642
6 (relating to deduction for amounts paid or permanently
7 set aside for a charitable purpose) is amended to read
8 as follows:
9 "(c) DEDUCTION FOR AMOUNTS PAID FOR A CHARI-
10 TABLE PURPOSE.—In the case of an estate or trust (other
11 than a trust meeting the specifications of subpart B) there
12 shall be allowed as a deduction in computing its taxable in-
13 come (in lieu of the deductions allowed by section 170(a),
14 relating to deduction for charitable, etc., contributions and
15 gifts) any amount of the gross income, without limitation,
16 which pursuant to the terms of the governing instrument is,
17 during the taxable year, paid for a purpose specified in sec-
18 tion 170(c). If a charitable contribution is paid after the
19 close of such taxable year and on or before the last day of
20 the year following the close of such taxable year, then the
21 trustee or administrator may elect to treat such contribution
22 as paid during such taxable year. The election shall be made
23 at such time and in such manner as the Secretary or his
24 delegate by regulations prescribes. To the extent that the
25 amount otherwise allowable as a deduction under this para-

1 graph consists of gain from the sale or exchange of capital
2 assets held for more than 12 months, proper adjustment shall
3 be made for any deduction allowable to the estate or trust
4 under section 1202 (relating to deduction for excess of
5 capital gains over capital losses). In the case of a trust, the
6 deduction allowed by this subsection shall be subject to
7 section 681 (relating to unrelated business income) and
8 section 507 (f) (relating to prohibited transactions)."
9 (2) CONFORMING AMENDMENTS.—
10 (A) Section 643 (a) (relating to definition of
11 distributable net income) is amended:
12 (i) by striking out ", permanently set
13 aside, or to be used" in the first sentence of
14 paragraph (3); and
15 (ii) by striking out ", permanently set
16 aside, or to be used" in that portion which fol-
17 lows paragraph (7) thereof.
18 (B) Section 651 (a) (2) (relating to deduc-
19 tion for trusts distributing current income only) is
20 amended by striking out ", permanently set aside,
21 or used".
22 (C) Section 663 (a) (2) (relating to special
23 rules applicable to sections 661 and 662) is
24 amended by striking out "or permanently set aside

1 or otherwise qualifying for the deduction" and in-
2 serting "as" in lieu thereof.
3 (g) TWO-YEAR CHARITABLE TRUSTS.—Section 673
4 (b) (relating to trusts where the income is payable to a
5 charitable beneficiary for at least a two-year period) is re-
6 pealed.
7 (h) DISALLOWANCE OF ESTATE AND GIFT TAX
8 DEDUCTIONS IN CERTAIN CASES.—
9 (1) ESTATES OF CITIZENS OR RESIDENTS.—Sub-
10 section (e) of section 2055 (relating to disallowance of
11 charitable deductions in certain cases) is amended to
12 read as follows:
13 "(e) DISALLOWANCE OF DEDUCTIONS IN CERTAIN
14 CASES.—
15 "(1) No deduction shall be allowed under this
16 section—
17 "(A) for a transfer to or for the use of an orga-
18 nization described in section 501 (c) (3) (relating
19 to exempt organizations) unless the organization—
20 "(i) is exempted from the requirements of
21 section 508 (a) and (b) pursuant to subsection
22 (c) thereof, or
23 "(ii) complies with section 508 (a), (b),
24 and (g); or
25 "(B) for a transfer in trust (other than one

1 to which the provisions of subparagraph (A) of
2 this paragraph apply) unless the governing instru-
3 ment of the trust includes provisions, the effects of
4 which are to prohibit the trust from—
5 "(i) engaging in any act of self-dealing
6 (as defined in section 4941 (d)),
7 "(ii) retaining any excess business hold-
8 ings (as defined in section 4943 (c)),
9 "(iii) making any speculative investments
10 in such manner as to subject the trust to tax
11 under section 4944, and
12 "(iv) making any taxable expenditures
13 (as defined in section 4945 (b)).
14 "(2) Where an interest in property passes or has
15 passed from the decedent to a person, or for a use, de-
16 scribed in subsection (a), and an interest in the same
17 property passes or has passed (for less than an adequate
18 and full consideration in money or money's worth) from
19 the decedent to a person, or for a use, not described in
20 subsection (a), no deduction shall be allowed under this
21 section for the interest which passes or has passed to the
22 person, or for the use, described in subsection (a) unless
23 the interest is in the form of a remainder interest in a
24 trust which is a charitable remainder annuity trust or a

1 charitable remainder unitrust described in section 664
2 (d)."
3 (2) ESTATES OF NONRESIDENTS NOT CITIZENS.—
4 Subparagraph (E) of section 2106 (a) (2) (relating to
5 disallowance of deductions in certain cases) is amended
6 to read as follows:
7 "(E) DISALLOWANCE OF DEDUCTIONS IN CER-
8 TAIN CASES.—The provisions of section 2055 (e)
9 also shall be applied in the determination of the
10 amount allowable as a deduction under this para-
11 graph."
12 (3) GIFT TAX.—Subsection (c) of section 2522
13 (relating to disallowance of charitable deductions in
14 certain cases) is amended to read as follows:
15 "(c) DISALLOWANCE OF DEDUCTIONS IN CERTAIN
16 CASES.—
17 "(1) No deduction shall be allowed under this
18 section—
19 "(A) for a transfer to or for the use of an
20 organization described in section 501 (c) (3) (re-
21 lating to exempt organizations) unless the organiza-
22 tion—
23 "(i) is exempted from the requirements of
24 section 508 (a) and (b) pursuant to subsec-
25 tion (c) thereof, or

1 "(ii) complies with section 508 (a), (b),
2 and (g); or
3 "(B) for a transfer in trust (other than one to
4 which the provisions of subparagraph (A) of this
5 paragraph apply), unless the governing instrument
6 of the trust includes provisions the effects of which
7 are to prohibit the trust from—
8 "(i) engaging in any act of self-dealing
9 as defined in section 4941 (d)),
10 "(ii) retaining any excess business hold-
11 ings (as defined in section 4943 (c)),
12 "(iii) making any speculative investments
13 in such manner as to subject the trust to tax
14 under section 4944, and
15 "(iv) making any taxable expenditures
16 (as defined in section 4945 (b)).
17 "(2) (A) Where a donor transfers an interest in
18 property to a person, or for a use, described in subsection
19 (a) or (b) and an interest in the same property is trans-
20 ferred or has been transferred (for less than an adequate
21 and full consideration in money or money's worth) from
22 the donor to a person, or for a use, not described in sub-
23 section (a) or (b), the deduction allowed under this sec-
24 tion for the interest which is, or has been transferred to
25 the person, or for the use, described in subsection (a) or

1 (b) shall not be greater than the amount allowed to the
2 donor as a deduction under section 170 in respect of such
3 interest, determined without regard to the percentage
4 limitation in subsection (b) thereof. For purposes of this
5 subparagraph, where the donor has elected the alterna-
6 tive set forth in subparagraph (B) of section 170(e)
7 (1) (relating to electing valuation of gifts of appreci-
8 ated property), the deduction allowed under section 170
9 shall be deemed to be the deduction that would have
10 been allowed had the alternative set forth in subpara-
11 graph (A) been elected.
12 "(B) Where any readjustment under section 170
13 (b) (1) (H) is made in the donor's income, at the time
14 the readjustment is made the donor shall, for purposes
15 of this chapter, be considered as making a gift (which
16 is not a gift of a present interest in property and for
17 which no deduction shall be allowed under this section)
18 of property in an amount equal to the amount required
19 to be included in income as a result of the readjustment,
20 except that if the alternative set forth in subparagraph
21 (B) of section 170(e) (1) had been elected, the amount
22 of such gift shall be considered to be in an amount equal
23 to the amount which would have been required to be
24 included in income as a result of the readjustment if the

1 alternative set forth in subparagraph (A) of such section
2 had been elected.
3 (i) CHARITABLE REMAINDER TRUSTS.—
4 (1) Subpart C of part I of subchapter J of chapter
5 1 (relating to estates and trusts which may accumulate
6 income or which distribute corpus) is amended by add-
7 ing at the end thereof the following new section:
8 "SEC. 664. CHARITABLE REMAINDER TRUSTS.
9 "(a) GENERAL RULE.—Notwithstanding any other pro-
10 vision of this subchapter, the provisions of this section shall,
11 in accordance with regulations prescribed by the Secretary
12 or his delegate, apply in the case of a charitable remainder
13 annuity trust and a charitable remainder unitrust.
14 "(b) CHARACTER OF DISTRIBUTIONS.—Amounts dis-
15 tributed by a charitable remainder annuity trust or by a
16 charitable remainder unitrust shall be considered as having
17 the following characteristics in the hands of the beneficiary
18 to whom is paid the annuity described in subsection (d) (1)
19 (A) or the payment described in subsection (d) (2) (A):
20 "(1) First, as amounts of income includible in
21 gross income to the extent of such income of the trust
22 for the year and such undistributed income of the trust
23 for prior years;

1 "(2) Second, as a capital gain to the extent of the
2 capital gain of the trust for the year and the undistrib-
3 uted capital gain of the trust for prior years;
4 "(3) Third, as other income to the extent of such
5 income of the trust for the year and such undistributed
6 income of the trust for prior years; and
7 "(4) Fourth, as a distribution of trust corpus.
8 For purposes of this section the trust shall determine the
9 amount of its undistributed capital gain on a cumulative net
10 basis.
11 "(c) EXEMPTION OF TRUST FROM TAXATION.—A
12 charitable remainder annuity trust and a charitable remain-
13 der unitrust shall not be subject to any tax imposed by
14 this subtitle.
15 "(d) DEFINITIONS.—
16 "(1) CHARITABLE REMAINDER ANNUITY TRUST.—
17 A charitable remainder annuity trust is a trust—
18 "(A) From which a sum certain is to be paid,
19 not less often than annually, to a person who is not
20 a person or organization described in section 170
21 (c), for a term of years or for the life of the person,
22 and
23 "(B) Following the termination of the annuity
24 described in subparagraph (A) the remainder in-
25 terest in the trust is to be transferred to, or for the

1 use of, an organization described in section 170 (c)
2 or is to be retained by the trust for such a use.
3 "(2) CHARITABLE REMAINDER UNITRUST.—A
4 charitable remainder unitrust is a trust—
5 "(A) From which a fixed percentage of the
6 net fair market value of its assets, valued annually,
7 is to be paid, not less often than annually, to a per-
8 son who is not a person or organization described
9 in section 170 (c), for a term of years or for the
10 life of the person, and
11 "(B) Following the termination of the interest
12 described in subparagraph (A) the remainder in-
13 terest in the trust is to be transferred to, or for the
14 use of, an organization described in section 170 (c)
15 or is to be retained by the trust for such a use."
16 (2) The table of sections for subpart C of part I
17 of subchapter J of chapter 1 (relating to estates and
18 trusts which may accumulate income or which distrib-
19 ute corpus) is amended by adding at the end thereof

"Sec. 664. Charitable remainder trusts."

20 (j) EFFECTIVE DATES.—
21 (1) The amendments made by subsection (a) shall
22 apply to contributions paid in taxable years beginning
23 after December 31, 1969, with the following exceptions:
24 (A) the amendments made in sections 170

1 (b) (1) (H) and (I) shall apply with respect to
2 transfers in trust and contributions made after April
3 22, 1969, and
4 (B) the amendment made in section 170(b)
5 (8) shall apply to contributions made after April 22,
6 1969.
7 (2) The amendment made by subsection (b) shall
8 apply to contributions which are paid (or treated as
9 paid under section 170(a)(2)) after December 31,
10 1969.
11 (3) The amendments made by subsection (c) shall
12 apply with respect to contributions which are paid (or
13 treated as paid under section 170(a)(2)) after Decem-
14 ber 31, 1969.
15 (4) The amendments made by subsection (d) shall
16 apply to sales made after May 26, 1969.
17 (5) The amendments made by subsections (e) and
18 (g) shall apply to transfers in trust made after April
19 22, 1969.
20 (6) The amendment made by subsection (f) shall
21 apply to amounts paid, permanently set aside, or to be
22 used for a charitable purpose after the date of enactment
23 of this Act.
24 (7) (A) The amendments made by paragraphs (1)
25 and (2) of subsection (h) shall apply in the case of

1 decedents dying after the date of enactment of this
2 Act.
3 (B) The amendment made by paragraph (3) of
4 subsection (h) shall apply to gifts made after April
5 22, 1969.
6 (8) The amendment made by subsection (i) shall
7 apply to transfers in trust made after the date of enact-
8 ment of this Act.

9 ## Subtitle B—Farm Losses, Etc.

10 **SEC. 211. GAIN FROM DISPOSITION OF PROPERTY USED**
11 **IN FARMING WHERE FARM LOSSES OFFSET**
12 **NONFARM INCOME.**

13 (a) IN GENERAL.—Part IV of subchapter P of chapter
14 1 (relating to special rules for determining capital gains and
15 losses) is amended by adding at the end thereof the follow-
16 ing new section:

17 **"SEC. 1251. GAIN FROM DISPOSITION OF PROPERTY USED**
18 **IN FARMING WHERE FARM LOSSES OFFSET**
19 **NONFARM INCOME.**

20 "(a) CIRCUMSTANCES UNDER WHICH SECTION AP-
21 PLIES.—This section shall apply with respect to any taxable
22 year only if—
23 "(1) there is a farm net loss for the taxable year, or
24 "(2) there is a balance in the excess deductions

1 account as of the close of the taxable year after applying
2 subsection (b) (3) (A).
3 "(b) EXCESS DEDUCTIONS ACCOUNT.—
4 "(1) REQUIREMENT.—Each taxpayer subject to
5 this section shall, for purposes of this section, establish
6 and maintain an excess deductions account.
7 "(2) ADDITIONS TO ACCOUNT.—
8 "(A) GENERAL RULE.—There shall be added
9 to the excess deductions account for each taxable
10 year an amount equal to the farm net loss.
11 "(B) EXCEPTION FOR INDIVIDUALS.—In the
12 case of an individual, subparagraph (A) shall not
13 apply for a taxable year—
14 "(i) unless his nonfarm adjusted gross in-
15 come for such year exceeds $50,000, and
16 "(ii) only to the extent his farm net loss
17 exceeds $25,000.
18 "(C) MARRIED INDIVIDUALS.—In the case of
19 a husband or wife who files a separate return, the
20 amount specified in subparagraph (B) (i) shall be
21 $25,000 in lieu of $50,000, and in subparagraph
22 (B) (ii) shall be $12,500 in lieu of $25,000. This
23 subparagraph shall not apply if the spouse of the
24 taxpayer does not have any nonfarm adjusted gross
25 income for the taxable year.

1 "(D) NONFARM ADJUSTED GROSS INCOME.—
2 For purposes of this section, the term 'nonfarm ad-
3 justed gross income' means the adjusted gross in-
4 come computed without regard to income or deduc-
5 tions attributable to farming.
6 "(3) SUBTRACTIONS FROM ACCOUNT.—If there
7 is any amount in the excess deductions account at the
8 close of any taxable year (determined before any amount
9 is subtracted under this paragraph for such year) there
10 shall be subtracted from the account—
11 "(A) an amount equal to the farm net income
12 for such year, plus the amount (determined as pro-
13 vided in regulations prescribed by the Secretary or
14 his delegate) necessary to adjust the account for
15 deductions which did not result in a reduction of the
16 taxpayer's tax under this subtitle for the taxable
17 year or any preceding taxable year (including such
18 amounts which did not result in a reduction of tax
19 because of the application of section 84 (relating to
20 limit on tax preferences)), and
21 "(B) after applying paragraph (2) or sub-
22 paragraph (A) of this paragraph (as the case may
23 be), an amount equal to the sum of the amounts
24 treated under subsection (c) as gain from the sale

1 or exchange of property which is neither a capital
2 asset nor property described in section 1231.
3 "(4) EXCEPTION FOR TAXPAYERS USING CERTAIN
4 ACCOUNTING METHODS.—
5 "(A) GENERAL RULE.—Except to the extent
6 that the taxpayer has succeeded to an excess deduc-
7 tions account as provided in paragraph (5), addi-
8 tions to the excess deductions account shall not be
9 required by a taxpayer who elects to compute tax-
10 able income from farming (i) by using inventories,
11 and (ii) by charging to capital account all expendi-
12 tures paid or incurred which are properly chargeable
13 to capital account (including such expenditures
14 which the taxpayer may, under this chapter or regu-
15 lations prescribed thereunder, otherwise treat or
16 elect to treat as expenditures which are not charge-
17 able to capital account).
18 "(B) TIME, MANNER, AND EFFECT OF ELEC-
19 TION.—An election under subparagraph (A) for
20 any taxable year shall be filed within the time pre-
21 scribed by law (including extensions thereof) for
22 filing the return for such taxable year, and shall be
23 made and filed in such manner as the Secretary or
24 his delegate shall prescribe by regulations. Such
25 election shall be binding on the taxpayer for such

1 taxable year and for all subsequent taxable years
2 and may not be revoked except with the consent
3 of the Secretary or his delegate.

4 "(C) CHANGE OF METHOD OF ACCOUNTING,
5 ETC.—If, in order to comply with the election made
6 under subparagraph (A), a taxpayer changes his
7 method of accounting in computing taxable income
8 from the business of farming, such change shall be
9 treated as having been made with the consent of
10 the Secretary or his delegate and for purposes of
11 section 481 (a) (2) shall be treated as a change not
12 initiated by the taxpayer.

13 "(5) TRANSFER OF ACCOUNT.—

14 "(A) CERTAIN CORPORATE TRANSACTIONS.—
15 In the case of a transfer described in subsection
16 (d) (3) to which section 371 (a), 374 (a), or 381
17 applies, the acquiring corporation shall succeed to
18 and take into account as of the close of the day of
19 distribution or transfer, the excess deductions
20 account of the transferor.

21 "(B) CERTAIN GIFTS.—If—

22 "(i) farm recapture property is disposed
23 of by gift, and

24 "(ii) the potential gain (as defined in sub-
25 section (e) (5)) on farm recapture property

1 disposed of by gift during any one-year period
2 in which any such gift occurs is more than 80
3 percent of the potential gain on farm recapture
4 property held by the donor immediately prior
5 to the first of such gifts,
6 the donees of the property shall succeed (as of the
7 close of the donor's taxable year in which the first
8 of such gifts is made) to the donor's excess deduc-
9 tions account (or in the case of more than one
10 donee, to his ratable share of such account) deter-
11 mined, after the application of paragraphs (2) and
12 (3) with respect to the donor, as of the close of
13 such taxable year.
14 "(6) JOINT RETURN.—In the case of an addition
15 to an excess deductions account for a taxable year for
16 which a joint return was filed under section 6013, for
17 any subsequent taxable year for which a separate return
18 was filed the Secretary or his delegate shall provide
19 rules for allocating any remaining amount of such addi-
20 tion in a manner consistent with the purposes of this
21 section.
22 "(c) ORDINARY INCOME.—
23 "(1) GENERAL RULE.—Except as otherwise pro-
24 vided in this section, if farm recapture property (as de-
25 fined in subsection (e)(1)) is disposed of during a

1 taxable year beginning after December 31, 1969, the
2 amount by which—
3 "(A) in the case of a sale, exchange, or in-
4 voluntary conversion, the amount realized, or
5 "(B) in the case of any other disposition, the
6 fair market value of such property,
7 exceeds the adjusted basis of such property shall be
8 treated as gain from the sale or exchange of property
9 which is neither a capital asset nor property described
10 in section 1231. Such gain shall be recognized notwith-
11 standing any other provision of this subtitle.
12 "(2) LIMITATION.—
13 "(A) AMOUNT IN EXCESS DEDUCTIONS AC-
14 COUNT.—The aggregate of the amounts treated
15 under paragraph (1) as gain from the sale or ex-
16 change of property which is neither a capital asset
17 nor property described in section 1231 for any tax-
18 able year shall not exceed the amount in the excess
19 deductions account at the close of the taxable year
20 after applying subsection (b) (3) (A).
21 "(B) DISPOSITIONS TAKEN INTO ACCOUNT.—
22 If the aggregate of the amounts to which paragraph
23 (1) applies is limited by the application of sub-
24 paragraph (A), paragraph (1) shall apply in re-

1 spect of such dispositions (and in such amounts)
2 as provided under regulations prescribed by the
3 Secretary or his delegate.
4 "(C) SPECIAL RULE FOR DISPOSITIONS OF
5 LAND.—In applying subparagraph (A), any gain
6 on the sale or exchange of land shall be taken into
7 account only to the extent of its potential gain (as
8 defined in subsection (e) (5)).
9 "(d) EXCEPTIONS AND SPECIAL RULES.—
10 "(1) GIFTS.—Subsection (c) shall not apply to a
11 disposition by gift.
12 "(2) TRANSFER AT DEATH.—Except as provided
13 in section 691 (relating to income in respect of a
14 decedent), subsection (c) shall not apply to a transfer
15 at death.
16 "(3) CERTAIN CORPORATE TRANSACTIONS.—If
17 the basis of property in the hands of a transferee is
18 determined by reference to its basis in the hands of the
19 transferor by reason of the application of section 332,
20 351, 361, 371 (a), or 374 (a), then the amount of
21 gain taken into account by the transferor under sub-
22 section (c) (1) shall not exceed the amount of gain
23 recognized to the transferor on the transfer of such
24 property (determined without regard to this section).
25 This paragraph shall not apply to a disposition to an

1 organization (other than a cooperative described in
2 section 521) which is exempt from the tax imposed by
3 this chapter.
4 "(4) LIKE KIND EXCHANGES; INVOLUNTARY
5 CONVERSION, ETC.—If property is disposed of and gain
6 (determined without regard to this section) is not
7 recognized in whole or in part under section 1031 or
8 1033, then the amount of gain taken into account by the
9 transferor under subsection (c)(1) shall not exceed
10 the sum of—
11 "(A) the amount of gain recognized on such
12 disposition (determined without regard to this sec-
13 tion), plus
14 "(B) the fair market value of property ac-
15 quired with respect to which no gain is recognized
16 under subparagraph (A), but which is not farm
17 recapture property.
18 "(5) PARTNERSHIPS.—
19 "(A) IN GENERAL.—In the case of a part-
20 nership, each partner shall take into account sep-
21 arately his distributive share of the partnership's
22 farm net losses, gains from dispositions of farm re-
23 capture property, and other items in applying this
24 section to the partner.

1 "(B) TRANSFERS TO PARTNERSHIPS.—If farm
2 recapture property is contributed to a partnership
3 and gain (determined without regard to this sec-
4 tion) is not recognized under section 721, then the
5 amount of gain taken into account by the transferor
6 under subsection (c) (1) shall not exceed the ex-
7 cess of the fair market value of farm recapture prop-
8 erty transferred over the fair market value of the
9 partnership interest attributable to such property.
10 If the partnership agreement provides for an allo-
11 cation of gain to the contributing partner with re-
12 spect to farm recapture property contributed to the
13 partnership (as provided in section 704 (c) (2)),
14 the partnership interest of the contributing partner
15 shall be deemed to be attributable to such property.
16 "(6) PROPERTY TRANSFERRED TO CONTROLLED
17 CORPORATIONS.—Except for transactions described in
18 subsection (b) (5) (A), in the case of a transfer, de-
19 scribed in paragraph (3), of farm recapture property
20 to a corporation, stock received by a transferor in the
21 exchange shall be farm recapture property to the ex-
22 tent attributable to the fair market value of farm recap-
23 ture property (or if less, the adjusted basis plus the
24 potential gain (as defined in subsection (e) (5)) on

1 farm recapture property) contributed to the corpora-
2 tion by such transferor.
3 "(e) DEFINITIONS.—For purposes of this section—
4 "(1) FARM RECAPTURE PROPERTY.—The term
5 'farm recapture property' means any property (other
6 than section 1250 property) described in paragraph
7 (1) (relating to business property held for more than
8 12 months), (3) (relating to livestock), or (4) (re-
9 lating to an unharvested crop) of section 1231 (b)
10 which is or has been used in the trade or business of
11 farming by the taxpayer or by a transferor in a trans-
12 action described in subsection (b) (5).
13 "(2) FARM NET LOSS.—The term 'farm net loss'
14 means the amount by which—
15 "(A) the deductions allowed or allowable by
16 this chapter which are directly connected with the
17 carrying on of the trade or business of farming,
18 exceed
19 "(B) the gross income derived from such trade
20 or business.
21 Gains and losses on the disposition of farm recapture
22 property referred to in section 1231 (a) (determined
23 without regard to this section or section 1245 (a))
24 shall not be taken into account.

1 "(3) FARM NET INCOME.—The term 'farm net
2 income' means the amount by which the amount re-
3 ferred to in paragraph (2) (B) exceeds the amount re-
4 ferred to in paragraph (2) (A).
5 "(4) TRADE OR BUSINESS OF FARMING.—
6 "(A) HORSE RACING.—In the case of a tax-
7 payer engaged in the raising of horses, the term
8 'trade or business of farming' includes the racing of
9 horses.
10 "(B) SEVERAL BUSINESSES OF FARMING.—If
11 a taxpayer is engaged in more than one trade or
12 business of farming, all such trades and businesses
13 shall be treated as one trade or business."
14 "(5) POTENTIAL GAIN.—The term 'potential gain'
15 means an amount equal to the excess of the fair market
16 value of property over its adjusted basis, but limited in
17 the case of land to the extent of the deductions allow-
18 able in respect to such land under sections 175 (relat-
19 ing to soil and water conservation expenditures) and
20 182 (relating to expenditures by farmers for clearing
21 land) for the taxable year and the 4 preceding taxable
22 years."
23 (b) CONFORMING AMENDMENTS.—
24 (1) Section 301 (b) (1) (B) (ii) (relating to cor-
25 porate distributions of property) is amended by striking

1 out "or 1250 (a)" and inserting in lieu thereof "1250
2 (a), or 1251 (c)".
3 (2) Section 301 (d) (2) (B) (relating to the basis
4 of property distributed by a corporation) is amended by
5 striking out "or 1250 (a)" and inserting in lieu thereof
6 "1250 (a), or 1251 (c)".
7 (3) Section 312 (c) (3) (relating to adjustment
8 to corporate earnings and profits) is amended by strik-
9 ing out "or 1250 (a)" and inserting in lieu thereof "1250
10 (a), or 1251 (c)".
11 (4) Section 341 (e) (12) (relating to nonapplica-
12 tion of section 1245 (a) with respect to collapsible cor-
13 porations) is amended by striking out "and 1250 (a)"
14 and inserting in lieu thereof "1250 (a), and 1251 (c)".
15 (5) Section 453 (d) (4) (B) (relating to distribu-
16 tion of installment obligations under certain liquidations)
17 is amended by striking out "or 1250 (a)" and inserting
18 in lieu thereof "1250 (a), or 1251 (c)".
19 (6) Section 751 (c) (relating to unrealized receiv-
20 ables in partnership transactions) is amended by striking
21 out "section 1250 (c)" and inserting in lieu thereof
22 "section 1250 (c), and farm recapture property (as
23 defined in section 1251 (e) (1))"; and by striking out
24 "1250 (a)" and inserting in lieu thereof "1250 (a), or
25 1251 (c)".

1 **(7) The table of sections for part IV of subchapter**
2 **P of chapter 1 is amended by adding at the end thereof**
3 **the following:**

**"Sec. 1251. Gain from disposition of property used in farming where farm losses offset nonfarm income."**

4 (c) EFFECTIVE DATES.—The amendments made by
5 this section shall apply to taxable years beginning after
6 December 31, 1969.

7 **SEC. 212. LIVESTOCK.**

8 (a) DEPRECIATION RECAPTURE.—
9 (1) GENERAL RULE.—Section 1245(a)(2) (re-
10 lating to recomputed basis with respect to gain from
11 disposition of certain depreciable property) is amended
12 by striking out "or" at the end of subparagraph (A),
13 by adding "or" at the end of subparagraph (B), and
14 by inserting immediately after subparagraph (B) the
15 following:
16 "(C) with respect to livestock, its adjusted
17 basis recomputed by adding thereto all adjustments
18 attributable to a period after December 31, 1969,"
19 (2) CONFORMING AMENDMENT.—Section 1245
20 (a)(3) (relating to section 1245 property) is amended
21 by striking out "(other than livestock)".
22 (3) EFFECTIVE DATE.—The amendments made by
23 paragraphs (1) and (2) shall apply with respect to tax-
24 able years beginning after December 31, 1969.

1 (b) LIVESTOCK USED IN TRADE OR BUSINESS.—
2 (1) AMENDMENT OF SECTION 1231.—Section
3 1231 (b) (3) (relating to property used in a trade or
4 business) is amended to read as follows:
5 "(3) LIVESTOCK.—Such term includes livestock
6 regardless of age, held by a taxpayer for draft, breeding,
7 sporting, or dairy purposes, but only if held by him for
8 at least 365 days after such animal normally would have
9 first been used for any of such purposes. Such term does
10 not include poultry."
11 (2) EFFECTIVE DATE.—The amendments made by
12 paragraph (1) shall apply to livestock acquired after
13 December 31, 1969.
14 **SEC. 213. HOBBY LOSSES.**
15 (a) Section 270 (relating to limitation on deductions
16 allowable to individuals in certain cases) is amended to read
17 as follows:
18 **"SEC. 270. LIMITATION ON DEDUCTIONS IN CERTAIN**
19 **CASES.**
20 "(a) GENERAL RULE.—Items attributable to an activity
21 shall be allowed only to the extent of the gross income from
22 such activity unless such activity is carried on with a reason-
23 able expectation of realizing a profit.
24 "(b) REBUTTABLE PRESUMPTION.—If the deductions
25 attributable to an activity exceed the gross income from such

1 activity by $25,000 or more for any 3 of 5 consecutive years
2 ending with the taxable year, then unless the taxpayer estab-
3 lishes to the contrary, the activity shall be deemed to have
4 been carried on without a reasonable expectation of realizing
5 a profit."
6 (b) (1) Section 6504 (relating to cross references with
7 respect to limitations on assessment and collection) is
8 amended by striking out paragraph (8).
9 (2) The table of sections for part IX of subchapter
10 B of chapter 1 is amended by striking out—

"Sec. 270. Limitation on deductions allowable to individuals in certain cases."

11 and inserting in lieu thereof the following:

"Sec. 270. Limitation on deductions in certain cases."

12 (c) The amendment made by this section shall apply
13 to taxable years beginning after December 31, 1969.

14 ## Subtitle C—Interest

15 SEC. 221. INTEREST.

16 (a) LIMITATION ON INTEREST DEDUCTION ATTRIB-
17 UTABLE TO INVESTMENT INDEBTEDNESS.—Section 163
18 (relating to interest) is amended by redesignating subsec-
19 tion (d) as (e), and by inserting after subsection (c) the
20 following new subsection:
21 "(d) LIMITATION ON INTEREST ON INVESTMENT IN-
22 DEBTEDNESS.—
23 "(1) IN GENERAL.—In the case of a taxpayer

1 other than a corporation (except an electing small busi-
2 ness corporation as defined in section 1371 (b)), the
3 amount of investment interest allowable as a deduction
4 under subsection (a) shall not exceed the sum of—
5 "(A) $25,000 ($12,500, in the case of a sep-
6 arate return by a married individual),
7 "(B) the amount of the net investment income
8 (as defined in paragraph (3) (C)), and
9 "(C) an amount equal to the amount by which
10 the net long-term capital gain exceeds the net short-
11 term capital loss for the taxable year.
12 "(2) CARRYFORWARD OF DISALLOWED INVEST-
13 MENT INTEREST.—The amount of disallowed investment
14 interest for any taxable year shall be treated (except
15 for purposes of paragraph (1) (A)) as investment in-
16 terest paid or accrued in the succeeding taxable year.
17 "(3) DEFINITIONS.—For purposes of this sub-
18 section—
19 "(A) INVESTMENT INCOME.—The term 'in-
20 vestment income' means the gross amount of income
21 from interest, dividends, rents, and royalties and net
22 short-term capital gains derived from the disposition
23 of property held for investment, but only to the
24 extent that such gross income or such gains are not
25 derived from the conduct of a trade or business.

1 "(B) INVESTMENT EXPENSES.—The term 'in-
2 vestment expenses' means all deductions allowable
3 under section 164(a) (1) or (2), 166, 167, 171,
4 212, or 611 directly connected with the produc-
5 tion of investment income.

6 "(C) NET INVESTMENT INCOME.—The term
7 'net investment income' means the excess, if any, of
8 investment income over investment expenses.

9 "(D) INVESTMENT INTEREST.—The term 'in-
10 vestment interest' means interest paid or accrued on
11 indebtedness incurred or continued to purchase or
12 carry property held for investment.

13 "(E) DISALLOWED INVESTMENT INTEREST.—
14 The term 'disallowed investment interest' means,
15 with respect to any taxable year, the amount dis-
16 allowed as a deduction solely by reason of the limi-
17 tation in paragraph (1).

18 "(4) SPECIAL RULES.—

19 "(A) PARTNERSHIPS.—In the case of a part-
20 nership, the provisions of this subsection shall apply
21 with respect to the partnership and with respect to
22 each partner.

23 "(B) NET OPERATING LOSSES OF ELECTING
24 SMALL BUSINESS CORPORATIONS.—The net operat-
25 ing loss deduction allowed to shareholders of an

1 electing small business corporation under section
2 1374 shall be deemed an investment interest deduc-
3 tion to the extent such investment interest is al-
4 lowed as a deduction to the corporation. Section
5 1374(d) shall be disregarded to the extent such
6 net operating loss deduction is deemed to be an in-
7 vestment interest deduction.

8 "(C) RENTS.—Gross income derived from
9 rents shall not be considered as gross income de-
10 rived from the conduct of a trade or business unless
11 (i) the sum of the deductions with respect to the
12 rent producing property which are allowable under
13 section 162 (relating to trade or business expenses)
14 equals or exceeds 15 percent of the rental income
15 produced by such property, and (ii) the taxpayer
16 is neither guaranteed a specified return nor is guar-
17 anteed in whole or in part against loss of income."

18 (b) CAPITAL GAINS DEDUCTION.—The first sentence
19 of section 1202 (relating to deduction for capital gains) is
20 amended by striking out "exceeds the net short-term capital
21 loss" and inserting in lieu thereof "exceeds the sum of the
22 net short-term capital loss and the amount of investment
23 interest allowable as a deduction under section 163(d)(1)
24 (C)".

25 (c) EFFECTIVE DATE.—The amendments made by this

1 section shall apply to taxable years beginning after Decem-
2 ber 31, 1969.

3 ## Subtitle D—Moving Expenses

4 SEC. 231. MOVING EXPENSES.

5 (a) DEDUCTION FOR MOVING EXPENSES.—Section 217
6 (relating to moving expenses) is amended to read as
7 follows:

8 "SEC. 217. MOVING EXPENSES.

9 "(a) DEDUCTION ALLOWED.—There shall be allowed
10 as a deduction moving expenses paid or incurred during the
11 taxable year in connection with the commencement of work
12 by the taxpayer as an employee at a new principal place of
13 work.

14 "(b) DEFINITION OF MOVING EXPENSES.—

15 "(1) IN GENERAL.—For purposes of this section,
16 the term 'moving expenses' means only the reasonable
17 expenses—

18 "(A) of moving household goods and personal
19 effects from the former residence to the new
20 residence,

21 "(B) of traveling (including meals and lodg-
22 ing) from the former residence to the new place of
23 residence,

24 "(C) of traveling (including meals and lodg-
25 ing), after obtaining employment, from the former

residence to the general location of the new principal place of work and return, for the principal purpose of searching for a new residence,

"(D) of meals and lodging while occupying temporary quarters in the general location of the new principal place of work during any period of 30 consecutive days after obtaining employment, or

"(E) constituting qualified residence sale, purchase, or lease expenses.

"(2) QUALIFIED RESIDENCE SALE, ETC., EXPENSES.—For purposes of paragraph (1) (E), the term 'qualified residence sale, purchase, or lease expenses' means only reasonable expenses incident to—

"(A) the sale or exchange by the taxpayer or his spouse of the taxpayer's former residence (not including expenses for work performed on such residence in order to assist in its sale) which (but for this subsection and subsection (e)) would be taken into account in determining the amount realized on the sale or exchange,

"(B) the purchase by the taxpayer or his spouse of a new residence in the general location of the new principal place of work which (but for this subsection and subsection (e)) would be taken into account in determining—

1 "(i) the adjusted basis of the new resi-
2 dence, or
3 "(ii) the cost of a loan (but not including
4 any amounts which represent payments or pre-
5 payments of interest),
6 "(C) the settlement of an unexpired lease on
7 property used by the taxpayer as his former resi-
8 dence, or
9 "(D) the acquisition of a lease by the taxpayer
10 or his spouse on property used by the taxpayer as
11 his new residence in the general location of the new
12 principal place of work (not including amounts
13 which are payments or prepayments of rent).
14 "(3) LIMITATIONS.—
15 "(A) DOLLAR LIMITS.—The aggregate amount
16 allowable as a deduction under subsection (a) in
17 connection with a commencement of work which is
18 attributable to expenses described in subparagraph
19 (C) or (D) of paragraph (1) shall not exceed
20 $1,000. The aggregate amount allowable as a deduc-
21 tion under subsection (a) which is attributable to
22 qualified residence sale, purchase, or lease expenses
23 shall not exceed $2,500, reduced by the aggregate
24 amount so allowable which is attributable to ex-

1 penses described in subparagraph (C) or (D) of
2 paragraph (1).
3 "(B) HUSBAND AND WIFE.—In the case of
4 a husband and wife filing separate returns, sub-
5 paragraph (A) shall be applied by substituting
6 '$500' for '$1,000', and by substituting '$1,250'
7 for '$2,500'.
8 "(C) INDIVIDUALS OTHER THAN TAX-
9 PAYER.—In the case of any individual other than
10 the taxpayer, expenses referred to in subparagraphs
11 (A) through (D) of paragraph (1) shall be taken
12 into account only if such individual has both the
13 former residence and the new residence as his prin-
14 cipal place of abode and is a member of the tax-
15 payer's household.
16 "(c) CONDITIONS FOR ALLOWANCE.—No deduction
17 shall be allowed under this section unless—
18 "(1) the taxpayer's new principal place of work—
19 "(A) is at least 50 miles farther from his
20 former residence than was his former principal place
21 of work, or
22 "(B) if he had no former principal place of
23 work, is at least 50 miles from his former residence,
24 and

1 "(2) during the 12-month period immediately fol-
2 lowing his arrival in the general location of his new
3 principal place of work, the taxpayer is a full-time em-
4 ployee, in such general location, during at least 39
5 weeks.

6 "(d) RULES FOR APPLICATION OF SUBSECTION (c)
7 (2).—

8 "(1) The condition of subsection (c) (2) shall not
9 apply if the taxpayer is unable to satisfy such condition
10 by reason of—

11 "(A) death or disability, or

12 "(B) involuntary separation (other than for
13 willful misconduct) from the service of, or trans-
14 fer for the benefit of, an employer after obtaining
15 full-time employment in which the taxpayer could
16 reasonably have been expected to satisfy such con-
17 dition.

18 "(2) If a taxpayer has not satisfied the condition of
19 subsection (c) (2) before the time prescribed by law
20 (including extensions thereof) for filing the return for
21 the taxable year during which he paid or incurred mov-
22 ing expenses which would otherwise be deductible under
23 this section, but may still satisfy such condition, then
24 such expenses may (at the election of the taxpayer) be

1 deducted for such taxable year notwithstanding subsec-
2 tion (c) (2).
3 "(3) If—
4 "(A) for any taxable year moving expenses
5 have been deducted in accordance with the rule
6 provided in paragraph (2), and
7 "(B) the condition of subsection (c) (2) (as
8 modified by paragraph (1) of this subsection)
9 cannot be satisfied at the close of a subsequent tax-
10 able year,
11 then an amount equal to the expenses which were so
12 deducted shall be included in gross income for the first
13 such subsequent taxable year.
14 "(e) DENIAL OF DOUBLE BENEFIT.—The amount rea-
15 lized on the sale of the residence described in subparagraph
16 (A) of subsection (b) (2) shall not be decreased by the
17 amount of any expenses described in such subparagraph
18 which are allowed as a deduction under subsection (a), and
19 the basis of a residence described in subparagraph (B) of
20 subsection (b) (2) shall not be increased by the amount of
21 any expenses described in such subparagraph which are
22 allowed as a deduction under subsection (a). This subsec-
23 tion shall not apply to any expenses with respect to which

1 an amount is included in gross income under subsection
2 (d) (3).
3 "(f) REGULATIONS.—The Secretary or his delegate
4 shall prescribe such regulations as may be necessary to carry
5 out the purposes of this section."
6 (b) INCLUSION IN GROSS INCOME OF MOVING EX-
7 PENSE REIMBURSEMENTS.—Part II of subchapter B of
8 chapter 1 (relating to items specifically included in gross
9 income) is amended by adding after section 81 the follow-
10 ing new section:
11 "SEC. 82. REIMBURSEMENT FOR EXPENSES OF MOVING.
12 "There shall be included in gross income (as compen-
13 sation for services) any amount received or accrued, directly
14 or indirectly, by an individual from his employer as a pay-
15 ment for or reimbursement of expenses of moving from one
16 residence to another residence."
17 (c) CLERICAL AMENDMENTS.—The table of sections
18 for part II of subchapter B of chapter 1 is amended by add-
19 ing at the end thereof the following:

"Sec. 82. Reimbursement for expenses of moving."

20 (d) EFFECTIVE DATES.—The amendments made by this
21 section shall apply to taxable years beginning after Decem-
22 ber 31, 1969, except that section 217 of the Internal Reve-
23 nue Code of 1954 (as amended by subsection (a)) shall
24 not apply to any item to the extent that the taxpayer received

1 reimbursement or other expense allowance for such item
2 on or before December 31, 1969, which was not included in
3 his gross income.

# 4 TITLE III—OTHER ADJUSTMENTS 5 PRIMARILY AFFECTING INDI- 6 VIDUALS

## 7 Subtitle A—Limit On Tax Preferences 8 And Allocation Of Deductions

9 SEC. 301. LIMIT ON TAX PREFERENCES FOR INDIVIDUALS,
10 ESTATES, AND TRUSTS.

11 (a) IN GENERAL.—
12 (1) Part II of subchapter B of chapter 1 (relating
13 to items specifically included in gross income) is
14 amended by adding at the end thereof the following new
15 section:

16 "SEC. 84. DISALLOWED TAX PREFERENCES.

17 "(a) GENERAL RULE.—In the case of a taxpayer
18 (other than a corporation), there shall be included in gross
19 income for the taxable year the amount of disallowed tax
20 preferences.

21 "(b) DISALLOWED TAX PREFERENCES.—For purposes
22 of this section, the amount of disallowed tax preferences for
23 a taxable year is the amount by which the sum of the items
24 of tax preference exceeds the limit on tax preferences.

1 "(c) ITEMS OF TAX PREFERENCE.—

2 "(1) GENERAL RULE.—For purposes of this sec-

3 tion, the items of tax preference are:

4 "(A) CHARITABLE CONTRIBUTION OF APPRE-

5 CIATED PROPERTY.—The amount of the deduction

6 (determined without regard to section 277) for

7 charitable contributions under section 170 or 642

8 (c) allowable for the taxable year which is attribut-

9 able to appreciation in the value of property not

10 included in gross income (determined without regard

11 to this section).

12 "(B) ACCELERATED DEPRECIATION.—With

13 respect to each section 1250 property (as defined

14 in section 1250(c)), the amount by which the de-

15 duction allowable for the taxable year for exhaus-

16 tion, wear and tear, obsolescence, or amortization

17 exceeds the depreciation deduction which would

18 have been allowable for the taxable year had the

19 taxpayer depreciated the property under the method

20 described in section 167(b)(1) (relating to the

21 straight line method of depreciation) for each tax-

22 able year of its useful life for which the taxpayer

23 has held the property.

24 "(C) INTEREST ON CERTAIN GOVERNMENTAL

25 OBLIGATIONS.—The excess (if any) of interest on

1 obligations which is excludable from gross income
2 for the taxable year under section 103 over the
3 sum of—
4 "(i) the amount of the proper adjustment
5 to basis required to be made for the taxable year
6 under section 1016(a) (5) or (6), and
7 "(ii) the amount of deductions allocable to
8 such interest which is disallowed by applica-
9 tion of section 265(a)(1) (relating to ex-
10 penses relating to tax-exempt income),
11 multiplied by the transitional percentage as deter-
12 mined under paragraph (5).
13 "(D) FARM LOSSES.—The amount by which
14 the farm net loss (as defined under section 1251(e)
15 (2) but not including any item of tax preference
16 specified in subparagraph (B)) exceeds the amount
17 of the farm loss (if any) which would have been
18 determined under the accounting methods described
19 in section 1251(b)(4).
20 "(E) CAPITAL GAINS DEDUCTION.—The
21 amount allowable as a deduction for long-term
22 capital gains under section 1202.
23 "(2) NONRESIDENT ALIENS.—In the case of a non-
24 resident alien, the items of tax preference shall include
25 only those items of income which are effectively con-

1 nected with the conduct of a trade or business within the
2 United States and those items of deductions which are
3 allowable as deductions in determining taxable income
4 which is effectively connected with the conduct of a trade
5 or business within the United States.

6 "(3) SPECIAL RULE FOR COMPUTING NET OPER-
7 ATING LOSS.—For purposes of computing the amount of
8 a net operating loss or the amount of a net operating loss
9 carryover, the items of tax preference shall be deter-
10 mined without regard to paragraph (1) (E).

11 "(4) SPECIAL RULE FOR SHAREHOLDERS OF AN
12 ELECTING SMALL BUSINESS CORPORATION.—Under reg-
13 ulations prescribed by the Secretary or his delegate, the
14 items of tax preference of an electing small business
15 corporation (as defined in section 1371(b)) for each
16 taxable year of the corporation shall be treated as items
17 of tax preference of the shareholders of such corporation
18 and shall be apportioned pro rata among such share-
19 holders in a manner consistent with section 1374(c) (1).
20 For purposes of the preceding sentence, this section
21 shall be treated as applying to such corporation.

22 "(5) TRANSITIONAL PERCENTAGE APPLICABLE
23 TO INTEREST ON CERTAIN GOVERNMENTAL OBLIGA-
24 TIONS.—The transitional percentage referred to in para-
25 graph (1) (C) is 10 percent multiplied by the number of

1 taxable years beginning on or after January 1, 1970
2 (but not in excess of 100 percent).
3 "(d) LIMIT ON TAX PREFERENCES.—For purposes
4 of this section, the limit on tax preferences is an amount
5 equal to the greater of—
6 "(1) one-half of the sum of (A) the items of tax
7 preference, and (B) the adjusted gross income computed
8 without regard to this section and section 218(a), or
9 "(2) $10,000 ($5,000 in the case of a married
10 individual filing a separate return).
11 "(e) AMOUNTS INCLUDED IN INCOME.—For purposes
12 of this chapter, the amount included in gross income under
13 this section shall be considered derived proportionately from
14 each item of tax preference.
15 "(f) CROSS REFERENCE.—

**"For rules relating to adjustments for amounts disallowed as tax preferences by this section, see section 218."**

16 (2) Part VII of subchapter B of chapter 1 (relat-
17 ing to additional itemized deductions for individuals) is
18 amended by renumbering section 218 as 219, and by
19 inserting after section 217 the following new section:
20 **"SEC. 218. ADJUSTMENTS FOR DISALLOWED TAX PREFER-**
21 **ENCES.**
22 "(a) GENERAL RULE.—If in any taxable year a tax-
23 payer has included disallowed tax preferences (as deter-

1 mined under section 84 (b)) in gross income, the amount
2 thereof shall be allowed, subject to subsection (b), as a
3 deduction in each of the 5 succeeding taxable years to the
4 extent not used as a deduction in earlier taxable years
5 which are subsequent to the taxable year in which the dis-
6 allowed tax preferences arose. For purposes of the pre-
7 ceding sentence, the amount of disallowed tax preferences
8 to which this section applies shall be reduced by the amount
9 of any basis adjustments resulting from application of sub-
10 section (c) during the taxable year to which this section
11 is being applied and any prior taxable years which are sub-
12 sequent to the taxable year in which the disallowed tax
13 preferences arose.
14 "(b) LIMITATIONS.—The deduction under subsection
15 (a) for any taxable year shall not exceed the amount of the
16 limit on tax preferences (as defined in section 84 (d)) for
17 such taxable year reduced by—
18 "(1) the items of tax preference for such taxable
19 year, and
20 "(2) the deduction under subsection (a) for such
21 taxable year resulting from application of this section to
22 disallowed tax preferences arising in taxable years pre-
23 ceding the taxable year in which the disallowed tax pref-
24 erences being applied arose.
25 "(c) ADJUSTMENT TO BASIS.—

1 "(1) IN GENERAL.—Except as provided in para-
2 graph (2)—
3 "(A) disallowed tax preferences which relate
4 to items of tax preference described in section 84 (c)
5 (1) (B) shall increase the basis of the asset to
6 which they relate, and
7 "(B) disallowed tax preferences which relate
8 to items of tax preference described in section 84
9 (c) (1) (D) shall increase the basis of any farm
10 asset other than section 1250 property (as defined
11 in section 1250 (c)),
12 to the extent not allowed as a deduction or as an addi-
13 tion to basis under this section for an earlier taxable year.
14 Such increase shall not be taken into account for pur-
15 poses of the deduction allowed by section 167.
16 "(2) FARM ASSETS.—The increase in basis of farm
17 assets provided in paragraph (1) shall apply to such
18 assets in the order of disposition and shall not increase
19 the basis of an asset to an amount greater than—
20 "(A) the amount which the basis would have
21 been had the taxpayer used the accounting methods
22 described in section 1251 (b) (4), or
23 "(B) if the taxpayer so chooses, an amount de-
24 termined by use of reasonable estimates of the unit
25 costs of the different classes of assets."

1 (b) TECHNICAL AMENDMENTS.—

2 (1) Section 62 (relating to definitions of adjusted
3 gross income) is amended by inserting after paragraph
4 (9) the following new paragraph:

5 "(10) ADJUSTMENTS FOR DISALLOWED TAX PREF-
6 ERENCES.—The deduction allowed by section 218."

7 (2) Section 1016 (relating to adjustments to basis)
8 is amended by redesignating subsection (c) as subsec-
9 tion (d) and by inserting after subsection (b) the fol-
10 lowing new subsection:

11 "(c) LIMIT ON TAX PREFERENCES.—Adjustments to
12 basis shall be computed under this section without regard to
13 section 84 and section 218 except as otherwise provided in
14 section 218(c)."

15 (c) CLERICAL AMENDMENTS.—

16 (1) The table of sections for part II of subchapter
17 B of chapter 1 is amended by adding at the end thereof
18 the following:

"Sec. 84. Disallowed tax preferences."

19 (2) The table of sections for part VII of subchap-
20 ter B of chapter 1 is amended by striking out the last
21 item and inserting in lieu thereof the following:

"Sec. 218. Adjustments for disallowed tax preferences.
"Sec. 219. Cross references."

1 (d) EFFECTIVE DATE.—The amendments made by this
2 section shall apply to taxable years beginning after Decem-
3 ber 31, 1969.

4 **SEC. 302. ALLOCATION OF DEDUCTIONS.**

5 (a) IN GENERAL.—Part IX of subchapter B of chapter
6 1 (relating to items not deductible) is amended by adding
7 at the end thereof the following new section:

8 **"SEC. 277. LIMITATION ON DEDUCTIONS FOR INDIVIDUALS.**

9 "(a) GENERAL RULE.—If a taxpayer (other than a
10 corporation) has allocable expenses for a taxable year, the
11 deduction otherwise allowable under this chapter for such ex-
12 penses shall be disallowed to the extent of an amount equal
13 to the lesser of—

14 "(1) the aggregate of such expenses multiplied by
15 the section 277 fraction, or

16 "(2) the allowable tax preferences.

17 "(b) SECTION 277 FRACTION.—For purposes of this
18 section, the section 277 fraction is the fraction the numera-
19 tor of which is the allowable tax preferences and the denomi-
20 nator of which is the sum of the allowable tax preferences
21 plus modified adjusted gross income.

22 "(c) DEFINITIONS.—For purposes of this section—

1 "(1) ALLOCABLE EXPENSES.—
2 "(A) IN GENERAL.—The term 'allocable ex-
3 penses' means the sum of the amounts allowable as
4 deductions (without regard to this section and sec-
5 tion 172 (d) ) by application of the following provi-
6 sions (to the extent not otherwise disallowed as a
7 deduction under section 265) :
8 "(i) section 163 (relating to interest),
9 determined without regard to section 163
10 (d) (1),
11 "(ii) section 164 (relating to taxes),
12 "(iii) section 165 (relating to losses), but
13 only with respect to a loss described in section
14 165 (c) (3) (relating to casualty losses),
15 "(iv) section 170 (relating to charitable
16 contributions),
17 "(v) section 172 (relating to net operat-
18 ing loss deduction), but only to the extent that
19 the amount allowable (without regard to this
20 section) as a deduction is attributable to a loss
21 described in section 165 (c) (3),
22 "(vi) section 213 (relating to medical,
23 dental, etc., expenses), and
24 "(vii) section 216 (relating to deduction

1 of certain amounts by cooperative housing corporation tenant-stockholders).

3 "(B) EXCEPTION.—Subparagraph (A) shall not apply to interest and taxes paid or incurred in the conduct of a trade or business (other than for investment interest, as defined in section 163(d)(3)(D)).

8 "(C) TAXABLE YEARS BEGINNING IN 1970.—For taxable years beginning in 1970, the allocable expenses shall be one-half of the amount determined under subparagraph (A).

12 "(2) ALLOWABLE TAX PREFERENCES.—

13 "(A) GENERAL RULE.—The term 'allowable tax preferences' means the excess (if any) of the total of the items of tax preference determined under section 84(c) (but only to the extent that such items are not included in gross income under section 84), as modified in subparagraphs (B), (C), and (D), over $10,000 ($5,000 in the case of a married individual filing a separate return).

21 "(B) INTEREST ON CERTAIN GOVERNMENTAL OBLIGATIONS.—For purposes of subparagraph (A), interest excludable from gross income under section

1 103 on obligations issued before July 12, 1969, shall
2 not be taken into account.

3 "(C) DEPLETION AND INTANGIBLE DRILLING
4 AND DEVELOPMENT COSTS.—With respect to each
5 property (as defined in section 614), there shall
6 be added to the items of tax preference (as deter-
7 mined under subparagraph (A)) the amount by
8 which the sum of the deduction for depletion allow-
9 able under section 611 for the taxable year, plus
10 the deduction for intangible drilling and develop-
11 ment costs allowable by application of the provi-
12 sions of section 263 (c) for the taxable year, exceeds
13 the sum of the amounts which would have been
14 allowable for the taxable year for depletion and
15 depreciation under section 611 if no deductions were
16 allowable in any taxable year by reason of the appli-
17 cation of section 613 or 263 (c). Intangible drilling
18 and development costs incurred in drilling a nonpro-
19 ductive well shall not be taken into account.

20 "(D) ADJUSTMENTS FOR DISALLOWED TAX
21 PREFERENCES.—There shall be added to the items
22 of tax preference (as determined in subparagraph
23 (A)) the amount of the deduction allowable for the

1 taxable year under section 218 (relating to adjust-
2 ments for disallowed tax preferences).
3 "(3) MODIFIED ADJUSTED GROSS INCOME.—
4 "(A) GENERAL RULE.—For purposes of this
5 section, the term 'modified adjusted gross income'
6 means taxable income (determined without regard
7 to this section) plus allocable expenses, but in no
8 case shall modified adjusted gross income be less
9 than zero.
10 "(B) NET OPERATING LOSS COMPUTATION.—
11 Taxable income and allocable expenses shall be
12 modified in computing modified adjusted gross in-
13 come, for purposes of determining the amount of a
14 net operating loss or a net operating loss carryover
15 by making the modifications specified in subsections
16 (b)(2)(A) and (d) of section 172.
17 "(d) AMOUNT DISALLOWED FROM EACH ALLOCABLE
18 EXPENSE.—For purposes of this chapter, the amount of de-
19 ductions disallowed by this section shall be disallowed pro-
20 portionately from each allocable expense.
21 "(e) LIMIT ON DISALLOWED INTEREST EXPENSE.—
22 For purposes of this section, the amount of investment

1 interest (as defined in section 163 (d) (3) (D) disallowed by
2 application of subsection (a) shall be reduced, but not below
3 zero, by the amount of such interest expense disallowed as a
4 deduction during the taxable year by application of section
5 163 (d) (1)."

6 (b) TECHNICAL AMENDMENTS.—

7 (1) Section 265 (relating to expenses and interest
8 relating to tax-exempt interest) is amended—

9 (A) by inserting "(a) GENERAL RULE.—"
10 before "No deduction",

11 (B) by amending paragraph (1) of subsection
12 (a) of section 265, as amended by subparagraph
13 (A) of this paragraph, to read as follows:

14 "(1) EXPENSES.—Any amount otherwise allow-
15 able as a deduction (without regard to section 277)
16 which is allocable to one or more classes of income other
17 than interest (whether or not any amount of income of
18 that class or classes is received or accrued) wholly
19 exempt from the taxes imposed by this subtitle, or any
20 amount otherwise allowable under section 212 (relating
21 to expenses for production of income) which is allocable
22 to interest (whether or not any amount of such interest
23 is received or accrued) wholly exempt from the taxes
24 imposed by this subtitle (without regard to section
25 84).",

1 (C) by amending paragraph (2) of subsection
2 (a) of section 265, as amended by subparagraph
3 (A) of this paragraph, by inserting "(without re-
4 gard to section 84)" immediately after "taxes im-
5 posed by this subtitle" each time it appears, and
6 (D) by adding at the end thereof the following
7 new subsection:
8 "(b) SPECIAL RULE FOR OBLIGATIONS DESCRIBED IN
9 SECTION 103.—In the case of a taxpayer (other than a cor-
10 poration), subsection (a) (2) shall not apply to that portion
11 of any interest on indebtedness (other than interest paid or
12 incurred in the conduct of a trade or business) incurred or
13 continued to purchase or carry an obligation, the interest on
14 which is wholly exempt from the taxes imposed by this sub-
15 title by application of section 103 (without regard to section
16 84), which bears the same ratio to the total amount of such
17 interest on indebtedness as the excess (if any) of the amount
18 of interest income determined under section 84(c) (1) (C)
19 as modified by section 277(c) (2) (B) over $10,000
20 ($5,000 in the case of a married individual filing a separate
21 return) bears to the amount of interest income wholly
22 exempt from the taxes imposed by this subtitle by appli-
23 cation of section 103 (without regard to section 84)."
24 (2) Section 643(a) (6) (A) (relating to the defi-
25 nition of distributable net income in the case of the in-

1 come of a foreign trust) is amended by inserting "(a)"
2 immediately after "section 265".
3 (c) CLERICAL AMENDMENT.—The table of sections for
4 part IX of subchapter B of chapter 1 is amended by adding
5 at the end thereof the following new item:

"Sec. 277. Limitation on deductions for individuals."

6 (d) EFFECTIVE DATE.—The amendments made by this
7 section shall apply to taxable years beginning after Decem-
8 ber 31, 1969.

9
## Subtitle B—Income Averaging

10 SEC. 311. INCOME AVERAGING.

11 (a) LIMITATION OF TAX.—Section 1301 (relating to
12 limitation on tax) is amended by striking out "30 percent
13 of such income" and all that follows and inserting in lieu
14 thereof "20 percent of such income to 120 percent of av-
15 erage base period income."
16 (b) AVERAGABLE INCOME.—Section 1302 (relating
17 to the definition of averagable income and related defini-
18 tions) is amended to read as follows:

19 "SEC. 1302. DEFINITION OF AVERAGABLE INCOME; RE-
20 LATED DEFINITIONS.

21 "(a) AVERAGABLE INCOME.—For purposes of this
22 part, the term 'averagable income' means the amount (if
23 any) by which taxable income for the computation year (de-
24 creased by the amount (if any) to which section 72(m)(5)

1 applies) exceeds 120 percent of average base period in-
2 come.

3 "(b) AVERAGE BASE PERIOD INCOME.—For purposes
4 of this part—

5 "(1) IN GENERAL.—The term 'average base period
6 income' means one-fourth of the sum of the base period
7 incomes for the base period.

8 "(2) BASE PERIOD INCOME.—The base period in-
9 come for any taxable year is the taxable income for such
10 year increased by the amount (if any) equal to the ex-
11 cess of—

12 "(A) the amount excluded from gross income
13 under section 911 (relating to earned income from
14 sources without the United States) and subpart D
15 of part III of subchapter N (sec. 931 and follow-
16 ing, relating to income from sources within posses-
17 sions of the United States), over

18 "(B) the deductions which would have been
19 properly allocable to or chargeable against such
20 amount but for the exclusion of such amount from
21 gross income.

22 "(c) OTHER RELATED DEFINITIONS.—For purposes of
23 this part—

24 "(1) COMPUTATION YEAR.—The term 'computa-

1 tion year' means the taxable year for which the taxpayer
2 chooses the benefits of this part.
3 "(2) BASE PERIOD.—The term 'base period' means
4 the 4 taxable years immediately preceding the computa-
5 tion year.
6 "(3) BASE PERIOD YEAR.—The term 'base period
7 year' means any of the 4 taxable years immediately
8 preceding the computation year.
9 "(4) JOINT RETURN.—The term 'joint return'
10 means the return of a husband and wife made under
11 section 6013."
12 (c) SPECIAL RULES.—Section 1304(b) (relating to
13 special rules applicable to income averaging) is amended—
14 (1) by striking out "$5,000" in paragraph (1) and
15 inserting in lieu thereof "$6,100";
16 (2) by striking out "and" at the end of paragraph
17 (3);
18 (3) by striking out the period at the end of para-
19 graph (4) and inserting in lieu thereof a comma; and
20 (4) by adding at the end thereof the following new
21 paragraphs:
22 "(5) section 668(b) (relating to limitation on tax
23 with respect to amounts deemed distributed by a trust
24 in preceding years), and

1 "(6) section 1348 (relating to 50-percent maxi-
2 mum rate on earned income)."
3 (d) CONFORMING AMENDMENTS.—
4 (1) Section 1303(c)(2)(B) is amended by strik-
5 ing out "adjusted".
6 (2) Section 1304 is amended—
7 (A) by striking out paragraph (3) of subsec-
8 tion (c) and by redesignating paragraphs (4) and
9 (5) of such subsection as paragraphs (3) and (4),
10 respectively;
11 (B) by striking out "Paragraphs (2), (3),
12 and (4)" in subsection (c)(1) and inserting in lieu
13 thereof "Paragraphs (2) and (3)";
14 (C) by striking out "paragraph (4)" in sub-
15 section (c)(1)(B) and inserting in lieu thereof
16 "paragraph (3)";
17 (D) by striking out "adjusted" in subpara-
18 graph (B) of subsection (c)(3) (as redesignated);
19 (E) by striking out "section 143" in subsection
20 (c)(4) (as redesignated) and inserting in lieu
21 thereof "section 153";
22 (F) by striking out in subsection (d) ", and
23 the $3,000 figure contained in section 1302(b)(2)
24 (C) shall be applied to the aggregate net incomes";

1 (G) by striking out subsections (e) and (f)
2 and inserting in lieu thereof the following:
3 "(e) TREATMENT OF CERTAIN OTHER ITEMS.—
4 "(1) SECTION 72(m)(5).—Section 72 (m) (5) (re-
5 lating to penalties applicable to certain amounts received
6 by owner-employees) shall be applied as if this part had
7 not been enacted.
8 "(2) OTHER ITEMS.—Except as otherwise pro-
9 vided in this part, the order and manner in which items
10 of income or limitations on tax shall be taken into ac-
11 count in computing the tax imposed by this chapter on
12 the income of any eligible individual to whom section
13 1301 applies for any computation year shall be deter-
14 mined under regulations prescribed by the Secretary or
15 his delegate."; and
16 (H) by redesignating subsection (g) as (f).
17 (3) Section 6511 (d) (2) (B) (ii) is amended—
18 (A) by striking out "1302 (e) (1)" and insert-
19 ing in lieu thereof "1302 (c) (1)"; and
20 (B) by striking out "1302 (e) (3)" and insert-
21 ing in lieu thereof "1302 (c) (3)".
22 (e) EFFECTIVE DATE.—The amendments made by this
23 section shall apply with respect to computation years (within
24 the meaning of section 1302 (c) (1) of the Internal Revenue
25 Code of 1954) beginning after December 31, 1969, and to

1 base period years (within the meaning of section 1302(c)
2 (3) of such Code) applicable to such computation years.

3 ## Subtitle C—Restricted Property

4 **SEC. 321. RESTRICTED PROPERTY.**

5 (a) In General.—Part II of subchapter B of chapter 1
6 (relating to items specifically included in gross income) is
7 amended by adding at the end thereof the following new
8 section:

9 **"SEC. 85. RESTRICTED PROPERTY.**

10 "(a) General Rule.—If, in connection with the per-
11 formance of services, property is transferred to any person
12 other than the person for whom such services are performed,
13 the excess of—
14 "(1) the fair market value of such property (de-
15 termined without regard to any restriction other than a
16 restriction which by its terms will never lapse) at the
17 first time the rights of the person having the beneficial
18 interest in such property are transferable or are not sub-
19 ject to a substantial risk of forfeiture, whichever occurs
20 earlier, over
21 "(2) the amount (if any) paid for such property,
22 shall be included in gross income in the first taxable year
23 in which the rights of the person having the beneficial in-
24 terest in such property are transferable or are not subject
25 to a substantial risk of forfeiture, whichever is applicable.

1 "(b) SUBSTANTIAL RISK OF FORFEITURE.—For pur-
2 poses of this section, the rights of a person in property are
3 subject to a substantial risk of forfeiture if the transferee's
4 rights to full enjoyment of such property are conditioned
5 upon the future performance of substantial services.

6 "(c) CERTAIN RESTRICTIONS WHICH WILL NEVER
7 LAPSE.—

8 "(1) VALUATION.—In the case of property sub-
9 ject to a restriction which by its terms will never lapse,
10 and which allows the transferee to sell such property
11 only at a price determined under a formula, such for-
12 mula price shall be deemed to be the fair market value
13 of the property unless established to the contrary by
14 the Secretary or his delegate, and the burden of proof
15 shall be on the Secretary or his delegate with respect to
16 such value.

17 "(2) CANCELLATION.—If, in the case of property
18 subject to a restriction which by its terms will never
19 lapse, the restriction is canceled, then, unless the tax-
20 payer establishes—

21 "(A) that such cancellation was not compensa-
22 tory, and

23 "(B) that the person, if any, who would be
24 allowed a deduction if the cancellation were treated
25 as compensatory, will treat the transaction as not

1 compensatory, as evidenced in such manner as the
2 Secretary or his delegate shall prescribe by
3 regulations,
4 the excess of the fair market value of the property (com-
5 puted without regard to the restrictions) at the time of
6 cancellation over the sum of—
7 "(C) the fair market value of such property
8 (computed by taking the restriction into account)
9 immediately before the cancellation, and
10 "(D) the amount, if any, paid for the
11 cancellation,
12 shall be treated as compensation for the taxable year
13 in which such cancellation occurs.
14 "(d) APPLICABILITY OF SECTION.—This section shall
15 not apply to—
16 "(1) a transaction to which section 421 applies,
17 "(2) a transfer to a trust described in section
18 401 (a),
19 "(3) the transfer of an option without a readily
20 ascertainable fair market value, or
21 "(4) the transfer of property pursuant to the ex-
22 ercise of an option with a readily ascertainable fair
23 market value at the date of grant.
24 "(e) HOLDING PERIOD.—In determining the period for
25 which the taxpayer has held property to which this section

1 applies, there shall be included only the period beginning
2 at the first time his rights in such property are transferable
3 or are not subject to a substantial risk of forfeiture, which-
4 ever occurs earlier.

5 "(f) TRANSITION RULES.—This section shall apply to
6 property transferred after June 30, 1969, except that this
7 section shall not apply to property transferred—

8 "(1) pursuant to a binding written contract en-
9 tered into before April 22, 1969,

10 "(2) upon the exercise of an option granted before
11 April 22, 1969, or

12 "(3) before February 1, 1970, pursuant to a writ-
13 ten plan adopted and approved before July 1, 1969."

14 (b) NON-EXEMPT TRUSTS AND NONQUALIFIED AN-
15 NUITIES.—

16 (1) BENEFICIARY OF NON-EXEMPT TRUST.—Sec-
17 tion 402 (b) (relating to taxability of beneficiary of non-
18 exempt trust) is amended to read as follows:

19 "(b) TAXABILITY OF BENEFICIARY OF NON-EXEMPT
20 TRUST.—Contributions to an employees' trust made by an
21 employer during a taxable year of the employer which ends
22 within or with a taxable year of the trust for which the
23 trust is not exempt from tax under section 501 (a) shall be
24 included in the gross income of the employee in accord-
25 ance with section 85 (relating to restricted property). The

1 amount actually distributed or made available to any dis-
2 tributee by any such trust shall be taxable to him in the
3 year in which so distributed or made available, under sec-
4 tion 72 (relating to annuities), except that distributions of
5 income of such trust before the annuity starting date (as
6 defined in section 72 (c) (4)) shall be included in the gross
7 income of the employee without regard to section 72 (e)
8 (1) (relating to amount not received as annuities). A bene-
9 ficiary of any such trust shall not be considered the owner
10 of any portion of such trust under subpart E of part I of
11 subchapter J (relating to grantors and others treated as
12 substantial owners)."

13 (2) BENEFICIARY UNDER NONQUALIFIED ANNU-
14 ITY.—Section 403 (relating to taxation of employee
15 annuities) is amended by striking out subsections (c)
16 and (d) and inserting in lieu thereof the following
17 new subsection:

18 "(c) TAXABILITY OF BENEFICIARY UNDER NON-
19 QUALIFIED ANNUITIES OR UNDER ANNUITIES PURCHASED
20 BY EXEMPT ORGANIZATIONS.—Premiums paid by an em-
21 ployer for an annuity contract which is not subject to subsec-
22 tion (a) shall be included in the gross income of the
23 employee in accordance with section 85 (relating to re-
24 stricted property). If the employer is exempt from tax under
25 section 501 (a) or 521 (a), the preceding sentence shall

1 apply only to that portion of the premiums paid which is not
2 excluded from gross income under subsection (b). The
3 amount actually paid or made available to any beneficiary
4 under such contract shall be taxable to him in the year in
5 which so paid or made available under section 72 (relating
6 to annuities)."
7 (c) CLERICAL AMENDMENT.—The table of sections for
8 part II of subchapter B of chapter 1 is amended by adding at
9 the end thereof the following new item

"Sec. 85. Restricted property."

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

## 15 Subtitle D—Other Deferred Compensation

16 **SEC. 331. DEFERRED COMPENSATION.**

17 (a) IN GENERAL.—Subchapter Q of chapter 1 (relating
18 to readjustment of tax between years and special limitations)
19 is amended by adding at the end thereof the following new
20 part:

21 "PART VIII—DEFERRED COMPENSATION

"Sec. 1354. Deferred compensation.

22 **"SEC. 1354. DEFERRED COMPENSATION.**

23 "(a) MINIMUM TAX.—If an individual receives a de-

1 ferred compensation payment during the taxable year, the
2 tax imposed by section 1 for the taxable year which is at-
3 tributable to the excess (if any) of such payment over
4 $10,000 shall not be less than the lower of—
5 "(1) the aggregate increase in tax resulting from
6 adding to the employee's taxable income (as modified
7 under subsection (c)) for each taxable year in which
8 such excess is deemed to have been earned the portion
9 of such excess deemed to have been earned in each such
10 year, or
11 "(2) the tax determined by multiplying by the
12 number of taxable years in the period during which
13 such excess is deemed to have been earned, the average
14 of the increase in tax resulting from adding to the em-
15 ployee's taxable income (as modified under subsection
16 (c)), for the 3 taxable years during the last 10 years
17 of such period for which his taxable income is highest,
18 the portion of such excess deemed to have been earned
19 in each such year.
20 "(b) YEAR IN WHICH EARNED.—A deferred compen-
21 sation payment shall be deemed to have been earned
22 ratably over (1) the employee's entire period of service
23 with the employer (or any predecessor or successor of the
24 employer or a parent or subsidiary corporation of the em-

1 ployer), or (2) a portion of such period if, under regula-
2 tions prescribed by the Secretary or his delegate, such pay-
3 ment is properly attributable to such portion.

4 "(c) EFFECT OF PRIOR DEFERRED COMPENSATION
5 PAYMENTS.—For purposes of applying subsection (a) with
6 respect to a deferred compensation payment, the employee's
7 taxable income for any taxable year referred to in subsection
8 (a) shall be first increased by any amount added to the
9 taxable income for such taxable year with respect to any
10 deferred compensation payment previously received.

11 "(d) EMPLOYEE.—For purposes of this section, the term
12 'employee' includes any individual who performs services
13 for any person, notwithstanding the fact that such individual
14 is not regarded as the employee of such person for any other
15 purpose of this title.

16 "(e) INFORMATION REQUIREMENT.—Subsection (a)
17 (1) shall not apply unless the taxpayer supplies such in-
18 formation as the Secretary or his delegate may by regulations
19 prescribe with respect to his income for each taxable year
20 in which the deferred compensation payment is deemed to
21 have been earned.

22 "(f) APPLICABILITY OF SECTION.—This section shall
23 not apply to any deferred compensation payment made under
24 a written plan—

1 "(1) which meets the requirements of section
2 401 (a) (3), (4), (5), (6), (7), and (8),
3 "(2) which would meet such requirements but for
4 the fact that such plan is unfunded, or
5 "(3) in the case of a plan in existence on August
6 4, 1969, which is amended before January 1, 1972, so
7 as to meet the requirements of paragraph (1) or (2).
8 "(g) TRANSITION RULES.—The minimum tax imposed
9 by subsection (a) shall not apply to the ratable portion of
10 any deferred compensation payment attributable to a taxable
11 year—
12 "(1) beginning before January 1, 1970, or
13 "(2) beginning before January 1, 1974, if paid
14 or made available pursuant to an obligation which was,
15 on July 11, 1969, and at all times thereafter, binding
16 (without regard to the effect of any possibility of for-
17 feiture by the employee)."
18 (b) CLERICAL AMENDMENT.—The table of parts for
19 subchapter Q of chapter 1 is amended by adding at the end
20 thereof the following new item:

"Part VIII. Deferred compensation."

21 (c) EFFECTIVE DATE.—The amendments made by sub-
22 sections (a) and (b) shall apply with respect to taxable
23 years ending after June 30, 1969.

1 # Subtitle E—Accumulation Trusts,
2 # Multiple Trusts, Etc.

3 SEC. 341. TREATMENT OF EXCESS DISTRIBUTIONS BY
4 TRUSTS.

5 (a) DEFINITIONS.—

6 (1) Subsections (b) and (c) of section 665 (re-
7 lating to definitions applicable to subpart D) are
8 amended to read as follows:

9 "(b) ACCUMULATION DISTRIBUTIONS.—For purposes
10 of this subpart, the term 'accumulation distribution' means,
11 for any taxable year of the trust, the amount by which—

12 "(1) the amounts specified in paragraph (2) of
13 section 661 (a) for such taxable year, exceed

14 "(2) distributable net income reduced (but not
15 below zero) by the amounts specified in paragraph (1)
16 of section 661 (a).

17 "(c) SPECIAL RULE APPLICABLE TO DISTRIBUTIONS
18 BY CERTAIN FOREIGN TRUSTS.—Any amount paid to a
19 United States person which is from a payor who is not a
20 United States person and which is derived directly or in-
21 directly from a foreign trust created by a United States
22 person shall be deemed in the year of payment to have been
23 directly paid by the foreign trust."

24 (2) Subsection (d) of such section is amended

1 by striking out "sections 667 and" and inserting in lieu
2 thereof "section".
3 (3) Subsection (e) of such section is amended to
4 read as follows:
5 "(e) PRECEDING TAXABLE YEAR.—In the case of a
6 trust (other than a foreign trust created by a United States
7 person), the term 'preceding taxable year' does not include
8 any taxable year of the trust ending before April 23, 1964.
9 In the case of a foreign trust created by a United States
10 person, the term does not include any taxable year of the
11 trust to which this part does not apply. In the case of a
12 preceding taxable year with respect to which a trust qualifies
13 (without regard to this subpart) under the provisions of sub-
14 part B, for purposes of the application of this subpart to such
15 trust for such taxable year, such trust shall, in accordance
16 with regulations prescribed by the Secretary or his delegate,
17 be treated as a trust to which subpart C applies."
18 (b) ACCUMULATION DISTRIBUTION ALLOCATED TO
19 PRECEDING YEARS.—
20 (1) So much of section 666 as precedes subsection
21 (b) is amended to read as follows:
22 "SEC. 666. ACCUMULATION DISTRIBUTION ALLOCATED TO
23 PRECEDING YEARS.
24 "(a) AMOUNT ALLOCATED.—In the case of a trust

1 which is subject to subpart C, the amount of the accumula-
2 tion distribution of such trust for such taxable year shall be
3 deemed to be an amount within the meaning of paragraph
4 (2) of section 661 (a) distributed on the last day of each
5 of the preceding taxable years to the extent that such amount
6 exceeds the total of any undistributed net incomes for any
7 taxable years intervening between the taxable year with
8 respect to which the accumulation distribution is deter-
9 mined and such preceding taxable year. The amount deemed
10 to be distributed in any such preceding taxable year under
11 the preceding sentence shall not exceed the undistributed
12 net income of such preceding taxable year. For purposes
13 of this subsection, undistributed net income for each of such
14 preceding taxable years shall be computed without regard
15 to such accumulation distribution and without regard to
16 any accumulation distribution determined for any succeed-
17 ing taxable year."
18 (2) Section 666 is amended by adding at the end
19 thereof the following new subsection:
20 "(d) SPECIAL RULE FOR DISTRIBUTIONS COVERED
21 BY SECTION 665 (b) BEFORE APRIL 23, 1969.—For the
22 purpose of determining the undistributed net income for any
23 preceding taxable year of a trust, amounts distributed before
24 April 23, 1969, which were excluded from the definition of
25 an accumulation distribution under section 665 (b) as in ef-

1 fect before such date shall reduce the undistributed net income
2 of the preceding taxable year or years of the trust on the last
3 day of which they are deemed to have been distributed under
4 this subpart."

5 (c) DENIAL OF REFUND TO TRUSTS.—Section 667 is
6 amended to read as follows:

7 "SEC. 667. DENIAL OF REFUND TO TRUSTS.

8 "No refund or credit shall be allowed to a trust for any
9 preceding taxable year by reason of a distribution deemed
10 to have been made by such trust in such year under section
11 666."

12 (d) AMOUNTS TREATED AS DISTRIBUTED IN PRIOR
13 YEARS.—Section 668 is amended to read as follows:

14 "SEC. 668. TREATMENT OF AMOUNTS DEEMED DISTRIB-
15 UTED IN PRECEDING YEARS.

16 "(a) GENERAL RULE.—The total of the amounts which
17 are treated under section 666 as having been distributed by
18 the trust in a preceding taxable year shall be included in the
19 income of a beneficiary or beneficiaries of the trust when
20 paid, credited, or required to be distributed to the extent
21 that such total would have been included in the income of
22 such beneficiary or beneficiaries under section 662 (a) (2)
23 and (b) if such total had been paid to such beneficiary or
24 beneficiaries on the last day of such preceding taxable year.

1 "(b) LIMITATION ON TAX.—

2 "(1) ALTERNATIVE METHODS.—The tax attribut-
3 able to the amounts treated under subsection (a) as hav-
4 ing been received by the beneficiary from a trust on the
5 last day of a preceding taxable year of the trust shall not
6 be greater than—

7 "(A) the aggregate of the taxes attributable to
8 those amounts had they been included in the gross
9 income of the beneficiary on such day in accordance
10 with section 662 (a) (2) and (b), or

11 "(B) the tax determined by multiplying by the
12 number of preceding taxable years of the trust, on
13 the last day of each of which an amount is deemed
14 under section 666 (a) to have been distributed, the
15 average of the increase in tax attributable to recom-
16 puting the beneficiary's gross income for the taxable
17 year and each of his 2 taxable years immediately
18 preceding the year of the accumulation distribution
19 by adding to the income of each of such years an
20 amount determined by dividing the amount required
21 to be included in income under subsection (a) by
22 such number of preceding taxable years of the trust.
23 The recomputation for the taxable year shall be
24 made without regard to the inclusion in income

1 required by subsection (a) of the accumulation dis-
2 tribution to which the limitation is being applied.
3 "(2) EXCEPTIONS.—
4 "(A) When an accumulation distribution is
5 deemed under section 666 (a) to have been dis-
6 tributed on the last day of less than 3 taxable years
7 of the trust, the taxable years of the beneficiary for
8 which a recomputation is made under paragraph
9 (1) (B) shall equal the number of years to which
10 section 666 (a) applies, commencing with the most
11 recent taxable year of the beneficiary.
12 "(B) If a beneficiary was not alive on the last
13 day of each preceding taxable year of the trust with
14 respect to which a distribution is deemed made under
15 section 666 (a), paragraph (1) (A) shall not apply.
16 In applying paragraph (1) (B), no recomputation
17 shall be made for a beneficiary for a taxable year
18 for which he was not alive.
19 "(3) EFFECT OF PRIOR ACCUMULATION DISTRIBU-
20 TIONS.—In computing the limitations on tax under para-
21 graph (1) for any beneficiary to whom a prior
22 accumulation distribution or distributions have been paid,
23 credited, or required to be distributed (whether from the
24 same trust or another trust), the income of the bene-

1 ficiary for each of his preceding taxable years shall in-
2 clude amounts previously deemed distributed to such
3 beneficiary for such year under section 666 as a result
4 of prior accumulation distributions.

5 "(4) MULTIPLE DISTRIBUTIONS IN THE SAME
6 TAXABLE YEAR.—In the case of accumulation distribu-
7 tions made from more than one trust which are includ-
8 able in the income of a beneficiary in the same taxable
9 year, the distributions shall be deemed to have been
10 made consecutively in whichever order the beneficiary
11 shall determine.

12 "(5) INFORMATION REQUIREMENT.—

13 "(A) The limitation on tax provided in para-
14 graph (1) (A) shall not be effective unless the
15 beneficiary supplies such information with respect
16 to his income, for each taxable year on the last
17 day of which an amount is deemed distributed under
18 section 666 (a), as the Secretary or his delegate
19 may by regulations prescribe.

20 "(B) In addition, in the case of a foreign trust
21 created by a United States person, the limitation
22 on tax provided in paragraph (1) shall not be
23 effective unless the beneficiary supplies such infor-
24 mation with respect to the operation and accounts
25 of the trust, for each taxable year on the last day

1 of which an amount is deemed distributed under
2 section 666(a), as the Secretary or his delegate
3 may by regulations prescribe.

4 "(c) CREDIT FOR TAXES PAID BY TRUST.—The tax
5 imposed on a beneficiary under this chapter shall be credited
6 with the amount of taxes deemed distributed to him under
7 section 666 (b) and (c)."

8 (e) DELETION OF SPECIAL RULES APPLICABLE TO
9 CERTAIN FOREIGN TRUSTS.—Section 669 (relating to spe-
10 cial treatment of beneficiaries of certain foreign trusts) is
11 repealed.

12 (f) TECHNICAL AMENDMENTS.—The table of sections
13 for subpart D of part I of subchapter J of chapter 1 (relat-
14 ing to treatment of excess distributions by trusts) is
15 amended—

16 (1) by striking out

"SEC. 666. Accumulation distribution allocated to 5 preceding years."

17 and inserting in lieu thereof

"SEC. 666. Accumulation distribution allocated to preceding years."

18 (2) by striking out

"SEC. 669. Special rules applicable to certain foreign trusts."

19 (g) EFFECTIVE DATE AND TRANSITIONAL RULES.—
20 (1) Except for amounts credited or required to be
21 distributed before April 23, 1969, and except as pro-

1 vided in paragraph (2), the amendments made by this
2 section shall apply with respect to all distributions by
3 trusts paid, credited, or required to be distributed after
4 April 22, 1969.
5 (2) For the taxable year of the trust in which
6 April 23, 1969, occurs—
7 (A) DISTRIBUTIONS NOT EXCEEDING $2,-
8 000.—If the total of the amounts specified in para-
9 graph (2) of section 661 (a) of the Internal Reve-
10 nue Code of 1954 do not exceed distributable net
11 income of the trust reduced by the amounts specified
12 in paragraph (1) of section 661 (a) of such Code
13 by more than $2,000, there shall be deemed to be
14 no accumulation distribution for such taxable year.
15 (B) If amounts were paid, credited, or were
16 required to be distributed by a trust during the
17 portion of the year occurring before April 23, 1969,
18 the accumulation distribution for the year shall be
19 the total of—
20 (i) The accumulation distribution for the
21 portion of the year before April 23, 1969, de-
22 termined in accordance with the law in effect
23 before the enactment of this Act, and
24 (ii). The accumulation distribution for the

1 portion of the year after April 22, 1969, deter-
2 mined in accordance with the law as amended
3 by this Act.
4 In making these determinations, there shall be al-
5 located to the portion of the year after April 22,
6 1969, the distributable net income of the trust ex-
7 cept to the extent it exceeds the amounts specified
8 in section 661 (a) of such Code for such portion of
9 the year. The remainder, if any, of the distributable
10 net income shall be allocated to the portion of the
11 year before April 22, 1969.

12 SEC. 342. TRUST INCOME FOR BENEFIT OF A SPOUSE.

13 (a) INCOME FOR BENEFIT OF GRANTOR'S SPOUSE.—
14 (1) Paragraphs (1), (2), and (3) of section 677
15 (a) (relating to income for benefit of grantor) are
16 amended by striking out "the grantor" each place it
17 appears and inserting in lieu thereof "the grantor or the
18 grantor's spouse".
19 (2) Section 677 (b) is amended by striking out
20 "beneficiary" and inserting in lieu thereof "beneficiary
21 (other than the grantor's spouse)".
22 (b) EFFECTIVE DATE.—The amendments made by
23 subsection (a) shall apply in respect of property transferred
24 in trust after April 22, 1969.

1 # TITLE IV—ADJUSTMENTS PRIMAR-
2 # ILY AFFECTING CORPORATIONS
3 ## Subtitle A—Multiple Corporations
4 **SEC. 401. MULTIPLE CORPORATIONS.**
5 (a) IN GENERAL.—
6 (1) Section 1561 (relating to surtax exemptions
7 in case of certain controlled corporations) is amended
8 to read as follows:
9 "**SEC. 1561. LIMITATIONS ON CERTAIN MULTIPLE TAX**
10 **BENEFITS IN THE CASE OF CERTAIN CON-**
11 **TROLLED CORPORATIONS.**
12 "(a) GENERAL RULE.—The component members of a
13 controlled group of corporations on a December 31 shall,
14 for their taxable years which include such December 31, be
15 limited for purposes of this subtitle to—
16 "(1) one $25,000 surtax exemption under section
17 11(d),
18 "(2) one $100,000 amount for purposes of com-
19 puting the accumulated earnings credit under section
20 535(c) (2) and (3), and
21 "(3) one $25,000 amount for purposes of com-
22 puting the limitation on the small business deduction of
23 life insurance companies under sections 804(a) (4) and
24 809(d) (10).
25 The amount specified in paragraph (1) shall be divided

1 equally among the component members of such group on such
2 December 31 unless all of such component members consent
3 (at such time and in such manner as the Secretary or his
4 delegate shall by regulations prescribe) to an apportionment
5 plan providing for an unequal allocation of such amount. The
6 amounts specified in paragraphs (2) and (3) shall be
7 divided equally among the component members of such group
8 on such December 31 unless the Secretary or his delegate
9 prescribes regulations permitting an unequal allocation of
10 such amounts.

11 "(b) CERTAIN SHORT TAXABLE YEARS.—If a corpo-
12 ration has a short taxable year which does not include a
13 December 31 and is a component member of a controlled
14 group of corporations with respect to such taxable year, then
15 for purposes of this subtitle—

16 "(1) the surtax exemption under section 11 (d),

17 "(2) the amount to be used in computing the
18 accumulated earnings credit under section 535 (c) (2)
19 and (3), and

20 "(3) the amount to be used in computing the limi-
21 tation on the small business deduction of life insurance
22 companies under sections 804 (a) (4) and 809 (d) (10),

23 of such corporation for such taxable year shall be the amount
24 specified in subsection (a) (1), (2), or (3), as the case may

1 be, divided by the number of corporations which are com-
2 ponent members of such group on the last day of such tax-
3 able year. For purposes of the preceding sentence, section
4 1563 (b) shall be applied as if such last day were substituted
5 for December 31."

6 (2) Section 1562 (relating to privilege of groups
7 to elect multiple surtax exemptions) is repealed.

8 (b) TRANSITIONAL RULES FOR CONTROLLED GROUPS
9 OF CORPORATIONS.—

10 (1) Part II of subchapter B of chapter 6 (relating
11 to certain controlled corporations) is amended by add-
12 ing at the end thereof the following new section:

13 "SEC. 1564. TRANSITIONAL RULES IN THE CASE OF CER-
14 TAIN CONTROLLED CORPORATIONS.

15 "(a) LIMITATION ON ADDITIONAL BENEFITS.—

16 "(1) IN GENERAL.—With respect to any Decem-
17 ber 31 after 1968 and before 1976, the amount of—

18 "(A) each additional $25,000 surtax exemp-
19 tion under section 1562 in exces of the first such
20 exemption,

21 "(B) each additional $100,000 amount under
22 section 535 (c) (2) and (3) in excess of the first
23 such amount, and

24 "(C) each additional $25,000 limitation on the
25 small business deduction of life insurance companies

1 under sections 804(a)(4) and 809(d)(10) in
2 excess of the first such limitation,
3 otherwise allowed to the component members of a con-
4 trolled group of corporations for their taxable years
5 which include such December 31 shall be reduced to
6 the amount set forth in the following schedule:

| "Taxable years including— | Surtax exemption | Amount under sec. 535(c)(2) and (3) | Small business deduction limitation |
|---|---|---|---|
| Dec. 31, 1969 | $21,875 | $87,500 | $21,875 |
| Dec. 31, 1970 | 18,750 | 75,000 | 18,750 |
| Dec. 31, 1971 | 15,625 | 62,500 | 15,625 |
| Dec. 31, 1972 | 12,500 | 50,000 | 12,500 |
| Dec. 31, 1973 | 9,375 | 37,500 | 9,375 |
| Dec. 31, 1974 | 6,250 | 25,000 | 6,250 |
| Dec. 31, 1975 | 3,125 | 12,500 | 3,125 |

7 "(2) ELECTION.—With respect to any Decem-
8 ber 31 after 1968 and before 1976, the component mem-
9 bers of a controlled group of corporations shall elect (at
10 such time and in such manner as the Secretary or his
11 delegate shall by regulations prescribe) which compo-
12 nent member of such group shall be allowed for its tax-
13 able year which includes such December 31 the surtax
14 exemption, the amount under section 535(c)(2) and
15 (3), or the small business deduction limitation which is
16 not reduced under paragraph (1).
17 "(b) DIVIDENDS RECEIVED BY CORPORATIONS.—
18 "(1) GENERAL RULE.—If—
19 "(A) an election of a controlled group of cor-
20 porations (as defined in section 1563(a)(1) or
21 (4)) under section 1562(a) (relating to privilege

1 of a controlled group of corporations to elect to have
2 each of its component members make its returns
3 without regard to section 1561) was made on or
4 before April 22, 1969, and

5 "(B) such election is effective with respect to
6 the taxable year of each component member of such
7 group which includes December 31, 1969,

8 then, with respect to a dividend distributed on or before
9 December 31, 1978, out of earnings and profits of a
10 taxable year including a December 31 after 1968 and
11 before 1976, subsections (a) (3) and (b) of section
12 243 (relating to dividends received by corporations)
13 shall be applied to the members that comprise an affili-
14 ated group (as defined in section 243 (b) (5)) in the
15 manner set forth in paragraph (2).

16 "(2) SPECIAL RULES.—

17 "(A) An election under section 243 (b) (2)
18 may be made for a taxable year including a De-
19 cember 31 after 1968 and before 1976, notwith-
20 standing that an election under section 1562 (a) is
21 in effect for the taxable year.

22 "(B) Section 243 (b) (1) (B) (ii) shall not
23 apply with respect to a dividend distributed on or
24 before December 31, 1978, out of earnings and

1 profits of a taxable year including a December 31
2 after 1968 and before 1976 for which an election
3 under section 1562 (a) is in effect, and in lieu of the
4 percentage specified in section 243 (a) (3) with re-
5 spect to such dividend, the percentage shall be the
6 percentage set forth in the following schedule:

| "If the dividend is distributed out of earnings and profits of the distributing corporation's taxable year which includes— | The percentage shall be— |
|---|---|
| December 31, 1969 | 87 percent |
| December 31, 1970 | 89 percent |
| December 31, 1971 | 91 percent |
| December 31, 1972 | 93 percent |
| December 31, 1973 | 95 percent |
| December 31, 1974 | 97 percent |
| December 31, 1975 | 99 percent. |

7 "(C) For taxable years which include a
8 December 31 after 1968 for which an election
9 under section 1562 (a) is in effect, section 243 (b)
10 (3) (C) (v) shall not be applied to limit the num-
11 ber of surtax exemptions.
12 "(c) CERTAIN SHORT TAXABLE YEARS.—If—
13 "(1) a corporation has a short taxable year begin-
14 ning after December 31, 1968 and ending before De-
15 cember 31, 1975, which does not include a December
16 31, and
17 "(2) such corporation is a component member of
18 a controlled group of corporations with respect to such

1 taxable year (determined by applying section 1563
2 (b) as if the last day of such taxable year were substi-
3 tuted for December 31),
4 then subsections (a) and (b) shall be applied as if the last
5 day of such taxable year were the nearest December 31 to
6 such day."
7 (2) If—
8 (A) an election of a controlled group of cor-
9 porations (as defined in section 1563(a)(1) of
10 the Internal Revenue Code of 1954) under section
11 1562(a) of such Code (relating to privilege of a
12 controlled group of corporations to elect to have
13 each of its component members make its returns
14 without regard to section 1561) was made on or
15 before April 22, 1969,
16 (B) such election is effective with respect to
17 the taxable year of each component member of
18 such group which includes December 31, 1969,
19 (C) one or more component members of such
20 group sustains a net operating loss (within the
21 meaning of section 172 of such Code) in a taxable
22 year ending on or after December 31, 1969, for
23 which the election under section 1562(a) is in
24 effect, and
25 (D) such net operating loss is a carryover to

1 a subsequent taxable year for which the members
2 of such group join in the filing of a consolidated
3 return,
4 then, under regulations prescribed by the Secretary or
5 his delegate, such net operating loss shall be allowed
6 (if it would have been allowable had the election under
7 section 1562 (a) not been in effect) as a deduction
8 against the income of other members of such group in
9 the same proportion as the additional surtax exemptions
10 of such group were reduced under section 1564 (a) of
11 such Code for the taxable year in which such net operat-
12 ing loss was sustained.
13 (3) (A) The first of sentence of section 1562 (b)
14 (1) is amended by striking out "$25,000" and insert-
15 ing in lieu thereof "the amount of such corporation's
16 surtax exemption for such taxable year".
17 (B) Section 11 (d) is amended by striking out
18 "section 1561" and inserting in lieu thereof "section
19 1561 or 1564".
20 (C) Section 535 (c) (5) is amended by striking
21 out "section 1551" and inserting in lieu thereof "sec-
22 tion 1551, and for limitation on such credit in the case
23 of certain controlled corporations, see section 1564".
24 (D) Section 804 is amended by adding after sub-
25 section (c) the following new subsection:

1 "(d) Cross Reference.—

"For reduction of the $25,000 amount provided in subsection (a)(4) in the case of certain controlled corporations, see section 1564."

2 (E) The table of sections for part II of subchapter
3 B of chapter 6 is amended by adding at the end thereof
4 the following:

"Sec. 1564. Transitional rules in the case of certain controlled corporations."

5 (c) Brother-Sister Controlled Groups.—Section
6 1563 (a) (2) is amended to read as follows:
7 "(2) Brother-sister controlled group.—Two
8 or more corporations if 5 or fewer persons who are indi-
9 viduals, estates, or trusts own (within the meaning of
10 subsection (d) (2)) stock possessing—
11 "(A) at least 80 percent of the total combined
12 voting power of all classes of stock entitled to vote
13 or at least 80 percent of the total value of shares of
14 all classes of the stock of each corporation, and
15 "(B) more than 50 percent of the total com-
16 bined voting power of all classes of stock entitled
17 to vote or more than 50 percent of the total value
18 of shares of all classes of stock of each corporation,
19 taking into account the stock ownership of each such
20 person only to the extent such stock ownership is
21 identical with respect to each such corporation."

1 (d) EXCLUDED STOCK RULES.—

2 (1) Section 1563 (c) (2) (A) is amended by strik-
3 ing out "or" at the end of clause (ii); striking out
4 "stock." at the end of clause (iii) and inserting in lieu
5 thereof "stock, or"; and adding after clause (iii) the
6 following new clause:

7 "(iv) stock in the subsidiary corporation
8 owned (within the meaning of subsection (d)
9 (2)) by an organization (other than the parent
10 corporation) to which section 501 (relating to
11 certain educational and charitable organizations
12 which are exempt from tax) applies and which
13 is controlled directly or indirectly by the parent
14 corporation or subsidiary corporation, by an
15 individual, estate, or trust that is a principal
16 stockholder (within the meaning of clause (ii))
17 of the parent corporation, by an officer of the
18 parent corporation, or by any combination
19 thereof."

20 (2) Section 1563 (c) (2) (B) is amended—

21 (A) by striking out "a person who is an indi-
22 vidual, estate, or trust (referred to in this paragraph
23 as 'common owner') owns" and inserting in lieu
24 thereof "5 or fewer persons who are individuals,

1 estates, or trusts (referred to in this paragraph as
2 'common owners') own";
3 (B) by striking out "or" at the end of clause
4 (i);
5 (C) by striking out in clause (ii) "such com-
6 mon owner", "the common owner", and "stock."
7 and inserting in lieu thereof "any of such common
8 owners", "any of the common owners", and "stock,
9 or", respectively; and
10 (D) by adding after clause (ii) the following
11 new clause:
12 "(iii) stock in such corporation owned
13 (within the meaning of subsection (d) (2))
14 by an organization to which section 501 (relat-
15 ing to certain educational and charitable or-
16 ganizations which are exempt from tax) applies
17 and which is controlled directly or indirectly by
18 such corporation, by an individual, estate, or
19 trust that is a principal stockholder (within the
20 meaning of subparagraph (A) (ii)) of such
21 corporation, by an officer of such corporation, or
22 by any combination thereof."
23 (e) INVESTMENT CREDIT.—
24 (1) Section 46(a) (5) is amended to read as
25 follows:

1 "(5) CONTROLLED GROUPS.—In the case of a con-
2 trolled group, the $25,000 amount specified under para-
3 graph (2) shall be reduced for each component mem-
4 ber of such group by apportioning $25,000 among the
5 component members of such group in such manner as
6 the Secretary or his delegate shall by regulations pre-
7 scribe. For purposes of the preceding sentence, the
8 term 'controlled group' has the meaning assigned to such
9 term by section 1563 (a)."
10 (2) Section 48 (c) (2) (C) is amended to read as
11 follows:
12 "(C) CONTROLLED GROUPS.—In the case of
13 a controlled group, the $50,000 amount specified
14 under subparagraph (A) shall be reduced for each
15 component member of the group by apportioning
16 $50,000 among the component members of such
17 group in accordance with their respective amounts
18 of used section 38 property which may be taken into
19 account."
20 (3) Section 48 (c) (3) (C) is amended to read as
21 follows:
22 "(C) CONTROLLED GROUP.—The term 'con-
23 trolled group' has the meaning assigned to such
24 term by section 1563 (a), except that the phrase
25 'more than 50 percent' shall be substituted for the

1 phrase 'at least 80 percent' each place it appears in
2 section 1563 (a) (1)."
3 (4) Section 48 (d) (2) is amended by striking
4 out "member" and "affiliated group" wherever they ap-
5 pear and inserting in lieu thereof "component member"
6 and "controlled group", respectively.
7 (f) ADDITIONAL FIRST-YEAR DEPRECIATION.—Sec-
8 tion 179 (d) is amended—
9 (1) by striking out in paragraph (2) (B) "mem-
10 ber" and "affiliated group" wherever they appear and
11 inserting in lieu thereof "component member" and "con-
12 trolled group", respectively, and
13 (2) by amending paragraphs (6) and (7) to read
14 as follows:
15 "(6) DOLLAR LIMITATION OF CONTROLLED
16 GROUP.—For purposes of subsection (b) of this sec-
17 tion—
18 "(A) all component members of a controlled
19 group shall be treated as one taxpayer, and
20 "(B) the Secretary or his delegate shall appor-
21 tion the dollar limitation contained in such subsec-
22 tion (b) among the component members of such
23 controlled group in such manner as he shall by
24 regulations prescribe.
25 "(7) CONTROLLED GROUP DEFINED.—For pur-

1 poses of paragraphs (2) and (6), the term 'controlled
2 group' has the meaning assigned to it by section
3 1563(a), except that, for such purposes, the phrase
4 'more than 50 percent' shall be substituted for the phrase
5 'at least 80 percent' each place it appears in section
6 1563(a)(1)."

7 (g) MUTUAL INSURANCE COMPANIES.—

8 (1) Section 821 (relating to tax on mutual in-
9 surance companies to which part II applies) is amended
10 by redesignating subsection (f) as subsection (g) and
11 by inserting after subsection (e) the following new
12 subsection:

13 "(f) CERTAIN CONTROLLED CORPORATIONS.—In the
14 case of a controlled group of corporations (as defined in sec-
15 tion 1563(a)), each of the stated dollar amounts in sub-
16 sections (a)(1) and (c) shall be apportioned, under
17 regulations prescribed by the Secretary or his delegate,
18 among the corporations subject to taxation under this sec-
19 tion which are component members (determined without
20 the application of section 1563(b)(2)(D)) of such
21 group."

22 (2) Section 823(c) (relating to special deduction
23 for small company having gross amount of less than
24 $1,100,000) is amended by adding at the end thereof
25 the following new paragraph:

1 "(8) CERTAIN CONTROLLED CORPORATIONS.—In
2 the case of a controlled group of corporations (as defined
3 in section 1563(a)), each of the stated dollar amounts
4 in paragraph (1) shall be apportioned, under regulations
5 prescribed by the Secretary or his delegate, among the
6 corporations subject to taxation under section 821 which
7 are component members (determined without the appli-
8 cation of section 1563(b)(2)(D)) of such group."
9 (3) Section 501(c)(15) (relating to exemption
10 from tax of certain mutual insurance companies) is
11 amended by striking out "$150,000" and inserting in
12 lieu thereof "the smaller of (A) $150,000, or (B) if
13 any amount is apportioned to such corporation in ac-
14 cordance with section 821(f), such amount".
15 (h) EFFECTIVE DATES.—
16 (1) The amendments made by subsection (a) shall
17 apply with respect to taxable years beginning after
18 December 31, 1975.
19 (2) The amendments made by paragraphs (1)
20 and (3) of subsection (b) shall apply with respect to
21 taxable years beginning after December 31, 1968.
22 (3) Paragraph (2) of subsection (b) shall apply
23 with respect to net operating losses sustained in taxable
24 years ending on or after December 31, 1969.
25 (4) The amendments made by subsections (c)

1 through (f) shall apply with respect to taxable years
2 ending on or after December 31, 1969.
3 (5) The amendments made by subsection (g) shall
4 apply with respect to taxable years beginning after
5 December 31, 1971.

## 6 Subtitle B—Debt-Financed Corporate 7 Acquisitions and Related Problems

8 SEC. 411. INTEREST ON INDEBTEDNESS INCURRED BY
9 CORPORATIONS TO ACQUIRE STOCK OR ASSETS
10 OF ANOTHER CORPORATION.

11 (a) DISALLOWANCE OF INTEREST DEDUCTION.—Part
12 IX of subchapter B of chapter 1 (relating to items not
13 deductible) is amended by adding at the end thereof the
14 following new section:

15 "SEC. 279. INTEREST ON INDEBTEDNESS INCURRED BY
16 CORPORATIONS TO ACQUIRE STOCK OR
17 ASSETS OF ANOTHER CORPORATION.

18 "(a) GENERAL RULE.—No deduction shall be allowed
19 for any interest paid or incurred by a corporation during the
20 taxable year with respect to its corporate acquisition indebted-
21 ness to the extent that such interest exceeds—
22 "(1) $5,000,000, reduced by
23 "(2) the amount of interest paid or incurred by
24 such corporation during such year on obligations which

1 are described in subsection (b) (1) but which are not
2 corporate acquisition indebtedness.
3 "(b) CORPORATE ACQUISITION INDEBTEDNESS.—For
4 purposes of this section, the term 'corporate acquisition in-
5 debtedness' means any obligation evidenced by a bond, de-
6 benture, note, or certificate or other evidence of indebtedness
7 issued by a corporation (hereinafter in this section referred
8 to as the 'issuing corporation') if—
9 "(1) such obligation is issued to provide considera-
10 tion for the acquisition of the stock in, or assets of, an-
11 other corporation (hereinafter referred to in this section
12 as the 'acquired corporation'), except that, where the
13 obligation is issued to provide consideration for the ac-
14 quisition of assets, at least two-thirds of the total value
15 of all the assets of the acquired corporation are acquired
16 pursuant to a plan of acquisition,
17 "(2) such obligation is subordinated to the claims
18 of trade creditors of the issuing corporation generally,
19 "(3) the bond or other evidence of indebtedness is
20 either—
21 "(A) convertible directly or indirectly into
22 stock of the issuing corporation, or
23 "(B) part of an investment unit or other ar-
24 rangement which includes, in addition to such bond
25 or other evidence of indebtedness, an option to ac-

1 quire, directly or indirectly, stock in the issuing cor-
2 poration, and
3 "(4) as of a day determined under subsection (c)
4 (1), either—
5 "(A) the ratio of debt to equity (as defined in
6 subsection (c) (2)), of the issuing corporation ex-
7 ceeds 2 to 1, or
8 "(B) the projected earnings (as defined in sub-
9 section (c) (3)), do not exceed 3 times the an-
10 nual interest to be paid or incurred (determined
11 under subsection (c) (4)).
12 "(c) RULES FOR APPLICATION OF SUBSECTION (b)
13 (4).—For purposes of subsection (b) (4)—
14 "(1) TIME OF DETERMINATION.—Determinations
15 are to be made as of the last day of any taxable year of
16 the issuing corporation in which it issues any obligation
17 to provide consideration for an acquisition described in
18 subsection (b) (1) of stock in, or assets of, the acquired
19 corporation.
20 "(2) RATIO OF DEBT TO EQUITY.—The term 'ratio
21 of debt to equity' means the ratio which the total indebt-
22 edness of the issuing corporation bears to the sum of its
23 money and all its assets (in an amount equal to their
24 adjusted basis for determining gain) less such total in-
25 debtedness.

1 "(3) PROJECTED EARNINGS.—
2 "(A) The term 'projected earnings' means the
3 'average annual earnings' (as defined in subpara-
4 graph (B)) of—
5 "(i) the issuing corporation only, if clause
6 (ii) does not apply, or
7 "(ii) both the issuing corporation and the
8 acquired corporation, in any case where the is-
9 suing corporation has acquired control (as de-
10 fined in section 368(c)), or has acquired sub-
11 stantially all of the properties, of the acquired
12 corporation.
13 "(B) The average annual earnings referred to
14 in subparagraph (A) is, for any corporation, the
15 amount of its earnings and profits for any 3-year
16 period ending with the last day of a taxable year
17 of the issuing corporation described in subsection
18 (c)(1), computed without reduction for—
19 "(i) interest paid or incurred,
20 "(ii) liability for tax under this chapter,
21 and
22 "(iii) distributions to which section 301
23 (c)(1) applies (other than such distributions
24 from the acquired to the issuing corporation),
25 and reduced to an annual average for such 3-year

1 period pursuant to regulations prescribed by the
2 Secretary or his delegate. Such regulations shall in-
3 clude rules for cases where any corporation was not
4 in existence for all of such 3-year period or such
5 period includes only a portion of a taxable year
6 of any corporation.
7 "(4) ANNUAL INTEREST TO BE PAID OR IN-
8 CURRED.—The term 'annual interest to be paid or in-
9 curred' shall be—
10 "(A) if subparagraph (B) does not apply, the
11 annual interest to be paid or incurred by the issuing
12 corporation only, determined by reference to its total
13 indebtedness outstanding, or
14 "(B) if projected earnings are determined un-
15 der clause (ii) of paragraph (3)(A) because
16 the issuing corporation has acquired control of the
17 acquired corporation, the annual interest to be paid
18 or incurred by both the issuing corporation and the
19 acquired corporation, determined by reference to
20 their combined total indebtedness outstanding.
21 "(d) TAXABLE YEARS TO WHICH APPLICABLE.—In
22 applying this section—
23 "(1) The deduction of interest on any obligation
24 shall not be disallowed under subsection (a) before the
25 first taxable year of the issuing corporation as of the

1 last day of which the application of either subparagraph
2 (A) or subparagraph (B) of subsection (b) (4) re-
3 sults in such obligation being corporate acquisition
4 indebtedness.

5 "(2) Except as provided in paragraph (3), if an
6 obligation is determined to be corporate acquisition in-
7 debtedness as of the last day of any taxable year of
8 the issuing corporation, it shall be deemed to be cor-
9 porate acquisition indebtedness for such taxable year
10 and all subsequent taxable years.

11 "(3) If an obligation is determined to be corporate
12 acquisition indebtedness as of the close of a taxable year
13 of the issuing corporation in which clause (i) of subsec-
14 tion (c) (3) (A) applied, but would not be corporate
15 acquisition indebtedness if the determination were made
16 as of the close of the first taxable year of such corpora-
17 tion thereafter in which clause (ii) of subsection (c)
18 (3) (A) could apply, such obligation shall be considered
19 not to be corporate acquisition indebtedness for such later
20 taxable year and all taxable years thereafter.

21 "(e) NONTAXABLE TRANSACTIONS.—An acquisition of
22 stock of a corporation of which the issuing corporation is in
23 control (as defined in section 368(c)) in a transaction in
24 which gain or loss is not recognized shall not be deemed an
25 acquisition described in subsection (b) (1) unless immedi-

1 ately before such transaction (1) the acquired corporation
2 was in existence, and (2) the issuing corporation was not in
3 control (as defined in section 368(c)) of such corporation.
4 "(f) EXEMPTION FOR CERTAIN ACQUISITIONS OF
5 FOREIGN CORPORATIONS.—Subsection (a) shall not apply
6 to interest paid or incurred on any indebtedness issued to any
7 person to provide consideration for the acquisition of stock
8 in, or assets of, any foreign corporation substantially all of
9 the income of which, for the 3-year period ending with the
10 date of such acquisition or for such part of such period as the
11 foreign corporation was in existence, is from sources without
12 the United States.
13 "(g) AFFILIATED GROUPS.—In any case in which the
14 issuing corporation is a member of an affiliated group, the
15 application of this section shall be determined, pursuant to
16 regulations prescribed by the Secretary or his delegate, by
17 treating all of the members of the affiliated group in the
18 aggregate as the issuing corporation, except that the ratio of
19 debt to equity, projected earnings, and annual interest to be
20 paid or incurred of any corporation (other than the issuing
21 corporation determined without regard to this subsection)
22 shall be included in the determinations required under sub-
23 paragraphs (A) and (B) of subsection (b)(4) as of any
24 day only if such corporation is a member of the affiliated

1 group on such day, and, in determining projected earnings of
2 such corporation under subsection (c) (3), there shall be
3 taken into account only the earnings and profits of such cor-
4 poration for the period during which it was a member of the
5 affiliated group. For purposes of the preceding sentence, the
6 term 'affiliated group' has the meaning assigned to such term
7 by section 1504 (a), except that all corporations other than
8 the acquired corporation shall be treated as includible cor-
9 porations (without any exclusion under section 1504 (b))
10 and the acquired corporation shall not be treated as an in-
11 cludible corporation.

12 "(h) CHANGES IN OBLIGATION.—For purposes of this
13 section—

14 "(1) Any extension, renewal, or refinancing of an
15 obligation evidencing a preexisting indebtedness shall
16 not be deemed to be a new obligation.

17 "(2) Any obligation which is corporate acquisition
18 indebtedness of the issuing corporation is also corporate
19 acquisition indebtedness of any corporation which be-
20 comes liable for such obligation as guarantor, endorser,
21 or indemnitor or which assumes liability for such obliga-
22 tion in any transaction.

23 "(i) EFFECT ON OTHER PROVISIONS.—No inference
24 shall be drawn from any provision in this section that any
25 instrument designated as a bond, debenture, note, or certifi-

1 cate or other evidence of indebtedness by its issuer represents
2 an obligation or indebtedness of such issuer in applying any
3 other provision of this title."
4 (b) CLERICAL AMENDMENT.—The table of sections for
5 part IX of subchapter B of chapter 1 is amended by adding
6 at the end thereof the following new item:

"Sec. 279. Interest on indebtedness incurred by corporations to acquire stock or assets of another corporation."

7 (c) EFFECTIVE DATE.—The amendments made by this
8 section shall apply to the determination of the allowability
9 of the deduction of interest paid or incurred with respect to
10 indebtedness incurred after May 27, 1969.
11 SEC. 412. INSTALLMENT METHOD.
12 (a) INSTALLMENT METHOD.—Section 453(b)(1)
13 (relating to sales of realty and casual sales of personalty) is
14 amended by inserting before the period at the end thereof the
15 following: ", but only if such sale or other disposition quali-
16 fies as an installment transaction (as defined in paragraph
17 (3))."
18 (b) SPECIAL RULE.—Section 453(b) (relating to sales
19 of realty and casual sales of personalty) is amended by add-
20 ing at the end thereof the following new paragraphs:
21 "(3) INSTALLMENT TRANSACTION DEFINED.—For
22 purposes of subsection (b), the term 'installment trans-
23 action' means a transaction in which the payments of

1 principal or principal and interest are required to be paid
2 periodically and in such amounts over the installment
3 period as prescribed under regulations by the Secretary
4 or his delegate. The requirement stated in the preceding
5 sentence shall be deemed to be satisfied if—
6 "(A) such payments are required to be made
7 at least once every 2 years in relatively even or
8 declining amounts over the installment period; or
9 "(B) at least 5 percent of the principal is re-
10 quired to have been paid by the end of the first
11 quarter of the installment period, at least 15 percent
12 of the principal is required to have been paid by the
13 end of the second quarter of the installment period,
14 and at least 40 percent of the principal is required
15 to have been paid by the end of the third quarter
16 of the installment period.
17 "(4) Rule for applying paragraph (2) (A)
18 (ii).—In applying clause (ii) of paragraph (2) (A),
19 a bond or other evidence of indebtedness issued by a
20 corporation or a government or political subdivision
21 thereof with interest coupons attached, in registered
22 form, or in any other form designed to render such bond
23 or other evidence of indebtedness readily tradable on an
24 established securities market shall not be treated as an
25 evidence of indebtedness of a purchaser."

1 (c) EFFECTIVE DATE.—The amendments made by this
2 section shall apply to sales or other dispositions occurring
3 after May 27, 1969.

4 SEC. 413. BONDS AND OTHER EVIDENCES OF INDEBTED-
5 NESS.

6 (a) BONDS AND OTHER EVIDENCES OF INDEBTED-
7 NESS.—Section 1232(a) (relating to general rule) is
8 amended to read as follows:
9 "(a) GENERAL RULE.—For purposes of this subtitle,
10 in the case of bonds, debentures, notes, or certificates or
11 other evidences of indebtedness, which are capital assets
12 in the hands of the taxpayer, and which are issued by any
13 corporation, or by any government or political subdivision
14 thereof—
15 "(1) RETIREMENT.—Amounts received by the
16 holder on retirement of such bonds or other evidences
17 of indebtedness shall be considered as amounts received
18 in exchange therefor (except that in the case of bonds
19 or other evidences of indebtedness issued before Janu-
20 ary 1, 1955, this paragraph shall apply only to those
21 issued with interest coupons or in registered form, or
22 to those in such form on March 1, 1954).
23 "(2) SALE OR EXCHANGE.—
24 "(A) CORPORATE BONDS ISSUED AFTER MAY
25 27, 1969.—Except as provided in subparagraph

1 (C), on the sale or exchange of bonds or other
2 evidences of indebtedness issued by a corporation
3 after May 27, 1969, held by the taxpayer more
4 than 6 months, any gain shall (except as provided
5 in the following sentence) be considered gain from
6 the sale or exchange of a capital asset held for more
7 than 6 months. If at the time of original issue there
8 was an intention to call the bond or other evidence
9 of indebtedness before maturity, any gain realized
10 on sale or exchange thereof which does not exceed
11 an amount equal to the original issue discount (as
12 defined in subsection (b)) shall be considered as
13 gain from the sale or exchange of property which
14 is not a capital asset.
15 "(B) CORPORATE BONDS ISSUED ON OR BE-
16 FORE MAY 27, 1969, AND GOVERNMENT BONDS.—
17 Except as provided in subparagraph (C), on sale
18 or exchange of bonds or other evidences of indebted-
19 ness issued by a government or political subdivision
20 thereof after December 31, 1954, or by a corpora-
21 tion after December 31, 1954, and on or before
22 May 27, 1969, held by the taxpayer more than 6
23 months, any gain realized which does not exceed—
24 "(i) an amount equal to the original issue
25 discount (as defined in subsection (b)), or

1 "(ii) if at the time of original issue there
2 was no intention to call the bond or other evi-
3 dence of indebtedness before maturity, an
4 amount which bears the same ratio to the origi-
5 nal issue discount (as defined in subsection
6 (b)) as the number of complete months that
7 the bond or other evidence of indebtedness was
8 held by the taxpayer bears to the number of
9 complete months from the date of original issue
10 to the date of maturity,
11 shall be considered as gain from the sale or ex-
12 change of property which is not a capital asset. Gain
13 in excess of such amount shall be considered gain
14 from the sale or exchange of a capital asset held
15 more than 6 months.
16 "(C) EXCEPTIONS.—This paragraph shall not
17 apply to—
18 "(i) obligations the interest on which is
19 not includible in gross income under section 103
20 (relating to certain governmental obligations),
21 or
22 "(ii) any holder who has purchased the
23 bond or other evidence of indebtedness at a
24 premium.
25 "(D) DOUBLE INCLUSION IN INCOME NOT

1 REQUIRED.—This section shall not require the in-
2 clusion of any amount previously includible in gross
3 income.
4 "(3) INCLUSION IN INCOME OF ORIGINAL ISSUE
5 DISCOUNT ON CORPORATE BONDS ISSUED AFTER MAY
6 27, 1969.—
7 "(A) GENERAL RULE.—There shall be in-
8 cluded in the gross income of the holder of any bond
9 or other evidence of indebtedness issued by a cor-
10 poration after May 27, 1969, the ratable monthly
11 portion of original issue discount multiplied by
12 the number of complete months (plus any fractional
13 part of a month determined in accordance with the
14 last sentence of this subparagraph) such holder held
15 such bond or other evidence of indebtedness during
16 the taxable year. Except as provided in subpara-
17 graph (B), the ratable monthly portion of original
18 issue discount shall equal the original issue discount
19 (as defined in subsection (b)) divided by the num-
20 ber of complete months from the date of original
21 issue to the stated maturity date of such bond or
22 other evidence of indebtedness. For purposes of this
23 section, a complete month commences with the date
24 of original issue and the corresponding day of each
25 succeeding calendar month (or the last day of a

1 calendar month in which there is no corresponding
2 day); and, in any case where a bond or other evi-
3 dence of indebtedness is acquired on any other day,
4 the ratable monthly portion of original issue discount
5 for the complete month in which such acquisition
6 occurs shall be allocated between the transferor and
7 the transferee in accordance with the number of days
8 in such complete month each held the bond or other
9 evidence of indebtedness.

10 "(B) REDUCTION IN CASE OF ANY SUBSE-
11 QUENT HOLDER.—For purposes of this paragraph,
12 the ratable monthly portion of original issue discount
13 shall not include an amount, determined at the time
14 of any purchase after the original issue of such bond
15 or other evidence of indebtedness, equal to the ex-
16 cess of—

17 "(i) the cost of such bond or other evi-
18 dence of indebtedness incurred by such holder,
19 over

20 "(ii) the issue price of such bond or other
21 evidence of indebtedness increased by the por-
22 tion of original discount previously includible in
23 the gross income of any holder (computed with-
24 out regard to this subparagraph),

25 divided by the number of complete months (plus

1 any fractional part of a month commencing with the
2 date of purchase) from the date of such purchase to
3 the stated maturity date of such bond or other evi-
4 dence of indebtedness.

5 "(C) PURCHASE DEFINED.—For purposes of
6 subparagraph (B), the term 'purchase' means any
7 acquisition of a bond or other evidence of indebted-
8 ness, but only if the basis of the bond or other evi-
9 dence of indebtedness is not determined in whole or
10 in part by reference to the adjusted basis of such
11 bond or other evidence of indebtedness in the hands
12 of the person from whom acquired, or under section
13 1014(a) (relating to property acquired from a de-
14 cedent).

15 "(D) EXCEPTION.—This paragraph shall not
16 apply to any holder who has purchased the bond
17 or other evidence of indebtedness at a premium.

18 "(E) BASIS ADJUSTMENTS.—The basis of
19 any bond or other evidence of indebtedness in the
20 hands of the holder thereof shall be increased by
21 the amount included in his gross income pursuant to
22 subparagraph (A)."

23 (b) ISSUE PRICE.—Section 1232(b)(2) (relating to
24 issue price) is amended by adding at the end thereof the
25 following:

1 "In the case of a bond or other evidence of indebtedness
2 and an option or other security issued together as an in-
3 vestment unit, the issue price for such investment unit
4 shall be determined in accordance with the rules stated
5 in this paragraph. Such issue price attributable to each
6 element of the investment unit shall be that portion
7 thereof which the fair market value of such element
8 bears to the total fair market value of all the elements
9 in the investment unit. The issue price of the bond or
10 other evidence of indebtedness included in such invest-
11 ment unit shall be the portion so allocated to it. In the
12 case of a bond or other evidence of indebtedness, or an
13 investment unit as described in this paragraph, issued
14 for property, the issue price of such bond or other evi-
15 dence of indebtedness or investment unit, as the case
16 may be, shall be the fair market value of such property."
17 (c) REQUIREMENT OF REPORTING.—Section 6049 (a)
18 (1) (relating to requirements of reporting interest) is
19 amended to read as follows:
20 "(a) REQUIREMENT OF REPORTING.—
21 "(1) IN GENERAL.—Every person—
22 "(A) who makes payments of interest (as de-
23 fined in subsection (b)) aggregating $10 or more
24 to any other person during any calendar year,
25 "(B) who receives payments of interest as a

1 nominee and who makes payments aggregating $10
2 or more during any calendar year to any other per-
3 son with respect to the interest so received, or
4 "(C) which is a corporation that has outstand-
5 ing any bond, debenture, note, or certificate or other
6 evidence of indebtedness in registered form as to
7 which there is during any calendar year an amount
8 of original issue discount aggregating $10 or more
9 includible in the gross income of any holder under
10 section 1232(a)(3) without regard to subpara-
11 graph (B) thereof,
12 shall make a return according to the forms or regula-
13 tions prescribed by the Secretary or his delegate, setting
14 forth the aggregate amount of such payments and such
15 aggregate amount includible in the gross income of any
16 holder and the name and address of the person to whom
17 paid or such holder."
18 (d) STATEMENTS TO BE FURNISHED TO PERSONS
19 WITH RESPECT TO WHOM INFORMATION IS FURNISHED.—
20 Section 6049(c) (relating to statements to be furnished to
21 persons with respect to whom information is furnished) is
22 amended to read as follows:
23 "(c) STATEMENTS TO BE FURNISHED TO PERSONS
24 WITH RESPECT TO WHOM INFORMATION IS FURNISHED.—

1 Every person making a return under subsection (a) (1) shall
2 furnish to each person whose name is set forth in such return
3 a written statement showing—
4 "(1) the name and address of the person making
5 such return, and
6 "(2) the aggregate amount of payments to, or the
7 aggregate amount includible in the gross income of, the
8 person as shown on such return.
9 The written statement required under the preceding sentence
10 shall be furnished to the person on or before January 31 of
11 the year following the calendar year for which the return
12 under subsection (a) (1) was made. No statement shall be
13 required to be furnished to any person under this subsection
14 if the aggregate amount of payments to, or the aggregate
15 amount includible in the gross income of, such person shown
16 on the return made under subsection (a) (1) is less than
17 $10."
18 (e) EFFECTIVE DATE.—The amendments made by this
19 section shall apply with respect to bonds and other evidences
20 of indebtedness issued after May 27, 1969.
21 SEC. 414. LIMITATION ON DEDUCTION OF BOND PREMIUM
22 ON REPURCHASE.
23 (a) LIMITATION ON DEDUCTION OF BOND PREMIUM
24 ON REPURCHASE.—Part VIII of subchapter B of chapter

1 of the Internal Revenue Code (relating to special deductions for corporations) is amended by adding at the end thereof the following new section:

"SEC. 249. LIMITATION ON DEDUCTION OF BOND PREMIUM ON REPURCHASE.

"(a) GENERAL RULE.—No deduction shall be allowed to a corporation for any premium paid or incurred upon the repurchase of a bond, debenture, note, or certificate or other evidence of indebtedness which is convertible into the stock of the issuing corporation, or a corporation in control of, or controlled by, the issuing corporation, to the extent the repurchase price exceeds an amount equal to the adjusted issue price plus a normal call premium on bonds or other evidences of indebtedness which are not convertible. The preceding sentence shall not apply to the extent that the corporation can demonstrate to the satisfaction of the Secretary or his delegate that such excess is attributable to the cost of borrowing and is not attributable to the conversion feature.

"(b) SPECIAL RULES.—For purposes of subsection (a)—

"(1) ADJUSTED ISSUE PRICE.—The adjusted issue price is the issue price (as defined in section 1232 (b)) increased by any amount of discount deducted prior to repurchase, or, in the case of bonds or other evidences of

1 indebtedness issued subsequent to February 28, 1913,
2 decreased by any amount of premium included in gross
3 income prior to repurchase by the issuing corporation.
4 "(2) CONTROL.—The term 'control' has the mean-
5 ing assigned to such term by section 368 (c)."
6 (b) CLERICAL AMENDMENT.—The table of sections for
7 part VIII of subchapter B of chapter 1 is amended by add-
8 ing at the end thereof the following new item:

"Sec. 240. Limitation on deduction of bond premium on repurchase."

9 (c) EFFECTIVE DATE.—The amendments made by this
10 section shall apply to a convertible bond or other convertible
11 evidence of indebtedness repurchased after April 22, 1969,
12 other than such a bond or other evidence of indebtedness
13 repurchased pursuant to a binding obligation incurred on or
14 before April 22, 1969, to repurchase such bond or other evi-
15 dence of indebtedness at a specified call premium, and no
16 inference shall be drawn from the fact that subsection (a)
17 does not apply to the repurchase of such convertible bond or
18 other convertible evidence of indebtedness.

## 19 Subtitle C—Stock Dividends

20 **SEC. 421. STOCK DIVIDENDS.**

21 (a) IN GENERAL.—Section 305 (relating to distribu-
22 tions of stock and stock rights) is amended to read as
23 follows:

1 "SEC. 305. DISTRIBUTIONS OF STOCK AND STOCK RIGHTS.
2 "(a) GENERAL RULE.—Except as otherwise provided
3 in this section, gross income does not include the amount of
4 any distribution made by a corporation to its shareholders,
5 with respect to the common stock of such corporation, in its
6 stock or in rights to acquire its stock.
7 "(b) EXCEPTIONS.—Subsection (a) shall not apply to
8 a distribution by a corporation of its stock (or rights to ac-
9 quire its stock), and the distribution shall be treated as a dis-
10 tribution of property to which section 301 applies—
11 "(1) DISTRIBUTIONS IN LIEU OF MONEY.—If the
12 distribution is, at the election of any of the shareholders
13 (whether exercised before or after the declaration there-
14 of), payable either—
15 "(A) in its stock (or in rights to acquire its
16 stock), or
17 "(B) in property.
18 "(2) DISPROPORTIONATE DISTRIBUTIONS.—If
19 the distribution (or a series of distributions of which
20 such distribution is one) has the result of—
21 "(A) the receipt of property by some share-
22 holders, and
23 "(B) an increase in the proportionate inter-
24 ests of other shareholders in the assets or earnings
25 and profits of the corporation.

1 "(3) CONVERTIBLE PREFERRED STOCK.—If the
2 distribution is of convertible preferred stock, unless it
3 is established to the satisfaction of the Secretary or his
4 delegate that such distribution will not have the re-
5 sult described in paragraph (2).
6 For purposes of paragraphs (1) and (2), section 306 stock
7 shall be treated as property which is not stock.
8 "(c) CERTAIN REDEMPTIONS, ETC., TREATED AS DIS-
9 TRIBUTIONS.—For purposes of this section and section 301,
10 the Secretary or his delegate shall prescribe regulations under
11 which a change in conversion ratio, a change in redemption
12 price, a redemption which is treated as a section 301 distri-
13 bution, or any transaction having a similar effect on the
14 interest of any shareholder (or a holder of rights or convert-
15 ible securities) shall be treated as a distribution with respect
16 to any shareholder (or a holder of rights or convertible
17 securities) whose proportionate interest in the earnings and
18 profits or assets of the corporation is increased by such
19 change, redemption, or similar transaction.
20 "(d) CROSS REFERENCES.—

"For special rules—

"(1) Relating to the receipt of stock and stock rights in corporate organizations and reorganizations, see part III (sec. 351 and following).

"(2) In the case of a distribution which results in a gift, see section 2501 and following.

"(3) In the case of a distribution which has the effect of the payment of compensation, see section 61(a)(1)."

1 (b) CONFORMING AMENDMENT.—Section 317 (a) (re-
2 lating to certain definitions) is amended to read as follows:
3 "(a) PROPERTY.—For purposes of this part, the term
4 'property' means money, securities, and any other property;
5 except that such term does not include stock (or rights to
6 acquire stock) in the corporation making the distribution
7 distributed with respect to the common stock of such
8 corporation."
9 (c) EFFECTIVE DATES.—
10 (1) Except as otherwise provided in this subsec-
11 tion, the amendments made by subsections (a) and (b)
12 shall apply with respect to distributions made or con-
13 sidered as made after January 10, 1969, in taxable years
14 ending after such date.
15 (2) The amendments made by subsections (a) and
16 (b) shall not apply to a distribution of stock (or rights
17 to acquire stock) made or considered as made before
18 January 1, 1991, with respect to stock outstanding on
19 January 10, 1969 (or with respect to stock issued pur-
20 suant to a contract binding on January 10, 1969, on the
21 distributing corporation).
22 (3) In cases to which Treasury Decision 6990
23 (promulgated January 10, 1969) would not have ap-
24 plied, in applying paragraphs (1) and (2) of this sub-

1 section April 22, 1969, shall be substituted for Janu-
2 ary 10, 1969.

3 ## Subtitle D—Foreign Tax Credit

4 **SEC. 431. FOREIGN TAX CREDIT REDUCTION IN CASE OF**
5 **FOREIGN LOSSES.**

6 (a) REDUCTION IN FOREIGN TAX CREDIT LIMITA-
7 TION.—Section 904 (a) (relating to limitation on credit)
8 is amended by adding at the end thereof the following new
9 paragraphs:

10 "(3) REDUCTION IN LIMITATION.—In the case of a
11 taxpayer who in a prior taxable year sustains a loss in a
12 foreign country or possession of the United States and
13 chooses the limitation provided in paragraph (1) for
14 such prior year, the amount of the taxpayer's taxable
15 income from sources within such country or possession
16 for the taxable year (but not the taxpayer's entire
17 taxable income for the same taxable year) shall, solely
18 for purposes of determining the applicable limitation
19 under paragraph (1) or (2), be determined without
20 regard to section 172 (relating to net operating loss
21 deduction) and be reduced by the lesser of—

22 "(A) (i) the amount of such loss, decreased by
23 "(ii) the amount of any reduction previously

1 made under this paragraph with respect to such loss,
2 or
3 "(B) an amount which is equal to 50 percent
4 of the taxpayer's taxable income for the taxable year
5 (determined without regard to this paragraph and
6 section 172) from sources within such country or
7 possession.
8 "(4) ALLOCATION OF LOSSES.—In applying para-
9 graph (3) for any taxable year to which subsection (f)
10 or (g) applies, a loss sustained in a foreign country or
11 possession of the United States shall be allocated to the
12 separate limitation (if any) under such subsection pur-
13 suant to regulations prescribed by the Secretary or his
14 delegate.
15 "(5) SPECIAL LIMITATION ON CARRYBACKS AND
16 CARRYOVERS.—For purposes of subsection (d), the
17 amount by which tax paid or accrued to any foreign
18 country or possession of the United States for any tax-
19 able year exceeds the applicable limitation under this
20 subsection shall be determined without regard to para-
21 graph (3).
22 "(6) CERTAIN DISPOSITIONS OF PROPERTY.—
23 "(A) Under regulations prescribed by the
24 Secretary or his delegate, if during any taxable year
25 property which is used in the trade or business

1 which gives rise to the loss referred to in paragraph
2 (3) is disposed of and such loss exceeds the amount
3 by which the taxpayer's taxable income was re-
4 duced under paragraph (3) for such taxable year
5 and preceding taxable years by reason of such loss,
6 an amount equal to such excess shall be included in
7 gross income for such taxable year.

8 "(B) No amount shall be included in gross
9 income under subparagraph (A) in any case in
10 which—

11 "(i) the property which is disposed of is
12 not a material factor in the realization of the
13 income (or loss) from the trade or business in
14 which such property is used or is not a substan-
15 tial portion of the assets used in, or held for use
16 in, the conduct of such trade or business,

17 "(ii) the property is disposed of on ac-
18 count of its destruction or damage by fire,
19 storm, shipwreck, or other casualty, or by rea-
20 son of its theft,

21 "(iii) the property is transferred by reason
22 of death, or

23 "(iv) the property is transferred in a
24 transaction to which section 381(a) applies."

1 (b) EFFECTIVE DATE.—The amendments made by this
2 section shall apply with respect to losses sustained in taxable
3 years beginning after December 31, 1969.

4 SEC. 432. SEPARATE LIMITATION ON FOREIGN TAX
5 CREDIT WITH RESPECT TO FOREIGN MINERAL
6 INCOME.

7 (a) LIMITATION ON AMOUNT OF FOREIGN TAXES TO
8 BE TAKEN INTO ACCOUNT.—Section 904 (relating to limi-
9 tation on credit) is amended by redesignating subsection (g)
10 as subsection (h), and by inserting after subsection (f) the
11 following new subsection:

12 "(g) APPLICATION OF SECTION IN CASE OF FOREIGN
13 MINERAL INCOME.—

14 "(1) IN GENERAL.—If any foreign country or pos-
15 session of the United States, or any agency or instru-
16 mentality of such country or possession—

17 "(A) requires the payment of any bonus or
18 royalty with respect to property which gives rise
19 to foreign mineral income,

20 "(B) holds substantial mineral rights with
21 respect to such property, or

22 "(C) imposes any income, war profits, or ex-
23 cess profits taxes on such income at an effective rate
24 higher than on other income,

25 subsections (a), (c), (d), and (e) of this section shall

1 be applied separately with respect to foreign mineral
2 income from sources within such country or possession.
3 "(2) FOREIGN MINERAL INCOME DEFINED.—
4 "(A) GENERAL RULE.—For purposes of para-
5 graph (1), the term 'foreign mineral income' means
6 taxable income from mines, wells, and other natural
7 deposits within any foreign country or possession
8 of the United States, to the extent such taxable in-
9 come constitutes 'taxable income from the property'
10 within the meaning of section 613. Such term in-
11 cludes, but is not limited to—
12 "(i) dividends received from a foreign
13 corporation in respect of which taxes are deemed
14 paid under section 902, to the extent such divi-
15 dends are attributable to foreign mineral income,
16 and
17 "(ii) that portion of the taxpayer's dis-
18 tributive share of the income of a partnership
19 attributable to foreign mineral income.
20 "(B) SPECIAL RULES.—
21 "(i) For purposes of subparagraph (A), if
22 for the taxable year a taxpayer's (or, where a
23 consolidated income tax return is filed, the affili-
24 ated group's) foreign mineral income is less
25 than $10,000, no part of the taxable income

1 for such year shall be treated as foreign mineral
2 income.
3 "(ii) For purposes of clause (i) of sub-
4 paragraph (A), if less than 30 percent and
5 less than $100,000, of the accumulated profits
6 of the year or years from which dividends are
7 paid, as determined under section 902 (c), are
8 attributable to foreign mineral income, no part
9 of the dividends shall be treated as foreign min-
10 eral income.
11 "(3) OVERALL LIMITATION NOT TO APPLY.—The
12 limitation provided by subsection (a) (2) shall not ap-
13 ply with respect to foreign mineral income. The Sec-
14 retary or his delegate shall by regulations prescribe the
15 manner of application of subsection (e) with respect to
16 cases in which the limitation provided by subsection (a)
17 (2) applies with respect to income other than foreign
18 mineral income.
19 "(4) TRANSITIONAL RULES FOR CARRYBACKS AND
20 CARRYOVERS.—
21 "(A) CARRYBACKS TO YEARS BEFORE TAX
22 REFORM ACT OF 1969.—If, after applying subsec-
23 tion (d), taxes paid or accrued to any foreign
24 country or possession of the United States in any
25 taxable year beginning after the date of the enact-

ment of the Tax Reform Act of 1969 are deemed paid or accrued in one or more taxable years beginning on or before such date, then the amount of such taxes deemed paid or accrued in such taxable year or years shall be determined without regard to the provisions of this subsection. To the extent the taxes paid or accrued to a foreign country or possession ~~of the United States~~ in any taxable year beginning after the date of the enactment of such Act are not, after applying the preceding sentence, deemed paid or accrued in any taxable year beginning on or before the date of the enactment of such Act, such taxes shall, for purposes of applying subsection (d), be deemed paid or accrued in a taxable year beginning after the date of the enactment of such Act with respect to foreign mineral income, and with respect to income other than foreign mineral income, in the same ratios as the amount of such taxes paid or accrued with respect to foreign mineral income, and the amount of such taxes paid or accrued with respect to income other than foreign mineral income, respectively, bear to the total amount of such taxes paid or accrued to such foreign country or possession of the United States.

"(B) CARRYOVERS TO YEARS AFTER TAX RE-

1 FORM ACT OF 1969.—Where under the provisions
2 of subsection (d) taxes paid or accrued to any for-
3 eign country or possession of the United States in
4 any taxable year beginning on or before the date of
5 the enactment of the Tax Reform Act of 1969
6 are deemed paid or accrued in one or more taxable
7 years beginning after such date, the amount of
8 such taxes deemed paid or accrued in any year
9 beginning after such date shall, with respect to
10 foreign mineral income, be an amount which bears
11 the same ratio to the amount of such taxes deemed
12 paid or accrued as the amount of the taxes paid or
13 accrued to such foreign country or possession for
14 such year with respect to foreign mineral income
15 bears to the total amount of taxes paid or accrued
16 to such foreign country or possession for such year;
17 and the amount of such taxes deemed paid or ac-
18 crued in any year beginning after such date with
19 respect to income other than foreign mineral income
20 shall be an amount which bears the same ratio
21 to the amount of such taxes deemed paid or ac-
22 crued for such year as the amount of taxes paid or
23 accrued to such foreign country or possession for
24 such year with respect to income other than foreign
25 mineral income bears to the total amount of the

1 taxes paid or accrued to such foreign country or
2 possession for such year."
3 (b) CONFORMING AMENDMENTS.—Section 904(b)
4 (relating to election of overall limitation) is amended—
5 (1) by striking out "with the consent of the
6 Secretary or his delegate with respect to any tax-
7 able year" in paragraph (1) and inserting in lieu
8 thereof "(A) with the consent of the Secretary or
9 his delegate with respect to any taxable year, or
10 (B) for the taxpayer's first taxable year beginning
11 after the date of the enactment of the Tax Reform
12 Act of 1969", and
13 (2) by striking out "If a taxpayer" in para-
14 graph (2) and inserting in lieu thereof "Except in
15 a case to which paragraph (1) (B) applies, if the
16 taxpayer".
17 (c) EFFECTIVE DATE.—The amendments made by this
18 section shall apply with respect to taxable years beginning
19 after the date of enactment of this Act.

20 ## Subtitle E—Financial Institutions

21 **SEC. 441. RESERVE FOR LOSSES ON LOANS; NET OP-**
22 **ERATING LOSS CARRYBACKS.**

23 (a) BAD DEBT DEDUCTIONS OF FINANCIAL INSTITU-
24 TIONS.—Part I of subchapter H of chapter 1 (relating
25 to rules of general application to banking institutions) is

1 amended by adding at the end thereof the following new
2 section:

3 "SEC. 585. RESERVES FOR LOSSES ON LOANS OF FINAN-
4 CIAL INSTITUTIONS.

5 "(a) INSTITUTIONS TO WHICH SECTION APPLIES.—
6 This section shall apply to the following financial institu-
7 tions—

8 "(1) to any—

9 "(A) bank (as defined in section 581) other
10 than an organization to which section 593 applies, or

11 "(B) corporation to which subparagraph (A)
12 would apply except for the fact that it is a foreign
13 corporation and in the case of such foreign corpora-
14 tion this section shall apply only with respect to
15 loans outstanding, the interest on which is effec-
16 tively connected with the conduct of a banking
17 business within the United States,

18 "(2) to a small business investment company oper-
19 ating under the Small Business Investment Act of
20 1958, and

21 "(3) to a business development corporation, which
22 shall mean a corporation which was created by or pur-
23 suant to an act of a State legislature for purposes of
24 promoting, maintaining, and assisting the economy and
25 industry within such State on a regional or statewide

1 basis by making loans which would generally not be
2 made by banks (as defined in section 581) within such
3 region or State in the ordinary course of their business
4 (except on the basis of a partial participation), and
5 which is operated primarily for such purpose.
6 "(b) ADDITION TO RESERVES FOR BAD DEBTS.—
7 "(1) GENERAL RULE.—For purposes of section 166
8 (c), except as provided in paragraph (2) the rea-
9 sonable addition to the reserve for bad debts of any
10 financial institution to which this section applies shall
11 not exceed the amount necessary to increase the balance
12 of the reserve for bad debts (as of the close of the
13 taxable year) to the greater of—
14 "(A) the amount which bears the same ratio
15 to loans outstanding at the close of the taxable
16 year as (i) the total bad debts sustained during the
17 taxable year and the 5 preceding taxable years (or,
18 with the approval of the Secretary or his delegate,
19 a shorter period), adjusted for recoveries of bad
20 debts during such period, bears to (ii) the sum
21 of the loans outstanding at the close of such 6 or
22 fewer taxable years, or
23 "(B) the lower of—
24 "(i) the balance in the reserve as of the
25 close of the base year, or

1 "(ii) if the amount of loans outstanding
2 at the close of the taxable year is less than
3 the amount of loans outstanding at the close
4 of the base year, the amount which bears the
5 same ratio to loans outstanding at the close of
6 the taxable year as the balance of the reserve
7 as of the close of the base year bears to the
8 amount of loans outstanding at the close of the
9 base year.
10 For purposes of this subparagraph, the term 'base
11 year' means the last taxable year beginning on or
12 before July 11, 1969.
13 "(2) NEW FINANCIAL INSTITUTIONS.—In the
14 case of any taxable year beginning not more than 10
15 years after the day before the first day on which a finan-
16 cial institution (or any predecessor) was authorized to do
17 business as a financial institution described in subsection
18 (a), the reasonable addition to the reserve for bad debts
19 of such financial institution shall not exceed the larger
20 of the amount determined under paragraph (1) or the
21 amount necessary to increase the balance of the reserve
22 for bad debts as of the close of the taxable year to the
23 amount which bears the same ratio (as determined by
24 the Secretary or his delegate) to loans outstanding at
25 the close of the taxable year as (i) the total bad debts

1 sustained by all institutions described in the applicable
2 paragraph of subsection (a) during the 6 preceding tax-
3 able years (adjusted for recoveries of bad debts during
4 such period), bears to (ii) the sum of the loans by all
5 such institutions outstanding at the close of such taxable
6 years."

7 (b) 10-YEAR NET OPERATING LOSS CARRYBACK.—
8 Section 172 (b) (1) (relating to net operating loss deduc-
9 tion) is amended by striking out in subparagraph (A) (i)
10 thereof "and (E)" and inserting in lieu thereof ", (E) and
11 (F)", and by adding at the end thereof the following new
12 subparagraph:

13 "(F) In the case of a financial institution to
14 which section 585 or 593 applies, a net operating
15 loss for any taxable year beginning after July 11,
16 1969, shall be a net operating loss carryback to
17 each of the 10 taxable years preceding the taxable
18 year of such loss and shall be a net operating loss
19 carryover to each of the 5 taxable years following
20 the taxable year of such loss."

21 (c) TECHNICAL AND CLERICAL AMENDMENTS.—

22 (1) Subsection (h) of section 166 (relating to
23 bad debts) is amended by adding at the end thereof
24 the following new paragraph:

33-865 O—69—pt. 1——25

1 "(4) For special rule for bad debt reserves of cer-
2 tain financial institutions other than certain mutual sav-
3 ings banks, domestic building and loan associations and
4 cooperative banks, see section 585."
5 (2) The table of sections for part I of subchapter
6 H of chapter 1 is amended—
7 (A) by striking out:

"Sec. 582. Bad debt and loss deduction with respect to securities held by banks."

8 and inserting in lieu thereof:

"Sec. 582. Bad debts, losses, and gains with respect to securities held by financial institutions."

9 (B) by adding at the end thereof the following:

"Sec. 585. Reserves for losses on loans of financial institutions."

10 (d) EFFECTIVE DATE.—The amendments made by this
11 section shall apply with respect to taxable years beginning
12 after July 11, 1969.
13 **SEC. 442. MUTUAL SAVINGS BANKS, ETC.**
14 (a) RESERVE FOR LOSSES ON LOANS.—Section 593 (b)
15 (relating to addition to reserves for bad debts) is amended—
16 (1) by striking out subparagraph (A) of para-
17 graph (1) and inserting in lieu thereof the following:
18 "(A) the amount determined to be a reason-
19 able addition to the reserve for losses on nonqualify-
20 ing loans, computed in the same manner as pro-
21 vided with respect to additions to reserves for bad

1 debts of financial institutions under section 585 (b)
2 (1) (A), plus"
3 (2) by striking out paragraphs (2), (3), (4),
4 and (5) and inserting in lieu thereof the following:
5 "(2) PERCENTAGE OF TAXABLE INCOME
6 METHOD.—The amount determined under this paragraph
7 for the taxable year shall be the excess of—
8 "(A) an amount equal to the applicable per-
9 centage of the taxable income for such year (deter-
10 mined under the following table), over:

| "For a taxable year beginning in— | The applicable percentage under this paragraph shall be— |
|---|---|
| 1969 | 60 percent. |
| 1970 | 57 percent. |
| 1971 | 54 percent. |
| 1972 | 51 percent. |
| 1973 | 48 percent. |
| 1974 | 45 percent. |
| 1975 | 42 percent. |
| 1976 | 39 percent. |
| 1977 | 36 percent. |
| 1978 | 33 percent. |
| 1979 or thereafter | 30 percent. |

11 "(B) that portion of the amount referred to in
12 paragraph (1) (A) for such year (not in excess of
13 100 percent) which bears the same ratio to such
14 amount as (i) 18 percent (28 percent in the
15 case of mutual savings banks) bears to (ii) the
16 percentage of the assets of the taxpayer which are
17 not assets described in section 7701 (a) (19) (C),
18 but the amount determined under this paragraph shall

not exceed the amount necessary to increase the balance (as of the close of the taxable year) of the reserve for losses on qualifying real property loans to 6 percent of such loans outstanding at such time. For purposes of this paragraph, taxable income shall be computed—

"(i) by excluding from gross income any amount included therein by reason of subsection (f),

"(ii) without regard to any deduction allowable for any addition to the reserve for bad debts,

"(iii) by excluding from gross income an amount equal to the net capital gain for the taxable year arising from the sale or exchange of stock of a corporation, or obligations described in section 103 (a) (1),

"(iv) by excluding from gross income an amount equal to the lesser of $\frac{3}{8}$ of the net long-term capital gain for the taxable year or $\frac{3}{8}$ of the net long-term capital gain for the taxable year from the sale or exchange of property other than property described in clause (iii), and

"(v) by excluding from gross income dividends with respect to which a deduction is allowed by part VIII of subchapter B.

"(3) Limitations.—If the percentage of the assets

1 of a taxpayer described in subsection (a), which are
2 assets described in section 7701(a)(19)(C), is less
3 than—

4 "(A) 82 percent of the total assets in the case
5 of a taxpayer other than a mutual savings bank, the
6 percentage provided by paragraph (2)(A) shall
7 be reduced (i) for taxable years beginning before
8 January 1, 1972, by 1 percentage point for each 1
9 percentage point of such difference, (ii) for taxable
10 years beginning after December 31, 1971, but be-
11 fore January 1, 1977, by 1 percentage point for
12 each 1⅓ percentage points of such difference, and
13 (iii) for taxable years beginning after December 31,
14 1976, by 1 percentage point for each 2 percentage
15 points of such difference, or

16 "(B) 72 percent of the total assets in the case
17 of a mutual savings bank, the percentage provided
18 by paragraph (2)(A) shall be reduced (i) for
19 taxable years beginning before January 1, 1972, by
20 2 percentage points for each 1 percentage point of
21 such difference, (ii) for taxable years beginning
22 after December 31, 1971, but before January 1,
23 1977, by 1½ percentage points for each 1 percentage
24 point of such difference, and (iii) for taxable years
25 beginning after December 31, 1976, by 1 percent-

1 age point for each 1 percentage point of such
2 difference.
3 If the percentage of such assets is less than 60 percent
4 of the total assets of such taxpayer, no amount shall be
5 allowed under paragraph (2).
6 "(4) EXPERIENCE METHOD.—
7 "(A) Except as provided in subparagraph
8 (B), the amount determined under this paragraph
9 to be a reasonable addition to the reserve for losses
10 on qualifying real property loans shall be computed
11 in the same manner as is provided with respect to
12 additions to reserves for bad debts of financial insti-
13 tutions under section 585(b) (1).
14 "(B) For any taxable year of an organization
15 to which this section applies, beginning not more
16 than 10 years after the day before the first day on
17 which it (or any predecessor) was authorized to
18 do business as an organization described in subsec-
19 tion (a), the amount determined under this para-
20 graph for such organization shall be computed in
21 the same manner as is provided with respect to
22 additions to reserves for bad debts of financial insti-
23 tutions under section 585(b) (2)."
24 (b) INVESTMENT STANDARDS.—Section 7701 (a) (19)
25 is amended to read as follows:

1 "(19) DOMESTIC BUILDING AND LOAN ASSOCIA-
2 TION.—The term 'domestic building and loan association'
3 means a domestic building and loan association, a
4 domestic savings and loan association, and a Federal sav-
5 ings and loan association—
6 "(A) which either (i) is an insured institution
7 within the meaning of section 401(a) of the
8 National Housing Act (12 U.S.C., sec. 1724(a)),
9 or (ii) is subject by law to supervision and exami-
10 nation by State or Federal authority having super-
11 vision over such associations;
12 "(B) substantially all of the business of which
13 consists of acquiring the savings of the public and
14 investing in loans; and
15 "(C) at least 60 percent of the amount of the
16 total assets of which (as of the close of the taxable
17 year) consists of—
18 "(i) cash,
19 "(ii) obligations of the United States or of
20 a State or political subdivision thereof, and stock
21 or obligations of a corporation which is an in-
22 strumentality of the United States or of a State
23 or political subdivision thereof, but not includ-
24 ing obligations the interest on which is ex-
25 cludable from gross income under section 103,

1 "(iii) certificates of deposit in, or obliga-
2 tions of, a corporation organized under a State
3 law which specifically authorizes such corpora-
4 tion to insure the deposits or share accounts of
5 member associations,

6 "(iv) loans secured by a deposit or share
7 of a member,

8 "(v) loans secured by an interest in real
9 property which is (or, from the proceeds of the
10 loan, will become) residential real property or
11 real property used primarily for church pur-
12 poses, loans made for the improvement of resi-
13 dential real property or real property used pri-
14 marily for church purposes, provided that for
15 purposes of this clause, residential real property
16 shall include single or multifamily dwellings,
17 facilities in residential developments dedicated
18 to public use or property used on a nonprofit
19 basis for residents, and mobile homes not used
20 on a transient basis,

21 "(vi) loans made for the improvement of
22 real property located within any urban renewal
23 area (as defined in section 110 (a) of the Hous-
24 ing Act of 1949, as amended) or in any area
25 covered by a program eligible for assistance

1 under section 103 of the Demonstration Cities
2 and Metropolitan Development Act of 1966, as
3 amended,
4 "(vii) loans secured by an interest in
5 educational, health, or welfare institutions or
6 facilities, including structures designed or used
7 primarily for residential purposes for students,
8 residents, and persons under care, employees, or
9 members of the staff of such institutions or facil-
10 ities,
11 "(viii) property acquired through the liq-
12 uidation of defaulted loans described in clause
13 (v), (vi), or (vii), and
14 "(ix) loans made for the payment of
15 expenses of college or university education or
16 vocational training, in accordance with such
17 regulations as may be prescribed by the Secre-
18 tary or his delegate,
19 "(x) property used by the association in
20 the conduct of the business described in sub-
21 paragraph (B).
22 At the election of the taxpayer, the percentage
23 specified in this subparagraph shall be applied on
24 the basis of the average assets outstanding during
25 the taxable year, in lieu of the close of the taxable

1 year, computed under regulations prescribed by the
2 Secretary or his delegate."
3 (c) CONFORMING AMENDMENTS.—Section 7701 (a)
4 (32) is amended—
5 (1) by striking out in subparagraph (B) ", (C),
6 (D), (E), and (F)" and inserting in lieu thereof
7 "and (C)", and
8 (2) by striking out the third sentence thereof.
9 (d) EFFECTIVE DATE.—The amendments made by this
10 section shall be effective for taxable years beginning after
11 July 11, 1969.
12 **SEC. 443. TREATMENT OF BONDS, ETC, HELD BY FINAN-**
13 **CIAL INSTITUTIONS.**
14 (a) GAIN ON SECURITIES HELD BY FINANCIAL INSTI-
15 TUTIONS.—Subsection (c) of section 582 (relating to bad
16 debt and loss deduction with respect to securities held by
17 financial institutions) is amended by striking out such sub-
18 section and inserting the following in lieu thereof:
19 "(c) BOND, ETC., LOSSES AND GAINS OF FINANCIAL
20 INSTITUTIONS.—For purposes of this subtitle, in the case of
21 a financial institution to which section 585 or 593 applies, the
22 sale or exchange of a bond, debenture, note, or certificate,
23 or other evidence of indebtedness, shall not be considered
24 a sale or exchange of a capital asset."
25 (b) CONFORMING AMENDMENT.—Paragraph (1) of

1 section 1243 (relating to loss of a small business investment
2 company) is amended to read as follows:
3 "(1) a loss is on stock received pursuant to the
4 conversion privilege of convertible debentures acquired
5 pursuant to section 304 of the Small Business Invest-
6 ment Act of 1958, and".
7 (c) CLERICAL AMENDMENT.—The heading for section
8 582 is amended to read as follows:
9 "SEC. 582. BAD DEBTS, LOSSES, AND GAINS WITH RESPECT
10 TO SECURITIES HELD BY FINANCIAL INSTI-
11 TUTIONS."
12 (d) EFFECTIVE DATE.—The amendments made by this
13 section shall apply with respect to taxable years beginning
14 after July 11, 1969.
15 SEC. 444. FOREIGN DEPOSITS IN UNITED STATES BANKS.
16 Sections 861 and 2104 are amended by striking out
17 "1972" wherever it appears in such sections and inserting
18 in lieu thereof "1975".

## 19 Subtitle F—Depreciation Allowed Regu-
## 20 lated Industries; Earnings and Profits
## 21 Adjustment for Depreciation

22 SEC. 451. PUBLIC UTILITY PROPERTY.
23 (a) IN GENERAL.—Section 167 (relating to deprecia-
24 tion) is amended by inserting after subsection (k) (added
25 by section 521) the following new subsection:

1 "(l) SPECIAL RULES IN CASE OF PUBLIC UTILITY
2 PROPERTY.—
3 "(1) EXISTING PUBLIC UTILITY PROPERTY.—In
4 the case of existing public utility property (as defined in
5 paragraph (5) (A)), the term 'reasonable allowance'
6 as used in subsection (a) means an allowance computed
7 under the straight-line method unless—
8 "(A) with respect to such property (or with
9 respect to property of the same kind as such prop-
10 erty) the taxpayer for his latest taxable year for
11 which a return was filed on or before July 22, 1969,
12 used a method other than the straight-line method,
13 and
14 "(B) the requirement of paragraph (2) (if ap-
15 plicable) is met with respect to such property.
16 "(2) CONTINUATION OF NORMALIZATION.—In
17 the case of public utility property described in paragraph
18 (1) with respect to which (or with respect to property
19 of the same kind) the taxpayer as of July 22, 1969,
20 used the normalization method of accounting, the tax-
21 payer may use, with respect to such property, for pur-
22 poses of computing taxable income, a method of depre-
23 ciation other than the straight line method only if he
24 continues to use the normalization method of accounting
25 with respect to such property.

"(3) OTHER PUBLIC UTILITY PROPERTY.—In the case of public utility property other than existing public utility property, the term 'reasonable allowance' as used in subsection (a) means an allowance computed under the straight-line method unless—

"(A) the taxpayer uses the normalization method of accounting with respect to such property, or

"(B) with respect to property of the same kind as such property, the taxpayer for his latest taxable year for which a return was filed on or before July 22, 1969, used a method other than the straight-line method, and computed his tax expense for the purposes of establishing his cost of service (or of reflecting operating results in his regulated books of account) by using the method of depreciation he used for purposes of computing his allowance for depreciation under this section.

"(4) PUBLIC UTILITY PROPERTY.—For purposes of this subsection, the term 'public utility property' means property used predominantly in the trade or business of the furnishing or sale of—

"(A) electrical energy, water, or sewage disposal services, or

1 "(B) gas through a local distribution system,
2 or
3 "(C) telephone services (other than those pro-
4 vided by the Communications Satellite Corpora-
5 tion for purposes authorized by the Communica-
6 tions Satellite Act of 1962 (76 Stat. 419; 47 U.S.C.
7 701)), or
8 "(D) transportation of gas, oil (including shale
9 oil), or petroleum products by pipeline,
10 if the rates for such furnishing or sale, as the case may
11 be, have been established or approved by a State or
12 political subdivision thereof, by any agency or instru-
13 mentality of the United States, or by a public service
14 or public utility commission or other similar body of any
15 State or political subdivision thereof.
16 "(5) OTHER DEFINITIONS.—For purposes of this
17 subsection—
18 "(A) EXISTING PUBLIC UTILITY PROPERTY.—
19 The term 'existing public utility property' means
20 public utility property—
21 "(i) the construction, reconstruction, or
22 erection of which is completed by the taxpayer
23 on or before December 31, 1969 (or if con-
24 struction, reconstruction, or erection is com-
25 pleted after December 31, 1969, that portion

1 of the basis of such property which is properly
2 attributable to construction, reconstruction, or
3 erection by the taxpayer on or before December
4 31, 1969), or

5 "(ii) which was acquired by the taxpayer
6 and the use of which commences with the tax-
7 payer on or before December 31, 1969.

8 "(B) NORMALIZATION METHOD OF ACCOUNT-
9 ING.—A taxpayer uses the normalization method of
10 accounting if, and only if, he—

11 "(i) computes his tax expense for purposes
12 of establishing his cost of service (or of reflect-
13 ing operating results in his regulated books of
14 account) by using a method of depreciation
15 other than the method he used for purposes of
16 computing his allowance for depreciation under
17 this section, and

18 "(ii) makes adjustments to a reserve for
19 deferred taxes to reflect the deferral of taxes
20 resulting from the use of such different methods
21 of depreciation.

22 "(C) STRAIGHT LINE METHOD.—The term
23 'straight line method' includes any method deter-
24 mined by the Secretary or his delegate to result in
25 a reasonable allowance under subsection (a), other

1 than (i) a declining balance method, (ii) the sum
2 of the years-digits method or, (iii) any other
3 method allowable solely by reason of the application
4 of subsection (b) (4) or paragraph (1) (C) of sub-
5 section (j)."

6 (b) EFFECTIVE DATE.—The amendment made by sub-
7 section (a) shall apply with respect to taxable years ending
8 after July 22, 1969.

9 **SEC. 452. EFFECT ON EARNINGS AND PROFITS.**

10 Section 312 (relating to effect on earnings and profits)
11 is amended by adding at the end thereof the following new
12 subsection:

13 "(m) EFFECT ON EARNINGS AND PROFITS OF DEPRE-
14 CIATION.—

15 "(1) For the purpose of computing its earnings and
16 profits with respect to any taxable year beginning after
17 June 30, 1972, a corporation shall use the aggregate
18 amount of depreciation which would be allowable with
19 respect to such year if depreciation had been computed
20 under—

21 "(A) the straight line method, or
22 "(B) a method determined by the Secretary or

1 his delegate to result in a reasonable allowance
2 under section 167 (a), not including—
3 "(i) any declining balance method,
4 "(ii) the sum of the years-digits method,
5 or
6 "(iii) any other method allowable solely
7 by reason of the application of subsection (b)
8 (4), (j) (1) (C), or (m) of section 167.
9 "(2) The provisions of paragraph (1) shall apply
10 notwithstanding the use, by a corporation, of methods
11 of depreciation otherwise allowable under section 167 or
12 179, and notwithstanding an election, by a corporation,
13 of the amortization deduction under section 168."

## 14 Subtitle G—Alternative Capital Gain
## 15 Rate for Corporations

16 **SEC. 461. INCREASE OF RATE.**

17 (a) IN GENERAL.—Section 1201 (a) (relating to alter-
18 native tax in the case of corporations) is amended by striking
19 out the last sentence of subsection (a), and by amending
20 paragraph (2) to read as follows:
21 "(2) an amount equal to 30 percent of such excess"
22 (b) CONFORMING AMENDMENTS.—

1 (1) Section 802(a)(2)(B) (relating to alterna-
2 tive tax in case of capital gains of life insurance com-
3 panies) is amended by striking out "25 percent" and
4 inserting in lieu thereof "30 percent".
5 (2) Section 852(b)(3) (relating to method of
6 taxation of regulated investment companies and their
7 shareholders in the case of capital gains) is amended:
8 (A) by striking out "25 percent", wherever
9 it appears in subparagraphs (A) and (D)(ii) of
10 such section, and inserting in lieu thereof "30 per-
11 cent", and
12 (B) by striking out "75 percent", in sub-
13 paragraph (D)(iii) of such section, and inserting
14 in lieu thereof "70 percent".
15 (3) Section 857(b)(3)(A) (relating to imposi-
16 tion of tax in the case of capital gains of real estate in-
17 vestment trusts) is amended by striking "25 percent"
18 and inserting in lieu thereof "30 percent".
19 (c) Effective Date.—The amendments made by this
20 section shall apply to sales and other dispositions after July
21 31, 1969. In the case of a taxable year beginning before and
22 ending after July 31, 1969, the amendments made by this
23 section shall be applied in a manner to be prescribed by the
24 Secretary of the Treasury or his delegate.

1 # TITLE V—ADJUSTMENTS AFFECT-
2 # ING INDIVIDUALS AND CORPO-
3 # RATIONS

4 ## Subtitle A—Natural Resources

5 SEC. 501. NATURAL RESOURCES.

6 (a) PERCENTAGE DEPLETION.—

7 (1) RATES.—Subsection (b) of section 613 (re-
8 lating to percentage depletion) is amended to read as
9 follows:

10 "(b) PERCENTAGE DEPLETION RATES.—The mines,
11 wells, and other natural deposits, and the percentages, re-
12 ferred to in subsection (a) are as follows:

13 "(1) 20 percent—oil and gas wells located in the
14 United States, in its possessions, in the Commonwealth
15 of Puerto Rico, or on the Outer Continental Shelf
16 (within the meaning of section 2 of the Outer Conti-
17 nental Shelf Lands Act, as amended and supplemented;
18 43 U.S.C. 1331).

19 "(2) 17 percent—

20 "(A) sulfur and uranium; and

21 "(B) if from deposits in the United States—
22 anorthosite, clay, laterite, and nephelite syenite (to
23 the extent that alumina and aluminum compounds

1 are extracted therefrom), asbestos, bauxite, celestite,
2 chromite, corundum, fluorspar, graphite, ilmenite,
3 kyanite, mica, olivine, quartz crystals (radio grade),
4 rutile, block steatite talc, and zircon, and ores of the
5 following metals: antimony, beryllium, bismuth,
6 cadmium, cobalt, columbium, lead, lithium, manga-
7 nese, mercury, nickel, platinum and platinum group
8 metals, tantalum, thorium, tin, titanium, tungsten,
9 vanadium, and zinc.
10 "(3) 15 percent—if the mines or deposits are
11 located in the United States—
12 "(A) gold, silver, copper, and iron ore mines,
13 and
14 "(B) oil shale.
15 "(4) 11 percent—
16 "(A) metal mines (if paragraphs (2) (B) or
17 (3) (A) do not apply), rock asphalt, and vermic-
18 ulite; and
19 "(B) if neither paragraph (2) (B), (6), or
20 (7) (B) applies, ball clay, bentonite, china clay,
21 sagger clay, and clay used or sold for use for pur-
22 poses dependent on its refractory properties.
23 "(5) 7 percent—asbestos (if paragraph (2) (B)

1 does not apply), brucite, coal, lignite, perlite, sodium
2 chloride, and wollastonite.
3 "(6) 5 percent—clay and shale used or sold for use
4 in the manufacture of sewer pipe or brick, and clay,
5 shale, and slate used or sold for use as sintered or burned
6 lightweight aggregates.
7 "(7) 4 percent—
8 "(A) gravel, peat, pumice, sand, scoria, shale
9 (except shale described in paragraphs (3) (B) and
10 (6)), and stone (except stone described in para-
11 graph (8));
12 "(B) clay used, or sold for use, in the manufac-
13 ture of drainage and roofing tile, flower pots, and
14 kindred products; and
15 "(C) if from brine wells—bromine, calcium
16 chloride, and magnesium chloride.
17 "(8) 11 percent—all other minerals (including,
18 but not limited to, aplite, barite, borax, calcium carbon-
19 ates, diatomaceous earth, dolomite, feldspar, fullers earth,
20 garnet, gilsonite, granite, limestone, magnesite, mag-
21 nesium carbonates, marble, mollusk shells (including
22 clam shells and oyster shells), phosphate rock, potash,
23 quartzite, slate, soapstone, stone (used or sold for use

1 by the mine owner or operator as dimension stone or
2 ornamental stone), thenardite, tripoli, trona, and (if
3 paragraph (2)(B) does not apply) bauxite, flake
4 graphite, fluorspar, lepidolite, mica, spodumene, and talc
5 (including pyrophyllite), except that, unless sold on bid
6 in direct competition with a bona fide bid to sell a
7 mineral listed in paragraph (4), the percentage shall be
8 4 percent for any such other mineral (other than slate to
9 which paragraph (6) applies) when used, or sold for
10 use, by the mine owner or operator as rip rap, ballast,
11 road material, rubble, concrete aggregates, or for similar
12 purposes. For purposes of this paragraph, the term 'all
13 other minerals' does not include—
14 "(A) soil, sod, dirt, turf, water, or mosses;
15 "(B) minerals from sea water, the air, or
16 similar inexhaustible sources; or
17 "(C) oil and gas wells."
18 (2) EFFECTIVE DATE.—The amendments made by
19 this subsection shall apply to taxable years beginning
20 after July 22, 1969.
21 (b) MINERAL PRODUCTION PAYMENTS.—
22 (1) IN GENERAL.—Subchapter I of chapter 1 (re-
23 lating to natural resources) is amended by adding at the
24 end thereof the following new part:

1 "PART IV—MINERAL PRODUCTION PAYMENTS

"Sec. 636. Income tax treatment f mineral production payments.

2 "SEC. 636. INCOME TAX TREATMENT OF MINERAL PRO-
3 DUCTION PAYMENTS.

4 "(a) CARVED-OUT MINERAL PAYMENT.—A produc-
5 tion payment carved out of mineral property shall be treated,
6 for purposes of this subtitle, as if it were a mortgage loan
7 on the property, and shall not qualify as an economic interest
8 in the mineral property. In the case of a production payment
9 carved out for exploration or development of a mineral prop-
10 erty, the preceding sentence shall apply only if and to the
11 extent gross income from the property (for purposes of
12 section 613) would be realized, in the absence of the appli-
13 cation of such sentence, by the person creating the production
14 payment.

15 "(b) RETAINED PRODUCTION PAYMENT ON SALE OF
16 MINERAL PROPERTY.—A production payment retained on
17 the sale of a mineral property shall be treated, for purposes
18 of this subtitle, as if it were a purchase money mortgage loan
19 and shall not qualify as an economic interest in the mineral
20 property.

21 "(c) RETAINED PRODUCTION PAYMENT ON LEASE OF
22 MINERAL PROPERTY.—A production payment retained in a
23 mineral property by the lessor in a leasing transaction shall

1 be treated, for purposes of this subtitle, insofar as the lessee
2 (or his successors in interest) is concerned, as if it were a
3 bonus granted by the lessee to the lessor payable in install-
4 ments. The treatment of the production payment in the hands
5 of the lessor shall be determined without regard to the pro-
6 visions of this subsection.

7 "(d) DEFINITION.—As used in this section, the term
8 'mineral property' has the meaning assigned to the term
9 'property' in section 614 (a).

10 "(e) REGULATIONS.—The existence and amount of
11 any production payment for purposes of this section and its
12 treatment under this subtitle shall be determined under regu-
13 lations prescribed by the Secretary or his delegate."

14 (2) CLERICAL AMENDMENT.—The table of parts
15 for subchapter I of chapter 1 is amended by adding at
16 the end thereof the following:

"Part IV. Mineral production payments."

17 (3) EFFECTIVE DATES.—

18 (A) GENERAL RULE.—The amendments made
19 by this subsection shall be applicable to mineral
20 production payments created on or after April 22,
21 1969.

22 (B) SPECIAL RULE.—If a taxpayer during the
23 taxable year which includes April 22, 1969, made
24 expenditures prior to such date which are deductible
25 under section 263 (c), 615, 616, or 617 of the

1 Internal Revenue Code of 1954, the amendment
2 made by paragraph (1) of this subsection shall
3 apply to proceeds of carved-out mineral production
4 payments sold during such taxable year on or after
5 April 22, 1969, to the extent the proceeds do not
6 exceed the aggregate of such expenditures, only for
7 the purposes of section 613 of such Code (relating to
8 percentage depletion) and section 904 of such Code
9 (relating to limitations on foreign tax credit).
10 (C) EXCEPTION.—The amendments made by
11 this subsection shall not apply to a mineral produc-
12 tion payment created prior to January 1, 1971,
13 pursuant to a binding contract entered into before
14 April 22, 1969.
15 (c) EXPLORATION EXPENDITURES.—
16 (1) AMENDMENT TO SECTION 615.—Section 615
17 (relating to exploration expenditures) is amended by
18 adding new subsection (h) at the end thereof:
19 "(h) RECAPTURE FOR CERTAIN EXPENDITURES.—The
20 rules set forth in subsections (b) through (g), inclusive, of
21 section 617 (relating to additional exploration expenditures
22 in the case of domestic mining) shall apply to expenditures
23 to which this section applies and which are made after
24 July 22, 1969."
25 (2) AMENDMENTS TO SECTION 617.—Section 617

1 (relating to additional exploration expenditures in the
2 case of domestic mining) is amended—
3 (A) by striking out the heading and inserting
4 in lieu thereof:
5 "SEC. 617. DEDUCTION AND RECAPTURE OF CERTAIN
6 MINING EXPLORATION EXPENDITURES."
7 (B) by redesignating subsection (h) as sub-
8 section (i), and
9 (C) by inserting a new subsection (h) as
10 follows:
11 "(h) EXCEPTION.—If the taxpayer's deductions under
12 this section and section 615 total less than $400,000, then
13 to the extent of the difference between $400,000 and such
14 total, a deduction shall be allowed under this section for
15 expenditures paid or incurred during the taxable year if paid
16 or incurred after July 22, 1969, for the purpose of ascer-
17 taining the existence, location, extent, or quality of any
18 deposit of ore or mineral not located in the United States
19 or on the Outer Continental Shelf (within the meaning of
20 section 2 of the Outer Continental Shelf Lands Act, as
21 amended and supplemented; 43 U.S.C. 1331)."
22 (d) CLERICAL AMENDMENT.—The table of sections
23 for part I of subchapter I of chapter 1 is amended by striking
24 out:

"Sec. 617. Additional exploration expenditures in the case of domestic mining."

1 and inserting in lieu thereof:

"Sec. 617. Deduction and recapture of certain mining exploration expenditures."

2 (c) TREATMENT PROCESSES IN THE CASE OF OIL
3 SHALE.—Section 613 (c) (4) (relating to treatment proc-
4 esses considered as mining) is amended by striking out
5 "and" at the end of subparagraph (G), by redesignating
6 subparagraph (H) as subparagraph (I), and by inserting
7 after subparagraph (G) the following new subparagraph:
8 "(H) in the case of oil shale—extraction from
9 the ground, crushing, loading into the retort, and
10 retorting, but not hydrogenation, refining, or any
11 other process subsequent to retorting; and".

12 ## Subtitle B—Capital Gains and Losses

13 **SEC. 511. REPEAL OF ALTERNATIVE CAPITAL GAINS TAX**
14 **FOR INDIVIDUALS.**

15 (a) IN GENERAL.—Section 1201 (relating to alterna-
16 tive tax) is amended by striking out subsection (b), and by
17 redesignating subsection (c) as (b).
18 (b) CONFORMING AMENDMENTS.—
19 (1) Section 5 (a) (relating to cross references
20 relating to tax on individuals) is amended by striking
21 out paragraph (3), and by renumbering paragraph (4)
22 as (3).
23 (2) Section 871 (b) (1) (relating to tax on non-

1 resident alien individuals) is amended by striking out
2 "or 1201 (b)".
3 (3) Section 877 (b) (relating to expatriation to
4 avoid tax) is amended by striking out "or section 1201
5 (b)".
6 (c) EFFECTIVE DATE.—The amendments made by this
7 section shall apply to sales and other dispositions after
8 July 25, 1969. In the case of a taxable year beginning
9 before and ending after July 25, 1969, the alternative tax
10 imposed by section 1201 (b) of the Internal Revenue Code
11 of 1954 shall be computed in a manner to be prescribed
12 by the Secretary of the Treasury or his delegate.
13 **SEC. 512. CAPITAL LOSSES OF INDIVIDUALS.**
14 (a) LIMITATION ON ALLOWANCE OF CAPITAL
15 LOSSES.—Section 1211 (b) (relating to limitation on capital
16 losses of taxpayers other than corporations) is amended to
17 read as follows:
18 "(b) OTHER TAXPAYERS.—
19 "(1) IN GENERAL.—In the case of a taxpayer other
20 than a corporation, losses from sales or exchanges of
21 capital assets shall be allowed only to the extent of the
22 gains from such sales or exchanges, plus (if such losses
23 exceed such gains) whichever of the following is
24 smallest:
25 "(A) the taxable income for the taxable year,
26 "(B) $1,000, or

1 "(C) the sum of—

2 "(i) the excess of the net short-term

3 capital loss over the net long-term capital gain,

4 and

5 "(ii) one-half of the excess of the net long-

6 term capital loss over the net short-term capital

7 gain.

8 "(2) MARRIED INDIVIDUALS.—In the case of a

9 husband or wife who files a separate return, the amount

10 specified in paragraph (1)(B) shall be $500 in lieu

11 of $1,000.

12 "(3) COMPUTATION OF TAXABLE INCOME.—For

13 purposes of paragraph (1), taxable income shall be com-

14 puted without regard to gains or losses from sales or

15 exchanges of capital assets and without regard to the de-

16 ductions provided in section 151 (relating to personal

17 exemptions) or any deduction in lieu thereof. If the

18 taxpayer elects to pay the optional tax imposed by sec-

19 tion 3, 'taxable income' as used in this subsection shall

20 read as 'adjusted gross income'."

21 (b) CAPITAL LOSS CARRYOVER.—Section 1212(b)

22 (relating to capital loss carryover of taxpayers other than

23 corporations) is amended by striking out "beginning after

24 December 31, 1963" at the beginning of paragraph (1),

25 by striking out the last sentence of paragraph (1), and by

1 striking out paragraph (2) and inserting in lieu thereof the
2 following new paragraphs:
3 "(2) SPECIAL RULES.—
4 "(A) For purposes of determining the excess
5 referred to in paragraph (1) (A), an amount equal
6 to the amount allowed for the taxable year under
7 section 1211(b) (1) (A), (B), or (C) shall be
8 treated as a short-term capital gain in such year.
9 "(B) For purposes of determining the excess
10 referred to in paragraph (1) (B), an amount equal
11 to the sum of—
12 "(i) the amount allowed for the taxable
13 year under section 1211(b) (1) (A), (B), or
14 (C), and
15 "(ii) the excess of the amount described
16 in clause (i) over the net short-term capital
17 loss (determined without regard to this subsec-
18 tion) for such year,
19 shall be treated as a short-term capital gain in such
20 year.
21 "(3) TRANSITIONAL RULE.—In the case of any
22 amount which, under paragraph (1) and section 1211
23 (b) (as in effect for taxable years beginning before
24 July 26, 1969), is treated as a capital loss in the first
25 taxable year beginning after July 25, 1969, paragraph
26 (1) and section 1211(b) (as in effect for taxable years

1 beginning before July 26, 1969) shall apply (and
2 paragraph (1) and section 1211(b) as in effect for
3 taxable years beginning after July 25, 1969, shall not
4 apply) to the extent such amount exceeds the total of
5 any net capital gains (determined without regard to this
6 subsection) of taxable years beginning after July 25,
7 1969."

8 (c) CONFORMING AMENDMENT.—Section 1222(9)
9 (defining net capital gain) is amended by striking out "In
10 the case of a corporation, the" and inserting in lieu thereof
11 "The".

12 (d) EFFECTIVE DATE.—The amendments made by this
13 section shall apply to taxable years beginning after July 25,
14 1969.

15 **SEC. 513. LETTERS, MEMORANDUMS, ETC.**

16 (a) TREATMENT AS PROPERTY WHICH IS NOT A
17 CAPITAL ASSET.—Section 1221(3) (relating to definition
18 of capital asset) is amended to read as follows:

19 "(3) a copyright, a literary, musical, or artistic
20 composition, a letter or memorandum, or similar prop-
21 erty, held by—

22 "(A) a taxpayer whose personal efforts created
23 such property,

24 "(B) in the case of a letter, memorandum, or
25 similar property, a taxpayer for whom such prop-
26 erty was prepared or produced, or

1 "(C) a taxpayer in whose hands the basis of
2 such property is determined, for purposes of deter-
3 mining gain from a sale or exchange, in whole or
4 part by reference to the basis of such property in
5 the hands of a taxpayer described in subparagraph
6 (A) or (B);".
7 (b) CONFORMING AMENDMENTS.—
8 (1) Section 341 (e) (5) (A) (iv) (relating to defi-
9 nition of subsection (e) asset in the case of collapsible
10 corporations) is amended to read as follows:
11 "(iv) property (unless included under
12 clause (i), (ii), or (iii)) which consists of a
13 copyright, a literary, musical, or artistic com-
14 position, a letter or memorandum, or similar
15 property, or any interest in any such property,
16 if the property was created in whole or in part
17 by the personal efforts of, or (in the case of a
18 letter, memorandum, or similar property) was
19 prepared or produced in whole or in part for,
20 any individual who owns more than 5 percent in
21 value of the stock of the corporation."
22 (2) Section 1231 (b) (1) (C) (relating to defini-
23 tion of property used in the trade or business) is amended
24 by inserting ", a letter or memorandum" before ", or
25 similar property".
26 (c) EFFECTIVE DATE.—The amendments made by

1 this section shall apply to sales and other dispositions oc-
2 curring after July 25, 1969.

3 SEC. 514. HOLDING PERIOD OF CAPITAL ASSETS.

4 (a) CAPITAL GAINS AND LOSSES.—Section 1222 (re-
5 lating to other terms relating to capital gains and losses) is
6 amended by striking out "6 months" wherever it appears
7 therein and inserting in lieu thereof "12 months".

8 (b) CONFORMING AMENDMENTS.—The following sec-
9 tions are amended by striking out "6 months" wherever it
10 appears therein and inserting in lieu thereof "12 months":

11 (1) Section 166(d)(1) (relating to nonbusiness
12 debts);

13 (2) Section 333(g)(1) and (2) (relating to
14 special rule as to liquidations in the case of the election
15 as to recognition of gain);

16 (3) Section 341(a) (relating to treatment of gain
17 to shareholders in the case of collapsible corporations);

18 (4) Section 342(a) (relating to liquidation of cer-
19 tain foreign personal holding companies);

20 (5) Section 402(a)(2) (relating to capital gains
21 treatment for certain distributions in the case of a bene-
22 ficiary of an exempt employees' trust);

23 (6) Section 403(a)(2) (relating to capital gains
24 treatment for certain distributions in the case of a bene-
25 ficiary under a qualified annuity plan);

33-865 O—69—pt. 1——27

1 (7) Section 423 (a) (1) (relating to employee
2 stock purchase plans);
3 (8) Section 424 (a) (1) and (c) (1) and (2) (re-
4 lating to restricted stock options);
5 (9) Section 584 (c) (1) (A) and (B) (relating
6 to inclusions in taxable income of participants in com-
7 mon trust funds);
8 (10) Section 631 (relating to gain or loss in the
9 case of timber, coal, or domestic iron ore);
10 (11) Section 702 (a) (1) and (2) (relating to
11 income and credits of partner);
12 (12) Section 817 (a) (1) (A) (relating to treat-
13 ment of capital gains and losses, etc., in the case of life
14 insurance companies);
15 (13) Section 852 (b) (3) and (4) (relating to
16 treatment of capital gain dividends by shareholders of
17 regulated investment companies);
18 (14) Section 856 (c) (4) (relating to definition
19 of real estate investment trust);
20 (15) Section 857 (b) (3) (B) (relating to treat-
21 ment of capital gain dividends by shareholders of real
22 estate investment trusts);
23 (16) Section 1231 (relating to property used in
24 the trade or business and involuntary conversions);

1 (17) Section 1232(a)(2) (relating to sale or
2 exchange in the case of bonds and other evidences of
3 indebtedness);
4 (18) Section 1233 (b), (d), and (e) (relating
5 to gains and losses from short sales);
6 (19) Section 1234(c)(1) (relating to special
7 rule for gain on lapse of an option granted as part of
8 a straddle);
9 (20) Section 1235(a) (relating to sale or ex-
10 change of patents);
11 (21) Section 1240 (relating to taxability to em-
12 ployee of termination payments);
13 (22) Section 1246(a)(4) (relating to holding
14 period in the case of gain on foreign investment company
15 stock);
16 (23) Section 1247(i) (relating to loss on sale or
17 exchange of certain stock in the case of foreign invest-
18 ment companies electing to distribute income currently);
19 and
20 (24) Section 1248 (b) and (f) (relating to gain
21 from certain sales or exchanges of stock in certain foreign
22 corporations).
23 (c) TIMBER.—Section 631(a) (relating to election to

1 treat cutting of timber as a sale or exchange) is amended
2 by striking out "before the beginning of such year" in the
3 first sentence.
4 (d) EFFECTIVE DATE.—The amendments made by this
5 section shall apply to taxable years beginning after July 25,
6 1969.
7 SEC. 515. TOTAL DISTRIBUTIONS FROM QUALIFIED PEN-
8 SION, ETC., PLANS.
9 (a) LIMITATION ON CAPITAL GAINS TREATMENT.—
10 (1) EMPLOYEES' TRUST.—Section 402(a) (relat-
11 ing to taxability of beneficiary of exempt trust) is
12 amended by adding at the end thereof the following new
13 paragraph:
14 "(5) LIMITATION ON CAPITAL GAINS TREAT-
15 MENT.—The first sentence of paragraph (2) shall apply
16 to a distribution paid after December 31, 1969, only to
17 the extent that it does not exceed the sum of—
18 "(A) the benefits accrued by the employee on
19 behalf of whom it is paid during plan years begin-
20 ning before January 1, 1970, and
21 "(B) the portion of the benefits accrued by
22 such employee during plan years beginning after De-
23 cember 31, 1969, which the distributee establishes
24 does not consist of the employee's allocable share of

1 employer contributions to the trust by which such
2 distribution is paid.
3 The Secretary or his delegate shall prescribe such regu-
4 lations as may be necessary to carry out the purposes of
5 this paragraph."
6 (2) EMPLOYEE ANNUITIES.—Section 403 (a) (2)
7 (relating to capital gains treatment for certain distribu-
8 tions under a qualified annuity plan) is amended by
9 adding at the end thereof the following new subpara-
10 graph:
11 "(C) LIMITATION ON CAPITAL GAINS TREAT-
12 MENT.—Subparagraph (A) shall apply to a pay-
13 ment paid after December 31, 1969, only to the ex-
14 tent that it does not exceed the sum of—
15 "(i) the benefits accrued by the employee
16 on behalf of whom it is paid during plan years
17 beginning before January 1, 1970, and
18 "(ii) the portion of the benefits accrued
19 by such employee during plan years beginning
20 after December 31, 1969, which the payee
21 establishes does not consist of the employee's
22 allocable share of employer contributions under
23 the plan under which the annuity contract is
24 purchased.

1 The Secretary or his delegate shall prescribe such
2 regulations as may be necessary to carry out the
3 purposes of this subparagraph."
4 (b) LIMITATION ON TAX.—Section 72 (n) (relating
5 to treatment of certain distributions with respect to contribu-
6 tions by self-employed individuals) is amended—
7 (1) by striking out so much thereof as precedes
8 paragraph (2) and inserting in lieu thereof the fol-
9 lowing:
10 "(n) TREATMENT OF TOTAL DISTRIBUTIONS.—
11 "(1) APPLICATION OF SUBSECTION.—
12 "(A) GENERAL RULE.—This subsection shall
13 apply to amounts—
14 "(i) distributed to a distributee, in the
15 case of an employees' trust described in section
16 401 (a) which is exempt from tax under sec-
17 tion 501 (a), or
18 "(ii) paid to a payee, in the case of an
19 annuity plan described in section 403 (a),
20 if the total distributions or amounts payable to the
21 distributee or payee with respect to an employee
22 (including an individual who is an employee within
23 the meaning of section 401 (c) (1)) are paid to
24 the distributee or payee within one taxable year of
25 the distributee or payee, but only to the extent that

1 section 402 (a) (2) or 403 (a) (2) does not apply
2 to such amounts.
3 "(B) DISTRIBUTIONS TO WHICH APPLI-
4 CABLE.—This subsection shall apply only to distri-
5 butions or amounts paid—
6 "(i) on account of the employee's death,
7 "(ii) with respect to an individual who is
8 an employee without regard to section 401
9 (c) (1), on account of his separation from the
10 service,
11 "(iii) with respect to an employee within
12 the meaning of section 401 (c) (1), after he has
13 attained the age of 59½ years, or
14 "(iv) with respect to an employee within
15 the meaning of section 401 (c) (1), after he has
16 become disabled (within the meaning of sub-
17 section (m) (7)).
18 "(C) MINIMUM PERIOD OF SERVICE.—This
19 subsection shall apply to a distribution from or under
20 a plan to an employee only if he has been a partici-
21 pant in such plan for 5 or more years before such
22 distribution.
23 "(D) AMOUNTS SUBJECT TO PENALTY.—This
24 subsection shall not apply to amounts described in
25 clauses (ii) and (iii) of subparagraph (A) of sub-

1 section (m) (5) (but, in the case of amounts
2 described in clause (ii) of such subparagraph, only
3 to the extent that subsection (m) (5) applies to
4 such amounts).''; and
5 (2) by adding at the end thereof the following new
6 paragraph:
7 "(4) REFUND OF TAX WITH RESPECT TO CERTAIN
8 DISTRIBUTIONS.—Notwithstanding any other provision
9 of this title, if the limitation of tax provided in paragraph
10 (2) on the total distributions or amounts payable with
11 respect to an individual who is an employee without
12 regard to section 401 (c) (1) exceeds—
13 "(A) the aggregate increase in tax that would
14 result from the inclusion in gross income of the re-
15 cipient of 20 percent of the amount to which this
16 subsection applies for the taxable year in which such
17 amount is received and each of his 4 succeeding tax-
18 able years, or
19 "(B) if the recipient dies within the 4-year pe-
20 riod beginning on the last day of the taxable year in
21 which such amount is received, 5 times the average
22 of the increase in tax that would result from the in-
23 clusion in gross income of the recipient of 20 percent
24 of the amount to which this subsection applies for
25 such taxable year and each succeeding taxable year

1 other than the taxable year ending with his death,
2 such excess shall be deemed to be an overpayment of the
3 tax imposed by this chapter for the last taxable year
4 referred to in subparagraph (A) or (B), whichever is
5 applicable."

6 (c) TECHNICAL AND CONFORMING AMENDMENTS.—

7 (1) Section 405 (e) (relating to capital gains treat-
8 ment not to apply to bonds distributed by trusts) is
9 amended—

10 (A) by striking out "CAPITAL GAINS TREAT-
11 MENT" in the heading and inserting in lieu thereof
12 "CAPITAL GAINS TREATMENT AND LIMITATION
13 OF TAX";

14 (B) by striking out "Section 402 (a) (2)" and
15 inserting in lieu thereof "Section 72 (n) and section
16 402 (a) (2)"; and

17 (C) by striking out "section" and inserting in
18 lieu thereof "sections".

19 (2) Section 406 (c) (relating to termination of
20 status as deemed employee not to be treated as separa-
21 tion from service for purposes of capital gain provisions)
22 is amended—

23 (A) by striking out "PROVISIONS." in the
24 heading and inserting in lieu thereof "PROVISIONS
25 AND LIMITATION OF TAX."; and

1 (B) by striking out "section 402 (a) (2)" and
2 inserting in lieu thereof "section 72 (n), section
3 402 (a) (2),".
4 (3) Section 407 (c) (relating to termination of
5 status as deemed employee not to be treated as sepa-
6 ration from service for purposes of capital gain provi-
7 sions) is amended—
8 (A) by striking out "PROVISIONS." in the
9 heading and inserting in lieu thereof "PROVISIONS
10 AND LIMITATION OF TAX."; and
11 (B) by striking out "section 402 (a) (2)" and
12 inserting in lieu thereof "section 72 (n), section
13 402 (a) (2),".
14 (4) Section 1304 (b) (2) (relating to certain pro-
15 visions inapplicable) is amended to read as follows:
16 "(2) section 72 (n) (2) (relating to limitation of
17 tax in case of total distribution)".
18 **SEC. 516. OTHER CHANGES IN CAPITAL GAINS TREAT-**
19 **MENT.**
20 (a) SALES OF TERM INTERESTS.—Section 1001 (re-
21 lating to determination of amount of and recognition of gain
22 or loss) is amended by adding at the end thereof the fol-
23 lowing new subsection:
24 "(e) CERTAIN TERM INTERESTS.—
25 "(1) IN GENERAL.—In determining gain or loss

1 from the sale or other disposition of a term interest in
2 property, that portion of the adjusted basis of such in-
3 terest which is determined pursuant to section 1014 or
4 1015 (to the extent that such adjusted basis is a portion
5 of the entire adjusted basis of the property) shall be
6 disregarded.

7 "(2) TERM INTEREST IN PROPERTY DEFINED.—
8 For purposes of paragraph (1), the term 'term interest
9 in property' means—

10 "(A) a life interest in property,

11 "(B) an interest in property for a term of
12 years, or

13 "(C) an income interest in a trust.

14 "(3) EXCEPTION.—Paragraph (1) shall not apply
15 to a sale or other disposition which is a part of a trans-
16 action in which a fee interest is transferred to any person
17 or persons."

18 (b) CERTAIN CASUALTY LOSSES UNDER SECTION
19 1231.—Section 1231(a) (relating to property used in the
20 trade or business and involuntary conversions) is amended
21 by striking out all that follows paragraph (1) and inserting
22 in lieu thereof the following:

23 "(2) losses (including losses not compensated for
24 by insurance or otherwise) upon the destruction, in
25 whole or in part, theft or seizure, or requisition or con-

1 demnation of (A) property used in the trade or business
2 or (B) capital assets held for more than 12 months shall
3 be considered losses from a compulsory or involuntary
4 conversion.
5 In the case of any involuntary conversion (subject to the pro-
6 visions of this subsection but for this sentence) arising from
7 fire, storm, shipwreck, or other casualty, or from theft, of any
8 property used in the trade or business or of any capital asset
9 held for more than 12 months and held for the production of
10 income, this subsection shall not apply to such conversion
11 (whether resulting in gain or loss) if, during the taxable
12 year, the recognized losses from such conversions exceed the
13 recognized gains from such conversions."
14 (c) TRANSFER OF FRANCHISES.—
15 (1) IN GENERAL.—Part IV of subchapter P of
16 chapter 1 (relating to special rules for determining capi-
17 tal gains and losses) is amended by adding at the end
18 thereof the following new section:
19 "SEC. 1252. TRANSFER OF FRANCHISES.
20 "(a) GENERAL RULE.—A transfer of a franchise shall
21 not be treated as a sale or exchange of a capital asset or of
22 property to which section 1231 applies, if the transferor re-
23 tains any significant power, right, or continuing interest with
24 respect to the subject matter of the franchise.
25 "(b) DEFINITIONS.—For purposes of this section—

1 "(1) FRANCHISE.—The term 'franchise' means a
2 franchise, distributorship, or other like interest.
3 "(2) SIGNIFICANT POWER, RIGHT, OR CONTINU-
4 ING INTEREST.—The term 'significant power, right, or
5 continuing interest' includes, but is not limited to—
6 "(A) a right to disapprove any assignment of
7 the franchise,
8 "(B) a right to disapprove any subcontract
9 made by the holder of the franchise, and
10 "(C) a right to terminate the franchise at will.
11 "(c) EXCEPTION.—Subsection (a) shall not apply with
12 respect to amounts received or accrued, in connection with
13 a transfer of a franchise, which are attributable to the trans-
14 fer of all substantial rights to a patent, trademark, or trade
15 name (or an undivided interest therein which includes a
16 part of all such rights), to the extent such amounts are
17 separately identified and are reasonable in amount."
18 (2) CLERICAL AMENDMENT.—The table of sec-
19 tions for part IV of subchapter P of chapter 1 is amended
20 by adding at the end thereof the following:

"Sec. 1252. Transfer of franchises."

21 (d) EFFECTIVE DATES.—The amendments made by
22 subsections (a) and (c) shall apply with respect to sales
23 and other dispositions, and transfers, after July 25, 1969.

1 The amendment made by subsection (b) shall apply to
2 taxable years beginning after July 25, 1969.

3 ## Subtitle C—Real Estate Depreciation

4 **SEC. 521. DEPRECIATION OF REAL ESTATE.**

5 (a) SECTION 1250 PROPERTY AND REHABILITATION
6 PROPERTY.—Section 167 (relating to depreciation) is
7 amended by redesignating subsection (j) as subsection (n),
8 and by inserting after subsection (i) the following new
9 subsections:

10 "(j) SPECIAL RULES FOR SECTION 1250 PROPERTY.—
11 "(1) GENERAL RULE.—Except as provided in
12 paragraphs (2) and (3), in the case of section 1250
13 property, subsection (b) shall not apply and the term
14 'reasonable allowance' as used in subsection (a) shall
15 include an allowance computed in accordance with regu-
16 lations prescribed by the Secretary or his delegate, under
17 any of the following methods:
18 "(A) the straight line method,
19 "(B) the declining balance method, using a
20 rate not exceeding 150 percent of the rate which
21 would have been used had the annual allowance
22 been computed under the method described in sub-
23 paragraph (A), and
24 "(C) any other consistent method productive
25 of an annual allowance which, when added to all

1 allowances for the period commencing with the tax-
2 payer's use of the property and including the tax-
3 able year, does not, during the first two-thirds of
4 the useful life of the property, exceed the total of
5 such allowances which would have been used had
6 such allowances been computed under the method
7 described in subparagraph (B).
8 Nothing in this paragraph shall be construed to limit or
9 reduce an allowance otherwise allowable under subsec-
10 tion (a) except where allowable solely by reason of
11 paragraph (2), (3), or (4) of subsection (b).
12 "(2) HOUSING.—Paragraph (1) of this subsection
13 shall not apply, and subsection (b) shall apply in any
14 taxable year, to a building or structure which is residen-
15 tial rental housing the original use of which commences
16 with the taxpayer. For purposes of the preceding sen-
17 tence, a building or structure shall be considered to be
18 residential rental housing with respect to any taxable
19 year if and only if 80 percent or more of the gross in-
20 come from such building or structure for such year is
21 derived from the use of dwelling units (within the mean-
22 ing of subsection (k) (3) (C)) in such building or
23 structure to provide living accommodations on a rental
24 basis. Any change in the computation of the allowance
25 for depreciation for any taxable year, permitted or re-

1 quired by reason of the application of this paragraph,
2 shall not be considered a change in a method of ac-
3 counting.

4 "(3) PROPERTY CONSTRUCTED, ETC., BEFORE
5 JULY 25, 1969.—Paragraph (1) of this subsection shall
6 not apply, and subsection (b) shall apply, in the case of
7 property—

8 "(A) the construction, reconstruction or erec-
9 tion of which was begun before July 25, 1969, or

10 "(B) for which a written contract entered into
11 before July 25, 1969, with respect to any part of the
12 construction, reconstruction, or erection or for the
13 permanent financing thereof, was at all times there-
14 after binding on the taxpayer.

15 Under regulations prescribed by the Secretary or his
16 delegate, rules similar to the rules provided in para-
17 graphs (5), (9), (10), and (13) of section 48(h)
18 shall be applied for purposes of subparagraphs (A)
19 and (B).

20 "(4) USED SECTION 1250 PROPERTY.—In the case
21 of section 1250 property acquired after July 24, 1969,
22 the original use of which does not commence with the
23 taxpayer, the allowance for depreciation under this sec-
24 tion shall be limited to an amount computed under—

25 "(A) the straight line method, or

1 "(B) any other method determined by the
2 Secretary or his delegate to result in a reasonable
3 allowance under subsection (a), not including—
4 "(i) any declining balance method,
5 "(ii) the sum-of-the-years digits method, or
6 "(iii) any other method allowable solely
7 by reason of the application of subsection
8 (b)(4) or paragraph (1)(C) of this
9 subsection.
10 "(k) DEPRECIATION OF REHABILITATION PROPERTY
11 CONSISTING OF LOW-COST RENTAL HOUSING.—
12 "(1) 60-MONTH RULE.—The taxpayer may at any
13 time elect in accordance with regulations prescribed by
14 the Secretary or his delegate to compute a depreciation
15 deduction in subsection (a) attributable to rehabilitation
16 expenditures made after July 24, 1969, under the
17 straight-line method using a useful life of 60 months.
18 Such method shall be in lieu of any other method of
19 computing the depreciation deduction under subsection
20 (a) and in lieu of any deduction for amortization.
21 "(2) LIMITATIONS.—
22 "(A) The aggregate amount of expenditures
23 with respect to any low-cost rental housing which
24 are eligible for the method provided by paragraph

1 (1) shall not exceed $15,000 per dwelling unit in
2 such housing.
3 "(B) EXCEPTION.—Expenditures in any tax-
4 able year shall be taken into account for purposes of
5 paragraph (1) only if the sum of the rehabilitation
6 expenditures over a period of two consecutive tax-
7 able years, including the taxable year, exceeds
8 $3,000 per dwelling unit of low-cost housing.
9 "(3) DEFINITIONS.—For purposes of this subsec-
10 tion—
11 "(A) REHABILITATION EXPENDITURES.—The
12 term 'rehabilitation expenditures' means amounts
13 chargeable to capital account and incurred for prop-
14 erty or additions or improvements to property (or
15 related facilities) with a useful life of 5 years or
16 more, in connection with the rehabilitation of an
17 existing building for low-cost rental housing; but
18 such term does not include the cost of acquisition of
19 such building or any interest therein.
20 "(B) LOW-COST RENTAL HOUSING.—The term
21 'low-cost rental housing' means any building the
22 dwelling units in which are held for occupancy on
23 a rental basis by families and individuals of low or
24 moderate income, as determined by the Secretary
25 or his delegate in a manner consistent with the poli-

1 cies of the Housing and Urban Development Act of
2 1968 pursuant to regulations prescribed under this
3 subsection.

4 "(C) DWELLING UNIT.—The term 'dwelling
5 unit' means a house or an apartment in a building
6 or structure, but does not include a unit in a hotel,
7 motel, inn, or other establishment more than one-
8 half of the units in which are used on a transient
9 basis."

10 (b) RECAPTURE OF ADDITIONAL DEPRECIATION.—
11 Section 1250(a) (relating to gain from dispositions of cer-
12 tain depreciable realty) is amended to read as follows:

13 "(a) GENERAL RULE.—Except as otherwise provided
14 in this section—

15 "(1) ADDITIONAL DEPRECIATION AFTER JULY 24,
16 1969.—If section 1250 property is disposed of after
17 July 24, 1969, the lower of—

18 "(A) that portion of the additional depreciation
19 (as defined in subsection (b)(1) or (4)) attrib-
20 utable to periods after July 24, 1969, in respect
21 of the property, or

22 "(B) the excess of—

23 "(i) the amount realized (in the case of
24 a sale, exchange, or involuntary conversion),

1 or the fair market value of such property (in
2 the case of any other disposition), over
3 "(ii) the adjusted basis of such property,
4 shall be treated as gain from the sale or exchange of
5 property which is neither a capital asset nor property
6 described in section 1231. Such gain shall be recognized
7 notwithstanding any other provision of this subtitle.
8 "(2) ADDITIONAL DEPRECIATION AFTER DECEM-
9 BER 31, 1963, AND BEFORE JULY 25, 1969.—
10 "(A) If section 1250 property is disposed of
11 after December 31, 1963, and the amount deter-
12 mined under subsection (a) (1) (B) exceeds the
13 amount determined under subsection (a) (1) (A),
14 then the applicable percentage of the lower of—
15 "(i) that portion of the additional deprecia-
16 tion attributable to periods before July 25,
17 1969, in respect of the property, or
18 "(ii) the excess of the amount determined
19 under subsection (a) (1) (B) over the amount
20 determined under subsection (a) (1) (A),
21 shall also be treated as gain from the sale or ex-
22 change of property which is neither a capital asset
23 nor property described in section 1231. Such gain
24 shall be recognized notwithstanding any other pro-
25 vision of this subtitle.

1 "(B) APPLICABLE PERCENTAGE.—For pur-
2 poses of paragraph (A) the term 'applicable per-
3 centage' means 100 percent minus 1 percentage
4 point for each full month the property was held
5 after the date on which the property was held for
6 20 full months."
7 (c) Section 1250(b) (relating to gain from certain
8 depreciable realty) is amended by adding at the end thereof
9 the following new paragraph:
10 "(4) ADDITIONAL DEPRECIATION ATTRIBUTABLE
11 TO REHABILITATION EXPENDITURES.—For purposes of
12 this section, the term 'additional depreciation' means,
13 in respect of the depreciation deduction allowed under
14 section 167(k), the adjustments computed under such
15 section, except that, in the case of property held more
16 than one year, it means such adjustments only to the
17 extent that they exceed the amount of the depreciation
18 adjustments which would have resulted if such adjust-
19 ments had been determined under the straight line
20 method of adjustment without regard to the useful life
21 permitted under section 167(k)."
22 (d) CHANGE IN METHOD OF COMPUTING DEPRECIA-
23 TION.—Section 167(e) (relating to depreciation) is
24 amended by adding at the end thereof the following new
25 paragraph:

1 "(3) CHANGE WITH RESPECT TO SECTION 1250
2 PROPERTY.—A taxpayer may, on or before the last day
3 prescribed by law (including extensions thereof) for
4 filing his return for his first taxable year beginning after
5 July 24, 1969, and in such manner as the Secretary or
6 his delegate shall by regulation prescribe, elect to change
7 his method of depreciation in respect of section 1250
8 property (as defined in section 1250(c)) from any
9 declining balance or sum of the years-digits method to
10 the straight line method. An election may be made
11 under this paragraph notwithstanding any provision to
12 the contrary in an agreement under subsection (d)."
13 (e) TECHNICAL AND CONFORMING CHANGES.—
14 (1) Subsection (d) of section 1250 is amended
15 by striking out "subsection (a)(1)" wherever it ap-
16 pears and inserting in lieu thereof "subsection (a)."
17 (2) Subsection (f) of section 1250 is amended—
18 (A) by striking out "subsection (a)(1)" in
19 paragraph (1) and inserting in lieu thereof "sub-
20 section (a)," and
21 (B) by striking out paragraph (2) thereof and
22 inserting in lieu thereof the following:
23 "(2) ORDINARY INCOME ATTRIBUTABLE TO AN
24 ELEMENT.—For purposes of paragraph (1), the amount
25 taken into account for any element shall be the sum of—

1 "(A) the amount which bears the same ratio
2 to the lower of the amounts specified in subpara-
3 graph (A) or (B) of subsection (a) (1) for the
4 section 1250 property as the additional depreciation
5 for such element attributable to periods after July
6 24, 1969, bears to the sum of the additional depre-
7 ciation for all elements attributable to periods after
8 July 24, 1969, and
9 "(B) the amount (if any) determined by
10 multiplying—
11 "(i) the amount which bears the same ratio
12 to the lower of the amounts specified in sub-
13 section (a) (2) (A) (i) or (ii) for the section
14 1250 property as the additional depreciation for
15 such element attributable to periods before July
16 25, 1969, bears to the sum of the additional
17 depreciation for all elements attributable to
18 periods before July 25, 1969, by
19 "(ii) the applicable percentage for such
20 element.
21 For purposes of this paragraph, determinations with re-
22 spect to any element shall be made as if it were a sepa-
23 rate property."
24 (f) Section 381 (c) (6) (relating to carryovers in cer-
25 tain corporate acquisitions) is amended to read as follows:

1 "(6) METHOD OF COMPUTING DEPRECIATION AL-
2 LOWANCE.—The acquiring corporation shall be treated
3 as the distributor or transferor corporation for purposes
4 of computing the depreciation allowance under para-
5 graphs (2), (3), and (4) of section 167(b), or sub-
6 section (j)(1), (k), or (m) of section 167, on property
7 acquired in a distribution or transfer with respect to so
8 much of the basis in the hands of the acquiring corpora-
9 tion as does not exceed the adjusted basis in the hands of
10 the distributor or transferor corporation."
11 (g) EFFECTIVE DATE.—The amendments made by this
12 section shall apply with respect to taxable years ending
13 after July 24, 1969.

14
## Subtitle D—Cooperatives

15 SEC. 531. COOPERATIVES.

16 (a) QUALIFIED WRITTEN NOTICE OF ALLOCATION.—
17 The last sentence of section 1388(c)(1) (relating to quali-
18 fied written notice of allocation defined) is amended to read
19 as follows:
20 "Such term does not include any written notice of allo-
21 cation which is paid as part of a patronage dividend or
22 as part of a payment described in section 1382(c)(2)
23 (A) unless—
24 "(C) at least 20 percent of the amount of such
25 patronage dividend, or such payment, is paid in

1 money or by qualified check, and in addition, during
2 the payment period for the taxable year to which
3 such patronage dividend, or such payment, relates
4 at least the 'applicable percentage' (as determined
5 under paragraph (5) ) of such patronage dividend,
6 or such payment, is paid in money or in qualified
7 check, either—

8 "(i) as a part of such patronage dividend,
9 or such payment,

10 "(ii) or in redemption (to the extent allo-
11 cated by the payor to such patronage dividend
12 for the purpose of meeting the requirements of
13 this clause, if not previously allocated to any
14 other patronage dividend) of any qualified writ-
15 ten notice of allocation previously paid as a
16 part of a patronage dividend, or such payment,
17 for any taxable year, and

18 "(D) either (i) at all times on and after the
19 date of issuance of such written notice of allocation,
20 the bylaws of the organization require the remainder
21 of such patronage dividend, or such payment, to be
22 paid in money within the 15-year period beginning
23 with the close of the taxable year with respect to
24 which such written notice of allocation is made, and
25 the bylaws provide that such requirement shall in no

1 event be changed without the consent of those ad-
2 versely affected, or (ii) an unconditional written
3 evidence of indebtedness is issued for the remainder
4 of such patronage dividend, or such payment, which
5 matures within such 15-year period."
6 (b) APPLICABLE PERCENTAGE.—Section 1388 (c) (re-
7 lating to qualified written notice of allocation) is amended
8 by adding at the end thereof the following new paragraph:
9 "(5) APPLICABLE PERCENTAGE.—For purposes
10 of subsection (a)—

| "For taxable years beginning in— | The applicable percentage is— |
|---|---|
| 1970 | 3 percent |
| 1971 | 6 percent |
| 1972 | 9 percent |
| 1973 | 12 percent |
| 1974 | 15 percent |
| 1975 | 18 percent |
| 1976 | 21 percent |
| 1977 | 24 percent |
| 1978 | 27 percent |
| 1979 or any subsequent year | 30 percent." |

11 (c) QUALIFIED PER-UNIT RETAIN CERTIFICATE.—
12 Section 1388 (h) (1) (relating to definition of qualified per-
13 unit retain certificate) is amended to read as follows:
14 "(1) DEFINED.—For purposes of this subchapter,
15 the term 'qualified per-unit retain certificate' means any
16 per-unit retain certificate—
17 "(A) which the distributee has agreed, in the
18 manner provided in paragraph (2) to take into ac-

1 count at its stated dollar amount as provided in sec-
2 tion 1385 (a), and
3 "(B) which (i) at all times on and after the
4 date of issuance of such certificate, the bylaws of
5 the organization require the stated dollar amount to
6 be paid in money within the 15-year period begin-
7 ning with the close of the taxable year with respect
8 to which such certificate is issued, and the by-laws
9 provide that such requirement shall in no event be
10 changed without the consent of those adversely
11 affected, or (ii) is in the form of an unconditional
12 written evidence of indebtedness which matures
13 within such 15-year period."
14 (d) EFFECTIVE DATE.—The amendments made by this
15 section apply to taxable years beginning after December 31,
16 1969.

## 17 Subtitle E—Subchapter S Corporations

18 **SEC. 541. QUALIFIED PENSION, ETC., PLANS OF SMALL**
19 **BUSINESS CORPORATIONS.**

20 (a) IN GENERAL.—Subchapter S of chapter 1 (relat-
21 ing to election of certain small business corporations as to
22 taxable status) is amended by adding at the end thereof
23 the following new section:

1 "SEC. 1379. CERTAIN QUALIFIED PENSION, ETC., PLANS.

2 "(a) ADDITIONAL REQUIREMENT FOR QUALIFICA-
3 TION.—A trust forming part of a stock bonus or profit-shar-
4 ing plan which provides contributions or benefits for employ-
5 ees some or all of whom are shareholder-employees shall
6 not constitute a qualified trust under section 401 (relating
7 to qualified pension, profit-sharing, and stock bonus plans)
8 unless the plan of which such trust is a part provides that
9 forfeitures attributable to contributions deductible under sec-
10 tion 404 (a) (3) for any taxable year (beginning after De-
11 cember 31, 1969) of the employer with respect to which it
12 is an electing small business corporation may not inure to
13 the benefit of any individual who is a shareholder-employee
14 for such taxable year. A plan shall be considered as satisfy-
15 ing the requirement of this subsection for the period begin-
16 ning with the first day of a taxable year and ending with
17 the 15th day of the third month following the close of such
18 taxable year, if all the provisions of the plan which are
19 necessary to satisfy this requirement are in effect by the end
20 of such period and have been made effective for all purposes
21 with respect to the whole of such period.

22 "(b) TAXABILITY OF SHAREHOLDER-EMPLOYEE
23 BENEFICIARIES.—

24 "(1) INCLUSION OF EXCESS CONTRIBUTIONS IN
25 GROSS INCOME.—Notwithstanding the provisions of sec-

1 tion 402 (relating to taxability of beneficiary of em-
2 ployees' trust), section 403 (relating to taxation of
3 employee annuities), or section 405 (d) (relating to
4 taxability of beneficiaries under qualified bond purchase
5 plans), an individual who is a shareholder-employee of
6 an electing small business corporation shall include in
7 gross income, for his taxable year in which or with
8 which the taxable year of the corporation ends, the ex-
9 cess of the amount of contributions paid on his behalf
10 which is deductible under section 404 (a) (1), (2),
11 or (3) by the corporation for its taxable year over the
12 lesser of—
13 "(A) 10 percent of the compensation received
14 or accrued by him from such corporation during its
15 taxable year, or
16 "(B) $2,500.
17 "(2) TREATMENT OF AMOUNTS INCLUDED IN
18 GROSS INCOME.—Any amount included in the gross in-
19 come of a shareholder-employee under paragraph (1)
20 shall be treated as consideration for the contract con-
21 tributed by the shareholder-employee for purposes of
22 section 72 (relating to annuities),
23 "(3) DEDUCTION FOR AMOUNTS NOT RECEIVED AS
24 BENEFITS.—If—

1 "(A) amounts are included in the gross income
2 of an individual under paragraph (1), and
3 "(B) the rights of such individual (or his bene-
4 ficiaries) under the plan terminate before payments
5 under the plan which are excluded from gross in-
6 come equal the amounts included in gross income
7 under paragraph (1),
8 then there shall be allowed as a deduction, for the taxable
9 year in which such rights terminate, an amount equal to
10 the excess of the amounts included in gross income under
11 paragraph (1) over such payments.
12 "(c) CARRYOVER OF AMOUNTS DEDUCTIBLE.—No
13 amount deductible shall be carried forward under the second
14 sentence of section 404(a)(3)(A) (relating to limits on
15 deductible contributions under stock bonus and profit-sharing
16 trusts) to a taxable year of a corporation with respect to
17 which it is not an electing small business corporation from a
18 taxable year with respect to which it is an electing small
19 business corporation.
20 "(d) SHAREHOLDER-EMPLOYEE.—For purposes of this
21 section, the term 'shareholder-employee' means an employee
22 or officer of an electing small business corporation who owns
23 (or is considered as owning within the meaning of section
24 318(a)(1)), on any day during the taxable year of such

1 corporation, more than 5 percent of the outstanding stock of
2 the corporation."
3 (b) CONFORMING AMENDMENT.—Section 62 (relat-
4 ing to adjusted gross income defined) is amended by adding
5 at the end thereof the following new paragraph:
6 "(9) PENSION, ETC., PLANS OF ELECTING SMALL
7 BUSINESS CORPORATIONS.—The deduction allowed by
8 section 1379(b)(3)."
9 (c) CLERICAL AMENDMENT.—The table of sections for
10 subchapter S of chapter 1 is amended by adding at the end
11 thereof the following new item:

"Sec. 1379. Certain qualified pension, etc., plans."

12 (d) EFFECTIVE DATE.—The amendments made by this
13 section shall apply with respect to taxable years of a corpora-
14 tion beginning after December 31, 1969.

# 15 TITLE VI—STATE AND LOCAL 16 OBLIGATIONS

17 SEC. 601. INTEREST ON CERTAIN GOVERNMENTAL OBLI-
18 GATIONS.

19 (a) ELECTION TO ISSUE TAXABLE BONDS.—Section
20 103 (relating to interest on certain governmental obliga-
21 tions) is amended by redesignating subsection (b) as sub-
22 section (e), by redesignating subsection (d) as subsection

1 (f), and by inserting after subsection (a) the following new
2 subsection:

3 "(b) ELECTION TO ISSUE TAXABLE BONDS.—

4 "(1) SUBSECTION (a) (1) NOT TO APPLY.—The
5 issuer of obligations described in subsection (a) (1)
6 may elect to issue obligations to which subsection (a)
7 (1) does not apply.

8 "(2) ELECTION.—The election described in para-
9 graph (1) shall be made (at such time, in such manner,
10 and subject to such conditions as the Secretary or his
11 delegate by regulation prescribes) with respect to each
12 issue of obligations to which it is to apply. An election
13 with respect to any issue once made shall be irrevocable.

14 "(3) CROSS REFERENCE.—

"For provisions relating to the payment by the United States of a portion of the interest cost of an obligation which is part of an issue for which the election described in this subsection has been made, see section 602 of the Tax Reform Act of 1969."

15 (b) ARBITRAGE OBLIGATIONS.—Section 103 is
16 amended by inserting after subsection (c) the following
17 new subsection:

18 "(d) ARBITRAGE OBLIGATIONS.—Under regulations
19 prescribed by the Secretary or his delegate, any arbitrage
20 obligation shall be treated as an obligation not described in
21 subsection (a) (1)."

22 (c) CLERICAL AMENDMENT.—The heading of subsec-

1 tion (e) of section 103 (as redesignated by subsection (a)
2 of this section) is amended to read as follows:
3 "(e) CERTAIN OBLIGATIONS OF THE UNITED
4 STATES.—".
5 (d) EFFECTIVE DATES.—The amendments made by
6 subsection (a) shall apply to obligations issued in calendar
7 quarters beginning after the date of the enactment of this
8 section. The amendment made by subsection (b) shall apply
9 to obligations issued after July 11, 1969.

10 SEC. 602. UNITED STATES TO PAY FIXED PERCENTAGE OF
11 INTEREST YIELD ON TAXABLE ISSUES.

12 (a) PERMANENT APPROPRIATION.—There are appro-
13 priated, out of any moneys in the Treasury not otherwise ap-
14 propriated, such sums as may be necessary to carry out the
15 provisions of this section; and such appropriations shall be
16 deemed permanent annual appropriations.
17 (b) PAYMENT OF FIXED PERCENTAGE OF INTEREST
18 YIELD.—
19 (1) IN GENERAL.—The Secretary of the Treasury
20 or his delegate shall pay a fixed percentage of the in-
21 terest yield on each issue of obligations to which an elec-
22 tion under section 103 (b) of the Internal Revenue Code
23 of 1954 applies. Before the first day of each calendar
24 quarter, the Secretary or his delegate shall determine

1 (and publish in the Federal Register) the fixed per-
2 centage—
3 (A) for calendar quarters beginning before
4 January 1, 1975, not less than 30 percent and not
5 more than 40 percent, and
6 (B) for calendar quarters beginning after De-
7 cember 31, 1974, not less than 25 percent and not
8 more than 40 percent,
9 of interest yield which he determines it is necessary for
10 the United States to pay in order to encourage the States
11 and political subdivisions thereof to make elections under
12 section 103(b). The fixed percentage so determined
13 and published shall apply with respect to all issues of
14 obligations made during such calendar quarter to which
15 elections under such section 103(b) apply.
16 (2) INTEREST YIELD.—For purposes of this sec-
17 tion, the interest yield on any issue of obligations shall
18 be determined immediately after such obligations are
19 issued.
20 (3) TIME OF PAYMENT.—Payment of any interest
21 required pursuant to paragraph (1) shall be made by
22 the Secretary of the Treasury or his delegate not later
23 than the time at which the interest payment on the
24 obligation is required to be made by the issuer.

1 (c) DUAL COUPON OBLIGATIONS.—At the request of
2 the issuer, the liability of the United States under this section
3 to pay interest to the holders of an issue of obligations shall
4 be made through assumption by the United States of the
5 obligation to pay a separate set of interest coupons issued
6 with the obligations.
7 (d) SECTION TO APPLY ONLY TO SECTION 103 (b)
8 OBLIGATIONS.—This section shall apply only to obligations
9 which, but for an election under section 103 (b) of the Inter-
10 nal Revenue Code of 1954, would be obligations to which
11 section 103 (a) (1) of such Code applies.
12 (e) EFFECTIVE DATE.—This section shall apply only to
13 obligations issued in calendar quarters beginning after the
14 date of the enactment of this section.

# 15 TITLE VII—EXTENSION OF TAX 16 SURCHARGE AND EXCISE TAXES; 17 TERMINATION OF INVESTMENT 18 CREDIT

## 19 SEC. 701. EXTENSION OF TAX SURCHARGE.

20 (a) SURCHARGE EXTENSION.—Section 51 (a) (relat-
21 ing to imposition of tax surcharge) is amended—
22 (1) by adding at the end of paragraph (1) (A)
23 the following:

1 # "CALENDAR YEAR 1970

TABLE 1.—SINGLE PERSON (OTHER THAN HEAD OF HOUSEHOLD) AND MARRIED PERSONS FILING SEPARATE RETURN

| If the adjusted tax is: | | The tax is— | If the adjusted tax is: | | The tax is— | If the adjusted tax is: | | The tax is— |
|---|---|---|---|---|---|---|---|---|
| At least | But less than | | At least | But less than | | At least | But less than | |
| 0 | $155 | 0 | $340 | $380 | $9 | $700 | $740 | $18 |
| $155 | 175 | $1 | 380 | 420 | 10 | 740 | 780 | 19 |
| 175 | 195 | 2 | 420 | 460 | 11 | 780 | 820 | 20 |
| 195 | 215 | 3 | 460 | 500 | 12 | 820 | 860 | 21 |
| 215 | 235 | 4 | 500 | 540 | 13 | 860 | 900 | 22 |
| 235 | 255 | 5 | 540 | 580 | 14 | 900 | 940 | 23 |
| 255 | 275 | 6 | 580 | 620 | 15 | 940 | 980 | 24 |
| 275 | 300 | 7 | 620 | 660 | 16 | 980 and over, 2.5% of the adjusted tax | | |
| 300 | 340 | 8 | 660 | 700 | 17 | | | |

TABLE 2.—HEAD OF HOUSEHOLD

| If the adjusted tax is: | | The tax is— | If the adjusted tax is: | | The tax is— | If the adjusted tax is: | | The tax is— |
|---|---|---|---|---|---|---|---|---|
| At least | But less than | | At least | But less than | | At least | But less than | |
| 0 | $230 | 0 | $390 | $410 | $9 | $700 | $740 | $18 |
| $230 | 250 | $1 | 410 | 430 | 10 | 740 | 780 | 19 |
| 250 | 270 | 2 | 430 | 460 | 11 | 780 | 820 | 20 |
| 270 | 290 | 3 | 460 | 500 | 12 | 820 | 860 | 21 |
| 290 | 310 | 4 | 500 | 540 | 13 | 860 | 900 | 22 |
| 310 | 330 | 5 | 540 | 580 | 14 | 900 | 940 | 23 |
| 330 | 350 | 6 | 580 | 620 | 15 | 940 | 980 | 24 |
| 350 | 370 | 7 | 620 | 660 | 16 | 980 and over, 2.5% of the adjusted tax | | |
| 370 | 390 | 8 | 660 | 700 | 17 | | | |

TABLE 3.—MARRIED PERSONS OR SURVIVING SPOUSE FILING JOINT RETURN

| If the adjusted tax is: | | The tax is— | If the adjusted tax is: | | The tax is— | If the adjusted tax is: | | The tax is— |
|---|---|---|---|---|---|---|---|---|
| At least | But less than | | At least | But less than | | At least | But less than | |
| 0 | $300 | 0 | $460 | $480 | $9 | $700 | $740 | $18 |
| $300 | 320 | $1 | 480 | 500 | 10 | 740 | 780 | 19 |
| 320 | 340 | 2 | 500 | 520 | 11 | 780 | 820 | 20 |
| 340 | 360 | 3 | 520 | 540 | 12 | 820 | 860 | 21 |
| 360 | 380 | 4 | 540 | 560 | 13 | 860 | 900 | 22 |
| 380 | 400 | 5 | 560 | 580 | 14 | 900 | 940 | 23 |
| 400 | 420 | 6 | 580 | 620 | 15 | 940 | 980 | 24 |
| 420 | 440 | 7 | 620 | 660 | 16 | 980 and over, 2.5% of the adjusted tax. | | |
| 440 | 460 | 8 | 660 | 700 | 17 | | | |

2 (2) by striking out the table in paragraph (1)(B)
3 and inserting in lieu thereof the following table:

| "Calendar year | Percent | |
|---|---|---|
| | Estates and trusts | Corporations |
| 1968 | 7.5 | 10.0 |
| 1969 | 10.0 | 10.0 |
| 1970 | 2.5 | 2.5". |

4 (3) by striking out "January 1, 1970" the first
5 time it appears in paragraph (2)(A) and inserting in
6 lieu thereof "July 1, 1970", and
7 (4) by striking out paragraph (2)(A)(ii) and
8 inserting in lieu thereof the following:

1 "(ii) a fraction, the numerator of which is
2 the sum of the number of days in the taxable
3 year occurring on and after the effective date of
4 the surcharge and before January 1, 1970, plus
5 one-half times the number of days in the taxable
6 year occurring after December 31, 1969, and
7 before July 1, 1970, and the denominator of
8 which is the number of days in the entire tax-
9 able year."

10 (b) RECEIPT OF MINIMUM DISTRIBUTIONS.—The last
11 sentence of section 963 (b) (relating to receipt of minimum
12 distributions by domestic corporations) is amended by strik-
13 ing out "December 31, 1969" and inserting in lieu thereof
14 "June 30, 1970".

15 (c) EFFECTIVE DATES.—The amendments made by
16 subsections (a) and (b) shall apply to taxable years ending
17 after December 31, 1969, and beginning before July 1,
18 1970.

19 SEC. 702. CONTINUATION OF EXCISE TAXES ON COMMUNI-
20 CATION SERVICES AND ON AUTOMOBILES.

21 (a) PASSENGER AUTOMOBILES.—

22 (1) IN GENERAL.—Section 4061 (a) (2) (A) (re-
23 lating to tax on passenger automobiles, etc.) is amended
24 to read as follows:

25 "(A) Articles enumerated in subparagraph

1 (B) are taxable at whichever of the following rates
2 is applicable:

| "If the article is sold— | The tax rate is— |
|---|---|
| Before January 1, 1971 | 7 percent. |
| During 1971 | 5 percent. |
| During 1972 | 3 percent. |
| During 1973 | 1 percent. |

3 The tax imposed by this subsection shall not apply
4 with respect to articles enumerated in subparagraph
5 (B) which are sold by the manufacturer, producer,
6 or importer after December 31, 1973."
7 (2) CONFORMING AMENDMENT.—Section 6412
8 (a) (1) (relating to floor stocks refunds on passenger
9 automobiles, etc.) is amended by striking out "Jan-
10 uary 1, 1970, January 1, 1971, January 1, 1972, or
11 January 1, 1973", and inserting in lieu thereof "Jan-
12 uary 1, 1971, January 1, 1972, January 1, 1973, or
13 January 1, 1974".
14 (b) COMMUNICATIONS SERVICES.—
15 (1) CONTINUATION OF TAX.—Section 4251 (a)
16 (2) (relating to tax on certain communications serv-
17 ices) is amended by striking out the table and inserting
18 in lieu thereof the following table:

| "Amounts paid pursuant to bills first rendered— | Percent— |
|---|---|
| Before January 1, 1971 | 10 |
| During 1971 | 5 |
| During 1972 | 3 |
| During 1973 | 1". |

1 (2) CONFORMING AMENDMENT.—Section 4251
2 (b) (relating to termination of tax) is amended by
3 striking out "January 1, 1973", and inserting in lieu
4 thereof "January 1, 1974".
5 (3) REPEAL OF SUBCHAPTER B OF CHAPTER 33.—
6 Section 105(b)(3) of the Revenue and Expenditure
7 Control Act of 1968 (82 Stat. 266) is amended to read
8 as follows:
9 "(3) REPEAL OF SUBCHAPTER B OF CHAPTER
10 33.—Effective with respect to amounts paid pursuant to
11 bills first rendered on or after January 1, 1974, sub-
12 chapter B of chapter 33 (relating to the tax on com-
13 munications) is repealed. For purposes of the preceding
14 sentence, in the case of communications services ren-
15 dered before November 1, 1973, for which a bill has
16 not been rendered before January 1, 1974, a bill shall
17 be treated as having been first rendered on Decem-
18 ber 31, 1973. Effective January 1, 1974, the table of
19 subchapters for chapter 33 is amended by striking out
20 the item relating to such subchapter B."
21 **SEC. 702. TERMINATION OF INVESTMENT CREDIT.**
22 (a) IN GENERAL.—Subpart B of part IV of subchapter
23 A of chapter 1 (relating to rules for computing credit for

1 investment in certain depreciable property) is amended by
2 adding at the end thereof the following new section:
3 "SEC. 49. TERMINATION OF CREDIT.
4 "(a) GENERAL RULE.—For purposes of this subpart,
5 the term 'section 38 property' does not include property—
6 "(1) the physical construction, reconstruction, or
7 erection of which is begun after April 18, 1969, or
8 "(2) which is acquired by the taxpayer after April
9 18, 1969,
10 other than pre-termination property.
11 "(b) PRE-TERMINATION PROPERTY.—For purposes of
12 this section—
13 "(1) BINDING CONTRACTS.—Any property shall be
14 treated as pre-termination property to the extent that
15 such property is constructed, reconstructed, erected, or
16 acquired pursuant to a contract which was, on April 18,
17 1969, and at all times thereafter, binding on the tax-
18 payer.
19 "(2) EQUIPPED BUILDING RULE.—If—
20 "(A) pursuant to a plan of the taxpayer in
21 existence on April 18, 1969 (which plan was not
22 substantially modified at any time after such date
23 and before the taxpayer placed the equipped build-
24 ing in service), the taxpayer has constructed, re-
25 constructed, erected, or acquired a building and the

1 machinery and equipment necessary to the planned
2 use of the building by the taxpayer, and
3 "(B) more than 50 percent of the aggregate
4 adjusted basis of all the property of a character sub-
5 ject to the allowance for depreciation making up
6 such building as so equipped is attributable to either
7 property the construction, reconstruction, or erection
8 of which was begun by the taxpayer before April 19,
9 1969, or property the acquisition of which by the
10 taxpayer occurred before such date,
11 then all property comprising such building as so equipped
12 (and any incidental property adjacent to such building
13 which is necessary to the planned use of the building)
14 shall be pre-termination property. For purposes of sub-
15 paragraph (B) of the preceding sentence, the rules of
16 paragraphs (1) and (4) shall be applied. For purposes
17 of this paragraph, a special purpose structure shall be
18 treated as a building.
19 "(3) PLANT FACILITY RULE.—
20 "(A) GENERAL RULE.—If—
21 "(i) pursuant to a plan of the taxpayer in
22 existence on April 18, 1969 (which plan was
23 not substantially modified at any time after
24 such date and before the taxpayer placed the
25 plant facility in service), the taxpayer has con-

1 structed, reconstructed, or erected a plant fa-
2 cility, and either
3 "(ii) the construction, reconstruction, or
4 erection of such plant facility was commenced
5 by the taxpayer before April 19, 1969, or
6 "(iii) more than 50 percent of the aggre-
7 gate adjusted basis of all the property of a
8 character subject to the allowance for deprecia-
9 tion making up such plant facility is attributable
10 to either property the construction, reconstruc-
11 tion, or erection of which was begun by the tax-
12 payer before April 19, 1969, or property the
13 acquisition of which by the taxpayer occurred
14 before such date,
15 then all property comprising such plant facility shall
16 be pre-termination property. For purposes of clause
17 (iii) of the preceding sentence, the rules of para-
18 graphs (1) and (4) shall be applied.
19 "(B) PLANT FACILITY DEFINED.—For pur-
20 poses of this paragraph, the term 'plant facility'
21 means a facility which does not include any building
22 (or of which buildings constitute an insignificant
23 portion) and which is—
24 "(i) a self-contained, single operating unit
25 or processing operation,

1 "(ii) located on a single site, and

2 "(iii) identified, on April 18, 1969, in the

3 purchasing and internal financial plans of the

4 taxpayer as a single unitary project.

5 "(C) SPECIAL RULE.—For purposes of this

6 subsection, if—

7 "(i) a certificate of convenience and neces-

8 sity has been issued before April 19, 1969, by

9 a Federal regulatory agency with respect to

10 two or more plant facilities which are included

11 under a single plan of the taxpayer to construct,

12 reconstruct, or erect such plant facilities, and

13 "(ii) more than 50 percent of the aggre-

14 gate adjusted basis of all the property of a

15 character subject to the allowance for deprecia-

16 tion making up such plant facilities is attribut-

17 able to either property the construction, re-

18 construction, or erection of which was begun by

19 the taxpayer before April 19, 1969, or prop-

20 erty the acquisition of which by the taxpayer

21 occurred before such date,

22 such plant facilities shall be treated as a single plant

23 facility.

24 "(D) COMMENCEMENT OF CONSTRUCTION.—

25 For purposes of subparagraph (A) (ii), the con-

1 struction, reconstruction, or erection of a plant facil-
2 ity shall not be considered to have commenced until
3 construction, reconstruction, or erection has com-
4 menced at the site of such plant facility. The preced-
5 ing sentence shall not apply if the site of such plant
6 facility is not located on land.

7 "(4) MACHINERY OR EQUIPMENT RULE.—Any
8 piece of machinery or equipment—

9 "(A) more than 50 percent of the parts and
10 components of which (determined on the basis of
11 cost) were held by the taxpayer on April 18, 1969,
12 or are acquired by the taxpayer pursuant to a bind-
13 ing contract which was in effect on such date, for
14 inclusion or use in such piece of machinery or equip-
15 ment, and

16 "(B) the cost of the parts and components of
17 which is not an insignificant portion of the total cost,
18 shall be treated as property which is pre-termination
19 property.

20 "(5) CERTAIN LEASE-BACK TRANSACTIONS, ETC.—
21 Where a person who is a party to a binding contract de-
22 scribed in paragraph (1) transfers rights in such con-
23 tract (or in the property to which such contract relates)
24 to another person but a party to such contract retains a
25 right to use the property under a lease with such other

1 person, then to the extent of the transferred rights such
2 other person shall, for purposes of paragraph (1), suc-
3 ceed to the position of the transferor with respect to such
4 binding contract and such property. In any case in
5 which the lessor does not make an election under sec-
6 tion 48(d)—

7 "(A) the preceding sentence shall apply only
8 if a party to the contract retains the right to use the
9 property under a lease for a term of at least 1 year;
10 and

11 "(B) if such use is retained, the lessor shall be
12 deemed for the purposes of section 47 as having
13 made a disposition of the property at such time as
14 the lessee loses the right to use the property.

15 For purposes of subparagraph (B), if the lessee transfers
16 the lease in a transfer described in paragraph (7), the
17 lessee shall be considered as having the right to use of
18 the property so long as the transferee has such use.

19 "(6) CERTAIN LEASE AND CONTRACT OBLIGA-
20 TIONS.—

21 "(A) Where, pursuant to a binding lease or
22 contract to lease in effect on April 18, 1969, a lessor
23 or lessee is obligated to construct, reconstruct, erect,
24 or acquire property specified in such lease or con-
25 tract, any property so constructed, reconstructed,

1 erected, or acquired by the lessor or lessee shall be
2 pre-termination property. In the case of any project
3 which includes property other than the property to
4 be leased to such lessee, the preceding sentence shall
5 be applied, in the case of the lessor, to such other
6 property only if the binding leases and contracts
7 with all lessees in effect on April 18, 1969, cover
8 real property constituting 25 percent or more of
9 the project (determined on the basis of rental
10 value). For purposes of the preceding sentences of
11 this paragraph, in the case of any project where one
12 or more vendor-vendee relationships exist, such
13 vendors and vendees shall be treated as lessors and
14 lessees.

15 "(B) Where, in order to perform a binding
16 contract or contracts in effect on April 18, 1969,
17 (i) the taxpayer is required to construct, recon-
18 struct, erect, or acquire property specified in any
19 order of a Federal regulatory agency for which ap-
20 plication was filed before April 19, 1969, (ii) the
21 property is to be used to transport one or more
22 products under such contract or contracts, and (iii)
23 one or more parties to the contract or contracts are
24 required to take or to provide more than 50 percent
25 of the products to be transported over a substantial

1 portion of the expected useful life of the property,
2 then such property shall be pre-termination prop-
3 erty.

4 "(7) CERTAIN TRANSFERS TO BE DISREGARDED.—

5 "(A) If property or rights under a contract
6 are transferred in—

7 "(i) a transfer by reason of death, or

8 "(ii) a transaction as a result of which the
9 basis of the property in the hands of the trans-
10 feree is determined by reference to its basis in
11 the hands of the transferor by reason of the
12 application of section 332, 351, 361, 371(a),
13 374(a), 721, or 731,

14 and such property (or the property acquired under
15 such contract) would be treated as pre-termination
16 property in the hands of the decedent or the trans-
17 feror, such property shall be treated as pre-termi-
18 nation property in the hands of the transferee.

19 "(B) If—

20 "(i) property or rights under a contract are
21 acquired in a transaction to which section 334
22 (b)(2) applies,

23 "(ii) the stock of the distributing corpora-
24 tion was acquired before April 19, 1969, or

1 pursuant to a binding contract in effect April 18,
2 1969, and
3 "(iii) such property (or the property ac-
4 quired under such contract) would be treated
5 as pre-termination prop.:ty in the hands of the
6 distributing corporation,
7 such property shall be treated as pre-termination
8 property in the hands of the distributee.
9 "(8) PROPERTY ACQUIRED FROM AFFILIATED COR-
10 PORATION.—For purposes of this subsection, in the case
11 of property acquired by a corporation which is a member
12 of an affiliated group from another member of the same
13 group—
14 "(A) such corporation shall be treated as hav-
15 ing acquired such property on the date on which it
16 was acquired by such other member,
17 "(B) such corporation shall be treated as hav-
18 ing entered into a binding contract for the construc-
19 tion, reconstruction, erection, or acquisition of such
20 property on the date on which such other member
21 entered into a contract for the construction, recon-
22 struction, erection, or acquisition of such property,
23 and
24 "(C) such corporation shall be treated as hav-
25 ing commenced the construction, reconstruction, or

1 erection of such property on the date on which such
2 other member commenced such construction, re-
3 construction, or erection.
4 For purposes of this subsection and subsection (c),
5 a contract between two members of an affiliated group
6 shall not be treated as a binding contract as between such
7 members. For purposes of the preceding sentences, the
8 term 'affiliated group' has the meaning assigned to
9 it by section 1504 (a), except that all corporations shall
10 be treated as includible corporations (without any ex-
11 clusion under section 1504 (b)).
12 "(9) BARGES FOR OCEAN-GOING VESSELS.—In the
13 case of any ocean-going vessel which is—
14 "(A) pre-termination property,
15 "(B) constructed under a binding contract
16 which was in effect on April 18, 1969, to which
17 the Maritime Administration, Department of Com-
18 merce, is a party, and
19 "(C) designed to carry barges,
20 then the barges specified in such contract (not in excess
21 of the number specified in such contract) constructed,
22 reconstructed, erected, or acquired for use with such
23 vessel, together with the machinery and equipment to
24 be installed on such barges and necessary for their
25 planned use, shall be treated as pre-termination property.

33-865 O—69—pt. 1——30

1 "(10) CERTAIN NEW-DESIGN PRODUCTS.—
2 Where—
3 "(A) on April 18, 1969, the taxpayer had
4 undertaken a project to produce a product of a new
5 design pursuant to binding contracts in effect on
6 such date which—
7 "(i) were fixed-price contracts (except
8 for provisions for escalation in case of changes
9 in rates of pay), and
10 "(ii) covered more than 60 percent of the
11 entire production of such design to be delivered
12 by the taxpayer before January 1, 1973, and
13 "(B) on or before April 18, 1969, more than
14 50 percent of the aggregate adjusted basis of all
15 property of a character subject to the allowance
16 for depreciation required to carry out such binding
17 contracts was property the construction, reconstruc-
18 tion, or erection of which had been begun by the
19 taxpayer, or had been acquired by the taxpayer
20 (or was under a binding contract for such con-
21 struction, reconstruction, erection, or acquisition),
22 then all tangible personal property placed in service by
23 the taxpayer before January 1, 1972, which is re-
24 quired to carry out such binding contracts shall be
25 deemed to be pre-termination property. For purposes of

1 subparagraph (B) of the preceding sentence, jigs, dies,
2 templates, and similar items which can be used only for
3 the manufacture or assembly of the production under the
4 project and which were described in written engineering
5 and internal financial plans of the taxpayer in existence
6 on April 18, 1969, shall be treated as property which
7 on such date was under a binding contract for construc-
8 tion.

9 "(c) LEASED PROPERTY.—In the case of property
10 which is leased after April 18, 1969 (other than pursuant
11 to a binding contract to lease entered into before April 19,
12 1969), which is section 38 property with respect to the
13 lessor but is property which would not be section 38 prop-
14 erty because of the application of subsection (a) if acquired
15 by the lessee, and which is property of the same kind which
16 the lessor ordinarily sold to customers before April 19, 1969,
17 or ordinarily leased before such date and made an election
18 under section 48(d), such property shall not be section 38
19 property with respect to either the lessor or the lessee.

20 "(d) RATE OF CREDIT WHERE PROPERTY IS PLACED
21 IN SERVICE AFTER 1970.—In the case of property placed
22 in service after December 31, 1970, section 38 and this
23 subpart shall be applied by reducing the 7 percent figure
24 of section 46(a)(1) by one-tenth of 1 percent for each

1 full calendar month between November 30, 1970, and the
2 date on which the property is placed in service, except
3 that in the case of property placed in service after December
4 31, 1974, 0 percent shall be substituted for 7 percent."

5 (b) LIMITATIONS ON USE OF CARRYOVERS AND
6 CARRYBACKS.—Section 46(b) (relating to carryback and
7 carryover of unused credits) is amended by adding at the
8 end thereof the following new paragraph:

9 "(5) TAXABLE YEARS BEGINNING AFTER DECEM-
10 BER 31, 1968, AND ENDING AFTER APRIL 18, 1969.—
11 The amount which may be added under this subsection
12 for any taxable year beginning after December 31,
13 1968, and ending after April 18, 1969, shall not exceed
14 20 percent of the higher of—

15 "(A) the aggregate of the investment credit
16 carrybacks and investment credit carryovers to the
17 taxable year, or

18 "(B) the highest amount computed under sub-
19 paragraph (A) for any preceding taxable year
20 which began after December 31, 1968, and ended
21 after April 18, 1969."

22 (c) RULES RELATING TO CERTAIN CASUALTIES AND
23 THEFTS.—Section 47(a)(4) (relating to rules with respect
24 to section 38 property destroyed by casualty, etc.) is
25 amended by adding at the end thereof the following:

1 "Subparagraphs (B) and (C) shall not apply with
2 respect to any casualty or theft occurring after April 18,
3 1969. In the case of any casualty or theft occurring
4 on or before April 18, 1969, to the extent of any
5 replacement after such date (with property which would
6 be section 38 property but for section 49) this part
7 shall be applied without regard to section 49."
8 (d) CONFORMING AMENDMENT.—The table of sections
9 for subpart B of part IV of subchapter A of chapter 1
10 (relating to rules for computing credit for investment in
11 certain depreciable property) is amended by adding at the
12 end thereof the following new item:

"Sec. 49. Termination of credit."

13 **SEC. 704. AMORTIZATION OF POLLUTION CONTROL FACILI-**
14 **TIES.**

15 (a) ALLOWANCE.—Part VI of subchapter B of chapter
16 1 (relating to itemized deductions for individuals and corpora-
17 tions) is amended by striking out sections 168 and 169 and
18 by inserting after section 167 the following new section:

19 **"SEC. 168. AMORTIZATION OF POLLUTION CONTROL FA-**
20 **CILITIES.**

21 "(a) ALLOWANCE OF DEDUCTION.—Every person, at
22 his election, shall be entitled to a deduction with respect to
23 the amortization of the adjusted basis (for determining gain)
24 of any certified pollution control facility (as defined in sub-

1 section (d)), based on a period of 60 months. Such amortiza-
2 tion deduction shall be an amount, with respect to each month
3 of such period within the taxable year, equal to the adjusted
4 basis of the pollution control facility at the end of such month
5 divided by the number of months (including the month for
6 which the deduction is computed) remaining in the period.
7 Such adjusted basis at the end of the month shall be com-
8 puted without regard to the amortization deduction for such
9 month. The amortization deduction provided by this section
10 with respect to any month shall be in lieu of the depreciation
11 deduction with respect to such pollution control facility for
12 such month provided by section 167. The 60-month period
13 shall begin, as to any pollution control facility, at the elec-
14 tion of the taxpayer, with the month following the month
15 in which such facility was completed or acquired, or with
16 the succeeding taxable year.

17 "(b) ELECTION OF AMORTIZATION.—The election of
18 the taxpayer to take the amortization deduction and to begin
19 the 60-month period with the month following the month
20 in which the facility is completed or acquired, or with the
21 taxable year succeeding the taxable year in which such facil-
22 ity is completed or acquired, shall be made by filing with
23 the Secretary or his delegate, in such manner, in such form,
24 and within such time, as the Secretary or his delegate may
25 by regulations prescribe, a statement of such election.

1 "(c) TERMINATION OF AMORTIZATION DEDUCTION.—
2 A taxpayer which has elected under subsection (b) to take
3 the amortization deduction provided in subsection (a) may,
4 at any time after making such election, discontinue the
5 amortization deduction with respect to the remainder of the
6 amortization period, such discontinuance to begin as of the
7 beginning of any month specified by the taxpayer in a notice
8 in writing filed with the Secretary or his delegate before
9 the beginning of such month. The depreciation deduction
10 provided under section 167 shall be allowed, beginning with
11 the first month as to which the amortization deduction does
12 not apply, and the taxpayer shall not be entitled to any
13 further amortization deduction under this section with respect
14 to such pollution control facility.
15 "(d) DEFINITIONS.—For purposes of this section—
16 "(1) CERTIFIED POLLUTION CONTROL FACILITY.—
17 The term 'certified pollution control facility' means
18 a new identifiable treatment facility which is used to
19 abate or control water or atmospheric pollution or con-
20 tamination, respectively, by removing, altering, dispos-
21 ing, or storing of pollutants, contaminants, wastes, or
22 heat and which—
23 "(A) the State certifying authority having
24 jurisdiction with respect to such facility has certi-

1 fied to the Federal certifying authority as having
2 been constructed, reconstructed, erected, or acquired
3 in conformity with the State program or require-
4 ments for abatement or control of water or atmos-
5 pheric pollution or contamination; and
6 "(B) the Federal certifying authority has cer-
7 tified to the Secretary or his delegate (i) as meeting
8 the minimum performance standards described in
9 subsection (e), (ii) as being in compliance with
10 the applicable regulations of Federal agencies, and
11 (iii) as being in furtherance of the general policy
12 of the United States for cooperation with the States
13 in the prevention and abatement of water pollution
14 under the Federal Water Pollution Control Act, as
15 amended (33 U.S.C. 466 et seq.), or in the pre-
16 vention and abatement of atmospheric pollution and
17 contamination under the Clean Air Act, as amended
18 (42 U.S.C. 1857 et seq.).
19 "(2) STATE CERTIFYING AUTHORITY.—The term
20 'State certifying authority' means, in the case of water
21 pollution, the State water pollution control agency as
22 defined in section 13(a) of the Federal Water Pollu-
23 tion Control Act and, in the case of air pollution, the air
24 pollution control agency as defined in section 302(b) of
25 the Clean Air Act. The term 'State certifying authority'

1 includes any interstate agency authorized to act in place
2 of a certifying authority of the State.
3 "(3) FEDERAL CERTIFYING AUTHORITY.—The
4 term 'Federal certifying authority' means, in the case of
5 water pollution, the Secretary of the Interior and, in the
6 case of air pollution, the Secretary of Health, Education,
7 and Welfare.
8 "(4) NEW IDENTIFIABLE TREATMENT FACILITY.—
9 For purposes of paragraph (1), the term 'new identi-
10 fiable treatment facility' includes only tangible property
11 (not including a building and its structural components,
12 other than a building which is exclusively a treatment
13 facility) which is of a character subject to the allowance
14 for depreciation provided in section 167, which is identi-
15 fiable as a treatment facility, and which is property—
16 "(A) the construction, reconstruction, or erec-
17 tion of which is completed by the taxpayer after
18 December 31, 1968, or
19 "(B) acquired after December 31, 1968, if the
20 original use of the property commences with the
21 taxpayer and commences after such date.
22 In applying this section in the case of property de-
23 scribed in subparagraph (A), there shall be taken
24 into account only that portion of the basis which is prop-

1 erly attributable to construction, reconstruction, or erec-
2 tion after December 31, 1968.

3 "(e) AUTHORIZATION OF SECRETARIES OF INTERIOR
4 AND OF HEALTH, EDUCATION, AND WELFARE TO SET
5 STANDARDS, ETC.—

6 "(1) PERFORMANCE STANDARDS.—The Federal
7 certifying authority shall from time to time promulgate
8 minimum performance standards for purposes of sub-
9 section (d) (1) (B), taking into account advances in
10 technology and specifying the tolerance of such pol-
11 lutants and contaminants as shall be appropriate.

12 "(2) PROFITMAKING ABATEMENT WORKS, ETC.—
13 The Federal certifying authority shall not certify any
14 property under subsection (d) (1) (B) to the extent it
15 appears that (A) by reason of profits derived through
16 the recovery of wastes or otherwise in the operation of
17 such property, its costs will be recovered over its actual
18 useful life, or (B) such property would be constructed,
19 reconstructed, erected, or acquired without regard to the
20 need to abate or control water or atmospheric pollution
21 or contamination.

22 "(f) ALLOCATION OF BASIS.—In the case of property
23 with respect to which an election has been made under sub-
24 section (a) but only a portion of the adjusted basis of which

1 is amortizable under this section, such portion of the adjusted
2 basis (hereinafter in this section referred to as 'amortization
3 basis') shall be determined under regulations prescribed by
4 the Secretary or his delegate. The depreciation deduction
5 provided by section 167 shall, despite the provisions of sub-
6 section (a) of this section, be allowed with respect to the
7 portion of the adjusted basis which is not amortizable under
8 this section.

9 "(g) INVESTMENT CREDIT NOT TO BE ALLOWED.—
10 In the case of any property with respect to which an election
11 has been made under subsection (a), so much of the adjusted
12 basis of the property as (after the application of subsection
13 (f)) constitutes the amortization basis for purposes of this
14 section shall not be treated as section 38 property within the
15 meaning of section 48(a).

16 "(h) LIFE TENANT AND REMAINDERMAN.—In the
17 case of property held by one person for life with remainder
18 to another person, the deduction under this section shall be
19 computed as if the life tenant were the absolute owner of
20 the property and shall be allowable to the life tenant.

21 "(i) CROSS REFERENCE.—

**"For special rule with respect to certain gain derived from the disposition of property the adjusted basis of which is determined with regard to this section, see section 1245."**

1 (b) CONFORMING, ETC., AMENDMENTS.—
2 (1) The table of sections for part VI of subchapter
3 B of chapter 1 is amended by striking out the items
4 relating to sections 168 and 169 and inserting in lieu
5 thereof the following new item:

"Sec. 168. Amortization of pollution control facilities."

6 (2) The heading and the first sentence of section
7 642(f) (relating to special rules for credits and deduc-
8 tions of estates and trusts) are amended to read as
9 follows:
10 "(f) AMORTIZATION OF POLLUTION CONTROL FACIL-
11 ITIES.—The benefit of the deductions for amortization of
12 pollution control facilities provided by section 168 shall be
13 allowed to estates and trust in the same manner as in the
14 case of an individual."
15 (3) Section 1082(a)(2)(B) (relating to basis
16 for determining gain or loss) is amended by striking
17 out "or 169".
18 (4) Section 1245(a) of such Code (relating to
19 gain from disposition of certain depreciable property)
20 is amended—
21 (A) by striking out "or" at the end of para-
22 graph (2)(A);
23 (B) by inserting "or" at the end of paragraph

1 (2) (B) and by inserting after such paragraph the
2 following new subparagraph:
3 "(C) with respect to any property referred to
4 in paragraph (3) (D), its adjusted basis recom-
5 puted by adding thereto all adjustments attributable
6 to periods beginning with the first month for which
7 a deduction for amortization is allowed under section
8 168,";
9 (C) by striking out "or" at the end of para-
10 graphs (3) (A) and (B);
11 (D) by striking out the period at the end of
12 paragraph (3) (C) and inserting in lieu thereof
13 ", or"; and
14 (E) by adding at the end of paragraph (3)
15 the following new subparagraph:
16 "(D) so much of any real property (other than
17 any property described in subparagraph (B)) as
18 is a certified pollution control facility which has
19 an adjusted basis in which there are reflected ad-
20 justments for amortization under section 168."
21 (c) EFFECTIVE DATE.—The amendments made by
22 this section shall apply with respect to taxable years ending
23 after December 31, 1968.

1 SEC. 705. DEPRECIATION OF CERTAIN RAILROAD ROLLING
2 STOCK.
3 (a) IN GENERAL.—Section 167 (relating to deprecia-
4 tion) is amended by inserting after subsection (l) (added
5 by section 451) the following new subsection:
6 "(m) DEPRECIATION OF CERTAIN RAILROAD ROLL-
7 ING STOCK.—A domestic common carrier by railroad subject
8 to part I of the Interstate Commerce Act may elect, in ac-
9 cordance with regulations prescribed by the Secretary or his
10 delegate, to compute the depreciation deduction provided by
11 subsection (a) attributable to railroad rolling stock (other
12 than locomotives)—
13 "(1) the construction or reconstruction of which is
14 completed by the taxpayer after July 31, 1969, and
15 then only to that portion of the basis which is properly
16 attributable to such construction or reconstruction after
17 such date, or
18 "(2) which was acquired by the taxpayer after
19 July 31, 1969, if the original use of such property com-
20 mences with the taxpayer and commences after such
21 date,
22 under the straight line method using a useful life of 84
23 months. Such method shall be in lieu of any other method of
24 computing the depreciation deduction under subsection (a)
25 and in lieu of any deduction for amortization."

1 (b) EFFECTIVE DATE.—The amendments made by sub-
2 section (a) shall apply with respect to taxable years ending
3 after July 31, 1969.

# 4 TITLE VIII—ADJUSTMENT OF TAX
# 5 BURDEN FOR INDIVIDUALS

## 6 SEC. 801. LOW INCOME ALLOWANCE; INCREASE IN STAND-
## 7 ARD DEDUCTION

8 (a) IN GENERAL.—Section 141 (relating to the stand-
9 ard deduction) is amended by striking out subsections (a),
10 (b), and (c) and inserting in lieu thereof the following:
11 "(a) STANDARD DEDUCTION.—Except as otherwise
12 provided in this section, the standard deduction referred to in
13 this title is the larger of the percentage standard deduction or
14 the low income allowance.
15 "(b) PERCENTAGE STANDARD DEDUCTION.—The per-
16 centage standard deduction is an amount equal to the appli-
17 cable percentage of adjusted gross income shown in the fol-
18 lowing table, but not to exceed the maximum amount shown
19 in such table (or one-half of such amount in the case of a
20 separate return by a married individual):

| "Taxable years beginning in— | Applicable percentage | Maximum amount |
|---|---|---|
| 1970 | 13 | $1,400 |
| 1971 | 14 | 1,700 |
| 1972 and thereafter | 15 | 2,000". |

21 "(3) LOW INCOME ALLOWANCE.—

1 "(1) IN GENERAL.—The low income allowance is
2 an amount equal to the sum of—
3 "(A) the basic allowance, and
4 "(B) the additional allowance.
5 "(2) BASIC ALLOWANCE.—For purposes of this
6 subsection, the basic allowance is an amount equal to
7 the sum of—
8 "(A) $200, plus
9 "(B) $100, multiplied by the number of
10 exemptions.
11 The basic allowance shall not exceed $1,100.
12 "(3) ADDITIONAL ALLOWANCE.—
13 "(A) IN GENERAL.—For purposes of this sub-
14 section, the additional allowance is an amount equal
15 to the excess (if any) of $900 over the sum of—
16 "(i) $100, multiplied by the number of
17 exemptions, plus
18 "(ii) the income phase-out.
19 "(B) INCOME PHASE-OUT.—For purposes of
20 subparagraph (A) (ii), the income phase-out is an
21 amount equal to one-half of the amount by which
22 the adjusted gross income for the taxable year ex-
23 ceeds the sum of—
24 "(i) $1,100, plus
25 "(ii) $600, multiplied by the number of
26 exemptions.

1 "(4) MARRIED INDIVIDUALS FILING SEPARATE
2 RETURNS.—In the case of a married taxpayer filing a
3 separate return—
4 "(A) the low income allowance is an amount
5 equal to the basic allowance, and
6 "(B) the basic allowance is an amount (not in
7 excess of $550) equal to the sum of—
8 "(i) $100, plus
9 "(ii) $100, multiplied by the number of
10 exemptions.
11 "(5) NUMBER OF EXEMPTIONS.—For purposes of
12 this subsection, the number of exemptions is the number
13 of exemptions allowed as a deduction for the taxable
14 year under section 151."
15 (b) DETERMINATION OF MARITAL STATUS.—Section
16 143 (relating to determination of marital status) is
17 amended—
18 (1) by striking out "For purposes of this part—"
19 and inserting in lieu thereof "(a) GENERAL RULE.—
20 For purposes of this part—"; and
21 (2) by adding at the end thereof the following new
22 subsection:
23 "(b) CERTAIN MARRIED INDIVIDUALS LIVING
24 APART.—For purposes of this part, if—
25 "(1) an individual who is married (within the

1 meaning of subsection (a)) and who files a separate
2 return maintains as his home a household which con-
3 stitutes for more than one-half of the taxable year the
4 principal place of abode of a dependent (A) who
5 (within the meaning of section 152) is a son, stepson,
6 daughter, or stepdaughter of the individual, and (B)
7 with respect to whom such individual is entitled to a
8 deduction for the taxable year under section 151,
9 "(2) such individual furnishes over half of the cost
10 of maintaining such household during the taxable year,
11 and
12 "(3) during the entire taxable year such indi-
13 vidual's spouse is not a member of such household,
14 such individual shall not be considered as married."
15 (c) TECHNICAL AND CONFORMING AMENDMENTS.—
16 (1) Section 4(c) (relating to married individuals filing
17 separate returns) is amended to read as follows:
18 "(c) HUSBAND OR WIFE FILING SEPARATE RE-
19 TURN.—
20 "(1) A husband or wife may not elect to pay the
21 optional tax imposed by section 3 if the tax of the other
22 spouse is determined under section 1 on the basis of
23 taxable income computed without regard to the stand-
24 ard deduction.
25 "(2) Except as otherwise provided in this subsec-

1 tion, in the case of a husband or wife filing a separate re-
2 turn the tax imposed by section 3 shall be the lesser of
3 the tax shown in Table IV or Table V of section 3.
4 "(3) Table V of section 3 shall not apply in the
5 case of a husband or wife filing a separate return if the
6 tax of the other spouse is determined with regard to the
7 percentage standard deduction; except that an individual
8 described in section 141 (d) (2) may elect (under regu-
9 lations prescribed by the Secretary or his delegate) to
10 pay the tax shown in Table V of section 3 in lieu of the
11 tax shown in Table IV of section 3. For purposes of this
12 title, an election under the preceding sentence shall be
13 treated as an election made under section 141 (d) (2).
14 "(4) For purposes of this subsection, determina-
15 tion of marital status shall be made under section 143."
16 (2) Section 141 (d) (relating to married individ-
17 uals filing separate returns) is amended—
18 (A) by striking out "minimum standard de-
19 duction" each place it appears and inserting in lieu
20 thereof "low income allowance"; and
21 (B) by striking out "10-percent" each place
22 it appears therein and inserting in lieu thereof
23 "percentage".
24 (3) Section 1304 (c) (5) (relating to special rules

1 for income averaging) is amended by striking out "sec-
2 tion 143" and inserting in lieu thereof "section 143
3 (a)".

4 (4) Section 6014(a) (relating to tax not com-
5 puted by taxpayer) is amended by striking out the last
6 sentence.

7 (d) EFFECTIVE DATE.—The amendments made by sub-
8 sections (a), (b), and (c) shall apply to taxable years
9 beginning after December 31, 1969.

10 (e) YEARS AFTER 1970.—Effective with respect to
11 taxable years beginning after December 31, 1970, section
12 141(c) (relating to low income allowance), as amended
13 by subsection (a), is amended to read as follows:

14 "(c) LOW INCOME ALLOWANCE.—The low income al-
15 lowance is $1,100 ($550, in the case of a married individual
16 filing a separate return)."

17 **SEC. 802. FIFTY-PERCENT MAXIMUM RATE ON EARNED**
18 **INCOME.**

19 (a) IN GENERAL.—Part VI of subchapter Q of chapter
20 1 (relating to other limitations) is amended by adding at
21 the end thereof the following new section:

22 **"SEC. 1348. FIFTY-PERCENT MAXIMUM RATE ON EARNED**
23 **INCOME.**

24 "(a) GENERAL RULE.—If an individual has earned
25 taxable income for any taxable year beginning after Decem-

1 ber 31, 1969, which exceeds the amount of taxable income
2 specified in paragraph (1), the tax imposed by section 1
3 for such year shall, unless the taxpayer chooses the benefits
4 of part I (relating to income averaging), be the sum of—
5 "(1) the tax imposed by section 1 on the lowest
6 amount of taxable income on which the rate of tax under
7 section 1 exceeds 50 percent,
8 "(2) 50 percent of the amount by which his
9 earned taxable income exceeds the lowest amount of
10 taxable income on which the rate of tax under section 1
11 exceeds 50 percent, and
12 "(3) the tax attributable to the remainder of his
13 taxable income, as determined under subsection (b) (3).
14 "(b) DEFINITIONS.—For purposes of this section—
15 "(1) EARNED INCOME.—The term 'earned income'
16 has the meaning assigned to such term by section 911
17 (b), except that such term does not include any distri-
18 bution to which section 72 (n), 402 (a) (2), or 403 (a)
19 (2) applies or any deferred compensation payment.
20 "(2) EARNED TAXABLE INCOME.—The earned tax-
21 able income of an individual is the amount which bears
22 the same ratio (but not in excess of 100 percent) to his
23 taxable income as his earned income bears to his adjusted
24 gross income.
25 "(3) TAX ON OTHER INCOME.—For purposes of

1 subsection (a) (3), the tax attributable to the remainder
2 of any individual's taxable income is the amount by
3 which the tax computed under section 1 without regard
4 to this section exceeds the tax so computed with refer-
5 ence solely to his earned taxable income.

6 "(c) MARRIED INDIVIDUALS.—This section shall apply
7 to a married individual only if such individual and his spouse
8 make a joint return for the taxable year."

9 (b) CLERICAL AMENDMENT.—The table of sections for
10 part VI of subchapter Q of chapter 1 is amended by adding
11 at the end thereof the following new item:

"Sec. 1348. Fifty-percent maximum rate on earned income."

12 **SEC. 803. INTERMEDIATE TAX RATES; SURVIVING SPOUSE**
13 **TREATMENT.**

14 (a) INTERMEDIATE TAX RATE INDIVIDUALS.—
15 (1) IN GENERAL.—Section 1(b)(2) (relating to
16 head of household) is amended—
17 (A) by striking out so much of such para-
18 graph as precedes subparagraph (A) and insert-
19 ing in lieu thereof the following:
20 "(2) DEFINITION OF INTERMEDIATE TAX RATE
21 INDIVIDUAL.—For purposes of this subtitle, an individ-
22 ual is an intermediate tax rate individual if, and only if,
23 such individual is not married at the close of his taxable
24 year, is not a surviving spouse (as defined in section
25 2(b)), and—";

1 (B) by striking out "or" at the end of sub-
2 paragraph (A) and by striking out the period at
3 the end of subparagraph (B) and inserting in lieu
4 thereof ", or"; and
5 (C) by inserting after subparagraph (B) the
6 following new subparagraph:
7 "(C) has attained age 35 before the close of his
8 taxable year or is an individual whose spouse died
9 before the beginning of his taxable year."
10 (2) TECHNICAL AND CONFORMING AMEND-
11 MENTS.—
12 (A) Section 1 (b) (3) is amended by striking
13 out "and" at the end of subparagraph (C), by strik-
14 ing out the period at the end of subparagraph (D)
15 and inserting in lieu thereof "; and", and by adding
16 at the end thereof the following new subparagraph:
17 "(E) if an individual has been married two or
18 more times, the status of such individual shall be
19 determined only with reference to his last marriage."
20 (B) Section 1 (b) (4) is amended by striking
21 out "a head of a household" and inserting in lieu
22 thereof "an intermediate tax rate individual".
23 (C) Sections 6014 and 6015 are amended by
24 striking out "a head of a household" each place it
25 appears in such sections and inserting in lieu thereof
26 "an intermediate tax rate individual".

1 (b) SURVIVING SPOUSE.—Section 2(b)(1)(A) (re-
2 lating to surviving spouse) is amended to read as follows:
3 "(A) whose spouse died before the beginning
4 of the taxable year, and".
5 (c) EFFECTIVE DATE.—The amendments made by this
6 section shall apply to taxable years beginning after De-
7 cember 31, 1969.
8 **SEC. 804. TAX RATES.**
9 (a) RATES OF TAX ON INDIVIDUALS.—Section 1(a)
10 is amended by inserting "and before January 1, 1971," after
11 "December 31, 1964," each place it appears and by adding
12 at the end thereof the following new paragraphs:
13 "(3) TAXABLE YEARS BEGINNING IN 1971.—In
14 the case of a taxable year beginning after December 31,
15 1970, and before January 1, 1972, there is hereby im-
16 posed on the taxable income of every individual (other
17 than an intermediate tax rate individual to whom sub-
18 section (b) applies) a tax determined in accordance
19 with the following table:

| "If the taxable income is: | The tax is: |
|---|---|
| Not over $500 | 13.5% of the taxable income. |
| Over $500 but not over $1,000 | $67.50, plus 14.5% of excess over $500. |
| Over $1,000 but not over $1,500 | $140, plus 15.5% of excess over $1,000. |
| Over $1,500 but not over $2,000 | $217.50, plus 16.5% of excess over $1,500. |

| "If the taxable income is—Con. | The tax is—Continued |
|---|---|
| Over $2,000 but not over $4,000 | $300, plus 18.5% of excess over $2,000. |
| Over $4,000 but not over $6,000 | $670, plus 21.5% of excess over $4,000. |
| Over $6,000 but not over $8,000 | $1,100, plus 24% of excess over $6,000. |
| Over $8,000 but not over $10,000 | $1,580, plus 27.5% of excess over $8,000. |
| Over $10,000 but not over $12,000. | $2,130, plus 31% of excess over $10,000. |
| Over $12,000 but not over $14,000. | $2,750, plus 35% of excess over $12,000. |
| Over $14,000 but not over $16,000. | $3,450, plus 38% of excess over $14,000. |
| Over $16,000 but not over $18,000. | $4,210, plus 41% of excess over $16,000. |
| Over $18,000 but not over $20,000. | $5,030, plus 43.5% of excess over $18,000. |
| Over $20,000 but not over $22,000. | $5,900, plus 46% of excess over $20,000. |
| Over $22,000 but not over $26,000. | $6,820, plus 48.5% of excess over $22,000. |
| Over $26,000 but not over $32,000. | $8,760, plus 51% of excess over $26,000. |
| Over $32,000 but not over $38,000. | $11,820, plus 52.5% of excess over $32,000. |
| Over $38,000 but not over $44,000. | $14,970, plus 55% of excess over $38,000. |
| Over $44,000 but not over $50,000. | $18,270, plus 57% of excess over $44,000. |
| Over $50,000 but not over $60,000. | $21,690, plus 60% of excess over $50,000. |
| Over $60,000 but not over $70,000. | $27,690, plus 62% of excess over $60,000. |
| Over $70,000 but not over $80,000. | $33,890, plus 63% of excess over $70,000. |
| Over $80,000 but not over $90,000. | $40,190, plus 64.5% of excess over $80,000. |
| Over $90,000 but not over $100,000. | $46,640, plus 65% of excess over $90,000. |
| Over $100,000 but not over $120,000. | $53,140, plus 66% of excess over $100,000. |
| Over $120,000 but not over $150,000. | $66,340, plus 66.5% of excess over $120,000. |
| Over $150,000 but not over $200,000. | $86,290, plus 67% of excess over $150,000. |
| Over $200,000 | $119,790, plus 67.5% of excess over $200,000. |

1 "(4) TAXABLE YEARS BEGINNING AFTER 1971.—
2 In the case of a taxable year beginning after December
3 31, 1971, there is hereby imposed on the taxable in-
4 come of every individual (other than an intermediate
5 tax rate individual to whom subsection (b) applies) a
6 tax determined in accordance with the following table:

| "If the taxable income is: | The tax is: |
|---|---|
| Not over $500 | 13% of the taxable income. |
| Over $500 but not over $1,000 | $65, plus 14% of excess over $500. |
| Over $1,000 but not over $1,500 | $135, plus 15% of excess over $1,000. |
| Over $1,500 but not over $2,000 | $210, plus 16% of excess over $1,500. |
| Over $2,000 but not over $4,000 | $290, plus 18% of excess over $2,000. |
| Over $4,000 but not over $6,000 | $650, plus 21% of excess over $4,000. |
| Over $6,000 but not over $8,000 | $1,070, plus 23% of excess over $6,000. |
| Over $8,000 but not over $10,000. | $1,530, plus 27% of excess over $8,000. |
| Over $10,000 but not over $12,000. | $2,070, plus 30% of excess over $10,000. |
| Over $12,000 but not over $14,000. | $2,670, plus 34% of excess over $12,000. |
| Over $14,000 but not over $16,000. | $3,350, plus 37% of excess over $14,000. |
| Over $16,000 but not over $18,000. | $4,090, plus 40% of excess over $16,000. |
| Over $18,000 but not over $20,000. | $4,890, plus 42% of excess over $18,000. |
| Over $20,000 but not over $22,000. | $5,730, plus 44% of excess over $20,000. |
| Over $22,000 but not over $26,000. | $6,610, plus 47% of excess over $22,000. |
| Over $26,000 but not over $32,000. | $8,490, plus 49% of excess over $26,000. |
| Over $32,000 but not over $38,000. | $11,430, plus 50% of excess over $32,000. |
| Over $38,000 but not over $44,000. | $14,430, plus 52% of excess over $38,000. |
| Over $44,000 but not over $50,000. | $17,550, plus 54% of excess over $44,000. |
| Over $50,000 but not over $60,000. | $20,790, plus 58% of excess over $50,000. |

| "If the taxable income is—Con. | The tax is—Continued |
|---|---|
| Over $60,000 but not over $80,000. | $26,590, plus 60% of excess over $60,000. |
| Over $80,000 but not over $100,000. | $38,590, plus 61% of excess over $80,000. |
| Over $100,000 but not over $120,000. | $50,790, plus 62% of excess over $100,000. |
| Over $120,000 but not over $150,000. | $63,190, plus 63% of excess over $120,000. |
| Over $150,000 but not over $200,000. | $82,090, plus 64% of excess over $150,000. |
| Over $200,000 | $114,090, plus 65% of excess over $200,000." |

1 (b) INTERMEDIATE TAX RATES.—Section 1 (b) (1)
2 is amended by inserting "and before January 1, 1971,"
3 after "December 31, 1964," each place it appears and by
4 adding at the end thereof the following new subparagraphs:
5 "(C) TAXABLE YEARS BEGINNING IN 1971.—
6 In the case of a taxable year beginning after Decem-
7 ber 31, 1970, and before January 1, 1972, there is
8 hereby imposed on the taxable income of every in-
9 dividual who is an intermediate tax rate individual
10 a tax determined in accordance with the following
11 table:

| "If the taxable income is: | The tax is: |
|---|---|
| Not over $1,000 | 13.5% of the taxable income. |
| Over $1,000 but not over $2,000 | $135, plus 15.5% of excess over $1,000. |
| Over $2,000 but not over $4,000 | $290, plus 17.5% of excess over $2,000. |
| Over $4,000 but not over $6,000 | $640, plus 19.5% of excess over $4,000. |
| Over $6,000 but not over $8,000 | $1,030, plus 21.5% of excess over $6,000. |
| Over $8,000 but not over $10,000 | $1,460, plus 24.5% of excess over $8,000. |

GP

| "If the taxable income is—Con. | The tax is—Continued |
|---|---|
| Over $10,000 but not over $12,000. | $1,950, plus 26.5% of excess over $10,000. |
| Over $12,000 but not over $14,000. | $2,480, plus 29.5% of excess over $12,000. |
| Over $14,000 but not over $16,000. | $3,070, plus 31% of excess over $14,000. |
| Over $16,000 but not over $18,000. | $3,690, plus 34% of excess over $16,000. |
| Over $18,000 but not over $20,000. | $4,370, plus 35.5% of excess over $18,000. |
| Over $20,000 but not over $22,000. | $5,080, plus 38.5% of excess over $20,000. |
| Over $22,000 but not over $24,000. | $5,850, plus 40% of excess over $22,000. |
| Over $24,000 but not over $26,000. | $6,650, plus 42% of excess over $24,000. |
| Over $26,000 but not over $28,000. | $7,490, plus 43% of excess over $26,000. |
| Over $28,000 but not over $32,000. | $8,350, plus 44% of excess over $28,000. |
| Over $32,000 but not over $36,000. | $10,110, plus 46.5% of excess over $32,000. |
| Over $36,000 but not over $38,000. | $11,970, plus 48% of excess over $36,000. |
| Over $38,000 but not over $40,000. | $12,930, plus 49.5% of excess over $38,000. |
| Over $40,000 but not over $44,000. | $13,920, plus 50.5% of excess over $40,000. |
| Over $44,000 but not over $50,000. | $15,940, plus 52.5% of excess over $44,000. |
| Over $50,000 but not over $52,000. | $19,090, plus 54.5% of excess over $50,000. |
| Over $52,000 but not over $60,000. | $20,180, plus 55.5% of excess over $52,000. |
| Over $60,000 but not over $64,000. | $24,620, plus 56.5% of excess over $60,000. |
| Over $64,000 but not over $76,000. | $26,880, plus 57.5% of excess over $64,000. |
| Over $76,000 but not over $80,000. | $33,780, plus 59% of excess over $76,000. |
| Over $80,000 but not over $88,000. | $36,140, plus 60% of excess over $80,000. |
| Over $88,000 but not over $100,000. | $40,940, plus 61% of excess over $88,000. |
| Over $100,000 but not over $120,000. | $48,260, plus 63% of excess over $100,000. |
| Over $120,000 but not over $140,000. | $60,860, plus 64% of excess over $120,000. |
| Over $140,000 but not over $160,000. | $73,660, plus 65% of excess over $140,000. |

| "If the taxable income is—Con. | The tax is—Continued |
|---|---|
| Over $160,000 but not over $200,000. | $86,660, plus 66% of excess over $160,000. |
| Over $200,000 but not over $240,000. | $113,060, plus 66.5% of excess over $200,000. |
| Over $240,000 but not over $300,000. | $139,660, plus 67% of excess over $240,000. |
| Over $300,000 | $179,860, plus 67.5% of excess over $300,000. |

1 "(D) TAXABLE YEARS BEGINNING AFTER
2 1971.—In the case of a taxable year beginning after
3 December 31, 1971, there is hereby imposed on the
4 taxable income of every individual who is an inter-
5 mediate tax rate individual a tax determined in
6 accordance with the following table:

| "If the taxable income is: | The tax is: |
|---|---|
| Not over $1,000 | 13% of the taxable income. |
| Over $1,000 but not over $2,000 | $130, plus 15% of excess over $1,000. |
| Over $2,000 but not over $4,000 | $280, plus 17% of excess over $2,000. |
| Over $4,000 but not over $6,000 | $620, plus 19% of excess over $4,000. |
| Over $6,000 but not over $8,000 | $1,000, plus 21% of excess over $6,000. |
| Over $8,000 but not over $10,000. | $1,420, plus 24% of excess over $8,000. |
| Over $10,000 but not over $12,000. | $1,900, plus 26% of excess over $10,000. |
| Over $12,000 but not over $14,000. | $2,420, plus 28% of excess over $12,000. |
| Over $14,000 but not over $16,000. | $2,980, plus 30% of excess over $14,000. |
| Over $16,000 but not over $18,000. | $3,580, plus 33% of excess over $16,000. |
| Over $18,000 but not over $20,000. | $4,240, plus 35% of excess over $18,000. |
| Over $20,000 but not over $22,000. | $4,940, plus 37% of excess over $20,000. |
| Over $22,000 but not over $24,000. | $5,680, plus 39% of excess over $22,000. |

| "If the taxable income is—Con. | The tax is—Continued |
|---|---|
| Over $24,000 but not over $26,000. | $6,460, plus 40% of excess over $24,000. |
| Over $26,000 but not over $28,000. | $7,260, plus 41% of excess over $26,000. |
| Over $28,000 but not over $32,000. | $8,080, plus 43% of excess over $28,000. |
| Over $32,000 but not over $36,000. | $9,800, plus 45% of excess over $32,000. |
| Over $36,000 but not over $38,000. | $11,600, plus 46% of excess over $36,000. |
| Over $38,000 but not over $40,000. | $12,520, plus 47% of excess over $38,000. |
| Over $40, 000 but not over $44,000. | $13,460, plus 48% of excess over $40,000. |
| Over $44,000 but not over $50,000. | $15,380, plus 51% of excess over $44,000. |
| Over $50,000 but not over $60,000. | $18,440, plus 53% of excess over $50,000. |
| Over $60,000 but not over $80,000. | $23,740, plus 55% of excess over $60,000. |
| Over $80,000 but not over $100,000. | $34,740, plus 57% of excess over $80,000. |
| Over $100,000 but not over $120,000. | $46,140, plus 60% of excess over $100,000. |
| Over $120,000 but not over $160,000. | $58,140, plus 62% of excess over $120,000. |
| Over $160,000 but not over $200,000. | $82,940, plus 63% of excess over $160,000. |
| Over $200,000 but not over $300,000. | $108,140, plus 64% of excess over $200,000. |
| Over $300,000 | $172,140, plus 65% of excess over $300,000." |

(c) OPTIONAL TAX TABLES.—Section 3 (b) (relating to optional tax), is amended—

(1) by inserting in the heading before the period the following: "And Before January 1, 1970";

(2) by inserting in the text "and before January 1, 1970," after "beginning after December 31, 1964,";

(3) by inserting after "After December 31, 1964" each place it appears in the tables the following: "And Before January 1, 1970"; and

1 (4) by adding at the end thereof the following new
2 subsection:
3 "(c) TAXABLE YEARS BEGINNING AFTER DECEMBER
4 31, 1969.—In lieu of the tax imposed by section 1, there is
5 hereby imposed for each taxable year beginning after Decem-
6 ber 31, 1969, on the taxable income of every individual
7 whose adjusted gross income for such year is less than
8 $5,000 ($6,100 for the calendar year 1970) and who has
9 elected for such year to pay the tax imposed by this section,
10 a tax determined under tables, applicable to such taxable
11 year, which shall be prescribed by the Secretary or his
12 delegate. The tables so prescribed shall be the same as the
13 tables contained in this subsection as in effect before August 1,
14 1969, except the amounts and rates of tax shall be computed
15 on the basis of the taxable income computed by taking the
16 standard deduction and on the basis of the rates prescribed
17 by section 1."
18 (d) TAX NOT COMPUTED BY TAXPAYER.—
19 (1) The first sentence of section 6014(a) (relat-
20 ing to election by taxpayer) is amended by striking out
21 "gross income is less than $5,000" and inserting in lieu
22 thereof "adjusted gross income and". The last sentence
23 of section 6014(a) is repealed.
24 (2) Section 6014(b) (relating to regulations) is
25 amended—

1 (A) by inserting after the first sentence the
2 following: "Such regulations may provide that the
3 credit provided for by section 37 (relating to re-
4 tirement income) shall be allowed in determining
5 the amount payable and that the Secretary or his
6 delegate shall compute the tax with regard to a
7 taxpayer's status as an intermediate tax rate indi-
8 vidual (as defined in section 1 (b)) or as a sur-
9 viving spouse (as defined in section 2 (b)) electing
10 the benefits of subsection (a).", and
11 (B) by adding at the end thereof the following
12 new sentence: "The Secretary or his delegate is
13 authorized to extend (under regulations) any elec-
14 tion made under subsection (a) to any taxpayer
15 regardless of the limitations provided by subsec-
16 tion (a)."
17 (3) The amendments made by this subsection shall
18 apply to taxable years beginning after December 31,
19 1969.
20 **SEC. 805. COLLECTION OF INCOME TAX AT SOURCE ON**
21 **WAGES.**
22 (a) REQUIREMENT OF WITHHOLDING.—The first sen-
23 tence of section 3402 (a) (relating to requirement of with-
24 holding) is amended by striking out "in accordance with the

1 following tables." and inserting in lieu thereof "in accord-
2 ance with tables prescribed by the Secretary or his delegate.
3 The tables so prescribed shall be the same as the tables con-
4 tained in this subsection as in effect before August 1, 1969,
5 except the amounts set forth as amounts of wages and
6 amounts of income tax to be withheld shall be computed on
7 the basis of the rates prescribed by section 1." The second
8 sentence of such section is amended by striking out "as
9 shown in the table in subsection (b) (1)" and inserting in
10 lieu thereof "as shown in the table prescribed by the Secre-
11 tary or his delegate pursuant to subsection (b) (1)".
12 (b) PERCENTAGE METHOD OF WITHHOLDING.—Para-
13 graph (1) of section 3402(b) (relating to percentage
14 method of withholding) is amended to read as follows:
15 "(1) The table referred to in subsection (a) shall
16 be prescribed by the Secretary or his delegate on the
17 basis of the amount of one withholding exemption being
18 $600."
19 (c) WAGE BRACKET WITHHOLDING.—Section 3402
20 (c) (relating to wage bracket withholding) is amended—
21 (1) by striking out paragraph (1) and inserting in
22 lieu thereof the following:
23 "(1) WAGE BRACKET WITHHOLDING.—At the elec-
24 tion of the employer with respect to any employee, the

1 employer shall deduct and withhold upon the wages paid
2 to such employee a tax (in lieu of the tax required to
3 be deducted and withheld under subsection (a)) de-
4 termined in accordance with tables prescribed by the
5 Secretary or his delegate. The tables so prescribed shall
6 be the same as the tables contained in this subsection as
7 in effect before August 1, 1969, except the amounts set
8 forth as amounts and rates of tax to be deducted and
9 withheld shall be computed on the basis of the rates of
10 tax prescribed by section 1 (a) and the additional low
11 income allowance."
12 (d) EFFECTIVE DATE.—The amendments made by this
13 section shall apply with respect to wages paid after Decem-
14 ber 31, 1969.

Passed the House of Representatives August 7, 1969.

Attest: W. PAT JENNINGS,

*Clerk.*

The CHAIRMAN. Our first witness at these hearings is the Honorable David M. Kennedy, the distinguished Secretary of the Treasury.

Mr. Secretary, we are pleased to have you here with us. I would suggest that you proceed and I would hope that we can have the Senators limit themselves to 10 minutes on interrogation on the first instance when we ask questions. After that why we will perhaps have a little more lenient rule.

## STATEMENT OF HON. DAVID M. KENNEDY, SECRETARY OF THE TREASURY; ACCOMPANIED BY CHARLS E. WALKER, UNDER SECRETARY OF THE TREASURY; EDWIN S. COHEN, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY; AND JOHN S. NOLAN, DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY

Secretary KENNEDY. Very good, Mr. Chairman.

Mr. Chairman and members of the committee: The Tax Reform Act of 1969 is a milestone in tax legislation. The administration strongly urges its enactment at the earliest practicable date.

### ADMINISTRATION RECOMMENDATIONS FOR IMPROVING H.R. 13270

While we endorse its enactment, we believe that the bill should be improved in a number of respects. Broadly, these are—

The long-run revenue loss in the bill of approximately $2.4 billion should be scaled down by about half;

The balance of tax shifts in the bill—a $7.3 billion reduction for individuals and a $4.9 billion increase for corporations—should be redressed by including a two-point reduction in the corporate tax rate;

A number of structural changes in the bill should be modified, some because they go too far, others because they do not go far enough.

Let us make no mistake about the nature of the legislation approved by the House of Representatives. H.R. 13270 is not only the most sweeping tax reform measure in the history of the Internal Revenue Code. It also embodies a significant amount of tax reduction. Reduction of this type and amount at this time can be questioned on three grounds.

### CONCERN OVER PROSPECTIVE REVENUE LOSSES

First, action now to reduce the national tax burden by a net $2.4 billion annually would represent a significant decision with respect to national priorities. Interim revenue losses, before all the revenue-raising measures take effect, are even greater. To the extent future revenues are today committed for such reduction, they cannot be used to support important Government programs. (It should be noted that the $2.4 billion projected revenue loss is expressed in terms of today's income levels. With incomes expected to rise significantly in the next decade, the revenue loss would be much higher.)

The administration's concern over the proposed cuts in individual taxes does not mean that we attach a low priority to this goal. But tax

reduction cannot be carried out without due consideration for other national needs. The extent to which we can responsibly curtail our defense outlays has to be determined by future events, many of which are beyond our control. Domestically, the Congress has enacted programs which call for increased spending in future years. This administration is committed to renovation of national welfare programs and to an imaginative program of revenue sharing with State and local governments. Proposals also will be forthcoming to promote additional hiring and training of the hard-core unemployed and to foster investment in poverty areas.

The Nation is committed to the goal of adequate housing for all of its citizens. Recent studies demonstrate that Federal surpluses, which would bring down interest rates and stimulate the flow of funds into mortgages, may well be the best way in which to promote such housing.

Even though this administration is determined to pursue a prudent spending policy, we simply do not know enough about the future to commit ourselves today to the degree of tax reduction embodied in H.R. 13270. In our suggested changes, we have not attempted to attain a precise balancing of estimated increases and decreases over the period. Indeed, revenue estimating is far too imperfect a science for that purpose. However, we urgently recommend that you reduce the expected shortfall in H.R. 13270 by approximately half, to $1.3 billion.

IS THE BILL EQUITABLE?

The second major question concerning the tax reduction in H.R. 13270 is whether it is equitable. The largest cuts are appropriately centered in the lowest brackets. But, in too many instances, certain taxpayers are given reductions much higher than others in comparable economic circumstances.

Our recommendations would reduce these inequities by:

Restoring the "phaseout" in the proposed low-income allowance, but at a rate of $1 tax for $4 income as contrasted with the $1 to $2 curve in President Nixon's original proposal as submitted in April of this year. This still would remove 5 million taxpayers, including almost all of those at the poverty level, from the Federal tax rolls.

Raising the present standard deduction of 10 percent with a $1,000 ceiling to 12 percent with a $1,400 ceiling, instead of 15 percent with a $2,000 ceiling, as in the House bill.

Liberalizing taxation of single persons as compared to married couples through a new rate schedule rather than allowing head-of-household status to those single persons over 35.

BIAS AGAINST INVESTMENT

The third shortcoming of H.R. 13270 is that it is weighted in favor of consumption to the potential detriment of the Nation's productive investment. To be sure, President Nixon recommended on April 21 the repeal of the 7 percent investment tax credit. Such repeal represents over half of the $4.0 billion increase in corporate taxes in the bill. While the administration's position on repeal of the investment

tax credit is unchanged, we are concerned about the bias in the bill against investment in favor of consumption. Such overweighting, embodied in the proposed treatment of capital gains as well as corporate tax increases, could impede economic growth in the years ahead by curtailing the incentive to make productive investments.

To help guard against this drag on growth, the administration is strongly urging, recommending that the tax rate on corporate profit be reduced by one point in calendar year 1971 and an additional point in 1972. This would reduce corporate taxes by an estimated $800 million in 1971 and $1.6 billion by 1972 (in terms of today's profit levels), thereby reducing the net increase in corporate taxes in H.R. 13270 from $4.9 billion to $3.5 billion (after other recommended adjustments). This change in the bill would not be unfair to individuals. Their tax relief, concentrated in the lower brackets, would still amount to a gross amount of $7.3 billion and a net figure of $4.8 billion.

Although no one can forecast perfectly the trend of the economy over the next 2 years, the administration's current timetable in its anti-inflationary program would allow for growth-inducing corporate tax reduction in 1971 and 1972. If not, the situation with respect to the entire program of tax relief in H.R. 13270, individual as well as corporate, will have to be reevaluated in the light of then existing conditions.

Investment in the years ahead may also be impeded by the proposed changes in tax treatment of capital gains. We believe these changes go too far. Our original proposals were designed to prevent excesses rather than fundamentally alter such tax treatment. Accordingly, we recommend retention of the 6-month holding period, as contrasted with the extension to 1 year in H.R. 13270. In addition, we favor retention of the maximum 25-percent rate on capital gains, except in cases of very large gains relative to ordinary income. In these instances, which would affect a relatively small number of individuals, the rate could rise as high as 32½ percent, or to half the new top bracket rate of 65 percent.

### CAPITAL GAINS TAXATION

Our recommendations concerning capital gains taxation and other provisions of H.R. 13270 are outlined in detail in Assistant Secretary Cohen's statement, which has been submitted to the committee. Before responding to questions, I would like to summarize several of these recommendations, and while Secretary Cohen will not read his statement but will answer questions or go over areas of it for you I think it would be well to cover just a few of the items.

### PETROLEUM TAXATION

First, petroleum taxation. In its tax proposals of April 22, the administration made no recommendation for change in percentage depletion as it affects the petroleum industry, except to include such depletion in the limit on tax preferences (LTP) and the allocation of deductions rule (ADR). We recommend that intangible drilling costs that would otherwise be capitalized also be included in the

LTP and ADR. Further, we proposed that certain sales of production payments be treated as loans to avoid manipulation of income and losses in mineral transactions.

The House of Representatives accepted our proposals relating to production payments. It included percentage depletion and intangible drilling costs in the allocation of deductions but dropped them from the limit on tax preferences. The House action also disallowed percentage depletion on foreign operations and reduced depletion on domestic operations from 27½ to 20 percent.

Although the administration did not recommend a cut in domestic percentage depletion, we accept the House approach to increasing the share of the national tax burden borne by the petroleum industry. But this cut in domestic depletion will not close the loophole which permits a wealthy oilman to pay little or no Federal income tax. To do so, we recommend that the Senate restore percentage depletion to the LTP. However, intangible drilling costs, included originally in the administration's LTP proposal, should be restored to the LTP only for investors and not for those individuals who receive 60 percent or more of their income from oil and gas operations.

On oil and gas we recognize that it is in the national interest that certain tax provisions be used as incentives for discovering new reserves. Accordingly, in our judgment, provisions in the form suggested will apply more reasonably to persons whose principal business is the discovery of new oil and gas deposits and to whom intangible drilling costs are more in the nature of an annual expense. They should avoid creating any serious disincentive to drilling. However, even in this form the limit on tax preferences should insure that substantially all taxpayers, including those in the oil business, will pay some reasonable amount of tax each year. Given the reduction in incentive resulting from the House passed cut in depletion to 20 percent, we strongly urge that the tax treatment of intangibles not be altered with respect to those persons whose principal business is the discovery of new oil and gas deposits.

## FINANCIAL INSTITUTIONS

On financial institutions: The administration does not object to the provisions of the bill which would base bad debt losses of commerical banks, mutual savings banks, and savings and loan associations on actual experience—subject to a 10-year carryback and 5-year carry forward for net operating losses. But we are concerned about the continued heavy reliance on investment restrictions to promote a flow of money into residential construction. Such restrictions limit the ability of the thrift institutions to compete for savings during periods of tight money. They also fail to recognize other important national goals.

We therefore recommend a special tax deduction for each of these three institutions, designed to encourage the flow of credit not only into residential construction, but also into other socially preferred uses, such as guaranteed loans to college students and loans guaranteed by the Small Business Administration. At the outset, this deduction could consist of 5 percent of gross interest income from such

loans. However, the deduction could not serve in any year to reduce the taxable income of any such institution to an amount less than 60 percent of taxable income, adjusted to include the full amount of dividend income and tax-exempt interest in the institution.

The result of these provisions would be to create tax equity among these competing institutions, enhance their competitive ability relative to other outlets for savings, and encourage the flow of money into uses determined by the Congress to be socially preferable.

### 5 ADDITIONAL ADMINISTRATION RECOMMENDATIONS

Other provisions: Five other administration recommendations should be noted:

H.R. 13270 goes to far in taxing foundations. We recommend that the proposed 7½ percent tax on income be replaced by a 2 percent "supervisory tax," which would raise sufficient funds for an adequate audit program in the Internal Revenue Service.

In order to make certain that the bill does not unduly restrict donations of property to charities, colleges, and other tax-exempt activities, we recommend deletion of the provision which would include appreciation on such property in the limit on tax preferences and the allocation of deductions.

The personal deduction allowed for State gasoline taxes should be repealed. Inasmuch as the State tax is, like the Federal tax, essentially a user charge, the existing deduction in effect shifts the burden of those taxpayers who itemize to the general taxpayer. Repeal would raise the average tax on those who itemize by only about 10 to 15 dollars.

The House bill goes beyond the administration's recommendations and includes interest on State and local bonds in the LTP. The administration opposes this inclusion for the same reasons we gave on April 22—there are constitutional doubts as to inclusion as well as the possibility of adverse repercussions in the market for State and local securities. However, we recommend as we did in April that the full amount of tax-exempt interest be included in the allocation of deductions rule, without the 10-year phase-in contained in the House bill.

To simplify compliance by millions of low-income individuals, persons not subject to tax under the new higher levels resulting from the low income allowance should not be required to file returns.

### A MILESTONE IN TAX LEGISLATION

Mr. Chairman, I repeat that the bill before you is a milestone in tax legislation. Almost all of the 16 substantive tax proposals which President Nixon submitted to the Congress in April, including the limit on tax preferences and the low income allowance, are included in the bill. The House Ways and Means Committee, as a result of its exhaustive hearings, added a number of constructive measures to those proposed by the administration. The resulting legislation was overwhelmingly approved by the House of Representatives.

Now it is up to the Senate. I am confident that this committee will proceed with the same determination shown in the House and that we

can look forward to final enactment of H.R. 13270, appropriately modified, before the end of 1969.

In the words of President Nixon, such enactment will represent a long step toward making taxation, if not popular, at least fair for all of our citizens.

That concludes my statement, Mr. Chairman. We would be glad to respond to questions.

The CHAIRMAN. Mr. Secretary, there are a lot of things you are recommending here and have recommended with which I agree. I think we are probably in agreement more than we are in disagreement. On my first turn that I am only asking about things about which we have some disagreement. I will come back to those I agree with you about later on. It is too bad sometimes you have to get your differences first but I think we will begin to lay them out on the record.

DEMOCRATIC PLATFORM COMMITTEE RECOMMENDATIONS

My own impression is that this is a bill that fulfills the Democratic platform, not the Republican platform. I know about the Democratic Party platform because as chairman of this committee I went before our platform committee and testified what I thought our tax policies should be. Generally speaking, it was that some people make a lot of money and pay virtually no taxes. Other people pay a lot of taxes when they make a lot of money, middle-income taxpayers and others, who for one reason or the other have a right to expect some adjustment in their tax burden. I think this minimum-maximum tax concept was mine before it was yours and it was mine before it was Treasury's under a previous administration. Hale Boggs, my colleague, was chairman of that platform committee and I think I was the principal witness for what that platform committee came out with in that regard.

Now, I notice in your testimony, and I tend to agree with most of what you have here, that you have advocated some relief for certain aspects of the House bill for nearly every affected group of taxpayers, with one notable exception, the natural resources industry, and in particular the oil and gas segment of that industry.

RETURN ON OIL AND GAS INVESTMENTS

On an overall basis you recommend much harsher treatment for this segment than the House bill recommends. From this I conclude that you believe that incentives for oil and gas exploration are excessive and that they should be reduced. Now, I would like to ask this: Is it not true that the return on investment of oil and gas companies is at present slightly lower than that for the average of manufacturing companies as a whole?

Secretary KENNEDY. I think, if you look at the figures that would be generally true. There are variations in that. It depends on what class—if you use the total I think it is true.

The CHAIRMAN. I put some of these studies made by bankers in the record. You are a banker and if you come to some of these people to ask them to pay a loan off that is what you would look at.

Secretary KENNEDY. With respect to the political aspects of this,

Senator, about it being Democratic, I have made the comment many times, and I feel in the matter of taxation it is neither Democrat or Republican, it is for the people of the United States, and this should be a people's tax bill; it has bipartisan support and should have bipartisan support so that we can come out with a bill in the end, after your changes, that will meet the needs.

The CHAIRMAN. We want to do what is right even if we have to rise above politics. [Laughter.]

OIL AND GAS RESERVES SHRINKING

Now, with regard to this industry: Is it not true that oil and gas reserves have been shrinking as compared to the demands?

Secretary KENNEDY. Domestic reserves have not been increasing in recent years, yes. Many of the explorations have been in foreign fields.

The CHAIRMAN. Reserves are not increasing, that is especially in relation to the demands for the product.

Secretary KENNEDY. That is right.

HIGH-RISK INDUSTRY

The CHAIRMAN. Is it not true that the oil and gas industry is a relatively high-risk industry?

Secretary KENNEDY. Assistant Secretary Cohen mentioned one exception to this last answer I gave, the discovery in Alaska that changes it to some extent, but up to that point the reserves were not increasing.

The CHAIRMAN. Well, I think you will find if you are looking at the increase in demand that even that Alaskan discovery doesn't really offset that. The increased demand——

Secretary KENNEDY. The objective being determined in total.

The CHAIRMAN. Yes.

Is this not a relatively high-risk industry?

Secretary KENNEDY. Yes, it is.

The CHAIRMAN. Is it not true that the industry is capital-intensive and that there is a deficiency of available capital within that industry?

Secretary KENNEDY. I am not sure that there is a deficiency of capital in the industry. It is a capital-intensive industry without any doubt.

The CHAIRMAN. I think it might be worth looking into it to see if——

Secretary KENNEDY. I think the answer would be, no, there is adequate capital in the oil industry. They have been able to float issues and stock and so on and they have been able to borrow money without any problems, at least the majors.

Now, the smaller operators there might be a——

Senator FULBRIGHT. Mr. Chairman, could the witness speak a little louder, please? There is something about the acoustics——

The CHAIRMAN. I can hear the witness but maybe the acoustics are bad over there.

Secretary KENNEDY. I will speak more in the mike.

The CHAIRMAN. My point is that in view of these facts how can you conclude that the present incentives are excessive?

Secretary KENNEDY. I don't think we are concluding that the incentives are excessive. I think we are concluding that there is and will be an incentive sufficient to carry the needs of the industry with this kind of tax and I think that it does place a fairer share of the burden of Federal taxation on this industry as such.

We did, however, in the recommendations we made, as you know, make a change on intangible drilling costs for those of the oil industry who do the very thing you are talking about, exploration.

The CHAIRMAN. I don't think they are getting any more than they had before, do they? They get less. You just don't trim it down to what somebody else might want.

Secretary KENNEDY. That is right. We don't give them an advantage.

The CHAIRMAN. I think they would be worse off than they were before.

Now the Treasury is recommending several proposals for making this bill even more burdensome on that industry than others.

Let's just take a look at what those parts will be.

### ANTI-OIL BILL?

Here is one. The House is recommending concurrently a cut in domestic percentage depletion to 20 percent from 27½ and repeal of the foreign depletion on oil and gas. (2) Including intangibles and percentage depletion in the limited tax preference. (3) Inclusion of intangibles and percentage depletion in allocation of deductions. (4) Elimination of carved out and production payments. (5) Elimination of investment tax credit. (6) Recapture of intangible drilling costs, ordinary income on the sale of mineral property. (7) Recapture of foreign losses under per country foreign tax credit limitation. (8) Limitations of foreign tax credit attributable to foreign mineral production. (9) Denial of a deduction for State gasoline taxes.

How do you justify this as being anything other than an extremely anti-oil bill?

Secretary KENNEDY. Well, I wouldn't indicate that this was an extremely anti-oil bill. It does, as you indicate, impose a tax that they have not had, but in total amount, and in relation to their resources and earnings it looks like a fair-share burden to us.

The CHAIRMAN. Well, they are making less on investments than the average for all manufacturing. If you look at all the taxes they are paying rather than just the Federal income tax they are paying a lot more than for all manufacturing, and then while I said myself with regard to capital gains I know we should have some moderation there, I know we should do something about capital gains but I find some reluctance to go along with the House bill. It hits capital gains in five different directions all in one bill, and here in this bill is if we accept your recommendations we will be hitting the oil industry in nine different directions all in one bill. It would seem to me that is very burdensome.

I know you say you want to do what is best for the country. I think both major parties do. Here is what the Republican Party platform said about this. In its party platform it said that "present economic incentives, including depletion allowances to encourage discovery o vital minerals and fuels, must be continued."

Now, would not your presentation, attacking this industry in nine different ways be a complete breach of that platform commitment?

Secretary KENNEDY. No, I don't think it would, Senator. I think there would still be an incentive. Their earnings are such that they would want to make exploration. It does, no question about it, it does tax them and it does take away some of the incentive, right?

The CHAIRMAN. Well, they are making less than the average of manufacturing now, other industries are making more. If you want to find something to invest your money in the average in manufacturing industries is more encouraging. And when you take a look and see what would happen here after you are increasing their tax burden in nine different ways how could that do anything more than make it less attractive for someone to invest their money?

Secretary KENNEDY. It will have a dampening effect. Although the depletion allowance when you reduce it from 27½ to 20, it is still 20 percent and that could be varied, but it is a depletion allowance.

The CHAIRMAN. Well, I won't go any further, Mr. Secretary. I think I probably have used my time up. I will yield to Senator Anderson. I will have questions on other matters later.

Senator Anderson?

### LIFE MAGAZINE ARTICLE ON INFLATION

Senator ANDERSON. In one of the magazines printed awhile back there was a statement showing that a person making $18,000 in 1959, and whose salary has been increased by 50 percent by 1969 came out financially exactly the same. Is there any desire to hold to this, or will you provide some relief for the middle classes? Did you see this article?

Secretary KENNEDY. I haven't noticed the article.

Senator ANDERSON. Life magazine is responsible for it.

Secretary KENNEDY. Dr. Walker says he saw it.

Dr. WALKER. I didn't quite catch the question, Senator. I saw the article, yes. It was a very revealing indication of what inflation has done.

Senator ANDERSON. Wasn't it discouraging to people of the middle-income brackets?

Dr. WALKER. It was discouraging to people in all brackets when you look through and see how much this rapid inflation has eaten into what people thought were rising real incomes and that is why we think we have got to have a firm anti-inflationary program in place.

### CAPITAL GAINS

Senator ANDERSON. What are you recommending about capital gains?

Secretary KENNEDY. On the capital gains, Senator, we are recommending a continuation of the 6-month holding period, no change there, and also the 25 percent except those that have capital gains of a high amount and that is their principal income, and then it would go up to 32½ percent as in the House bill.

Senator ANDERSON. Would a person be affected if the bill changes the capital gains holding period?

Secretary KENNEDY. We felt it was necessary in this case to change the mix in this bill to some extent from a complete taxing of the

corporations and discouragement of investments and that sort of thing by the two means, one, of the corporate rate reduction that I mentioned, and also the capital gains provisions which would encourage, or look at it the other way, would discourage investment. And we felt this was a reasonable change.

FOUNDATIONS

Secretary ANDERSON. Are you still pretty favorable to foundations?

Secretary KENNEDY. On the foundations, Senator, we felt that the tax of the 7½ percent imposed in the bill was not warranted because the money is given to charity, education, and various other fields, and if there are abuses, things that have developed in the foundation area, they should be handled administratively. Internal Revenue has stepped up its program, and it will cost considerably more to audit foundations and take care of this, so that we thought a 2 percent, which you can call a fee or a service tax of some kind, would be reasonable, not too burdensome, and it would take care of the administrative costs of working with the foundations.

Senator ANDERSON. You are trying to help the foundations.

Secretary KENNEDY. Yes, I think the foundations have served a very useful purpose in our country. The private foundations have stimulated education and various other fields and should be encouraged but they should be, of course, regulated to see that if they are going to have tax exemption, they have the actions and policies that would conform to that kind of an exemption. And I think that the bill as we would recommend the change will do that.

Senator ANDERSON. I have no further questions.

The CHAIRMAN. Thank you.

Senator Williams?

DEPLETION ALLOWANCES

Senator WILLIAMS. Mr. Secretary, first, I want to congratulate you in behalf of the administration for a long overdue recognition of the need of a reduction in the depletion allowances. I have been for it 20 years and, as a member of this committee for 20 years, I have been waiting for some administration to endorse this and I want to congratulate you on that step. I think you are doing right.

I noticed you mentioned a reduction in oil specifically. Do I understand your endorsement also goes to the other changes in depletion rates in the various other minerals in the House bill?

Secretary KENNEDY. Yes, it does.

Senator WILLIAMS. That was my understanding, too.

LTD AND OIL EXPLORATION

I notice that you also suggest that a change be made in limited tax preferences for oil for investors only, but not those who are in exploration. Why the separation?

Secretary KENNEDY. I will give you an explanation and then I think I will turn the microphone over to Mr. Cohen.

My explanation to that is the doctor, the dentist, the outside investor, he has choices all up and down the line for investment, and he can use these preferences not only singly but in combination and for that reason there should be an inclusion in his case.

In the case of those who are in the oil business, that is their business, and we want to encourage exploration, not discourage it, and there is risk, as Senator Long indicated in this field, and they should be rewarded for the risk. It seems to me that that is a good explanation but maybe Mr. Cohen would have a more detailed one.

Mr. COHEN. If I may amplify that briefly, Senator: We suggested a limit on tax preferences as a means of providing an overall limit on the extent to which a person could reduce his income by using the provisions that were intended as incentives in the law; and with respect to an investor we wanted this provision to operate in even-handed fashion so that it would not prefer real estate investment over oil or over farm investment under the favorable methods of accounting given there.

So with respect to the investor we returned to our original recommendation in April to the Ways and Means Committee that both depletion and intangibles be included in the overall limit on tax preferences.

We had recommended that treatment in April for all persons, not only the investor but also those who are engaged principally in oil and gas exploration. The House bill deletes both depletion and intangibles from the limit on tax preferences.

On reconsidering our position, while we would recommend that both be restored in accordance with our original proposal for the investor, we feel that depletion alone should be restored with respect to the person who is principally engaged in the oil exploration business because in his case he, being active in the business, may appropriately regard intangible drilling expenses as a part of his business operations. There is not in the case of the oil and gas operator the problem of making sure that the provision is consistent with real estate, farm losses, and other matters.

We felt also that this provision, while it would protect the Treasury and would make sure that we collected a reasonable tax, would not create the disincentive which I do think our April proposal did create in the oil and gas business.

Senator WILLIAMS. Do I understand under your proposal that in each instance there would be some tax collected in all cases?

Mr. COHEN. Yes.

In all cases depletion would be treated as a preference in accordance with our original proposal.

Senator WILLIAMS. Now, I noticed in your statement, Mr. Secretary, that you speak of the shortfall of H.R. 13270 by—you want to reduce it to approximately one-half, about $1.3 billion.

LOW INCOME ALLOWANCE

Now, as I understand it, the House committee originally got rid of the phaseout of the low income allowances and you recommended a standard deduction. It is my understanding that you supported that

at the time. Then they decreased the rates in the $7,000 to $20,000 class and it was also my understanding you were in favor of that rate decrease, and today, as I understand it, you are recommending the rate cut and not the other changes in full. And I just wondered what were the changes that represents?

Secretary KENNEDY. I think your statement that we favored that was not quite accurate, Senator. We acted as technical advisers at that point. Our proposal on the low income allowance was a gradual phaseout, $1 for $2, and I think in the House, when they added up the revenue they were getting from the bill they decided not to phase it out that way but carry it forward, which used considerably more money. In reappraising, instead of coming back to our April position of $1 to $2 phaseout, we came somewhat between and recommend it on the basis of $1 for $4 phaseout. I think in the other cases, too, we were acting as technical advisers. Do you want to comment on that?

Mr. COHEN. Senator, when the Ways and Means Committee first reported out the bill, the reductions in the low income brackets were primarily with respect to the extended low income allowance and the standard deduction, and the reductions in the upper income brackets were made by way of rate reduction.

By a committee amendment made after the bill had been reported, the rate reductions were extended all the way down to the bottom, to the lowest rate, and this led to the result that those who file standard deduction returns would get a benefit from a very extensive increase in the standard deduction and would also get the benefit of the rate reduction, whereas those who itemize deductions would get only the benefit of a rate reduction. We thought as between the two groups, itemizers and those taking a standard deduction, that the bill gave double benefits to those who with the standard deduction, and we had a choice as to whether we would recommend to you retaining the large standard deduction increases in the lower brackets or retaining the rate reduction. We concluded as between the two choices that the rate reduction is a more even handed relief all up and down the scale and, hence, we have suggested to you the cutback on the standard deduction. It still would involve an increase in the standard deduction over the present law, raising it from 10 percent with $1,000 ceiling to 12 percent with a $1,400 ceiling.

CAPITAL GAINS HOLDING PERIOD FOR LIVESTOCK

Senator WILLIAMS. My time is running out. Just one other question: I notice that you recommend a change back from the House bill on the capital gains holding period from the 12 months proposed by the House to the original 6 months as embraced in the law.

Now, under existing law, and this question relates to dealing with farm losses primarily, livestock, as you know, are subject to capital gains if they are held 6 months in certain cases. Does your recommending to extending the 6 months period back for livestock and for sale of timber that is purchased on Government land as well as all other types?

Secretary KENNEDY. The answer, I think, to that is yes. But I am not sure on the timber.

Mr. COHEN. Senator, it is my understanding under existing law that the holding period for livestock is 1 year—is 12 months, whereas for securities and real estate it is 6 months.

Senator WILLIAMS. That is correct, but I was wondering if you were recommending a change for that to 6 months, too, as well.

Mr. COHEN. Well, the bill will change the holding period for livestock so that it would be required that the taxpayer hold it for 1 year after the livestock is normally put in service, and we would be willing, consistent with our recommendation, to reduce the 12 months holding period in the case of livestock to 6 months after the animal is normally placed in service—not 6 months after it is born but 6 months after it is normally placed in service.

Senator WILLIAMS. In other words, you are recommending changing the 12 months holding period in existing law to 6 months under the definition of the House bill?

Mr. COHEN. Under the definition in the House bill, which will, however, you will understand, because of a different starting period, actually have the effect of extending the time that the livestock has to be held.

Senator WILLIAMS. It would if the same man owned it throughout the period.

Mr. COHEN. Yes.

Well, if he bought the livestock, we have a recapture provision so that if he has taken depreciation on the animal and then has sold it, having gotten an ordinary income deduction for the depreciation, if he recoups that depreciation on the sale of the livestock he would not get capital gain until he had made good the ordinary deduction from the depreciation.

CAPITAL GAINS TREATMENT OF TIMBER

Senator WILLIAMS. And on timber sales, even timber contracts, on timber purchased on Government land, Government timber you are recommending that that be changed back from the House bill, from 12 months to 6 months, is that correct?

Mr. COHEN. Yes.

If that decision is made, I think we ought to restore it to the provision in existing law. Now, the House bill extended it to 12 months. It extended it to 12 months from the date of the contract, whereas under existing law, as I recall it, it is 6 months from the start of the year, and I think if we are going to make one change we ought to change it back to the existing law.

Senator WILLIAMS. My time is up and I will pursue this further, but there has been a question in the minds of some of us as to the validity of the proposal for capital gains treatment on timber being sold on Government land and also capital gains for livestock, and we will debate that a little further when we reach that point.

Mr. COHEN. Yes; I realize that, Senator. I just call your attention to the fact there is another recommendation with respect to capital gains. Under the House bill, the capital gains tax on corporations, including that for timber companies, would rise from 25 percent to 30 percent, and we have recommended to you that that be accepted, except with respect to the first $50,000 of capital gains.

Senator WILLIAMS. But without pursuing it too far here, as I understand it, the bulk of the timber operations that are operating primarily with Government timber would continue to pay taxes solely under the capital gains provisions of the law, is that not true?

Mr. COHEN. That is correct, Senator.

Senator WILLIAMS. Yes, sir.

The CHAIRMAN. Senator Gore.

TAX REDUCTIONS TO CORPORATIONS

Senator GORE. Mr. Secretary, if I understand your recommendation it is to take some of the tax relief provided by the bill for the low-income groups away from them and, instead, give tax reductions to the corporations. Would you explain to what extent that is true?

Secretary KENNEDY. Well, as you know, the bill repeals the investment tax credit and makes other changes, and increases the corporate tax burden about $4.9 billion. Under the changes that we have recommended, corporations would not have their taxes reduced. Instead of having it increased by 4.9 they would have tax increases of $3.5 billion so there would be a tax increase.

Senator GORE. May I interrupt just a moment. My question was with respect to your recommendations concerning the bill, not the present law. I understand, as you have stated, and I agree, that the bill increases the tax on corporations.

Secretary KENNEDY. The burden, yes.

Senator GORE. Increases the burden. But your recommendations would reduce that burden of taxation for corporations contained in the bill.

Secretary KENNEDY. That is right.

Senator GORE. To what extent?

Secretary KENNEDY. By a billion six on corporations, resulting from a two-point rate reduction, but it would be a billion four net. Net a billion four.

Senator GORE. Then how much would you increase taxation——

Secretary KENNEDY. That is about the amount that we let the bill go unbalanced.

Senator GORE. Yes.

Secretary KENNEDY. So it is not a change in the individual rates that caused that. We were trying to balance the bill, and we did that balancing by taking the provisions of the House bill and making changes, mainly for equity purposes where they had the same people making the same general income, receiving widely varying relief. They gave the tax relief through the standard deduction and then later changed the rate structure also. So we went back to a rate structure revision basically and that balanced the bill out generally, and then we recommended the corporate change after that which imbalanced the bill.

Senator GORE. Which——

Secretary KENNEDY. So we go to a new balance.

Senator GORE. Which means, as I understand it, that you take tax relief away from the lower income bracket taxpayers and shift it by your recommendation to the corporations.

Secretary KENNEDY. Well, that is not quite the way I say it but it is maybe your way of saying it.

Senator GORE. I understand. We are using different language but we are saying the same thing. I believe mine is easier for the people to understand. [Laughter.]

Secretary KENNEDY. Well, I think it is the way one looks at it. Actually——

Senator GORE. We are looking at it the same way. We are just describing it differently.

Secretary KENNEDY. Well, looks and description are somewhat the same.

Now, if you take the changes that the House made in the case of a married couple with two dependents with deductible expenses of 10 percent of income, say, and then the changes that we made at $4,000 of income the House bill would give a 53.6 percent reduction in taxes. The bill as we provide would give 42.1 percent. That is a pretty substantial, almost half cut.

The $5,000 bracket would be, in the House bill, a 31 percent cut, 12.8 under this bill; and at $7,500 income, 16.2 percent, and under the recommendation we have 10.3 percent. The percentages go down as the income goes up to 9.2 at $10,000; $12,500, 7.6; $15,000, 5.4; and it goes along at about a 5-percent level thereafter.

#### $1,250 PERSONAL EXEMPTION ASKED

Senator GORE. Well, the second point I wish to make in my brief time to interrogate you is that, in my view, one goal of tax reform should be fairness in distribution of the tax burden. It seems to me that the most unfair provision in tax law is the $600 exemption from Federal income tax for a taxpayer and for each of his dependents. I suggest that we omit reductions in the rate schedule and provide instead an increase in the personal exemption from $600 to $1,250. This would be more commensurate with the increase in the cost of living.

As late as 1940 the exemption for a man and wife was $2,000. Now, it is down for a man and wife to $1,200. It seems to me that there ought to be enough income exempt from taxation by the U.S. Government for a father and mother to rear a child at least at the subsistence level. Six hundred dollars does not equal that cost. I would solicit your response to that.

Secretary KENNEDY. Well, I think your proposal would be impossible as far as cost is concerned to the Government at this stage, and I am not so sure it is the best way to accomplish what you would have in mind. I would think that the deductions we have in the rate structure are a better way to reach this than increasing the exemption.

You would, of course, put a very large premium on large families?

Senator GORE. Don't you think they are entitled to it?

Secretary KENNEDY. I think they are entitled to it, but I think they get it this other way.

Senator GORE. You don't provide it.

Secretary KENNEDY. Let Mr. Cohen, he has some thoughts about it.

Mr. COHEN. May I supplement what the Secretary has said, Senator? I think the concern that you have is one that we felt very deeply when we took office, and this was the reason for our suggestion of the low-income allowance. I think it accomplishes what you have in mind

at the bottom of the scale. But it does not provide the large benefits at the top of the scale.

If you increase the personal exemption——

Senator GORE. Would you let me interrupt just there?

Mr. COHEN. Yes, sir.

Senator GORE. I agree with you that the low-income allowance does give some relief to the taxpayers in the low-income brackets.

Mr. COHEN. Yes, sir.

Senator GORE. I believe, Mr. Secretary, that the people really hardest hit by the unfair distribution of the prevailing tax burden are the lower middle-income groups, say from $7,000 to $15,000, people who are trying to meet the payment on a home and rear a family of children. This bill really does nothing for them. The low-income allowance doesn't reach them. An increase in the exemption would reach them.

Mr. COHEN. Senator, this bill does something for them. It knocks at least one point off of every bracket, so that in the brackets that you are talking about there would be at least a 5-percent reduction in tax. The suggestion that you make of increasing the personal exemption from $600 to $1,250 would, we estimate, cost in the neighborhood of $20 billion. At the $1,200 figure it would cost $18 billion out of our total personal income tax revenue, which is in the neighborhood of $80 billion. So it would give up close to 25 percent of the revenue from the individual income tax. The exemption is really a function of the rate. Once one passes the level of the exemption it is really a function of the rate or the total overall burden.

Senator GORE. Mr. Secretary, I couldn't agree with you precisely there because the difference between a family of three and a family of six is not a function of the rate. It is a function of nature.

[Laughter.]

Mr. COHEN. I would agree. It may involve some other emotions.

[Laughter.]

Senator GORE. And perhaps some mistakes. [Laughter.]

The clerk tells me I have 1 more minute and I will not have the time to make the point by question but I will just use the minute to state that your recommendation and this bill do violence to the system of progressive taxation. We have done violence before.

I wish to submit for the record an example, I will come back to it later, which I have asked the tax experts I have been able to obtain for my staff to prepare. This is an example of a corporate executive who has a salary of $200,000 and a tax exempt income of $100,000, a total income of $300,000.

Before the tax reduction bill of 1964 this taxpayer would have paid $156,820 in taxes, or 53 percent. Under the present law that taxpayer has a tax liability of $125,490, or 41 percent. Under your recommendation this taxpayer would have a tax liability of $96,030, a rate of only 32 percent.

In other words, his nontaxable take-home pay would be increased from $143,180 in 1964 to $203,970 under the present bill.

Now, to give you another quick example, a taxpayer with $700,000 income divided between $400,000 in salary and $300,000 in tax exempt income under your recommendation would pay an effective rate of only 28 percent.

Now then, you speak of tax exemption as being a function of rate. I want to do something to the rate and also to provide some exemption for the man with the largest number of children to educate. Thank you very much.

Senator BENNETT. Mr. Chairman, the chairman of the committee, maybe wisely, led us into the political thicket on this bill and maybe it is just as well we get it over with as quickly as possible so that we can eventually get down to discuss the mechanics and the actual economic effects of the bill.

I have enjoyed listening to my friend from Tennessee, who would like to raise the exemption to $1,250 at a cost of $20 billion. This would put us back into the kind of a deficit we had in the last Johnson year.

Now, he is very much concerned that we are not trying to take care of the people with big families.

The Democrats controlled both the White House and the Congress for the last 8 years, they had no concern over this during those 8 years. They left the exemption where it was. In fact every reduction in the exemption which was once $1,000 and which later went down to $500 was made by the Democrats, and the only increase we have had in exemption came in the 80th Congress and it was an additional $100 made by the Republicans. It was passed over the veto of a Democratic President. So if we want to play politics with exemptions that is the record, and it seems to me it is a little late to come in now that we have a Republican administration and say we have to raise the exemption when all down through the years the members of my colleague's party have been cutting.

Now, I guess we are going to go through some of these exercises, but in the end we are here to write a tax bill which will affect every citizen, Republican or Democrat. We are here to try to find some kind of a balance between the burden on industry, which provides jobs, and the burden on the individuals who fill them.

I would like in the time I have to raise one or two questions.

TAX TREATMENT OF SINGLE INDIVIDUALS

You are suggesting a change in the tax treatment of single individuals.

Secretary KENNEDY. That is right.

Senator BENNETT. Can you tell me what would be the comparative difference between the two approaches, let's say a stenographer earning $5,000 or $6,000 a year, what would be the difference in dollars between the approach of the bill and your recommendation? Would your recommendation impose a higher or lower tax burden? I realize you haven't got figures worked out but can you give us a general picture?

Mr. COHEN. Senator, this is a function of whether a person in a particular bracket is going to take the standard deduction or is going to itemize. In general a homeowner would be more inclined to itemize.

Senator BENNETT. Well, give it to us each way.

Mr. COHEN. Well, I could illustrate this if you take a married couple with two dependents at a level of $7,500——

Senator BENNETT. You didn't understand my question, I am sorry. I am trying to just get the comparison in the effect on a single person of the two approaches.

Mr. COHEN. Well, if you take a person with $5,000 of adjusted gross income who is over 35 years of age.

Senator BENNETT. Yes.

Mr. COHEN. The House bill had a very significant effect. Under the present law her tax would be $671 on the standard deducation basis. Under the tax bill her tax would have been reduced to $501. Under our proposal she would pay $614. She would have a reduction under our proposal but not as great as under the House bill.

Now, the House bill gives a combination of benefits to such a person.

Senator BENNETT. Yes.

Mr. COHEN. They give triple benefits to a person in that partciular category.

Senator BENNETT. Your proposal is broader in one sense, it applies at every age.

Mr. COHEN. It would make no distinction between those under 35 or those over 35. It would insist that a single person regardless of age who does not have a household to support would pay no more than 20 percent above the tax that would be paid by a married couple with the same income.

Senator BENNETT. Well, now, just to nail this down for a minute, under the House bill a person with a $5,000 income age 30 would still pay $671?

Mr. COHEN. Well, I think it would be a little less than that because there was a rate reduction.

Senator BENNETT. OK.

Mr. COHEN. In the House bill the tax of such person, because of the increase in the standard deduction and the reduction in the rate, because of those two benefits, would be reduced from $671 to $524. Under our proposal he would pay the same $614 that a person over 35 would pay.

Senator BENNETT. Are you taking into consideration your new standard deduction in calculating the $614.

Mr. COHEN. Yes; that is taken into account.

Senator BENNETT. But you put a blanket 20 percent, an automatic 20 percent cutoff regardless of what the rate produces?

Mr. COHEN. The differences are not very great at that level. The single person suffers by comparison with a married person more in the middle income brackets and upper middle income brackets. In the $15,000 to $25,000 category, a single person's rates have gone up very substantially whereas the married person's rates have gone up much less and that is where our limitation to 20 percent above the married person's rate would be more effective to cut them back.

## MINERALS DEPLETION ALLOWANCE

Senator BENNETT. Just one more question in another field. There has been a discussion here about the effect of the proposed changes on the depletion allowance on oil. Do you accept the House language on depletion for other extractive industries?

Mr. COHEN. Yes, we do.

Senator BENNETT. Including oil shale?

Mr. COHEN. I am sorry; we would make an exception in that regard. We do not object to the House provision which, as I recall it retained the depletion on oil shale at the percentage that it previously was. There were five minerals which were not reduced by roughly a quarter, gold, silver, copper, oil shale and iron ore, and we would accept that. There is a special provision in the House bill, however, to extend the cutoff point for determining the value of shale oil that is subject to percentage depletion, and the House bill would extend the value into the manufacturing process, and we think that this is a very dangerous precedent. We have always held to the mining values and not the manufacturing values.

Senator BENNETT. I know, but there are many other minerals you have to take some preliminary manufacturing processes to establish whether or not you have a value. Those of us who come from States which have rich oil shale reserves can't see in the end any difference between the oil produced from shale and the oil produced from wells. We think that you obviously cannot treat them exactly the same, but we think you are probably justified in making some manufacturing exemption to move closer to the protection of the oil.

If you are going to insist that you are only going to put a depletion on the actual shale before the oil comes out you will never get any oil shale produced in this country. When we are talking about incentives and trying to maintain the incentives to get the production of petroleum from wells, you should be concerned about the incentives for production from shale and tar sands.

Mr. COHEN. We are quite concerned about it and interested in developing an appropriate incentive, including the raising of the rate to the same as for other oil, from 15 to 20 percent; we see no objection to that.

Other encouragements which might be considered would include rapid amortization of equipment, but if we do what the bill does, that would be equivalent to increasing the rate, we estimate, up above 30 percent, and I think it is a dangerous precedent to get that far down into the manufacturing process. We are anxious to provide an incentive, and realize the tremendous benefits that will come from——

Senator BENNETT. If before this bill is finally written it would be possible to develop some kind of a recommendation which would handle it and develop a fair relationship I hope the Treasury can give us some help in that regard. My time is up.

Mr. COHEN. We would recognize that problem, Senator, and be anxious to develop something.

Senator ANDERSON. Senator Hartke.

Senator HARTKE. Thank you, Mr. Chairman.

### TAX REFORM BILL A MAJOR VICTORY FOR THE FORGOTTEN AMERICAN

The tax reform bill, in my opinion, as it was passed by the House of Representatives is a major victory for the forgotten American, and I think it is a meaningful tax reform and the nature of which really provides for a better balance and fairness to the ordinary taxpayer.

And at the same time while the tax reform bill frankly is hailed by everyone as being meaningful, it is not going to really bring a brighter life to a lot of people unless it means to them tax relief and that is what the average American interprets what we are going to do in this Congress, that we are going to provide for some type of tax relief.

Frankly, I don't think the average American taxpayer is looking at this time for more promises of tax relief and balancing of the circumstances. What he is really looking for is the reality of equity and that is hopefully what we are going to do, and I think Senator Gore makes a very valid point that the administration has presented to the Senate in the name of balancing, a reenactment of present inequities.

HOUSE BILL AS COMPARED WITH ADMINISTRATION RECOMMENDATIONS

If we follow the recommendations of the administration, we receive a reenactment of the old imbalance in the name of balancing, because if I am correct in reading the statistics in table 2, the increase over the House of Representatives bill for the average individual or for the individuals, is increased by $1,732 million or $1.7 billion while at the same time in this, the effect is to decrease the taxation for corporations by $1.6 billion.

In other words, what we have here is an increase for the average person of $1.7 billion over the House bill, and a decrease of $1.6 billion for corporations. Is that correct now?

Secretary KENNEDY. That is right, in general, yes; not as against existing circumstances.

Senator HARTKE. I understand, as against the House passed bill.

Secretary KENNEDY. Yes; as against the bill itself. We think the bill went too far in upsetting the balance between consumption and investment.

Senator HARTKE. I understand. I want to come to that in a moment.

What you have said here in substance is that the old balance is more nearly correct than the new balance.

Secretary KENNEDY. I think that a $3½-billion increase in corporate taxation is a sizable increase in taxation, and it does create imbalance, and then balance is obtained through individual taxation in those areas where they had preferences that were used in combination to eliminate taxes, so there is balance there and there is equity there.

Senator HARTKE. But the average forgotten American who is looking at this tax bill looked at it as it passed the House of Representatives, and as I went back home over the recess and talked to the people they really thought they were going to have finally some redistribution of the payment of taxation. They thought that the average forgotten American was finally going to be treated in a fair method and provide for taxation of those people who heretofore had been in a position where they could avoid paying their fair share of the taxes.

Secretary KENNEDY. As I gave the figures, Senator, to Senator Gore, each of the brackets, each of the areas down to the $25,000 area, each have about a 5-percent decrease the way it turns out.

Senator HARTKE. Yes; but you are talking in relation to the present circumstances, and I am talking in relation to the bill as it was passed by the House of Representatives.

Secretary KENNEDY. Well, but the area between the two is when you get beyond the very low levels, which were 53 percent in the case of the House bill, going down to 42, that is still a very large thing.

Senator HARTKE. Yes.

Let me just clarify a point only for the sake of making sure we have a clear understanding, that in relation to the House bill, individual income taxes have been increased by $1.7 billion and corporate taxes have been decreased by $1.6 billion which is a very, almost an exact balance that you have taken from the average individual and given it to the corporations.

Secretary KENNEDY. We brought equity in the various tax brackets so that persons making the same income would receive generally the same kind of relief.

Mr. Cohen has a comment.

Mr. COHEN. Can I make one point, Senator? We provide exactly the same quantum of relief that the House Ways and Means Committee did after almost 6 months' study in the bill that they reported out. After they had reported the bill out they added in a rather hurried action another $2½ billion.

Senator HARTKE. Mr. Cohen, let me——

Mr. COHEN. This bill, this recommendation, that we have made extends the same amount of relief as was extended in the bill reported out by the Ways and Means Committee.

Senator HARTKE. Mr. Cohen, just to be sure, it provided the same amount of dollar relief as far as the Treasury is concerned, there is no real big difference. What has happened here is you have taken $1.7 billion from the a¯erage forgotten American and you have given it to the corporations, isn't that right? That is right, isn't it?

Mr. COHEN. Senator——

Senator HARTKE. All right.

I just want to get the facts straight.

Mr. COHEN. Senator, all the facts are in the record.

Senator HARTKE. In other words, the even handedness has been given and he got both the front and the back of the hand.

Mr. COHEN. Well, in the House bill corporations had had their taxes increased by almost $5 billion.

Senator HARTKE. I understand but the ordinary person felt for a long time that he has been taking it on the chin and he wanted to stop taking it on the chin for the people who had been making the bulk of the wealth.

Mr. COHEN. Some taxpayers, those with the standard deduction returns, were getting double benefits as compared with others and those are the ones who will not get the benefit, under our proposal, in double fashion. They would not have gotten it either under the bill as reported out by the Ways and Means Committee.

Senator HARTKE. Let me say in this regard that I share with Senator Gore the concern for these people with children and I do believe that the ordinary taxpayer again can understand what you are talking about if he has one child he is going to get an additional exemption; if he has five, he is going to have five exemptions. He can understand that and that means something to him and that is what

the ordinary taxpayer would like to see, and I would hope that some place along the line, if we cannot go to the $1,250 extent that we can at least do as well as we did before World War II by increasing it to $1,000.

Dr. WALKER. Senator, this just can't stop by looking at the tax impact. As Senator Bennett appropriately pointed out, the impact on investments and job creating capacity of U.S. industry is at stake here and the taxpayer in the short run, yes, might like to see his taxes reduced significantly but if in the process he makes it more difficult for jobs to be created by taxing corporations tremendously more heavily, he is cutting off his nose to spite his face because his real claim to comfort in living is a good job.

INFLATION CONTROL

Senator HARTKE. Yes, but let me say in regard to that as far as the future is concerned, you have expressed the feeling really that productivity and inflation are really going to be in a different light in 2 years; isn't that correct?

Dr. WALKER. Our timetable for inflation control is to bring inflation under control within——

Senator HARTKE. And yet at the same time instead of just asking for a suspension of the investment credit you have asked for the elimination of the investment credit, and shifted that part of the tax over to a reduction in the corporate rate; isn't that correct?

Secretary KENNEDY. That is right.

I felt all along that the investment tax credit was not the best way to stimulate. I felt a general tax reduction on corporations across the board would be more effective and that at some point perhaps the depreciation schedule should be looked at but those are matters for the future.

Senator HARTKE. I am willing to look at those depreciation schedules. I frankly have always thought we ought to have some type of reinvestment depreciation allowance which really increases productivity, which does not provide a tax windfall as investment credit did. But the investment credit was the second best approach, and am I correct in assuming then you are really considering some type of program?

Secretary KENNEDY. Down the line, yes; not part of this bill.

Senator HARTKE. Not part of this bill but a reinvestment depreciation concept?

Secretary KENNEDY. Too much study is needed because we have also the question of modernizing our industry competitively with the world now. As you know, Senator, in the Common Market countries, they have the value added tax everywhere.

Senator HARTKE. When you go back to 1962 and look at the bill I introduced along that line when they had the reinvestment, I mean when they had the investment credit——

Secretary KENNEDY. I think it is a very serious matter and we should take a look at it but that one requires a lot of study and education and I would like to know more about it before making a statement.

CAPITAL GAINS

Senator HARTKE. Let me ask you another question in regard to another point and that is basically on this question of capital gains.

As I understand in the field of taxation that there are really two things that people are concerned about no matter where they are. One of them is tax relief and the other is tax simplicity. Now, if you, and I don't say that this is something which could be done but I would like to have your comment, if you completely eliminate the whole theory of capital gains tax and substituted in its place this new theory which we now have, substantially sophisticatedly adopted and put in average over a 10- or 5-year period, and if you did that you could cut and be in a situation in which no one would be required to pay more than 50 percent taxes under any circumstances, whether corporate or individual, at the same time, you could eliminate about 60 percent of the tax confusion in regard to filing computation, is that correct?

Secretary KENNEDY. I think that simplicity is an important matter in taxation, and to the extent that that could be done I think it is right. At some point there may be interest in making some change there. There are questions of revenue involved, as you know.

Senator HARTKE. Yes.

Secretary KENNEDY. I think your point is well taken. You might want to comment on that, Mr. Cohen. It is an interesting point.

Mr. COHEN. Senator, it would be a great simplification in the Internal Revenue Code if there were no distinctions between capital gains and income but I think the 10-year average will have its own vast complications in adjusting records back over 10 years. We have liberalized the averaging provisions in the present bill over 5 years. I think 10 years would require quite a few recalculations constantly.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. Mr. Chairman, there are many proposals that are of interest, I cannot reach them because of lack of time. That does not indicate a lack of interest. I have a question which you may have Mr. Cohen answer, Mr. Secretary.

FOUNDATIONS

Isn't it true under the House-passed bill there will be some foundations who may have given substantially all of their income to charity that will be taxed as regular corporations?

I will explain. Suppose here is a foundation whose sole asset is a wholly owned business, and that business pays full corporate tax like all of its competitors, and suppose the fundings to the foundation, and the foundation faithfully, without any abuses, gives it to charity. The 7½-percent tax figures out the same as if the foundation was a regular corporation. Because of the dividend credit you tax 15 percent at 50 percent; isn't that true?

Mr. COHEN. That would be approximately correct, Senator.

Senator CURTIS. Yes.

That is not a farfetched hypothetical case, and I want to commend the Treasury on their provision to reduce the tax on foundations from the House bill of 7½ percent to 2 percent. I accept all reasonable regu-

lation of foundations. I think the abuses are abominable, but in reality this tax on foundations, in the ultimate, is taxing the beneficiaries of the foundations, the charities, the hospitals, the colleges, the research institutions; isn't that correct?

Mr. COHEN. We came to that conclusion, Senator.

Senator CURTIS. Yes.

### 2 PERCENT TAX FOR PRIVILEGE OF TAX EXEMPTION

Now, I was very much interested in the slight remark that the Secretary made in supporting the 2 percent.

He said they might call it a fee or something—he didn't say an excise tax. But I think that perhaps it should be termed something other than an income tax because the right or the privilege rather, it is not a right, it is a privilege, the privilege of tax exemption requires policing, and those who claim it ought to pay for the policing. This seems to me compatible with the entire theory of tax exemption.

Couldn't the same purpose be accomplished without these conceptual problems by utilizing some other mechanism than the income tax, such as a fee or excise tax system which would produce the money to cover the cost of enforcement. Could not the amount of the fee or excise fee be measured by some standard other than income?

Mr. COHEN. Senator, we would prefer to use income rather than some other standard, such as assets, to measure the amount of the fee.

The revenue agents and the whole Internal Revenue Service are geared to the determination of income, and if they have to determine——

Senator CURTIS. But would it have to be called an income tax?

Mr. COHEN. I was coming to that point. I do not see that it has to be called an income tax and we would be satisfied to regard it as an excise tax measured by income, which would produce the same result, provided we can satisfactorily determine what is the event on which the excise is imposed. For example, in order to make an excise tax a valid provision I think we would have to say that the tax is on the act of carrying on activities as a private foundation for charitable and educational purposes, and to me that raises some problem as to whether one wants to put a tax on that particular act, whereas a tax on income does not seem to be a tax on a charitable and educational activity.

Now, I would say that if we can decide what is the appropriate type of event on which the excise is to be imposed, the Treasury would be willing to have it so defined.

Senator CURTIS. It wouldn't have to be called an income tax.

Mr. COHEN. It would not have to be called an income tax.

Senator CURTIS. I am pleased to hear that. Now, my State, and many States, place the State income tax as a percentage of the Federal tax. So there is going to be a cumulative effect of taxing our churches and our colleges and our hospitals and other very fine institutions because if we declare for the principle of an income tax on foundations States, municipalities, and everybody else are going to do likewise.

Mr. COHEN. That is a very intersting point. I am familiar, in general, with the Nebraska tax which is based upon the Federal tax, and if this were an excise tax it is my recollection the Nebraska tax would

not pick it up, but it would pick it up perhaps if it were an income tax.

Senator CURTIS. As a matter of fact private colleges which, in my State, are all church colleges, carry 80 percent of the cost of higher education. I don't think there is one of them that could exist without the aid of foundations. And as I interpret the House bill, I judge for no one else, it is a tax that, in effect, will be paid in reduced grants to the beneficiaries of the foundations. And it is not necessary so far as proper policing is concerned, is it, that we tax them rather highly? There are other methods.

Mr. COHEN. We agree.

Senator CURTIS. Yes.

Now, one thing that I think is very important in tax exempt organizations, whether they be foundations or cooperatives or what not, is that we have adequate informational returns. It is my understanding that the House bill, while not changing that particular section does some other things that will make the informational returns of private foundations more meaningful. Is it not?

Mr. COHEN. Yes, and we plan some changes administratively also.

Senator CURTIS. I regard most private foundations actually to be public institutions and I would even go further so far as publicity is concerned.

Now, in reference to the provisions in the House bill that would compel a divestiture of interest in businesses owned by foundations above the 20-percent rule, that would bring in no revenue at all; would it?

Mr. COHEN. We wouldn't anticipate revenue from it. It was merely a question of conditioning the exemption of the foundation on not owning and controlling private businesses.

Senator CURTIS. Has there been any indepth research done on what constitute the abuses in private foundations where there is self-dealing and that sort of thing?

Mr. COHEN. Well, there have been fairly extensive hearings conducted, I believe, in the House under the chairmanship of Congressman Patman. I think he has made substantial studies of this.

Senator CURTIS. Yes.

I think what would happen is through the back door of a tax bill we would accept the Patman philosophy in regard to foundations, and we would tax foundations, which means taxing the beneficiaries and in some cases we would tax them as regular corporations, and we would not increase the revenue, and if that is to be done, I think maybe it should be a special study and not involved in all of the ramifications that this committee must take into account in this revenue bill.

Mr. COHEN. Well, the Treasury Department, Senator, in the last administration conducted a study and presented a report to the Congress in 1965, and that has significant information and recommendations in it.

STATE AND MUNICIPAL BONDS

Senator CURTIS. Briefly switching to another subject: What changes would be made if the Treasury recommendations were followed in reference to State and municipal bonds?

Mr. COHEN. What changes from existing law or from the House bill?

Senator CURTIS. No.

What changes from existing law. My time is up, so if you can make it brief.

Mr. COHEN. Briefly, we would include tax-exempt interest in the preferences for determining the extent to which an individual can deduct his nonbusiness deductions—his State taxes, mortgage interest, and so on. Those are required under the bill to be allocated so that nontaxable income bears its share of those personal expenditures. We would put tax-exempt interest in that, so that if a person had, say, half his income in salary and half from tax-exempt interest he could deduct only one-half of his normal personal deductions. That would be a change in existing law. We would not have the tax-exempt interest, though, in our limit on tax preferences.

Senator CURTIS. You wouldn't have the impact of the House bill?

Mr. COHEN. No.

Senator CURTIS. Thank you, Mr. Chairman, my time is up.

I did want to go into several other matters, agriculture and boxcars and so on. But my time is up.

The CHAIRMAN. Senator Fulbright.

Senator FULBRIGHT. Thank you, Mr. Chairman.

Pursuing that last question just for a moment, I understood from the Secretary's statement that he raises a question of constitutionality of changing the tax exemption of municipal bonds. Didn't you refer to that, Mr. Secretary?

Secretary KENNEDY. Yes; I did, Senator. In connection with the provision of putting tax-exempt income in the limit on tax preferences we have two reasons: (1) the question of constitutionality. That was not the controlling question. The controlling question was what it would do to the markets and the ability of the States and municipalities to market their securities because it would have an impact on that.

Senator FULBRIGHT. The anticipation of this has already had considerable effect upon the market for municipal bonds, has it not?

Secretary KENNEDY. Yes; the discussion of it has fluctuated the market, yes.

Senator FULBRIGHT. It has been very bad.

What would be your attitude in this connection with whatever is done, if anything is done, making the change prospective only in operation? I have had a considerable complaint about making the change, in effect, retroactive. These complaints concern the provisions in the House bill affecting the existing securities of municipalities which had been issued and bought upon the assumption they were free from tax.

Secretary KENNEDY. I will ask Mr. Cohen to answer that.

Mr. COHEN. Senator our suggestion regarding allocation of deductions would apply both to outstanding and future issues. The precedent for this is in the action of the Congress in 1959 when this was done with respect to the taxation of life insurance companies, and their operating expenses were required to be allocated between the taxable income and the tax-exempt interest provided it was constitutional to do so. The Supreme Court has since held that it was constitutional to do so.

We think for the limited purpose of the allocation of deductions we should take into account both the existing and the future issues, because that does not involve a tax on tax-exempt interest. That is only requiring that the deductions be allocated.

Senator FULBRIGHT. But it is indirectly a tax. I think this is part of the overall question of the credibility of our Government. To change the rules in the middle of the game seems to me to expose the Government to further criticisms.

I have had the same observation made with regard to the question of carved out mineral production payments, making it effective to the past or to a period that has already passed before the enactment of the law. This always irritates people who do not have knowledge of changes being made.

Mr. COHEN. If I may add one other comment on the tax-exempt interest, we felt that this would not have a material effect on the market, but if you distinguished and if it did have an effect on the market, it would give greater benefit to outstanding securities than to future securities, a distinction which would interject some confusion in the market.

Senator FULBRIGHT. Well, it is a market involving outstanding bonds which would all be liquidated, I believe, in something like an average of 10 years; isn't that true?

Mr. COHEN. It may be an average of 10 years because I would assume that the bulk of the issues are short term, but there are many of these issues that would be outstanding 30 years from now. I think we figured that at least 10 percent of them would be outstanding more than 30 years.

With respect to the carved out payments, we did not apply it to any carve out sold before April 22 which was the date on which we appeared before the House of Representatives, and we think that that gave adequate warning to persons who might sell such payments in the future.

Senator FULBRIGHT. Well, it has raised some difficulties which I won't pursue at the present time but we will at a later time, I think.

On this question of changes of the rules in the middle of the game, it isn't based upon the idea that changes shouldn't be made for the future, but that the effect should not be retroactive.

Mr. COHEN. Surely.

### SIMPLIFICATION OF THE TAX SYSTEM

Senator FULBRIGHT. Mr. Secretary, you did say, I believe, that you were studying ways and means for simplification of the tax system; is that correct?

Secretary KENNEDY. Yes, we have, but when you look at this bill it looks like it is more complicated.

Senator FULBRIGHT. That is what I was going to say. Have you given up any idea that it is possible to simplify it, especially for individuals. I think it is a much greater burden on individuals than corporations, most of whom have their expert accountants, et cetera; but for individuals, it is a great burden, it seems to me.

Secretary KENNEDY. There is some simplification, Senator, in the fact that a good many of them have been taken off the rolls and won't

have to file returns, and then with the increase in the standard deduction there will be more people who would go on the standard deduction rather than itemize their deductions but other than that all these provisions for limited preferences will make it more difficult to fill out returns.

Senator FULBRIGHT. It does seem to me with all the modern methods that we hear about, computers and so on, that would interfere in many irritating ways in our lives, some beneficial use could be made of these to reach a formula which would reduce the enormous burdens of preparing highly complicated income tax returns. One of our staff members tells me that the Treasury has estimated it costs taxpayers, individuals, over $500 million annually just to prepare their returns, to say nothing of the tax they have to pay. So this in itself is a terrible burden. I think it is something we ought to give more attention to.

Mr. COHEN. Senator, I might say that our low income allowance, and the suggestion we have made this morning to you, will take 5 million taxpayers off the tax rolls, and we are recommending that no returns be required in those cases.

Senator FULBRIGHT. I think that is good.

Mr. COHEN. And the standard deduction increase that we have recommended would enable 4 million persons to shift from itemizing deducations to the standard deduction return. I think the complexities of the bill come in the loophole closing phases, which will be applicable to a limited number of high bracket persons.

## NUMBER OF TAX EXEMPT ORGANIZATIONS

Senator FULBRIGHT. How many tax exempt foundations, how many tax exempt organizations, are there in this country?

Mr. COHEN. I think that it is in the neighborhood of 30,000 foundations that we have on the rolls of the Internal Revenue Service. I think we have 400,000 tax exempt organizations.

Senator FULBRIGHT. I didn't hear that last, what?

Mr. COHEN. We have on the lists of the Internal Revenue Service, and we have recently prepared this list to put it on the computer, 400,000 tax exempt organizations of all types. My recollection is there are 30,000 foundations, but the 30,000 figure might include some organizations beyond those we would call private foundations in this bill.

Senator FULBRIGHT. You really don't know very much about them, do you? There never has been a thorough canvass made of them, is that correct?

Mr. COHEN. I think after this bill we would know a good deal.

Senator FULBRIGHT. But you referred to the study of the House Banking Committee. As I understood it, they only studied some 500, between 500 and 600 of these foundations. They really didn't undertake to survey the field, did they?

Mr. COHEN. I don't think so, but I am not familiar, Senator, with the full extent of their work. But the Treasury report on foundations in 1965 represented a rather extensive study, and we are planning to increase substantially the staff and operations of the Internal Revenue Service in this field. This 2 percent tax we have recommended today is

designed to provide in the neighborhood of about $15 million, we estimate, in 1970, to match the costs that would be involved. There would be a substantial increase in our program of study of the foundations.

Secretary KENNEDY. I would like to make one comment, Senator, if I might, on that. Heretofore, the tax returns of the foundations had been sent to the districts, and had been examined by the district Internal Revenue people on rules and regulations submitted by the Treasury, but no matter how you write those rules you have some difference of interpretation in complicated matters, and when this became a subject of great interest after taking office, we immediately asked for all of these to be centered in Washington, so that you could have a section that would take a look at these in total, and individually and get consistency of administration, and I think that will do much, do a great deal, to avoid and take care of the many abuses that have or might develop and then you can reject the tax exempt status if they don't measure up.

Senator FULBRIGHT. Mr. Chairman, I ask that the text of an amendment I offered yesterday and my statement of explanation be made a part of the record in order that the committee may give attention to it in the course of its hearings.

(The amendment and explanation follow:)

THE REVISED TAX LAW AND TAX-EXEMPT SECURITIES—AMENDMENT TO H.R. 13270

AMENDMENT NO. 141

Mr. FULBRIGHT. Mr. President, the tax reform bill (H.R. 13270) is now pending before the Finance Committee and hearings are scheduled during the period September 4 through October 3. I submit for reference to the Finance Committee an amendment to H.R. 13270, and ask unanimous consent that the amendment be printed at this point in the RECORD.

The PRESIDING OFFICER. Without objection, it is so ordered.

The amendment submitted by Mr. FULBRIGHT was referred to the Committee on Finance, as follows:

Under "Limitation on Tax Preferences; Exclusion of Interest on Outstanding Governmental Obligations," on page 167, line 1, strike out "obligations" and insert "obligations issued on or after July 12, 1969".

On page 175 strike out subparagraph (B) beginning on line 21 and ending on line 2, page 176.

On page 176, line 3, redesignate subparagraph "(C)" as "(B)".

On page 176, line 20, redesignate subparagraph "(D)" as "(C)".

On page 175, lines 18 and 19, strike out "as modified in subparagraphs (B), (C), and (D)," and insert "as modified in subparagraphs (B) and (C),".

Mr. FULBRIGHT. Mr. President, the purpose of my amendment is to correct an inequity in the bill. This inequity arises under provisions of the bill designed to limit to 50 percent that portion of income which may be excluded from taxation as a result of various legal exemptions and special deductions. This is a worthy purpose, and I support it. However, H.R. 13270, as presently worded, treats unfairly those taxpayers who have purchased State and local bonds in the expectation that income from these bonds would be tax exempt.

Although the revised tax law would be prospective as it affects future income, it would be retroactive as it affects the value and marketability of capital assets represented by the tax-exempt bonds. To change public policy regarding taxation of income from securities purchased after the change may be wise and fair. But to change the rules affecting income from securities purchased prior to the change is certainly not fair, and in my opinion is not wise.

I have no desire to perpetuate rules which provide an unlimited tax shelter for our most wealthy citizens. But the transition to new rules and new public policy should not break faith with anyone who has relied upon and followed the law no matter what may have been the motives of the individuals involved.

My amendment would apply provisions of the bill, which limit the use of tax preferences, only to income from State and local bonds issued on or after July 12, 1969. This date would make such provisions consistent with another section of the bill dealing with tax-exempt interest. This other section provides that income from bonds issued prior to July 12, 1969, need not be taken into consideration when allocating itemized nonbusiness deductions between taxable and tax-free income. I believe that treatment of this interest income should be prospective entirely, and my amendment would have this result.

Mr. President, I submit this amendment to indicate my minimum reservation with respect to the proposed indirect taxation of income from State and local bonds. I am aware of the constitutional question inherent in this proposal. I hope that the constitutional issue is thoroughly illuminated in the hearings. After further consideration I may be persuaded that a more comprehensive amendment is needed, but at this time I submit this one for the consideration of the committee.

DEFENSE EXPENDITURES

Senator FULBRIGHT. My time is almost up but I would like to ask the Secretary about one sentence in his statement on page 2 where he says:

The extent to which we can responsibly curtail our defense outlays has to be determined on future events, many of which are beyond our control.

Well, this is an important matter, of course, which deeply involves the Treasury and I wonder why he believes, or does the administration believe, that such things as a Vietnam war may be beyond our control. Are you accepting the inevitability of the continuation of this kind of an event?

Secretary KENNEDY. I accept, Senator, the sovereignty of other powers and the fact we have to maintain strength to meet those powers, and that events, as they have been foreshadowed over the years, have shown us that many unforeseen developments have taken place.

Senator FULBRIGHT. So you have given up hope?

Secretary KENNEDY. We have not given up any hope but we are working on the defense expenditure side and on the point of trying to trim it to where we can.

Senator FULBRIGHT. I hope you can because having to raise money you ought to be sympathetic with what we are doing in the Senate now.

Secretary KENNEDY. I am fast becoming very unpopular in some of these matters.

Senator FULBRIGHT. I am glad to hear that.

(Laughter.)

Senator FULBRIGHT. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Miller.

Senator MILLER. Thank you, Mr. Chairman.

REPUBLICAN PLATFORM

Mr. Secretary, a little over a year ago the National Republican Party at Miami adopted a platform and in the statement it says:

The current need for tax reform and simplification will have our priority attention.

This is my ninth year in the Senate and this is the first time in 9 years that representatives of any administration have come before the Congress to recommend what I think is generally regarded as tax reform, and I commend you for doing so.

I may not agree with all of the recommendations but I think the fact that you are here and living up to the platform statement of the party is to be commended.

Secretary KENNEDY. Thank you.

INCREASING PERSONAL EXEMPTION

Senator MILLER. Now, some talk has been heard over the possibility of increasing the individual or personal exemption from $600 to $1,200. As I understand it, you are opposed. My calculations would indicate to me if this were done that the low-income taxpayers, for example, the taxpayer with a 15-percent tax rate, would enjoy only $180 of tax benefit by increasing the exemption from $600 to $1,200, whereas the wealthy taxpayer or a person with an income in excess of an income of $200,000 in a tax bracket of 70 percent would enjoy a tax benefit of $840, which sounds to me to be a most regressive, nonprogressive approach to tax equity. Do you agree?

Secretary KENNEDY. I agree 100 percent. We took a look at that and if you take the total dollar figure in that the great percentage will go to the higher income tax brackets rather than to the lower.

Senator MILLER. So if we are interested in doing something for the benefit of the low-income taxpayer and not for the benefit of the high-income taxpayers the tax rate approach seems to be the best, does it not?

Secretary KENNEDY. That is what we decided upon after considering it very carefully. We did take care of the low ones by a special measure by the low-income allowance, taking them off the rolls and by a larger percentage deduction in the lower brackets.

MUNICIPAL BOND INTEREST AND LTP

Senator MILLER. On page 10 of your statement you indicate that one of the factors in your decision not to recommend inclusion of tax exempt municipal bond interest in the limit on tax preferences was the possibility of adverse repercussions in the market, and yet in the next sentence you indicate that you support the inclusion in tax exempt State and municipal and bond interest in the allocation of deductions rule, and it would seem to me this could have an adverse repercussion on the market, too.

Secretary KENNEDY. The impact there, Senator, is not very large, and the only impact that I can see is the psychological one of a foot-in-the-door taxation of municipal securities by the Federal Government, because the amounts involved in that would be not serious.

We have checked this out pretty carefully with market men and with the market and there was very little, if any, reaction, market reaction, when our first proposal came out and the market impact that Senator Fulbright referred to came about when the House Ways and Means Committee included tax exempt income in the limit on tax preferences. Then there was market reaction and great uncertainty, and I had calls from a few of my mayor friends and Governor friends and so on around the country.

Senator MILLER. Well, of course, I am interested in market reaction to these things.

Secretary KENNEDY. They have to raise money.

PERCENTAGE OF BONDS HELD BY CORPORATIONS

Senator MILLER. Because all of our local governments need to be viable but what percentage, can you give us an estimate, of how many of these bonds are held by corporations?

Secretary KENNEDY. I will turn that over to Mr. Cohen. The commercial banks are large holders but they have been liquidating over this tight money period so your figures will have to be adjusted downward.

Senator MILLER. Well, I can ask you what percent are held by individuals.

Mr. COHEN. I think that the banks, Senator, have been buying in the recent years, as much as 90 percent of the issues and in the effect on the market, you have to take into account not only where the present securities are held but who is buying the new issues.

Senator MILLER. That is close enough.

Now, my point is——

Mr. COHEN. But they do not own 90 percent of the total outstanding. I think it is—45 percent are owned by banks and about 25 percent are owned by nonbank institutional investors.

Senator MILLER. Well, you have 90 percent of purchases made by corporations, you have 70 percent held by corporations. There is no proposal to include the tax exempt municipal bond interest in a limit on tax preferences for corporations so what we are talking about, as I understand it, is we are talking about individuals buying 10 percent of these new issues and ultimately perhaps 30 percent being held by individuals, and the only way these individuals would be affected by your limit on tax preference would be if they put in over half of their investment or derived over half of their income from tax exempt municipals, and I can't imagine that there would be too many of those, I would hope not, and so I am wondering why all this furor over the market situation in the face of public opinion which is very, very strong against wealthy people having a lot of income and paying not 1 cent of Federal tax on it. Anyhow that is a concern I wish to express to you.

APPRECIATED VALUE OF PROPERTY AND LTP

Another one is along the same line. As I understand it you do not propose to have the appreciated value of property which is donated to charity included in the limit on tax preference?

Secretary KENNEDY. That is correct.

Senator MILLER. As a result of that, is my understanding correct, you can have some rather wealthy individuals who will give appreciated property away and will not have to pay 1 cent of income tax? For example, if a person who has an oil property that cost him $1,000, but is worth $100,000 today, gives it away, he has practically $100,000 tax deduction and if he has $100,000 income, no tax. Now is that a result that can be achieved, $100,000, for example, in the case of wages, he offsets the $100,000 appreciated gift against that, and pays no income tax, do I understand that correctly under your proposal?

Mr. COHEN. But, Senator, that is subject to some limitations. We have recommended, and the bill provides, that one cannot do that with respect to property which, if sold would produce ordinary income, such

as inventory given, or a work of art that is given by the artist who produced it—that would be eliminated under this bill. Similarly, those transfers, any transfers, to private foundations would be eliminated from that rule unless the private foundation promptly channels it through to public charities. But the existing law limits the extent to which contributions can be deducted to 30 percent of adjusted income. While we are increasing that limit to 50 percent in this bill, we are not letting appreciated property enjoy the benefits of the additional 20 percent. So if a person wants to give appreciated property to charity he would be limited to 30 percent of his income.

We are removing the unlimited charitable contribution deduction. So I don't think the person with $100,000 of salary could take a deduction beyond $30,000 if his property was fully appreciated.

Senator MILLER. Would he be allowed to carry the excess over for use in subsequent years under your proposal?

Mr. COHEN. I think probably so and that may well be something that we should be careful about. I hadn't thought of that, Senator, and I would like to think about that further. I would agree that is a problem.

Senator MILLER. Thank you, my time is up.

Secretary KENNEDY. One point here, Senator, that impresses me, that here he is actually giving an asset and it is going to charity, so while to the extent of the 30 percent you don't get the tax, the fund does go to education, it does go to other fields. It is an encouragement for that kind of giving.

Senator MILLER. Well, the net answer is that the use of appreciated value property cannot be—cannot result in——

Secretary KENNEDY. That is right.

Senator MILLER (continuing). Elimination of tax.

Secretary KENNEDY. That is right.

Mr. COHEN. That is correct.

Senator MILLER. It can result in diminution but not elimination.

Mr. COHEN. Right.

Secretary KENNEDY. Right.

Senator MILLER. Thank you very much.

The CHAIRMAN. Senator Harris.

Senator HARRIS. Thank you, Mr. Chairman.

Mr. Secretary, I suppose there are really three different questions involved in this bill: One is equity and fairness, and there have been some questions asked about that in regard to what you recommend so far as individuals are concerned and corporations and comparing the two, and I think other questions might be asked on that.

Secondly, inflation, the effect of this bill on the economy.

And, thirdly, how we pay for what the Government does or what sort of priorities may be set in this bill.

Now, would you give me three figures, one, under the House bill and, one under your recommendation. First of all, what new revenue is produced by the bill and by your recommendations? What new revenue is lost or what new losses or revenue are there under the House bill and under your recommendations? And then lastly the net effect to Treasury of both the House bill and of your recommendation?

NEW REVENUE PRODUCED BY THE HOUSE BILL AS COMPARED WITH THE ADMINISTRATION RECOMMENDATIONS

Secretary KENNEDY. I will ask Mr. Cohen to give you those figures if I may, they are here in this table.

Mr. COHEN. Senator, I am not sure that I have them conveniently arranged in that fashion. I will try to present them to you. I would say that the single most important revenue increase in the bill is the repeal of the investment credit which will raise $3.3 billion.

Senator HARRIS. That is the same under the bill and under your recommendation.

Mr. COHEN. No change in that.

Senator HARRIS. What about capital gains? How much new revenue would be produced by the House bill's recommendations on capital gains, and on that same item what would be the revenue situation under your recommendation?

Mr. COHEN. Well, taking the two changes, the 6 months rule and the removal of the 25-percent ceiling as contrasted with what we have recommended, where we would still allow some amounts to be under the 25-percent ceiling, the House bill would have provided $635 million for individuals in additional taxes, and $175 million for corporations, a total of about, I think, $810 million.

Our provision would provide $425 million for individuals and $175 million for corporations, a total of $600 million additional tax. So we would raise $600 million whereas the House bill would raise $810 million.

Senator HARRIS. Well, are you then not able, Mr. Cohen, to give me those three figures in each instance.

Mr. COHEN. I can in a few minutes. We just don't have them arranged in that fashion.

Senator HARRIS. All right.

While your associate there tries to get those figures together, then just give me the last figure on each. What is the net revenue position of Treasury under the House bill and under your own recommondations.

Mr. COHEN. The net difference is $1.3 billion—$1.1 billion—$1.1 billion of less revenue loss under our bill than under the House bill.

Senator HARRIS. That is not my question.

Mr. COHEN. Under the House bill.

Senator HARRIS. I am comparing——

Mr. COHEN. I am sorry——

Senator HARRIS. I am comparing it with the present situation. What is the net Treasury position under the House bill as compared with the present situation and what is it under your recommendation as compared to the present situation?

Mr. COHEN. Well, the House bill——

Senator HARRIS. I am sorry to take so much time. It seems a rather simple question.

Mr. COHEN. On the long run effect after all the phase-ins the House bill——

Senator HARRIS. Can you take it first or do you have to go how far ahead, 5 years ahead?

Mr. COHEN. $2.4 billion net revenue loss, long run under the House bill, and $1.3 billion net revenue loss under our proposal. It is a difference of $1.1 billion.

Senator HARRIS. All right.

Now, long range are you talking about 5 years or what?

Mr. COHEN. This is a 10-year effect because many of the provisions in the bill phase in over various periods up to 10 years.

Senator HARRIS. Right.

So then we are talking about——

Mr. COHEN Let me say that short run the bill and our proposals will produce a significant surplus in revenues for the fiscal year 1970 and 1971. It is only the long run effect that will be to produce a revenue loss.

Senator HARRIS. So you are advocating less revenue loss than the House bill over the long run by a $1.3 billion, is that it?

Mr. COHEN. A billion one.

Senator HARRIS. A billion one?

Mr. COHEN. A billion one difference.

Senator HARRIS. There is a story in this morning's Washington Post written by Hobart Rowen:

> The Nixon Administration is seriously concerned by the prospect that the House-passed tax reform bill—hearings on which start in the Senate today—rule in annual tax cuts of $4 billion by 1975, instead of $4 billion in additional revenue as it planned.

You seem to say there is a net over the long pull of a difference of only $1.1 billion whereas this story says, headline, "Nixon Sees $8 billion Loss in House Tax Reform Bill."

Dr. WALKER. Our figures are in terms of current income and profit levels, that figure takes account of economic growth expected over a period, they are not comparable figures. Our figures should be multiplied by the growth factor to show the difference.

Senator HARRIS. So should the House bill, too.

Dr. WALKER. Yes.

Senator HARRIS. So the net is still not $8 billion, is it?

Dr. WALKER. They are talking about the difference between what would have been a plus $4 billion gain versus a minus $4 billion loss or an $8 billion shortfall. I didn't read the whole article, if I interpret the article correctly.

Senator HARRIS. Does this administration endorse this paragraph, it starts off, "The Nixon administration proposal will result in annual tax cuts of $4 billion rather than increased revenue of $4 billion as it planned," is that correct?

Mr. COHEN. Senator, as I was about to explain, the reason why you can't give a simple answer is that due to the various effective dates of various provisions the revenue impact is not the same in one year as in another year.

Senator HARRIS. I take it then you repudiate this story that seems to quote the Nixon administration.

Secretary KENNEDY. What I would like to say is we endorse it without recourse. [Laughter.]

Senator HARRIS. Does that mean then that you do not accept it, I take it? That is not a correct story?

Mr. COHEN. Senator, what will happen under this bill is that in the first 2 years, fiscal 1970 and 1971, there will be substantial revenue increases net. In the periods in 1973 and 1974 the bill would produce larger revenue losses than it would in 1979 when all the provisions——

Senator HARRIS. I understand.

Mr. COHEN. That is the reason why this story has picked that period of 1974 which is the year in which, as I recall it, the net loss is the greatest under the bill, due to the effective date provisions that are scattered through the bill.

Senator HARRIS. Well, I would think it is fair to say that you have to be a little more complicated than that simple statement in the story, correct?

Mr. COHEN. Yes, sir.

Senator HARRIS. OK.

### REVENUE SHARING

What about this then. Talking about how to use money, you say that we should reduce the amount of tax reduction relief that would otherwise be allowed individuals in this bill. The overall effect of that would be $1.1 billion a year for the long run, as I understand it, and instead enact a revenue-sharing plan. Keeping the tax on individuals at your level and give that money back to States which, as I understand it, by 1976 would run $5 billion a year, under your calculations. Is that a proper statement?

Secretary KENNEDY. Senator, the tax bill has nothing to do with revenue-sharing.

Senator HARRIS. It has a great deal to do, Mr. Secretary.

Secretary KENNEDY. No, the revenue sharing——

Senator HARRIS. What you do, we said a while ago, Mr. Secretary, this bill involved the question of what you do with your money and priorities.

Secretary KENNEDY. That is correct.

Senator HARRIS. And this story in the Washington Post this morning says the Nixon administration doesn't like the priorities established in this bill and I take it then it isn't correct to say what you wanted to do was to spend this money on social programs, as this story says, but it says you want to give it back to the States, is that correct?

Secretary KENNEDY. No, there are many priorities involved. There is the family assistance program. There is the aid to the ghetto areas. There are many of these that would be expenditures of the Government apart from the tax bill.

The thing I was concerned about is that we are not in this to make it difficult or impossible to meet some of those priorities by giving too much away in the way of tax reductions at this time.

Senator HARRIS. You do advocate revenue sharing which, as I understand it, would amount over the long pull to $5 billion a year, that would be given back to the States, after being collected by the Federal Government, is that correct?

Secretary KENNEDY. Yes, under some formula. I think it is 1 percent.

Senator HARRIS. The formula isn't important. We are making the

decision we would reduce the tax or a portion of it, reduce the revenue or a portion of it, and then the State might decide whether or not it wanted to collect that additional revenue. That is a question which is really before us here, isn't it?

Secretary KENNEDY. Well, I don't think that question is really before us. I think the question is this tax bill, whether it is equitable or right from the standpoint of the economy, both from the standpoint of equity and the standpoint of individual taxpayers as well as the mix between consumption and production.

Senator HARRIS. Let me add this comment, my time is up. I think it obviously is a decision that is before us, what we will do with revenue, whether we will forgo revenue or if we will collect it, and if we collect it how we will spend it or give it back to the States. That question is obviously involved in this bill.

I think also involved obviously in this bill is the inflation question and the fairness question. I am really appalled at the recommendations which have been made here which would do less for the overburdened middle- and lower-income taxpayer than the House bill would do, and I think ought to be done and, at the same time, give more to the upper brackets and to corporations. I think that is a rather appalling recommendation which is the net effect of your testimony here today.

But we will go into that and some other details in later questioning, Mr. Chairman.

The CHAIRMAN. Mr. Jordan.

Senator JORDAN. Thank you, Mr. Chairman.

COMPLEXITY OF THE BILL

Mr. Secretary, some critics have said that the House legislation, that we are considering here today, will be a boon to the taxpayers and to accountants. Now, how do you answer that and does your administration's recommendation alleviate some of that criticism?

Secretary KENNEDY. I don't think that will be true, Senator, with respect to the average or the majority of the taxpayers. But those that are in the area where they are taking tax preferences, whatever they might be, in real estate, municipals, or with anything else, they will have to take account of the provisions of this law and those are sophisticated people, they know how to handle it, so I haven't the concern about them that I would have for the average taxpayer.

Actually we are taking a good many off the rolls, and in the case of increasing the standard deduction it is making it simpler for them to submit a more simplified return.

Senator JORDAN. I think you testified in your statement that some 5 million taxpayers would be off the rolls under your recommendation. How many would go off the rolls under the House bill?

Secretary KENNEDY. I think about the same number.

Senator JORDAN. About the same number. To that extent we are working toward simplification?

Secretary KENNEDY. That is right.

Mr. COHEN. The House bill incorporated the recommendation we made on the low income allowance.

Senator JORDAN. Yes.

### HOUSING CONSTRUCTION

I want to get into the subject of residential housing with you. You touched on it in your statement, Mr. Secretary. You said we are concerned about the continued heavy reliance on investment restriction to promote the flow of money into residential construction.

We have had testimony before this committee and others that we need 26 million housing units within the next 10 years and money must be found from some source to build that housing. How do you propose to make money available from institutions on some kind, on an incentive basis, to accommodate that demand?

Secretary KENNEDY. Well, the thing I was talking about here, Senator, was that in the taxation of financial institutions, savings and loans, savings banks and commercial banks, that we agreed with the provision of taxation and about the amounts that the House bill has, but we thought that the limitation that savings institutions have in the tax bill, should be eliminated and that they should have complete freedom in investments and, at the same time, they should have another 5 percent encouragement, provided that was not too much. Do you want to make a comment on that?

Mr. COHEN. I would just like to add that in addition to encouraging directly the making of residential mortgage loans by all types of financial institutions, we have given housing a preference in the depreciation provisions because we continue to allow double declining balance depreciation for housing but would no longer permit it for nonhousing real estate construction. In addition, the bill contains a provision for 5-year amortization of the costs of rehabilitating housing for low- and middle-income groups that we think would be an important stimulant.

### TAXATION OF FOUNDATIONS

Senator JORDAN. Turning to another phase of your recommendations, I am concerned about how much revenue will be lost by some of your recommendations: for instance, the reduction of the proposed 7½-percent tax on income of foundations in the House bill which you will reduce to 2 percent in your recommendations as a supervisory tax.

What would be your estimate of the loss of revenue for this recommendation?

Mr. COHEN. Our estimate in that regard is that our proposal will raise long-run $25 million in lieu of the $100 million, a $75 million reduction in that regard.

I might say that overall the provisions for reform in our proposals would raise about $20 million more than those in the House bill, and that may be what Senator Harris was asking me for.

On page 5 of my statement we have this information. The total revenue from reform in the case of individuals and corporations reform under the bill involves about a $8.085 billion increase; in our proposals it would involve about $8.105 increase—$20 million more, but substantially the same; while we changed the mix in our recommendations, overall they are substantially the same. Overall the difference in the extent of the relief provisions is with respect to the combination of the standard deduction and rate reduction.

Senator JORDAN. These are taken into account in your totals, in the summary of your totals?

Mr. COHEN. Yes, sir, that is in our totals.

DEPLETION ALLOWANCE

Senator JORDAN. Have you given any consideration in any of your studies to the possibility of exempting from depletion allowance reductions certain critical and strategic metals that are in short supply that the country has to import from other countries? Have you given any consideration in any of your studies to the possibility of not reducing the depletion allowance for minerals of that nature?

Mr. COHEN. Well, no reduction is provided in the bill for the five categories, gold, silver, oil shale, iron ore, and copper. This was after discussion with representatives of the Department of Interior, who attended executive sessions of the Ways and Means Committee.

This bill does provide, Senator, for the elimination of depletion allowance on foreign oil and gas production, but not on any other minerals.

We have suggested that depletion continue to be allowed on all foreign minerals to the same extent as in the United States, but we have made suggestions and recommendations with respect to the foreign tax credit, so that the allowance will not be a means of tax minimization.

Senator JORDAN. My State produces no oil, unfortunately, but we do produce lead and zinc, and I wonder why lead and zinc which meet the same qualifications of being in short supply and have the same characteristics as the other metals you have suggested here, why they were not excluded along with gold, silver, oil shale, iron ore, and copper.

Mr. COHEN. We will be glad to consider it, Senator. But I am not that familiar with the specific facts in the case, and would like to go into it.

Senator JORDAN. I wish you could. I wish you could.

I will yield back to the chairman.

The CHAIRMAN. Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Secretary, I certainly agree with you about the problems concerning relief to the individual taxpayers, that we do not relieve them of the jobs. It is very important to know that we have a competitive situation, too, as far as industry is concerned, and we just cannot tax industry to the point to where they will not be in position to provide jobs and could not compete internationally.

INDUSTRIAL DEVELOPMENT BONDS

It is a very serious proposition. But in looking for additional revenue, Mr. Secretary, would you recommend elimination of tax exemption on industrial development bonds as distinguished from municipal bonds?

Secretary KENNEDY. That is a separate category, as you know, and it has been very controversial because it has been used in some States,

but not in other States, and that is one I would like to look into very carefully.

Senator FANNIN. I did not understand you.

Secretary KENNEDY. I say that is one I would like to look into very carefully to see if there is any change that should be made. I am not really in any position to make any comment on that. Maybe Mr. Cohen is.

Mr. COHEN. Senator——

Senator FANNIN. Mr. Cohen.

Mr. COHEN. Senator, I am sure you know, and I am sure you understand, that Congress has cut back on the use of industrial revenue bonds, and our conclusion was that the Congress, having acted, as I recall, not once but twice in the last session, we felt that attention ought to be devoted to other matters in the reform bill, but we could consider it further.

Senator FANNIN. I would certainly be interested in that. I am certain the committee would be interested in how much revenue would be involved in that matter because I think this is very important.

This is used as a competitive tool between States, as we have discussed before, and I think it is something that could be eliminated and would result in additional revenue, and I would be very much concerned as to how much would be produced by so doing.

(The Department of the Treasury subsequently supplied the following additional information:)

## INDUSTRIAL DEVELOPMENT BOND MATERIAL

### HISTORY OF THE ISSUE

For some years state and local governments have issued industrial development bonds using the proceeds to build industrial plants for business concerns locating within their areas. Such bonds have been secured by rentals or installment sales payments obtained from these concerns. The arrangements have permitted business firms to secure financing through lower tax-exempt interest rates in place of the higher rates that would obtain on their own taxable obligations.

In the initial stage of state and local industrial development bond financing, the Internal Revenue Service issued private rulings which permitted this use of the tax-exemption feature, and, in 1954, a public ruling was issued. At that time, only a few states had authorized industrial bond issues and the total annual amount of debt issued, the amounts of individual issues, and the size of business concerns benefited were relatively small.

The situation changed dramatically, however, in the mid-nineteen sixties. As interest rates on corporate bonds and other corporate borrowing increased, an upsurge occurred in industrial development bond flotations. In state after state enabling legislation was passed and the major industrial concerns began to turn to these bonds as a method of financing their fixed-capital requirements. As the large corporations began to utilize this technique, individual bond issues of the size of $50 million and even $100 million became common place. This, in turn, had a marked impact on the annual volume of new issues. Thus, in comparison with a total volume of new issues of less than $100 million in 1962, the reported volume of new issues had reached $500 million by 1966 and in 1968 rose to a level of $1.56 billion.

Once the expansion in these bonds was underway, the very real dangers in this device became apparent. It became clear to municipal and county officials that the expansion in these bonds was forcing interest rates on regular municipal bonds to higher levels. The expansion was also having an increasingly greater effect upon Treasury revenues. It was estimated that if the prevailing rate of growth of new issues had continued, the annual revenue loss would have amounted to $1.5 billion by 1975.

RECENT LEGISLATION

As you know, under the Conference Report on the Revenue and Expenditure Control Act of 1968, action was taken to curb the use of tax-exempt bonds for private industrial and commercial pursuits. Under this legislation, tax exemption was retained for bonds issued to finance certain exempt activities (*e.g.*, residential housing, airports, docks, etc., facilities for the furnishing of power and water) or for financing industrial parks. Exemption was also retained for small issues, defined as issues below $1 million. For purposes of applying this $1 million limitation, prior issues used to finance facilities for the same or a related company, if located in the same municipality or county, had to be taken into account to the extent still outstanding on the date of the later issue. A subsequent amendment raised the $1 million limitation to $5 million in conjunction with a provision under which, if the issuer elected to have the higher limitation apply, capital expenditures made by the same company, or related company, in the same municipality or county within three years preceding or three years following the date of the tax-exempt issue would be treated as outstanding bond issues for the purpose of calculating the $5 million limitation.

Recent data on the volume of tax exempt industrial development bond financing indicate this legislation has well served the intent of the Congress to limit this use of tax exemption. In 1968, 165 tax-exempt bond issues, amounting to more than $1.5 billion, were floated to finance manufacturing and commercial facilities as defined by the legislation. In comparison, in the first half of 1969, only 28 issues, amounting to $14 million, were issued. The amount of debt issued in the first two quarters of the year subsequent to the enactment of the legislation contrasts with the first two quarters of the year which preceded enactment when 65 issues totaling more than $600 million were floated.

INCREASES IN PRICE OF OIL SEEN

Senator FANNIN. When we are talking about a competitive position, the oil and gas industry in the United States is characterized by a complex of delicate series of interrelationships between income taxation, domestic price levels, oil imports, domestic and foreign production and reserves, national security, and balance of payments. There are so many factors that we must take into consideration.

Once one of these factors is changed it creates an impact on one or more of these factors. I think we discussed that.

For example, if these tax exemptions or recommendations are enacted, the cost of oil will immediately increase. I think we can take that for granted, especially, as has been brought out today, since the return on investment in the oil industry is currently slightly less than that of the manufacturing companies, and it is not reasonable to expect these costs to be absorbed.

I am sure all will agree, you will agree, with that. I am wondering how much the U.S. price of gasoline will be increased as a result of these proposals.

Secretary KENNEDY. I have no suggestions, but I have heard discussion of it by some of the oil company people who have talked with me.

Dr. WALKER. This is, economically speaking, Senator, a very difficult area to make estimates in, and I understand many petroleum companies have made that point. They also make the point at the same time they have a low return on capital.

I would ask the question if they have the power to raise prices any time they want to under those circumstances, why have they not done so to increase their return on capital.

The point is when you start getting into one of these situations

and analyzing how much of the incidence of a tax would be borne by the corporation, the stockholder, and the ultimate purchaser of the product, you can get into a jungle pretty quick on this sort of thing.

Senator FANNIN. I agree——

Dr. WALKER. It is related to the oil import policy, too, which is under review; all of that enters into that picture.

ELIMINATING GASOLINE TAX DEDUCTION

Senator FANNIN. Yes. It is a very complex problem, I realize that. But here we are eliminating deduction for State gasoline taxes, and now we are throwing another burden on the individuals. If we are going to throw these burdens on them, what good is it going to do them to give them tax relief in one area and place a heavier burden on another. There would be some people who would be quite heavily affected.

Dr. WALKER. Well, with the State gasoline tax, of course, that, in practically every instance, almost all instances, will be much less than the rate deduction they would receive in that same bracket. The average there is about $10, $15 per taxpayer.

Senator FANNIN. You would not say that for a salesman or someone who is using a car.

Dr. WALKER. But that is a business cost he can continue to deduct.

Senator FANNIN. True. It is an extra expense to the business, though, regardless of how you would look at it, and certainly it is a consideration so far as his business is concerned.

Mr. COHEN. This proposal, Senator, for eliminating the gasoline tax deduction would not be applicable to business operations. The salesman could continue to deduct his full cost of the gasoline, including the gasoline tax, as a business expense.

Senator FANNIN. I agree with that. But that is still something which would not completely offset his costs. It would offset it to a certain extent, but it depends on his income and other factors involved, the type of contractual arrangement he may have.

FOREIGN OIL

I take it, Mr. Walker, you said imports of foreign oil would be involved?

Dr. WALKER. It is involved. I am not saying what policy would be there.

Senator FANNIN. It would be changed, but this results, at least, in greater imports of foreign oil through the relaxation of quotas and domestic gas level prices may drop in spite of the tax burden imposed by these recommendations.

Now, any substantial drop would result in large numbers of domestic wells becoming uneconomic and, therefore, closed down. I think that has been brought out very forcefully, when we talked about a fairer share and burden on oil. But when we close a business down and you lose a job it has gone beyond fair and equitable. I think you are quite familiar, being from Texas, that when they close a well down it is not always economically sound that you just return and

open it again. Sometimes, there are seepage and other problems involved. We all recognize that.

But if we do this, both jobs and equipment may disappear. I think it is something to look into.

Then, too, it has been brought out we were concerned about national security and the balance of payments. We are still the world's largest single oil purchaser, and the very chance of success or failure in any conflict, we all recognize, hinges on oil. In Southeast Asia today about 50 percent of military tonnage consists of petroleum products, while only about 10 percent of the petroleum required for the war effort comes from the United States, and we must maintain a capability of the United States to support our war needs in case foreign sources are denied, as they were for a short time in the 1967 Middle East crisis.

Don't you think this is being jeopardized if we follow through with these recommendations found in this bill?

Dr. WALKER. We recognize all of these problems, Senator. We think the legislation, as we propose, as modified, represents a reasonable balancing of all these considerations involved. It is just a consideration that was strongly felt in the House and by many other people that the minerals industry and that part of it, particularly, the petroleum industry, was not bearing an adequate share of the national tax burden, and that route was taken in the House to increase that burden.

OIL EXPLORATION INCENTIVES

Senator FANNIN. Well, I come from a State where we are hoping for exploration, and we realize we are not going to have it unless we do have incentives. We do know statistically our exploration starts have certainly dropped considerably in the last few years, even with the incentives they have today, and now we are going to reduce the incentives.

Dr. WALKER. The original proposal with respect to LTP included intangible drilling costs, going on the assumption the independent operators will continue to do a great deal of exploration, could have diminished incentives more than were desirable. We think the adjustment made in dropping intangible drilling costs from that will maintain adequate incentives for exploration, particularly on the part of the independents.

Senator FANNIN. I am sure you understand many people do not agree with that statement.

Dr. WALKER. Yes.

Senator FANNIN. Then, of course, I think time will tell. The House bill provides for great many of the changes that certainly will already place a tremendous burden on the oil industry.

LARGE UNIONS SEEN RECEIVING PREFERENTIAL TREATMENT

I am not referring only to the oil industry but, fortunately, our State has copper and produces 50 percent of all the copper in the country. We are not expecting to extend it only to oil, but I hope we will find oil, but we are looking to the revenue, and I think there are some areas, and I am just wondering if you have thought about the greater equity and simplification, if you are proceeding to bring equity, why

you did not recommend a change in the very preferential treatment given to giant unions.

I am wondering if that has been considered.

You are talking about all these tax-exempts, churches, hospitals, eleemosynary institutions, and all, what about the preferential treatment given to unions?

Mr. COHEN. We have not recommended any tax on tax-exempt organizations of any kind. There is a long list of tax-exempt organizations that goes beyond labor unions—horticultural organizations, cemetery companies, and so on.

We have suggested the 2 percent tax or fee as a means only of defraying the cost to the Internal Revenue Service of its intensified program of audit of private foundations.

But there is no such need with respect to the other organizations that we see at this time, and if there were, I think we would extend a similar principle to them.

Senator FANNIN. I just asked a question: have you made a study of the special tax privileges given to unions and the effect curtailing them would have on the tax revenues?

Mr. COHEN. We do have a study proceeding with respect to the remaining area of tax-exempt organizations, but I do not mean by that to indicate that we are contemplating taxing the labor unions. But we do plan to present to the Congress a study and review of the whole problem of tax-exempt organizations.

Senator FANNIN. Well, of course, you recognize, there are many businesses and industries throughout the country that do receive special consideration, that are run by unions, and it is all thrown back into their funds that are tax-exempt. So I am just wondering why this would not be given consideration.

Mr. COHEN. Well, we do have provisions in the bill, Senator, to make sure that the tax on unrelated business income that exists in present law is extended to additional types of organizations, including churches, for example, that own and maintain businesses that compete with private industry. Under this bill—and we have recommended this—the tax on unrelated business income of tax-exempt organizations would be applied to a list of organizations not now subject to it, including the churches.

Senator FANNIN. There are churches, and there are other nonprofit organizations, which do nationwide lobbying, and there are millions of dollars, hundreds of millions of dollars spent each year by the unions, giant unions. Still there does not seem to be much concern about this.

Mr. COHEN. The tax on unrelated business income applies to the labor unions. It does not now apply to churches, but it would be extended.

There is also another provision in the bill to apply to all these organizations if they borrow money to purchase investment assets, such as real estate or personal property. To the extent that they use that tax exemption to enable them to pay a higher price for property than a taxable owner could pay, we would impose a tax under this bill.

Senator FANNIN. Fine. But I am talking about revenue.

Mr. COHEN. Pardon me?

Senator FANNIN. I am talking about revenue. In other words, talking about the earnings.

For instance, in Washington they own buildings, they own hotels. How about tightening up the basis of handling their revenue?

Mr. COHEN. If they have a hotel operation, that would be a business, and any of these organizations that operate a hotel or a motel would be subject to the tax on their net business income—not on their dues that they receive from members, not on their investment income from portfolio securities, but if they operate a hotel business or a restaurant then they would pay tax just as their competitors would.

Senator FANNIN. Well, my time is up. But do you feel that they are being properly taxed on their unrelated income or are they able to avoid taxation?

Mr. COHEN. If they use their own funds for investment purposes, and neither borrow for investment purposes nor get into a business operation in competition with private industry we would not tax them.

But if they use borrowed funds or buy on an installment basis or they actually engage in business operations in competition with private industry, the bill, under our proposal, would impose a tax on them.

Senator FANNIN. I trust you will look into it because I think millions of dollars of revenue is being lost.

Mr. COHEN. I would be happy to, Senator.

Senator FANNIN. Thank you.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

### INDIVIDUALS PAYING NO TAXES

Mr. Secretary, if your recommendations are adopted, would the pending legislation eliminate the existing situation whereby individuals with substantial incomes pay no taxes?

Secretary KENNEDY. Yes, Senator, with the possible exception of the person whose total income is in tax-exempt securities.

Senator BYRD. Would that be an exception or possible exception?

Secretary KENNEDY. Possible exception.

Senator BYRD. Possible exception.

Secretary KENNEDY. Possible exception because it is not likely that very many, if any at all, would have their entire income from tax-exempt securities.

Senator BYRD. Thank you.

### ABUSES OF FOUNDATIONS' TAX-EXEMPT STATUS

Does the Treasury Department feel that there have been abuses of tax-exempt status by many private foundations?

Secretary KENNEDY. I should say that in looking it over that there have been abuses, and I think that our actions in the Treasury administratively are appropriate and will be quite effective. I think that the bill itself will help. I do not think that the answer, however, is the 7½ percent tax on foundations.

Senator BYRD. What steps does the Treasury plan to take to eliminate the abuses?

Secretary KENNEDY. Well, in further examination and more reporting and public information about them, so that the facts will be clear, and if there are abuses the tax-exempt privilege will be revoked.

Senator BYRD. In your judgment, Mr. Secretary——

Mr. COHEN. Senator, the bill contains a number of restrictions on the activities of private foundations, most of which we recommended in substantially this form, and we are agreeable, in general, to the minor changes that were made in the House bill. But they go a long way toward prohibiting the abuses that have occurred in the past.

Not only have we set up an administrative program in the Internal Revenue Service, but this bill itself will eliminate many of the possibilities of abuses.

Senator BYRD. This bill itself puts additional restrictions on them?

Mr. COHEN. A great many, sir.

Secretary KENNEDY. That is right.

Senator BYRD. Thank you.

### OIL DEPLETION ALLOWANCE

Mr. Secretary, in your judgment, would the reduction in the oil depletion allowance jeopardize oil exploration?

Secretary KENNEDY. No, it would not, and if I thought it would I surely would be against the provisions because I think we need exploration. We need development of our resources.

What I think it does is this: It gives a reasonable tax burden on the part of the oil industry without destroying incentive.

Senator BYRD. Do you feel the 20 percent depletion allowance recommended in the legislation would be adequate?

Secretary KENNEDY. Reduction from 27½ to 20 at one fell swoop is a large reduction, and I think it is about—it is adequate.

Senator BYRD. I do not mean an adequate reduction. I meant would it be adequate to encourage exploration.

Secretary KENNEDY. Twenty percent seems to me adequate.

Senator BYRD. Is this the position—I take it this is the position of the Nixon administration?

Secretary KENNEDY. We did not recommend this, as you know, in our proposals to the House Ways and Means Committee. We acted in their executive sessions as technical advisers. We feel that with the change on intangible drilling expenses—taking it out of the preferences, that we will have a fair balance. We are not opposing it; we are accepting it.

Senator BYRD. You feel the 20 percent, the change from 27½ to 20 percent, would be a fair proposal from the point of view of the taxpayer?

Secretary KENNEDY. That is correct, looking at——

Senator BYRD. And would leave an adequate depletion allowance from the point of view of encouraging oil exploration?

Secretary KENNEDY. Twenty percent, yes.

Senator BYRD. Thank you, sir.

COST OF RAISING PERSONAL EXEMPTION TO $1,250

Now, in regard to changing the individual exemptions concerning the $600, as I understand the testimony this morning, if it were changed to $1,250, the cost would be $20 billion, is that correct?

Mr. COHEN. That is a rough figure, Senator, and we could estimate it more precisely. It changes as income goes up.

My recollection is that if you raised it from $600 to $700 the revenue costs would be between $3 billion and $3.5 billion. This would go up as the Nation's income goes up, and it is now close to $3½ billion for each $100.

But when you go up to $1,200, the last $100 does not cost as much as the first $100 would cost, and so I was estimating that at $1,200, the figure would be about $17 billion; and with $1,250 and the continuing rise in national personal income, I was rounding it off in the neighborhood of $20 billion.

Senator BYRD. So any change in the personal exemption would cost a tremendous amount of revenue.

Secretary KENNEDY. That is right.

Senator BYRD. No doubt about that. So if you do change the—if you increase the—exemption, which is one way of doing it; if you are going to get the same amount of tax dollars you would have to increase the rates all down the line, I would assume?

Secretary KENNEDY. If we are going to keep a balanced program that would be precisely right.

BILL TO BENEFIT MIDDLE INCOME TAXPAYER

Senator BYRD. Mr. Secretary, I am very much interested in reducing the tax burden on the middle-income group because I think this is the group that is bearing a very heavy share of these taxes.

As a matter of fact, if my figures are correct, and if they are not I would be glad for you to correct me, but I understand, and my belief is, that two-thirds of all the individual income taxes that are paid into the Federal Government each year are paid by those with incomes of $20,000 or less.

Now, does this bill help give tax relief to those in the middle income brackets?

Secretary KENNEDY. Yes, it does, very definitely.

Mr. COHEN. I cannot quickly find the figures with respect to those below $20,000, but we can get them in a moment, but most of the relief in the bill is in those income brackets.

In the higher income brackets there is a net increase in tax because even though rates have been reduced somewhat the reform provisions

will cause the high income groups to pay additional taxes under the bill. So most of the relief, which is, I think, $9 billion roughly under the House bill and $7.3 billion under our bill for individuals, will be in the less than $20,000 category.

At the $20,000 level, both under the House bill and our proposals, there would be between a 5- and 6-percent reduction in the tax burden.

Senator BYRD. So the larger share of the reduction in taxes will come, will go to those in what you would call the middle economic group?

Secretary KENNEDY. $25,000 and under will all get at least between 5 and 6 percent. In fact, 5.5 at $25,000 for a typical married couple with two dependents.

Senator BYRD. It seems to me that the only real way, the only effective way, to reduce taxes is to get spending under control. The only reason you have taxes is because of the spending, and if we can get spending under control, than we can give tax reduction. If we do not get spending under control, regardless of how we juggle the personal exemptions, regardless of how we juggle the tax rates, we are going to have heavy taxation.

I think that, in my judgment, the major cause for this very severe inflation we have had has resulted from that $25 billion deficit that the Government ran in fiscal year 1968, just 1 year ago. I think we are headed toward a better fiscal situation than we have had in the past, but if we do not get our financial house in order then I am convinced that we are going to have either very heavy taxation—and it is too heavy now—or we are going to continue this severe inflation which also is working a great hardship on the American people.

So while I think that this bill is headed in the right direction, and I am glad it will give relief to, particularly to, the middle-income group, I think in the long run that this Congress and this administration must put its prime efforts on spending policies.

Thank you, Mr. Chairman, and thank you.

Mr. COHEN. Senator, may I give you the information specifically with regard to those under $20,000. Under our proposal it would involve net relief for all individuals of $4.8 billion. Of that—nearly the whole net amount of that relief will go to persons under $50,000 of income, and in the $20,000 to $50,000 category there would be about $800 million.

So almost $4 billion of relief will go to those under $20,000 in income.

Senator BYRD. And that is where the relief should go because the figures will show, I think, that two-thirds of all the taxes are paid by those individuals. They are the ones who are bearing the heaviest burden for the simple reason that there are more of them.

Mr. COHEN. I would say, I do not know what you would define as the middle-income group, but if you take $7,000 to $20,000, the combined relief is in the neighborhood of $2.5 billion. That is more than half of the $4.8 billion figure. These are very rough figures.

Of course, there is a larger proportionate relief for those below the poverty levels who are being excused entirely, but we can do that

at a cost of only $625 million under our April 22 proposal or $920 million under our current proposal, so that does not involve as much in dollar revenue loss to the Government as relief to the middle-income bracket because they are the ones who have been paying such large amounts of revenue.

Senator BYRD. Thank you, sir. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hansen, you have been sitting here listening to everything that went on. I think you are entitled to ask a question or two if you want to. Fire away at the Secretary and his assistants.

Senator HANSEN. Thank you, very much, Mr. Chairman.

I want to first of all compliment you for the extremely able manner in which you have conducted these hearings so far.

### OIL INDUSTRY IN WYOMING

I want to say that I share the conviction and concern indicated by the chairman respecting the oil industry. We are talking about an industry that must find 87 billion barrels of oil. I know the oil people are investing $9.7 billion annually in the search.

I am concerned because of the stake my State of Wyoming has in taxes paid at the county level. A third of all the county taxes paid are by the oil industry.

The oil industry represents almost 30 percent of the assessed valuation of my State, and I am concerned because at the State level in property taxation, 26½ percent are paid by the oil industry.

Now, my concern is, Mr. Secretary, and I do appreciate your kindness and consideration and that of the committee, with the anxiety expressed not only by the Nixon administration but also by the previous administration, in trying to keep jobs going in this country. Secretary Stans said recently that he thinks we are exporting jobs, and I share his conviction. What will be done to replace the loss of jobs in Wyoming if the tax proposals that have been made by the House bill and others now proposed are implemented?

I am told by the people of my State that perhaps 90 percent of the independent oil activity—an activity which has brought about the discovery of between 75 and 80 percent of all of the new reserves in this country, exclusive of those on the Outer Continental Shelf—that if these tax proposals are enacted about 90 percent of the independents will go out of business. What will be done to provide jobs in my State and in other oil-producing States for those who will be unemployed because such a significant portion of the oil industry will be out of business?

Secretary KENNEDY. That is a very leading question, Senator, because I do not agree that 90 percent of them will go out of business. I think that the provision here for the independents not being included in the tax preference with respect to intangible drilling costs will be helpful to them if they are in the oil business. I do not share that conclusion.

Senator HANSEN. Well, I would say this: While the bill which has been proposed does not include the independents, I just point out that the independents in my State depend primarily upon outside sources of income for their drilling activities, and while they are excluded in certain aspects, their sources of income have come from outside sources. Would you not agree that it will affect those outside sources?

Secretary KENNEDY. Yes, to some extent, but there would still be incentive to invest. It is a question of where these investment moneys go, because a person will still have an advantage in making an investment.

Senator HANSEN. Would it not be reasonable to assume that an individual investor would choose, other things being equal, an industry which is not high risk? Would it not be reasonable to assume that an individual investor would try to put his money where the return is the greatest?

Mr. COHEN. Senator, I wanted to point out in our limit on tax preferences, there would be no effect whatsoever if a person does not use the preferences beyond one-half of his aggregate income.

A man with a $60,000 salary could put $30,000 in these preferences with no effect whatsoever. This is only an effort to try to balance between the giving of the incentives to investment and the desire to see that everyone pays some reasonable tax. So it does not prohibit the investor from investing. It just says that we are going to limit the use of this to half of his income, and we allow a 5-year averaging provision for that purpose.

Senator HANSEN. I have no argument at all with the thrust, with the desire, with the attempt of the bill to bring about equity and fairness. I am very much concerned over the practical application of a measure which, I think, will have far more significant effects upon an industry than I know is shared by some other people.

I do not disparage at all what you say. I just happen not to agree with you.

Thank you very much, Mr. Chairman.

Secretary KENNEDY. I talked to some of the oil people in your area, and I do not get quite the 90 percent.

Senator HANSEN. I missed that.

Secretary KENNEDY. They are concerned, but I do not think they will be seriously affected.

Senator HANSEN. We hope it is not going down the drain. Thank you, sir.

The CHAIRMAN. If I might say, Mr. Secretary, we are in for a bad time in the oil industry if all of these things happen. That is all we are going to ask you about for the time being.

You have been here now under fire for a solid 3 hours. I do not know how those hot television lights affect you, but they affect me. I have managed to find a shield, but notwithstanding that, I have tried to duck those lights that are focused on me.

Secretary KENNEDY. I am going to bring my colored glasses when I come back.

The CHAIRMAN. So far as I know, you were not warned in advance of any questions that would be asked you, and with very few exceptions you have been responding all morning to adverse questions like a batter who does not know what the pitcher is going to throw. I would suggest now we quit, in view of the fact that the hour is 10 after 1; that we quit until 3 o'clock. That might give you a chance to catch up with what is going on down at the Treasury.

But come back to answer further interrogations this afternoon. Thank you.

(Whereupon, at 1:10 p.m., the committee recessed, to resume at 3 p.m. this same day.)

AFTERNOON SESSION

Senator ANDERSON (presiding). We will start off the afternoon by calling the committee to order, and we will ask Mr. Cohen to make his statement.

FORTHCOMING TREASURY TECHNICAL EXPLANATIONS

Mr. COHEN. Yes.

Mr. Chairman, there is a reference at the front of the printed copy of the Secretary's statement and my statement to the effect that we will have available shortly a more detailed memorandum making further recommendations.*

I would like to say that this is not intended to cover any important basic policy recommendations but is to be more in the nature of a technical explantion or expansion of the items that have been covered broadly in the Secretary's statement and mine.

We thought there were some things of a more detailed nature that could be best left for a further statement rather than the present one. But it is not intended by that further statement to have major changes or expansion of the recommendations that we have in our present statement.

Senator ANDERSON. Thank you very much. Go right ahead.

Mr. COHEN. We would be prepared to answer questions, but have no further statement to offer at this time.

Senator ANDERSON. We will print your prepared statement at this point in the record.

(Hon. Edwin S. Cohen's prepared statement follows:)

---

*Appendix A of this book.

TREASURY DEPARTMENT
WASHINGTON, D.C.

This Statement is Totally Embargoed Until Actual Delivery Time, Scheduled for 10:00 A.M., Thursday, September 4, 1969.

STATEMENT OF THE HONORABLE EDWIN S. COHEN
ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY
BEFORE
THE SENATE FINANCE COMMITTEE
ON THE PROVISIONS OF H.R. 13270
THE TAX REFORM ACT OF 1969
SEPTEMBER 4, 1969, 10:00 A.M.

Mr. Chairman and Members of the Committee:

It is my pleasure to join in Secretary Kennedy's statement and to present the Administration's position on the specific provisions of H.R. 13270, the Tax Reform Act of 1969.

The bill in its present form when fully effective provides tax relief of $9.7 billion to individuals and also contains certain incentive provisions which involve a revenue loss of $0.8 billion--a total revenue reduction of $10.5 billion. These are offset by revenue raising provisions which in the long run will total $8.1 billion (including $3.3 billion from repeal of the investment credit), resulting in a net revenue loss of $2.4 billion. In some years in the early 1970's the net revenue loss will be about $1.0 billion higher. The bill would commit at this time revenues which may be needed for programs of high priority, such as President Nixon's family assistance plan, the Administration's program for revenue

sharing with state and local governments, and other vital measures. The size of this revenue loss requires that the tax relief provisions of the bill be carefully evaluated.

The provision giving $4.5 billion of rate reductions to individuals represents reasonable, equitable tax relief. The other broad impact of the bill--the individual relief provisions other than rate reduction--converting the Administration's proposed Low Income Allowance to a flat minimum standard deduction allowance of $1,100, extending the standard deduction to 15 percent with a $2,000 maximum, extending head-of-household treatment to all single persons over age 35, and extending special relief to widows and widowers, provide disproportionately high tax reduction in many instances. In effect, these various benefits cumulate in some of the income brackets, particularly with respect to single persons, and create some serious imbalances in the allocation of the total tax relief. While there is merit in these changes, in the aggregate they go too far and should be cut back. The imbalances,we believe, should be corrected.

The bill would result in a net long-term shift in tax burden between corporations and individuals as follows:

Individuals: $-7.3 billion

Corporations: $+4.9 billion

The resulting shift in emphasis of this magnitude from investment to consumption is in our judgment inadvisable.

The Administration recommends a revised program of tax relief for both individuals and corporations designed to decrease the revenue loss in the bill, distribute the tax relief among individuals more equitably, and reduce to an acceptable degree the shift in emphasis from investment to consumption. This revised program would provide substantial relief for individuals of the same general types as are contained in the bill. The program also calls for a corporate rate reduction ultimately reaching two percentage points -- relief of the same general magnitude as the individual rate reductions.

This revised program would result in a long-term revenue loss of $1.3 billion per year, approximately half as much as the $2.4 billion revenue loss which would result from the House bill. It

would result in a net increase in corporate taxes of $3.5 billion and a reduction for individuals of $4.8 billion. While this still represents some shift in emphasis from investment to consumption, it is one that is much less severe than that provided in the House bill and is one that is warranted by the economic conditions which we expect to prevail in the year 1972 and thereafter, when it will have its principal effect.

The general composition of the bill by rate reduction, reform, relief and incentive, for individuals and corporations, is shown in Table 1. Table 2 contains a list of the specific provisions in the House bill in the order that I will discuss them, with the long-run revenue estimate of the House bill and the proposed Treasury change. Table 2 also provides a table of contents for those topics in the following discussion.

I have attached at the end of this statement tables showing the effects of the principal provisions on a typical married taxpayer at various income levels. There is also a

Table 1*

Comparison of House Bill and Treasury Proposal
by Principal Feature in Terms of Long Run Revenue Effect

| | House Bill | Treasury Proposal | Difference (-) is increased revenue loss or decreased gain |
|---|---|---|---|
| | (............ | $ millions | ............) |
| **Rate Reduction and Relief Provisions** | | | |
| Individual | | | |
| Rate reduction............................ | -4,498 | -4,705 | -207 |
| Standard deduction........................ | -4,025 | -1,690 | 2,335 |
| Single person............................. | - 650 | - 445 | 205 |
| Other..................................... | - 500 | - 500 | - |
| Total..................................... | -9,673 | -7,340 | 2,333 |
| Corporation | | | |
| Rate reduction............................ | - | -1,600 | -1,600 |
| **Incentive Provisions** | | | |
| Individual................................ | - 70 | - 70 | - |
| Corporation............................... | - 760 | - 440 | 320 |
| Total Rate Reduction, Relief and Incentive ... | -10,503 | -9,450 | 1,053 |
| **Reform Provisions** | | | |
| Individuals | | | |
| Investment credit repeal.................. | 600 | 600 | - |
| Other..................................... | 1,815 | 1,975 | 160 |
| Total..................................... | 2,415 | 2,575 | 160 |
| Corporations | | | |
| Investment credit repeal.................. | 2,700 | 2,700 | - |
| Other..................................... | 2,970 | 2,830 | -140 |
| Total..................................... | 5,670 | 5,530 | -140 |
| Total Individuals and Corporations Reform .... | 8,085 | 8,105 | 20 |
| Total: | | | |
| Individuals............................... | -7,328 | -4,835 | 2,493 |
| Corporations.............................. | 4,910 | 3,490 | -1,420 |
| Combined ................................. | -2,418 | -1,345 | 1,073 |

Office of the Secretary of the Treasury
Office of Tax Analysis

September 2, 1969

*Department of the Treasury subsequently revised this table. The revised table appears at page 911.

Table 2

Long Run Revenue Effects of H.R. 13270
as Passed by the House and
Proposed Treasury Changes by Major Provision

| Page number in following discussion | | Long Run Revenue Effects: House Bill | Current Treasury proposal | Difference is greater revenue lo[ss] |
|---|---|---|---|---|
| | | (.......... $ millions ........ | | |
| | **Tax relief - Individuals** | | | |
| 553 | Rate reduction | -4,498 | -4,705 1/ | -207 2/ |
| 554 | Low income allowance - minimum standard deduction | -2,652 | -920 | 1,732 |
| 555 | Standard deduction | -1,373 | -770 | 603 |
| 556 | Single persons | -650 | -445 | 205 |
| 559 | Reporting by low income taxpayers | -- | -- | -- |
| 560 | Earned income rate limit | -100 | -100 | 0 |
| 561 | Gasoline tax deduction | 0 | 390 | 390 |
| | **Tax relief - Corporations** | | | |
| 561 | Rate reduction | 0 | -1,600 | -1,600 |
| | **Others** | | | |
| 562 | Foundations | 100 | 25 | -75 |
| 567 | Exempt organizations - unrelated business income | 20 | 20 | 0 |
| 569 | Charitable contributions | 20 | 20 | 0 |
| 573 | Farm losses | 20 | 50 | 30 |
| 576 | Interest deductions | 20 | 0 | -20 |
| 578 | Moving expenses | -100 | -100 | 0 |
| 578 | Limit on tax preferences | 85 | 60 | -25 |
| 578 | Allocation | 460 | 480 | 20 |
| 584 | Income averaging | -300 | -300 | 0 |
| 584 | Restricted property | * | * | * |
| 585 | Deferred compensation | 25 | 0 | -25 |
| 587 | Accumulation trusts | 70 | 70 | 0 |
| 588 | Multiple corporations | 235 | 235 | 0 |
| 589 | Corporate securities | 70 | 70 | * |
| 590 | Stock dividends | * | * | * |
| 592 | Foreign income | 65 | 50 | -15 |
| 598 | Financial institutions | 460 | 410 | -50 |
| 603 | Regulated utilities | 310 | 310 | 0 |
| 606 | Tax-free dividends | 80 | 80 | 0 |
| 607 | Natural resources | 600 | 600 | 0 |
| 609 | Capital gains and losses of individuals | 635 | 425 | -210 |
| 614 | Capital gains of corporations | 175 | 175 | 0 |
| 614 | Real estate | 1,005 | 1,005 | 0 |
| 615 | Cooperatives | * | * | * |
| 616 | Subchapter S | * | * | * |
| 620 | Investment credit repeal | 3,300 | 3,300 | 0 |
| 620 | Amortization of freight cars | -100 | 0 | 100 |
| 620 | Amortization of pollution equipment | -400 | -180 | 220 |
| 618 | Taxation of state and local bonds | * | * | * |
| | **Total** | -2,418 | -1,345 | 1,073 |

Office of the Secretary of the Treasury
Office of Tax Analysis
September 2, 1[969]

*Less than $2.5 million.
1/ 1979, calendar year liability
2/ Increase due to broader tax base associated with a lower standard deduction.

table showing by adjusted gross income classes the pattern of total tax change under the bill and under the proposed changes. It demonstrates that our program continues but moderates the pattern of the House bill of heavier reductions in the bottom brackets, cuts of about 5 percent in the middle brackets, and an increase in the top brackets.

The Administration's position on the provisions of the House bill is as follows. A separate more detailed memorandum making further recommendations as to various matters is also being submitted to the Committee.

1. Tax Relief--Individuals (Secs. 801, 802, 803, 804, 805*)

Rate Reductions. The $4.5 billion rate cut in the bill does not discriminate between itemizers and nonitemizers, between homeowners and tenants, between married persons and single persons, between heads of households supporting dependents and single persons without this burden, or between taxpayers with different sources of income. The Administration recommends retention of the $4.5 billion rate cut ** in the form contained in the House bill because it provides such even-handed nondiscriminatory relief.

*References are to section numbers of H.R. 13270.
**The rate cuts will cost $4.7 billion under our proposals because our changes in the standard deduction broaden the income base.

Low Income Allowance. The Administration in April 1969, recommended a Low Income Allowance designed to relieve persons and families with incomes below the poverty level from any tax liability. To reduce the revenue loss from this additional special deduction, and to direct its impact at those below or near the poverty level, it was to be "phased-out," i.e., the special Allowance was to be reduced at the rate of 50 cents for each dollar of income over the specified "poverty" levels. This limited the bulk of the relief to persons with incomes below $5,000. The Allowance in this form would have relieved over 5 million presently taxable persons from any tax liability, would have reduced the tax of 7 million more persons, and would have resulted in an annual revenue loss of only $625 million. The Low Income Allowance in this form was favorably reported in H.R. 12290 by this Committee.

The present bill contains the Low Income Allowance but provides for the phase-out for the year 1970 only. Thus, the bill completely eliminates the phase-out for 1971 and subsequent years, resulting in an additional revenue cost of $2.0 billion.

The Administration recommends that the phase-out be retained but be stretched out by application at the rate of 25 cents for each dollar of income above the poverty level. This will extend the tax benefits provided by the Allowance to somewhat higher brackets where they are justified, but without converting the Allowance to a minimum standard deduction of $1,100, which is the effect of the House bill. The Low Income Allowance with this extended phase-out will result in a revenue loss of $920 million in lieu of the $625 million as originally proposed. It will thus save some $1.7 billion of the cost of outright elimination of the phase-out.

Standard Deduction. The provisions of the House bill increasing the standard deduction over a three-year period from the present 10 percent, with a ceiling of $1,000, to a level of 15 percent, with a ceiling of $2,000, should be changed. The increase should be limited to a level of 12 percent with a ceiling of $1,400. This more limited extension of the standard deduction would still result in major simplification since some 4 million taxpayers will be able to switch from itemizing their deductions to the standard deduction.

The combined effect of the rate reduction, the Low Income Allowance and standard deduction increase will be to reduce taxes for some 63 million taxpayers and to remove some 6 million persons completely from the tax rolls. The revenue cost of the standard deduction liberalization in this more limited form will be $770 million as compared to $1,373 million cost of the House bill provision.

Single Persons. The tax burden on single persons is disproportionately high in relation to that of married persons who enjoy the benefits of income splitting. However, in our judgment the provision of the House bill extending head-of-household treatment to all single persons age 35 and over is not the best means of dealing with this inequity. While a test based on maintenance of a household might have been devised, it would have been extremely difficult to administer where the taxpayer had no dependents, and in any event, the inequity to be corrected is the disparity in burden between single persons, whether or not they have dependents, and married couples. It seems preferable to reserve more favorable treatment for individuals who both maintain households and support dependents, as opposed to single persons who do not,

but yet also narrow the tax differential between single and married persons. Further, the selection of age as a dividing line for preferential treatment seems arbitrary and bears no relationship to actual ability to pay.

Accordingly, in lieu of the provisions of the House bill, the Administration recommends that a new rate schedule be adopted for single persons. This schedule would be constructed so that the difference between single person rates and married couple rates would be narrowed; no single person with the same taxable income as a married couple would pay a tax more than 20 percent greater than the tax paid by the married couple. The head-of-household rates would be reserved for persons maintaining a household for the support of dependents, and would continue to fall approximately halfway between the new single person rate schedule and the rates applicable to married couples. This proposed maximum 20 percent differential reflects a reasonable judgment of the additional costs of living of married couples and their ability to pay as compared to single persons.

The provision of the bill extending without limitation split income treatment to surviving spouses with dependents (rather than for only two years after the death of the spouse, as provided by existing law) should be deleted. A surviving spouse will become entitled to head-of-household treatment after the two-year period if the surviving spouse continues to support a dependent, and there is no rational basis for providing more favorable treatment to a surviving spouse than to any other head of household. The limited two-year period following the other spouse's death is appropriate because this is a period of transition, but we believe the split income benefits should not be extended beyond this period as the House bill provides.

The revenue cost of the lower rate schedule for single persons and heads of households, after deleting the unlimited extension of split income treatment for surviving spouses, would be $445 million as compared to the $650 million cost of the House bill provision.

Reporting by Low Income Taxpayers. To simplify compliance by millions of low income individuals, the Administration recommends a liberalization of the filing requirements. Under present law (not changed by the House bill), an individual is required to file a return if his gross income is $600 or more, except that an individual over 65 years of age is required to file a return only if his income is $1,200 or more. Consequently, 5 million nontaxable individuals with incomes which exceed these levels but which are less than the amounts exempted from tax by the Low Income Allowance would still be required to file returns. Since the Low Income Allowance is built into the withholding provisions of the bill, many of these persons will not be filing for refunds. The filing requirements should be raised to the new nontaxable levels.

Earned Income Rate Limitation. The Administration strongly supports the provisions of the House bill placing a 50 percent maximum tax rate on earned income. This limitation will provide an important incentive to the earning of income by personal services, both by employees and self-employed persons. Many of the devices for conversion of ordinary income into capital gain, and for deferment of income, have been nurtured out of the natural desire of persons who have reached high earned income levels to avoid the burden of very high rates. With a 50 percent top marginal rate on earned income, the successful executive or professional man will be more inclined to concentrate his efforts in the field in which he is qualified and devote less of his attention to intricate means of minimizing the effect of high tax rates. Particularly when coupled with the many provisions of the bill which eliminate or curb existing tax avoidance techniques, we think the 50 percent ceiling rate on earned income represents a substantial improvement in the law.

Gasoline Tax Deduction. The Administration recommends that the personal deduction allowed for state gasoline taxes be repealed. It is appropriate to discontinue this deduction as a part of an over-all program of rate reductions and liberalization of the standard deduction. The state tax, like the Federal tax, is essentially a user charge for highway facilities paid by those who use the highways. As a user charge, the existing deduction simply shifts part of the burden of those taxpayers who itemize to the general taxpayer. No other nonbusiness user charges are deductible. The proposed repeal of the deduction would not affect state gasoline taxes paid for business purposes. The revenue gain from repeal would be $390 million, an average tax increase from this change of about $10 - $15 to taxpayers who itemize their deductions.

2. Tax Relief--Corporations

The Administration recommends a corporate rate reduction of two points, a one-point reduction effective in 1971 and a full two-point reduction effective in 1972 and thereafter. The present corporate

rate, including the surcharge, is 52.8 percent for the calendar year 1969. This will reduce to 49.2 percent for the calendar year 1970 if the surcharge is extended at 5 percent for half the year as recommended by the Administration. The regular 48 percent rate, which would otherwise be effective for 1971, should be reduced to 47 percent for that year. The rate should be further reduced to 46 percent for 1972 and subsequent years. This program of continuing reduction will provide an important offset to the provisions of the bill withdrawing incentives to investment, such as the repeal of the investment credit. This rate reduction would result in a revenue loss of $800 million in 1971 and $1.6 billion in 1972 and thereafter.

3. Private Foundations (Sec. 101)

Much of the property of private foundations derives from the income, gift and estate tax deductions allowed for contributions to their creation or support and from the income tax exemption enjoyed by the organizations. The Federal Government thus has a vital interest in insuring that their assets are properly applied. The provisions of the House

bill dealing with private foundations will tend to insure that their property is devoted solely to charitable purposes. Private foundations will thus become an even more useful as a flexible source of support for achievement of new levels of thought and action, relieving the burdens of government.

In summary, the House bill would regulate certain activities of foundations. Self-dealing between a private foundation and its substantial contributors would be prohibited. Foundations would be required to distribute the greater of their income or 5 percent of the value of their corpus on a relatively current basis. Where a business is controlled by a foundation, or by a foundation and its substantial contributors, the foundation would be required within a 10-year period to limit or dispose of its interest unless common control is otherwise eliminated. These provisions were recommended by the Administration to the Congress in substantially the form contained in the bill.

The bill prohibits grass-roots lobbying, and it also proscribes other activities designed to influence legislation even though they represent only an insubstantial part

of the foundation's activities. Existing law with respect to political activities would not otherwise be changed except that activities which influence the outcome of any public election would be significantly restricted. Individual grants would be prohibited unless made pursuant to an objective and nondiscriminatory procedure. Certain transactions with government officials which might raise substantial questions of propriety would also be prohibited. We regard these rules as necessary restrictions on foundation activity which will not interfere with attainment of their charitable objectives.

Penalties for violations would be imposed in the form of a graduated series of sanctions designed to compel compliance. Foundation managers would not be penalized for any such improper act unless carried out by them with knowledge that it constituted a violation of these provisions. For example, reliance on the advice of counsel would be sufficient defense for a manager.

The provision of the bill on this subject which requires the most careful evaluation is the imposition of a 7-1/2 percent tax on investment income, including capital gains, of a private foundation. We have

concluded that a tax designed to raise revenue from private foundations cannot be justified once the other restrictions imposed on them by the bill have been enacted to insure that their funds will be used solely for charity. That is, there is no reason to reduce funds available for charitable activities by a tax once their tax exempt status has been justified in the first instance.

However, the Administration considers that it is unfair to require taxpayers in general to pay the increasing cost of administering the audit program for these organizations when such program is required to insure that charity receives the full benefit of foundation resources. Thus, the Administration recommends an annual supervision tax of 2 percent of private foundation investment income. This will raise about $25 million per year in the long-run effect (about $17 million in 1970), which approximates the estimated audit cost.

The bill also contains special provisions granting permanent exemption for two existing private foundations from those provisions designed to prohibit foundation control of operating businesses. We do not believe these two foundations can appropriately be distinguished from other foundations

which are subject to the bill; the reasons for applying the business holdings rule to existing foundations--an assurance that their assets, interests, and activities are totally committed to their charitable function--apply equally to these two foundations. We believe these two special exemptions should be eliminated from the bill.

The bill fails to provide an exemption from the business holding requirements where an organization's charter precludes disposition of certain business interests, although it does provide that these requirements are suspended while efforts are being made to secure court authorization of charter amendment. Even if disposition of business holdings is ultimately found by the court to be prohibited, the sanctions of the bill would then be applicable. The House Ways and Means Committee was concerned that if a permanent exemption were granted, the courts would tend to deny permission to amend the instrument. There is, however, a permanent exemption from the income pay-out rules for those organizations which are required by their governing instruments to accumulate income and which find it impossible to effect a change. It appears that the provision pertaining to dispositions of business

holdings is too stringent and should be changed to conform to the income pay-out rule.

4. Other Exempt Organizations (Sec. 121)

The provisions of the bill dealing with other exempt organizations adopt the Administration's recommendation to extend the application of the unrelated business tax. The business income of churches and other exempt organizations from commercial transactions in direct competition with tax-paying business would no longer be tax exempt. Further, borrowing by a tax exempt organization to purchase income producing assets which are unrelated to the exempt functions of the organization would be discouraged by taxing all such debt financed income, including investment income. This prevents a tax exempt organization from extending its tax shelter to a nonexempt seller through inflation of the price.

Investment income used to finance the social activities of members of social clubs and similar groups would be taxed, since in this situation it relieves the members of personal expense which otherwise would be paid by them out of after tax income.

Finally, rents, interest, and royalties from controlled subsidiaries of any tax exempt organization would be taxed. This will prevent avoidance of the unrelated business tax by transferring active business operations to taxable organizations while siphoning off the profits from such operations in the form of "passive" income (representing deductible payments to the taxable organization).

The bill also codifies previously existing Treasury regulations defining activities such as advertising, which will be treated as unrelated business. On the other hand, it eases the qualification requirements for voluntary employee beneficiary associations which are in reality health and welfare trusts established pursuant to collective bargaining agreements.

The Administration supports these basic provisions of the House bill. However, these provisions are only a beginning step in resolving the tax problems which exist with respect to exempt organizations. These problems are presently being given further intensive study. For example, the Treasury Department is presently re-examining the requirements for exempt status and the consequences of loss of exemption.

Additional recommendations in this area will be presented to Congress as soon as they can be developed.

5. Charitable Contributions (Sec. 201)

The bill provides in general for an increase in the limitation on the charitable contributions deduction from 30 percent to 50 percent for gifts to churches, educational institutions, and publicly supported charities, as recommended by the Administration. This will provide even greater incentive for private support of these institutions in the United States. Charitable gifts of appreciated property will remain subject to the 30 percent limit. Since we are recommending that appreciation in such property be removed from the Limit on Tax Preferences and the Allocation of Deductions rules, as hereinafter explained, we believe that the retention of the 30 percent limit for such gifts is appropriate. However, in its present form in the bill, it could have an unintended harsh result in some cases. A significant portion of the charitable deduction may be denied where the appreciation in the contributed property is nominal. This provision should be changed so that (a) the appreciation element in charitable gifts of property may not exceed 30 percent of adjusted gross

income, and (b) the basis of the property would be counted against the additional 20 percent allowance.

In order to limit some of the present tax advantages of gifts of appreciated property in particular cases, the bill provides that taxpayers making such contributions under certain specified circumstances must either: (a) limit their deduction to the cost or other basis of the property, or (b) take the larger deduction based on the fair market value of the property and include the appreciation in income. This treatment is to apply to gifts of property which would give rise to ordinary income if sold by the taxpayer, gifts to private foundations (other than an operating foundation) unless the property is channeled to a publicly supported charity within one year, gifts of tangible personal property, and gifts of future interests of property.

Our recommendation (discussed below) to delete the appreciation element from the Limit on Tax Preferences and the Allocation of Deductions provisions makes most of these limitations appropriate even though they go beyond our recommendations on April 22, 1969. However, we recommend that this rule not be extended to all tangible personal property

as provided in the bill. Under other provisions of the bill collections of papers will produce ordinary income if sold, just as are paintings sold by the artist under existing law. As we recommended on April 22, 1969, the bill prohibits deduction of the value of ordinary income property unless the appreciation is included in ordinary income. But the extension of this rule to gifts of all works of art, even though not created by the donor, appears unduly severe. Our finest museums and art galleries are dependent on such gifts, and their contribution to the good of our society is universally acknowledged. We see no sufficient reason to distinguish such gifts from gifts of appreciated securities to other charities. The problems of valuation of tangible personal property have been substantially resolved by changes in the income tax form, by improved audit programs, and by the creation of a special advisory group to the Commissioner of Internal Revenue on valuation of art objects. Moreover, these valuation problems are not eliminated by the rule in the bill since the donor would still be entitled to deduct the value of the art work against ordinary income even though the appreciation were treated as capital gain.

The bill provides for repeal of the unlimited charitable deduction, the change to be phased in over five years. This differs somewhat from the Administration's original recommendation that the unlimited deduction be limited so that the charitable deduction, when taken together with other itemized deductions, could not result in reducing the taxpayer's adjusted gross income by more than 80 percent thereof. However, the provision in the bill is also a reasonable solution and we support it.

The bill restricts the availability of the charitable contribution deduction where, by the use of a trust, property interests are split between charitable and noncharitable beneficiaries. On reconsideration, we believe the bill is unduly stringent in permitting a deduction for the value of a charitable income interest only where the income is taxable to the grantor under other rules. The donor should be allowed a deduction for the value of any long-term income interest to charit which is in the form of a guaranteed annuity or a "unitrust". Under the bill a "unitrust" is a trust in which the income beneficiary is entitled to a return equal to a fixed percentage of the value of the assets of the trust each year, thus

assuring the income beneficiary a certain return irrespective of the investment policies of the trust.

We also recommend that the effective date of the new estate tax provisions governing charitable deductions be deferred so that the new rules will apply only to persons dying after December 31, 1970. This will provide time for amendments of wills. Moreover, the new estate tax rules should not apply to trusts created heretofore that cannot be amended.

6. Farm Losses (Secs. 211, 212, 213)

Our studies have demonstrated that large farm losses generally represent capital expenditures which have been deducted under the liberal cash method of accounting. The cash method has been allowed to farmers primarily to help small farmers, but taxpayers with large farm losses are generally not in this class but are wealthy investors who obtain a tax shelter. The bill requires that taxpayers maintain an excess deductions account (EDA) for large farm "losses." On the later sale of farming property, any gain--to the extent it would otherwise be taxed as a long-term

33-865 O—69—pt. 1——37

capital gain--will be treated as ordinary income to the extent of the balance in the excess deductions account. The provision would not apply if the taxpayer used inventories and capitalized items properly chargeable to a capital account as part of his method of accounting for the farming operation.

In its present form, this provision of the bill applies only to individuals with nonfarm adjusted gross income in excess of $50,000. Taxpayers with nonfarm income over $50,000 are permitted to exclude the first $25,000 of their farm losses each year from the operation of the EDA provisions. In practice, this exclusion renders the bill ineffective.

The Administration recommended this EDA treatment on April 22, 1969, but at that time proposed that only $5,000 of losses in any year be excluded. We believe the higher exclusions in the bill should be modified. We now recommend that the EDA rules apply to any taxpayer with nonfarm adjusted gross income in excess of $25,000 whose farm losses exceed $15,000. In such a case, all of the losses should be included in the excess deductions account. These changes will not affect the small farmer or the person with modest nonfarm income.

We estimate that as so modified the EOA rule would apply to only 9,300 individuals, whose farm losses would aggregate $418 million, an average farm loss per individual of $44,700. The effect of this particular provision would not be to disallow the loss, but only to require that future gains from the sale of cattle, race horses, orange groves, etc., raised on the farm could not be reported as capital gains until they had offset these losses previously deducted from ordinary income.

The bill also provides new rules to deal with the problem of hobby losses. Under the bill, losses will be disallowed if the activity is not carried on with a reasonable expectation of profit. The taxpayer will be presumed not to have a reasonable expectation of profit if the losses from the activity exceed $25,000 in three out of any five consecutive years. The Administration urges adoption of this proposal as an effective means of dealing with cases where the tax laws are being used to subsidize the hobbies of wealthy taxpayers. However, in order to make it clear that the provision is not intended to apply to legitimate business operations,

it is recommended that the term "profit" be specifically defined to include not only immediate economic profit but also any reasonably anticipated long-term increase in the value of property.

7. Interest (Sec. 221)

Under the bill, the deduction for interest in excess of $25,000 on indebtedness incurred to purchase or carry investment assets is allowed only to the extent that the interest is not in excess of investment income plus long-term capital gains. This provision is designed to deal with an abuse resulting from the opportunity to deduct an unlimited amount of interest expense, making it possible to acquire growth potential property with borrowed funds and deduct the interest against ordinary income with the anticipated gain on disposition being subject to the capital gains rate.

However, the bill in fact fails to correct many of the problems in this area. By permitting the interest deduction to the extent of investment income, it discriminates against the taxpayer who has only earned income out of which to pay

his interest expense. The abuse is the same in either case, though under the bill the individual with earned income, but not a person receiving dividends or other investment income, might lose his interest deduction.

We have been studying many alternatives to the approach of the bill. The only truly equitable solution would require tracing the interest expense to the particular investment for which the funds were borrowed. We are inclined to believe, however, that an attempt to trace investment interest to the related investment would be administratively unworkable. Other alternatives do not appear to correct any substantial number of the actual abuses and uniformly add extraordinary complexity.

In light of these considerations, the Administration recommends that the interest provision of the bill be deleted, although we shall continue to explore the problem in an effort to develop a workable solution. The Allocation of Deductions provision (referred to below) will prevent individuals from offsetting all of their interest deductions against ordinary income when they have tax preferences, such as capital gains, in the current year, and will serve as a major limitation on the use of interest expense as a tax shelter.

8. <u>Moving Expenses</u> (Sec. 231)

The bill extends the deduction of employee moving expenses to expenses of house hunting trips, temporary living quarters at the new location and the sale or purchase of a house. Reasonable limitations are provided. The bill adopts the Administration's recommendations in this regard, except that the distance requirement of existing law is increased from 20 miles to 50 miles. The Administration recommends that the 20-mile test be restored.

9. <u>Limit on Tax Preferences and Allocation of Deductions (Secs. 301, 302)</u>

Present law imposes no limit on the amount of economic income which an individual may exclude from tax through preferential treatment contained in various provisions of the Code. These preferences were intended as incentives to investment, but they contain no adequate limits on their use. In recent years, many high bracket individual taxpayers have used these preferences alone or in combination so as to pay little or no tax for the support of the Federal Government.

Neither does present law prevent a taxpayer from charging all personal deductions against taxable income even though the presence of substantial amounts of preferential income make it apparent that, from an economic standpoint, such nontaxable

income in fact bears its share of the burden of such personal expenditures.

The bill seeks to correct these inequities through the Limit on Tax Preferences and the Allocation of Deductions provisions. The Limit on Tax Preferences places an over-all limit on the combined use of preferences; the Allocation of Deductions rule requires that a proper portion of itemized deductions be charged against income sheltered by tax preferences.

The House bill goes beyond the Administration's recommendations and provides that tax exempt interest on state and local bonds is included as a preference item for the Limit on Tax Preferences provision. The Administration opposes this inclusion for the same reasons we gave on April 22 -- there are constitutional doubts as to the inclusion of tax exempt interest and its inclusion will adversely affect the ability of hard-pressed state and local governments to market their bonds. On the other hand, the House bill provides that tax exempt interest will be treated as a preference for the Allocation of Deductions rule only to the extent such interest is paid on future issues and even then only with a 10-year phase-in rule. In April, we recommended that all tax exempt interest be included without such a phase-in rule, and we renew that recommendation at this time.

Under the bill, the excess of percentage depletion over cost and the intangible drilling cost deduction are not treated as preference items under the Limit on Tax Preferences (LTP) provision, although they are included as preferences under the Allocation of Deductions rule. Since making our original tax reform proposals in April, in which both percentage depletion and intangible drilling costs were included in the Limit on Tax Preferences as well as the Allocation of Deductions rule, we have studied carefully the operation of these provisions. We have concluded that some changes in our original proposals are warranted.

First, in view of the substantial reduction in percentage depletion contained in the bill, the inclusion of the intangible drilling cost deduction as a tax preference item could work an unintended hardship in the case of an individual whose principal business is exploration for oil and gas. Accordingly, the Administration proposes that the intangible drilling cost deduction be excluded from the Limit on Tax Preferences provision, but not the Allocation of Deductions provision, if at least 60 percent of the taxpayer's gross income is from the sale of oil and gas. We also recommend, however,

as a complement to this rule that a recapture rule be added to the Code treating as ordinary income any gain on sale or transfer of a well, including a transfer to a controlled corporation, to the extent of intangible drilling costs previously deducted.

For all other purposes, however, both percentage depletion and intangible drilling costs should be included in the Limit on Tax Preferences as well as the Allocation of Deductions provision. Thus, an investor who is not primarily engaged in the oil business will be subject to this broader LTP rule.

In our judgment the provisions in this form will apply more reasonably to persons whose principal business is the discovery of new oil and gas deposits and to whom intangible drilling costs are more in the nature of an annual expense. They should avoid creating any serious disincentive to drilling. However, even in this form the Limit on Tax Preferences should insure that substantially all taxpayers, including those in the oil business, will pay some reasonable amount of tax each year.

High bracket taxpayers will no longer be able to avoid any substantial Federal income tax liability each year by regularly investing their funds in successful wells. (Dry hole costs, of course, will not constitute preferences for any purpose.) The provisions as recommended are essential from the standpoint of fairness in view of the various other preferences which have been included in the LTP.

Second, it appears that the inclusion of gifts of appreciated property to charity as a tax preference item will reduce the benefit of the contribution and, thus, unduly restrict public support of worthwhile educational and other public charitable institutions. For this reason the Administration proposes that this item be deleted from the Limit on Tax Preferences and Allocation of Deductions provisions.

Third, further study of the excessive use of tax preferences by some taxpayers has led to the conclusion that three additional preferences should be added both to the Limit on Tax Preferences and Allocation of Deductions provisions. Accelerated depreciation in excess of straight-line depreciation taken on equipment and other personal property by a

lessor of the property under a net lease arrangement should be included. Accelerated depreciation on real property is already treated as a preference under the bill, and accelerated depreciation on leased personal property offers an equivalent shelter to reduce taxes on other income. In addition, the excess of interest, taxes and rent over receipts (if any) from unimproved real property during the period of construction of improvements should be included as a preference. These amounts are part of the economic cost of the improvement and when allowed as a deduction result in excessive tax benefits to some high-bracket investors. Finally, rapid amortization of rehabilitation expenditures for low cost housing (provided elsewhere in the bill) should be included as a preference. This new provision could easily be used to such an extent as to shelter all of the taxpayer's income unless some limit is placed on its use.

The bill in certain instances allows a basis adjustment in the amount of disallowed preferences with respect to property when the property is later sold. A similar adjustment should be allowed in connection with amounts disallowed under the Allocation of Deductions proposal to the extent ordinary income is realized on a later sale of the property.

10. Income Averaging (Sec. 311)

The bill substantially liberalizes the income averaging provisions. The eligibility requirement is reduced from 133-1/3 to 120 percent of base period income, and averaging is permitted for capital gains, income from gifts and bequests, and wagering income. Removal of these exceptions from present law adds simplification, while achieving greater equity. The Administration strongly supports this provision.

11. Restricted Property (Sec. 321)

During the past few years there has been a rapid growth in the number of so-called "restricted stock plans." Under these plans, an employee receives stock or other property subject to certain restrictions, such as a prohibition on sale for a specified period. Under existing Treasury regulations, a tax is not imposed until the restrictions expire. The compensation deemed to be realized at that time is based in most cases upon the lower value of the property at the time of its previous receipt. This combination of deferral and capital gain treatment of appreciation during the deferral period with respect to property received as compensation represents an unwarranted and unintended benefit.

The Administration's recommendation is adopted in the bill. In general, the bill provides for the imposition of

tax when the employee's rights to the property become non-forfeitable even if the property is subject to restrictions. The tax is imposed on the then current value of the property determined without regard to these restrictions. Similar treatment is proposed for property transferred in trust. The Administration urges adoption of this provision.

12. Deferred Compensation (Sec. 331)

This bill provides a minimum tax on deferred compensation payments exceeding $10,000. This minimum tax would be based, in effect, on the individual's rate of tax in the years in which such payments are deemed to have been earned.

From a conceptual standpoint, this provision modifies in certain respects both the cash method of accounting and the annual accounting period. The annual accounting concept underlies our entire tax system. While the cash method of accounting may not lead to perfect results in some cases, the imperfections extend to many areas other than deferred compensation. We believe that with further study of this problem in the context of the tax treatment of all deferred compensation, including amounts paid under both qualified pension and profit sharing plans and nonqualified plans, a better solution in principle can be developed.

In addition, there are a number of problems in the practical operation of this provision which the Treasury Department has not solved satisfactorily. For example, we have been unable to date to develop a satisfactory definition of the term "deferred compensation." Further, while the bill authorizes Treasury regulations to determine the year in which deferred compensation is deemed to have been "earned," we are concerned about the difficulty of developing satisfactory and workable tests for this purpose.

Deferred compensation is only one aspect of the over-all employee benefits problem. Under present law the form of the business organization materially affects the tax treatment of the contributions to retirement funds. Thus many partnerships have been induced to convert into essentially artificial corporations. Recent court decisions invalidating regulations defining "professional corporations," as well as the present incongruity in the treatment of deferred compensation plans of "small business (Subchapter S) corporations" (created in the bill), make it essential that the Treasury Department develop comprehensive recommendations dealing with the tax consequences of all deferred compensation arrangements.

We have undertaken a comprehensive study of both qualified and nonqualified plans. Our study will be completed and will result in recommendations to the Congress without extended delay. For these reasons, and because of the basic difficulties in these provisions of the bill, the Administration recommends that this provision be deleted from the present bill.

13. Accumulation Trusts (Secs. 341, 342)

This provision of the bill adopts the Administration's recommendation to limit the present tax advantage inherent in the use of trusts which accumulate income at low rates. It provides an unlimited "throwback" rule which imposes an additional tax on the beneficiary at the time a trust distributes accumulated income to him. This provision would apply to all future distributions of trust income, including that accumulated in years commencing with 1964.

On further study, we have become concerned as to the retroactive effect of this provision. The Administration recommends that present law be continued for accumulations

of income in taxable years beginning before April 22, 1969, and that the unlimited throwback provided by the bill apply only to accumulations made in taxable years beginning after that date.

14. Multiple Corporations (Sec. 401)

The bill adopts the Administration's recommendation to limit a controlled group of corporations to a single $25,000 surtax exemption, one $100,000 accumulated earnings credit, and one $25,000 limitation on the small business deduction of life insurance companies. These limitations would be phased-in over an eight-year transition period beginning on January 1, 1969. This is a more liberal transition period than that recommended by the Administration.

The bill also contains two special eight-year transitional rules for corporations which are affected by this provision. There is a gradual increase of the dividends received deduction from 85 to 100 percent for transition period dividends. The second rule operates with respect to a controlled group filing a consolidated return and permits the deduction of a gradually increasing portion

of certain pre-consolidation net operating losses arising in the transition period. These special transition rules introduce extraordinary complexity, and we believe are not justified in view of the phase-in rules already provided for the change. Accordingly, we recommend that these additional special transitional rules be eliminated. Also, while we do not oppose the eight-year phase-in period, a five-year phase-in period as we originally recommended seems adequate to do equity and would reduce the administrative complexity of the lengthy transition involved.

15. Corporate Securities (Sec. 411)

The bill seeks to curb tax benefits obtained by conglomerates and other acquisition minded companies by the substitution of an interest deduction for nondeductible dividends. This may occur where, for example, convertible debentures or other debt instruments having equity characteristics are used to effect a merger or acquisition. Under the bill, interest in excess of $5 million incurred for acquisition purposes would be disallowed where (i) the indebtedness is convertible or has warrants attached, (ii) the indebtedness is subordinated,

33-865 O—69—pt. 1——38

and (iii) either the debt to equity ratio of the acquiring corporation (including affiliated corporations) exceeds 2:1, or the projected annual earnings of the acquiring corporation are less than three times the annual interest expense of the company.

Although the Treasury Department is presently seeking to develop regulations which will aid in distinguishing debt from equity in all contexts, the Administration supports these particular statutory rules designed to deal specifically with the merger situation.

In addition, the Administration supports those provisions of the bill which adopt the Administration's prior recommendations. These include some (but not all) of the provisions of the bill dealing with installment sale treatment under Section 453 and the provisions of the bill dealing with corporate securities issued at a discount and repurchase by a corporation of its convertible securities.

16. Stock Dividends (Sec. 421)

The distribution of common stock dividends on common stock does not normally represent a taxable event to the shareholder. The shareholder simply receives additional shares to represent the same unchanged equity interest in

the corporation. The Internal Revenue Code does, however, provide for taxing a distribution of stock dividends where the shareholder has an election to receive either cash or stock. Many new sophisticated types of stock have been developed in recent years to avoid the impact of this rule, such as increasing and decreasing conversion ratios.

Present law does not adequately distinguish between taxable and nontaxable stock dividends and other corporate adjustments which have the effect of a stock dividend. A general provision is necessary to tax all stock dividends which change the proportionate interest of the shareholder in the corporation where such change is related to a cash dividend on other outstanding shares. Without such a provision substantial revenue losses resulting from circumvention of existing law are anticipated.

The bill substantially adopts the recommendation of the Administration, and we continue to support its enactment. The bill makes it clear that an increase in a shareholder's interest in a corporation, when related to a taxable dividend paid to other shareholders, is to be taxed. In addition to setting out a clear standard for the application of the statute, the section provides needed flexibility for its administration by regulation.

17. <u>Foreign Tax Credit</u> (Secs. 431, 432)

The bill deals with two separate circumstances in which the foreign tax credit is extended under existing law beyond its basic purpose of preventing double taxation of the same income.

The first type of case involves taxpayers, particularly U.S. mineral companies with foreign operations, who choose the "per-country" limitation on the credit (as opposed to the "over-all" limitation) in order to deduct losses incurred in a particular foreign country, such as those arising from the favorable rules applicable with respect to oil drilling expenses, against U. S. source income. When operations in that country become profitable, they are able to credit foreign taxes on the income against the U.S. tax even though there has been no net income over the span of years from that country and there is no net U.S. tax against which the credit should be applied. The taxpayer obtains a double benefit: in the year of the loss, he deducts the loss against U.S. source income, and in a subsequent profitable year, he claims the full foreign tax credit for the income from that country.

The bill deals with this problem by requiring a carryover of the losses in applying the limitation on the credit in

subsequent years where the per-country limitation was used in the loss year. We support this provision and recommend that it be extended to apply also where there has been an over-all foreign loss under the over-all limitation.

The bill also deals with the problem of foreign taxes paid on mineral income excess of U. S. taxes paid on such income. The bill provides for the separate computation of the foreign tax credit limitation with respect to mineral income in those cases where the foreign country holds mineral rights to the property or other conditions suggest that the high excess foreign tax may constitute a disguised royalty payment. The separate computation prevents any excess credit with respect to such income from being applied to shelter other foreign income which may be subject to foreign tax at an effective rate less than the U.S. effective rate on such income.

The Administration supports, in part, the effect of this second provision. However, while we recognize the hidden royalty problem at which the House bill is directed, we do not feel that the bill provides an equitable solution to that problem. On further examination of the tax and royalty structure applicable to the international minerals industry, we do not feel that it

is proper to characterize all foreign taxes on mineral income in excess of U.S. taxes on such income as disguised royalties. It is impossible to ascertain the extent to which income taxes in any particular country are a substitute for royalties, and in many cases the foreign country receives royalty payments which are even greater than royalties customarily paid in the United States. Also, foreign countries frequently impose income tax on nonmineral income, as well as on mineral income, at a rate in excess of the U.S. rate.

If, then, this separate limitation in the bill regarding mineral income is not justified on the ground that any foreign tax in excess of the effective U.S. tax on mineral income is a royalty, it works unfairly for mineral companies as compared to all other U.S. taxpayers with foreign operations. It completely denies mineral companies the opportunity, available to other taxpayers, to average the excess of foreign tax over U.S. tax on mineral income against any excess of U.S. tax over foreign tax on their other foreign income. This result occurs even though the foreign tax on the mineral income is at a reasonable rate judged by world standards and even though such averaging is precisely the purpose of the over-all limitation.

In our view, the special problem connected with foreign mineral income which can and should be dealt with arises from the lower effective U.S. rate on mineral production resulting from our percentage depletion incentive. While the bill denies percentage depletion with respect to foreign oil and gas production, we are recommending (as hereinafter described) that this provision be deleted from the bill. While the over-all limitation normally allows high foreign tax rates to be averaged with low foreign tax rates, in our judgment this is inappropriate in the case of mineral production income where the excess credits arise because the foreign country does not match our percentage depletion allowance.

We therefore recommend that excess foreign tax credits which result from the allowance of percentage depletion by the United States should not be available against other foreign income. Thus, to the extent the foreign tax in a particular foreign country exceeds the U.S. tax on the same foreign mineral income, but is less then the U. S. tax on such income computed without percentage depletion being allowed, the excess credits could not be applied against other foreign income. We believe this rule will effectively deal with the problem of percentage depletion on foreign mineral production. A similar rule

now applies in the Code to Western Hemisphere Trade Corporations, which are taxed at an effective rate approximately 14 percentage points less than the usual corporate rate.

We also recognize that, even aside from not allowing percentage depletion, foreign tax rates on mineral income sometimes exceed the top rates generally applicable by world tax standards to other income.* This also, of course, results in unusually high excess credits to be applied against other foreign income. This problem could be resolved on the basis that typically the top rate on distributed income by world standards does not exceed 60 percent. Thus, it could be provided that to the extent the foreign tax exceeded 60 percent of the foreign mineral income from a particular country determined by U.S. standards without a percentage depletion allowance (this allowance having been dealt with by the proposal previously described), excess credits could not be used against other income. This approach could be justified on the ground that taxes in exeess of 60 percent represent

*In some cases the foreign country achieves high effective tax rates by requiring the taxpayer to compute taxable income on the basis of "posted prices" which are substantially in excess of arm's length prices and thus artificially inflate taxable income for their tax purposes.

a substitute for royalties. However, as stated above, not all high foreign rates can be properly characterized as royalty substitutes, and it is impossible to establish to what extent such characterization is proper. Since aside from percentage depletion it is difficult to justify dealing with high foreign taxes in the case of foreign mineral production income but not high foreign taxes imposed on other types of income, we believe it preferable to deal with high foreign tax rates in a general context. We plan to present recommendations to Congress on this subject as a part of comprehensive proposals relating to the U.S. taxation of foreign source income which we are presently developing.

Consideration of the foreign tax credit as applied to mineral income points up the need for clarification of the tax status of the continental shelf. There is no general provision to this effect in the present bill. The continental shelf areas of the world are being developed at an accelerated pace, and existing uncertainties as to the tax consequences could discourage development of natural resources or result in unintended tax preferences to taxpayers with continental shelf operations. We recommend that the tax status of these areas be clarified by: (1) amending the definition of "United States" in the Code, consistent with

our rights and obligations under international law, to include the continental shelf of the United States with respect to the exploration for natural resources; and (2) defining the term "foreign country" as used in the Code to include the continental shelf which pertains to the foreign country concerned.

18. Financial Institutions (Secs. 441, 442, and 443)

Commercial banks will be required under the bill to compute their reserves for bad debts on the basis of actual bad debt experience; they will no longer be entitled to the special rule under existing law granting them an absolute reserve of 2.4 percent of outstanding uninsured loans. The special bad debt deduction now allowed mutual thrift institutions is to be substantially reduced under the bill over a 10-year transitional period; their special deduction based on 3 percent of increases in real estate loans would be repealed, and their alternative deduction of 60 percent of taxable income would be reduced to 30 percent. The allowance of this 30 percent deduction is tied to a sliding scale permitting the full deduction to a savings and loan institution only if at least 82 percent of its assets is invested in residential real estate loans and certain other qualifying items. In the case of mutual savings banks, the required level would be 72 percent.

To furnish protection against unusually large losses, all financial institutions would be permitted to carry back net operating losses for 10 years (instead of three years) and to carry forward net operating losses for five years.

The bill also provides that gain on disposition of debt securities of financial institutions will be treated as ordinary gain rather than capital gain. Net losses on such securities are now allowed as ordinary losses, and the bill seeks to provide parallel treatment for net gains.

The Administration endorses the concept that the bad debt deduction should be based on actual loss experience, but we also support the allowance of a special deduction to encourage investment by financial institutions in residential real estate mortgages. Investment by these institutions in residential mortgages is a vital policy goal of the Administration and traditionally has been encouraged through the use of tax incentives. We believe that this goal will be more effectively accomplished by extending the same incentive to all banking institutions, not just the mutual thrift institutions.

The investment standards applied by existing law and the bill to savings and loan institutions and mutual savings banks serve this goal imperfectly and limit free and open competition between these institutions and commercial banks. Conversely, those commercial banks which have traditionally invested in home mortgage financing will be prejudiced by the provisions of the bill which deny their present special deduction but retain a special deduction for the other two types of institutions with which they compete.

Accordingly, the Administration recommends that a special deduction, not tied to bad debt reserves, be provided for banking institutions as an incentive for investment in residential real property loans, student loans, and certain other loans which are made pursuant to national policy objectives. This incentive would be provided by a special deduction equal to a specified percentage of gross interest income from such residential real property and other loans, except that the deduction could not serve in

any year to reduce taxable income to an amount less than 60 percent of taxable income, adjusted (for purpose of this calculation only) to include the full amount of dividend income and tax exempt interest. The latter limitation will insure that the incentive could not be used to reduce the effective rate of tax on these institutions below an equitable level. We suggest that the special deduction be 5 percent of gross interest income from such loans, subject to the limitation stated above.

To prevent undue hardship on mutual savings banks and savings and loan institutions and to minimize the possible adverse effect of these proposed changes on the housing market, a five-year transition rule should be provided to phase in gradually the increased tax burden on these institutions.

19. Foreign Bank Deposits (Sec. 444)

The bill extends from December 31, 1972, to December 31, 1975, the expiration date of the rule of existing law relieving from Federal income tax certain interest paid on deposits by U.S. banks to nonresident aliens and foreign corporations.

This rule applies where the interest constitutes income not effectively connected with the alien's or corporation's trade or business in the United States. This extension would also apply to the existing relief from Federal estate tax for such deposits by nonresident aliens with U.S. banks.

Because of balance of payments considerations, the Administration recommended in April that these relief provisions not be permitted to expire at the end of 1972 but be continued indefinitely. We would prefer complete removal of the expiration date so long as the balance of payments problem exists, but the provision of the House bill extending the provisions through 1975 seems adequate for the time being.

Under current law, interest paid by U.S. branches of foreign banks to nonresident aliens or foreign corporations ordinarily is not subject to U.S. income tax whether or not the deposit is effectively connected with the depositor's U.S. trade or business. In the case of U.S. banks, the interest income is free of tax only if the deposit is not so connected.

While the Foreign Investors Tax Act of 1966 recognized that U.S. business-connected deposits in U.S. branches of foreign banks should be subject to U.S. tax to the same extent as if the deposits were made in a U.S. bank, that Act provided that such deposits in U.S. branches of foreign banks would not become taxable until January 1, 1973. We see no reason for any delay in achieving parallel treatment, and therefore recommend that interest paid by U.S. branches of foreign banks be treated the same as interest paid by U.S. banks effective for the calendar year following enactment of the bill. A similar problem arises with respect to deposits in U.S. branches of foreign banks by nonresident aliens for purposes of the estate tax liability, and we recommend similar action.

20. Regulated Utilities (Sec. 451)

Regulated public utility companies in general account for depreciation on a straight-line basis for purposes of the rate-making process. Where accelerated depreciation is taken for tax purposes, the actual Federal tax paid is lower than

the tax liability which would result from the straight-line depreciation taken for rate-making purposes. Some regulatory commissions permit taxpayers to "normalize" their tax for rate-making purposes; that is, they treat as a cost the tax which would have been imposed if straight-line depreciation had been used and treat the difference between this amount and the actual tax as a reserve for future taxes. In other situations the regulatory commissions require companies to take into account in determining the current cost of their operations only the actual tax paid, with the result that the tax reduction due to accelerated depreciation is "flowed through" to the customer as a reduction in price, thus further reducing profits and income tax revenues.

Many commissions are presently switching from normalization to flow-through, and others are even imputing the use of accelerated depreciation where the utility in fact is using straight-line depreciation for tax purposes. This trend will force utilities to switch to accelerated depreciation for tax purposes, and the "flow through" consequences will have a double effect in reducing tax revenues, since it results in a reduction in utility gross revenues as well.

Under the bill gas and oil pipeline, telephone, gas and electric utility companies, and water and sewage disposal companies would be allowed accelerated depreciation only if they "normalize" the tax saving for rate-making purposes. Thus they could not be required by regulatory agencies to "flow through" their tax savings to their consumers at the expense of Federal revenues. An exception would be provided for utilities which are presently using "flow through." Where straight-line depreciation is being taken with respect to property constructed or placed in service before December 31, 1969, no accelerated method will be permitted.

We support this provision of the bill. It would generally "freeze" the present situation, and prevent a major revenue loss estimated as high as $1.5 billion annually, which would result if the present trend by regulatory commissions toward "flow through" were allowed to continue.

33-865 O—69—pt. 1——39

There is one transitional problem which should be corrected. In determining whether a utility will be allowed to use accelerated depreciation and "flow through," the bill looks to the taxpayer's latest return filed prior to July 22, 1969. We recommend that a utility be granted this right if, as of July 22, 1969, the utility had established by book entries or certain other means that it was adopting accelerated depreciation and "flow through".

21. Effect of Accelerated Depreciation on Corporate Dividends (Sec. 452)

Under present law, a dividend is a distribution out of earnings and profits. A distribution exceeding the amount of earnings and profits is not taxed as a dividend but treated as a return of capital. Through the use of accelerated depreciation many companies, particularly in the utility and real estate fields, have been able to distribute substantial amounts to shareholders without current tax to the shareholders.

The bill adopts our recommendation made in April to require companies to compute earnings and profits by using

only the amount of depreciation allowable under the straight-line method. The Administration supports this provision.

22. Natural Resources (Sec. 501)

The bill puts an end to the tax benefits arising from carved out production payments and ABC transactions by treating these as loan transactions, a result which is in accord with their true nature. The bill also provides recapture rules for all hard mineral exploration costs. The Administration endorses these provisions.

The bill reduces the percentage depletion allowance for oil and gas from 27-1/2 percent to 20 percent and makes similar reductions for other minerals except copper, gold, silver, iron ore, and oil shale. While the Administration did not recommend these reductions, we do not oppose the decision of the House to increase the share of the national tax burden of the mineral industry.

However, the bill also extends the cut-off point for determining percentage depletion on oil shale to include certain non-mining processes. We oppose this provision because it would approximately double the effective depletion allowance on oil shale and would constitute an important breach in the principle that percentage depletion is to be computed on

gross income from mining, not manufacturing to any extent. As stated, the bill makes no reduction in the depletion rate for oil shale while reducing nearly all other rates. This would seem to provide a special incentive. If any additional incentive is to be provided, it should be granted in terms of the research and development objective, or at most in terms of the rate, not the cut-off point, or by some other means.

Finally, the bill eliminates percentage depletion with respect to foreign oil and gas production. Our analysis of this provision indicates, in the light of our foreign tax credit provisions, that after a brief period it will probably result in foreign countries increasing their effective tax rates on income from oil and gas production to "sponge up" any additional tax revenue otherwise accruing to the United States. Thus the denial of foreign depletion will increase the effective U.S. rate of tax on such income, which tax the foreign governments will then offset by increasing their rates. The end result will be that the U. S. taxpayer will pay additional tax to those countries, but no additional tax to the United States.

For these reasons, the elimination of percentage depletion on foreign deposits of oil and gas is unlikely to increase

U. S. revenues significantly, and will merely increase the burden of foreign taxes on U. S. businesses. We recommend, therefore, that this provision be deleted from the bill. Our proposal with respect to the foreign tax credit, previously described, adequately deals with percentage depletion on foreign deposits by preventing the depletion allowance on foreign mineral production from being used to reduce U. S. tax on other income and will not induce the foreign country to raise its tax on the American company.

23. Capital Gains and Losses of Individuals (Secs. 511-516)

The bill repeals the alternative capital gains tax rate of 25 percent and increases the holding period for long-term capital gains from 6 to 12 months. It also provides that net long-term capital losses are reduced by 50 percent before being available as an offset against ordinary income. The bill narrows the definition of a capital asset so that the sale of letters, papers, or memoranda by a person whose efforts created them, or by a person for whom they were produced, will give rise to ordinary income. The bill provides that an employer's contribution to a pension plan, when paid to the employee as part of a lump sum distribution, is taxed as ordinary income.

Additional changes made by the bill include a provision that life interests received by gift, bequest or inheritance, are not accorded a tax basis when sold. Under the bill, all casualty gains and losses on capital assets and section 1231 property are consolidated for the purposes of determining whether they give rise to an ordinary loss or to a gain which is consolidated with other section 1231 gains and losses. Finally, the bill provides that transfers of franchises will not give rise to capital gain treatment if the transferor retains any significant rights in connection with the transfer.

We are opposed to the complete elimination of the alternative tax and to the extension of the holding period. These changes in our judgment impose too great a burden on capital investment. The effect of the bill would be to remove a large measure of the incentive for private capital to engage in new and expanded business ventures. Present capital investments would tend to be frozen and the economy as a whole would suffer. We believe that the six months' holding period should be maintained and that, in general, the alternative tax should be retained.

However, the 25 percent ceiling rate on long-term capital gains has been used regularly by some wealthy persons who at the same time have minimized their ordinary income. By this means they have reduced their over-all effective income tax rate well below that of other persons of comparable or lesser ability to pay. We recommend that a maximum limit be placed on the extent to which the 25 percent ceiling rate can be used in relation to the amount of ordinary income.

The inclusion of the omitted one-half of long-term capital gains in the list of preferences contained in the Limit on Tax Preferences (LTP) generally has no operative effect because the purpose of that provision is only to insure that preferences do not exceed one-half of a person's income determined without the preferences. Thus, for example, when a long-term capital gain of $50,000 is realized, 50 percent or $25,000 is included as a preference in the LTP calculation, but it has no effect on that calculation since LTP operates only to limit tax preferences to 50 percent of income. However, if a taxpayer has $1 million of capital gains which are taxed at 25 percent instead of the

65 percent top rate applicable to ordinary income under the bill, his actual preference is 40/65 of this amount, or about 61.5 percent, instead of the 50 percent preference permitted by LTP. Thus, the actual preference due to the 25 percent alternative capital gains tax rate, which may be well above the 50 percent nominally excluded, should appropriately be reflected in LTP.

As a means of simplifying the calculation that would be required under LTP but at the same time achieving a comparable result, the Administration proposes that the 25 percent alternative capital gain tax be limited in its use by any taxpayer to long-term capital gains which do not exceed the higher of the two following amounts:

1. $140,000 in the case of a married person and $85,000 in the case of a single person if their other tax preferences do not exceed $10,000; or

2. Four times the taxpayer's taxable income (other than long-term capital gains) if his other preferences do not exceed $10,000. (If his other preferences do exceed $10,000, the allowable amount would be four times his taxable income adjusted under the LTP and Allocation of Deductions rules, less the amount of those other preferences.)

As an illustration, a married person with tax preferences of less than $10,000 could always realize at least $140,000 of long-term capital gains in any year and be assured of availability of the 25 percent alternative rate. Moreover, if he has $60,000 of taxable ordinary income from salary, dividends, etc., he could have $240,000 of capital gains at the 25 percent rate. However, beyond that amount he would lose the benefit of the alternative tax computation; in effect, to the extent his long-term capital gains exceed such amount, 50 percent of such amount would be added to his ordinary income and taxed at effective rates ranging from 25 percent up to 32.5 percent (one-half of the regular rates).

To prevent undue hardship arising from occasional realization of a large capital gain, the taxpayer would be permitted to carry over the unused portion of his limit on the alternative tax computation for any taxable year to each of the five succeeding years. This will achieve a fair averaging result.

The result of this rule will be to insure that a taxpayer who consistently realizes large capital gains in relation to his ordinary income will not be able to use the 25 percent ceiling tax to excess so as constantly to reduce his total effective tax rate.

In all other respects, we support the capital gain and loss provisions of the bill.

24. <u>Capital Gains Rates for Corporations</u> (Sec. 461)

The alternative capital gains tax on corporations is increased from 25 to 30 percent. The Administration supports this provision. Consistent with the rule we recommend for individuals, an amount up to $50,000 of capital gains could continue to be subject to the 25% rate, subject to the multiple corporation provisions.

25. <u>Real Estate</u> (Sec. 521)

The bill would limit accelerated depreciation on new real estate construction (other than housing) to 150 percent declining balance depreciation. Two hundred percent declining balance and sum-of-the-years digits depreciation methods would continue to be available for new housing starts only. The bill would deny accelerated depreciation to real estate purchased from prior owners, but it provides for a five-year write-off of capital costs incurred in the rehabilitation of housing made available for persons of low and moderate income. The bill would amend the present recapture provisions of the Code to deny long-term capital gain treatment on the sale of real estate to the extent of all depreciation claimed in excess of straight line, eliminatin the 10-year phase-out of the recapture provisions under present law.

We believe those provisions represent a major advance in the tax treatment of real estate and are consistent with the national housing objectives. We urge their approval. We recommend, however, that the special incentive for housing should be restricted to that constructed in the United States and its possessions. Moreover, we are concerned with the continued heavy reliance upon tax incentives as a means of achieving our national housing goals, and believe that consideration should be given in the near future to other additional methods of doing so.

26. Cooperatives (Sec. 531)

Under present law, cooperative organizations are permitted to reduce their taxable income by the amount of patronage dividends distributed to members if 20 percent of the patronage allocation is paid to the patron in cash. There is no requirement for redemption of the remaining amount in cash. The bill requires patronage dividends to be paid in cash over a period of no more than 15 years. It also requires that an additional 30 percent of the amount of current dividends be paid to patrons either with respect to the current allocation or in redemption of prior allocations. This additional 30 percent requirement is phased in over a 10-year period.

The additional 30 percent requirement is complex and creates serious administrative problems. Since the 15-year requirement assures that cooperatives will make significant current payments, we recommend that the additional 30 percent pay-out rule be eliminated.

27. Small Business Corporations--Subchapter S (Sec. 541)

The bill provides limitations similar to those applicable to partnerships with respect to contributions to retirement plans for individuals who are significant shareholders of Subchapter S small business corporations. The bill adopts only this one element of our comprehensive recommendations in April dealing with the tax treatment of small business corporations. Our recommendations would have made the tax rules applicable to Subchapter S corporations simpler and easier to satisfy by conforming them more closely to the partnership rules. These changes, worked out through extended discussions with the members of a committee of the American Bar Association, would also have eliminated several unintended abuses in the Subchapter S provisions.

We recognize that the constraints of time made it impossible for the House to deal with the entire Subchapter S proposal, but we do not feel that additional limitations should be placed on the use of Subchapter S without making the liberalizing changes proposed. It is also clear, as I noted earlier, that treatment of deferred compensation and qualified pension and profit-sharing plans needs over-all revision. Accordingly, we recommend that this provision be deleted from the present bill and be dealt with when the other aspects of Subchapter S and compensation plans are dealt with in legislation.

28. Taxation of State and Local Bonds (Secs. 601 and 602)

The bill grants states and localities the option of issuing obligations the interest on which would be taxable, in which case the higher interest cost would be offset by the Federal Government paying a percentage of the total interest cost of the issue. The amount of the subsidy is to be set by the Secretary of the Treasury, in advance, for each calendar quarter, and may range between 30 and 40 percent of the interest yield of the issue of obligations until 1974, and thereafter between 25 and 40 percent. The provisions of the bill are entirely elective with the issuer: if the issuer chooses to issue taxable obligations, the Federal subsidy follows automatically, but the state or municipality may always issue tax exempt bonds if it prefers. These provisions of the bill were not contained in the Treasury's April 22 proposals.

The Administration has been quite concerned over the problems facing the states and localities as their demands for funds increase, driving the interest cost of tax exempt obligations closer to the interest cost of taxable obligations.

The Administration has studied this provision in the bill as well as alternate means for alleviation of these problems and has concluded that it will not recommend enactment of this provision. The Administration plans to recommend to the Congress a different proposal at an early date.

The bill would also deny tax exempt status to so-called "arbitrage bonds," the specific definition of which is left to the regulations. We believe that this is in general a proper method of handling that abuse, but we believe the scope of the term "arbitrage obligation" should be described with some further particularity in the bill.

29. Income Tax Surcharge (Sec. 701)

The bill would impose the income tax surcharge at a 5 percent rate for the first six months of calendar year 1970. This temporary extension of the surcharge is essential to control the inflationary forces now present in our economy, and to provide a firm basis for future economic growth. The Administration strongly urges the adoption of this proposal.

30. Automobile and Communications Services Excise Taxes (Sec. 702)

This bill would extend the existing rates of the excise taxes on automobiles (7 percent) and on communications services (10 percent) for one year until December 31, 1970, and would postpone scheduled reductions in future years. These measures would contribute substantially to our efforts to control the inflationary forces now present in our economy. We support their adoption.

31. Termination of the Investment Credit (Sec. 703)

The bill provides for repeal of the investment credit effective as of April 18, 1969. It also provides for transitional rules similar to the rules employed when the credit was suspended in 1966. The Administration recommends no change in these provisions.

32. Rapid Depreciation for Pollution Control Facilities and Railroad Cars (Secs. 704 and 705)

The bill contains a provision for rapid 5-year amortization of expenditures for certain facilities for the control or abatement of air and water pollution. The bill also gives railroads an option to depreciate rolling stock other than

locomotives on a 7-year straight-line basis. These provisions of the bill are designed as a substitute for the investment credit.

Our national concern as to problems of pollution and environmental control should not obscure the heavy revenue costs ($400 million annually in long-run operation) of the pollution proposal. The necessity for, and effectiveness of, any such provision is doubtful. The overwhelming incentive for industrial pollution control will continue to be governmental anti-pollution enforcement action, or the threat thereof. A tax relief provision in this setting is not an incentive so much as it is a type of cost sharing, or more accurately, an interest-free loan, to reduce the industrial cost of compliance with enforcement action.

As recommended by Secretary Kennedy in his previous appearance before this Committee in connection with the surcharge extension legislation in July, we urge that as a minimum certain corrective amendments be made to this provision. It should be amended to--

33-865 O—69—pt. 1——40

(1) limit the fast write-off to the portion of cost that would otherwise be depreciated over the first 15 years of the life of the facility (as now drawn the provision would confer a benefit roughly equivalent to a 20 percent investment credit in the case of facilities with a 50-year life--almost three times as liberal as the 7 percent investment credit the write-off is designed to replace);

(2) restrict the write-off to facilities installed as anti-pollution facilities in existing plants.

The fast write-off for railroad cars will provide a substantial tax advantage, involving some $100 million annual revenue loss in full operation, to a relatively small number of profitable railroads which already have adequate buying power to acquire new cars. It will be of no financial assistance to the more depressed railroads. Further it will not be an effective instrument for dealing with the specialized problem of seasonal shortages of general purpose freight cars. We are opposed to this provision.

Conclusion

With the changes we have recommended, we believe that the Tax Reform Act of 1969 will provide a much more equitable division of the tax burden and will materially strengthen the structure of our tax system. We shall continue to study the provisions of the bill and present any further recommendations to the Committee as they are developed. Our objective now and in the future will be to improve the equity and effectiveness of our tax laws.

Table 3

**Tax Under Present Law and Tax Change Under H.R. 13270 and the Treasury Proposals Before the Senate Finance Committee**

| Adjusted gross income class | Present law tax | Change in H.R. 13270 tax | Treasury change before Senate Finance | Percent change: H.R. 13270 from present law | Percent change: Treasury from present law |
|---|---|---|---|---|---|
| ($ 000) | (........... $ millions | | ..........) | | |
| 0 - 3 | 1,169 | - 765 | - 661 | -65.4% | -56.5% |
| 3 - 5 | 3,320 | -1,025 | - 448 | -30.9 | -13.5 |
| 5 - 7 | 5,591 | - 960 | - 423 | -17.2 | - 7.6 |
| 7 - 10 | 11,792 | -1,276 | - 794 | -10.8 | - 6.7 |
| 10 - 15 | 18,494 | -1,798 | -1,155 | - 9.7 | - 6.2 |
| 15 - 20 | 9,184 | - 699 | - 511 | - 7.6 | - 5.6 |
| 20 - 50 | 13,988 | - 827 | - 781 | - 5.9 | - 5.6 |
| 50 - 100 | 6,659 | - 306 | - 308 | - 4.6 | - 4.6 |
| 100 and over | 7,686 | + 363 | + 246 | + 4.7 | + 3.2 |
| Total | 77,884 | -7,293 | -4,835 | - 9.4 | - 6.2 |

Office of the Secretary of the Treasury
Office of Tax Analysis

September 2, 1969

Table 4

Present Law Tax, Tax Under H. R. 13270,
Tax Under Treasury Proposals
Before Senate Finance Committee, and Percent Tax Change

Married Couple with Two Dependents

Deductible Non-business Expenses of 10 Percent of Income

| AGI | Present law tax | H. R. 13270 tax | Treasury proposals before Senate Finance | Percent tax change: P. L. to H. R. 13270 | Percent tax change: P. L. to Treasury proposals |
|---|---|---|---|---|---|
| $ 3,000 | 0 | 0 | 0 | 0 | 0 |
| 3,500 | $ 70 | 0 | 0 | -100.0% | -100.0% |
| 4,000 | 140 | $ 65 | $ 81 | -53.6 | -42.1 |
| 5,000 | 290 | 200 | 253 | -31.0 | -12.8 |
| 7,500 | 687 | 576 | 616 | -16.2 | -10.3 |
| 10,000 | 1,114 | 958 | 1,012 | -14.0 | -9.2 |
| 12,500 | 1,567 | 1,347 | 1,447 | -14.0 | -7.6 |
| 15,000 | 2,062 | 1,846 | 1,951 | -10.5 | -5.4 |
| 17,500 | 2,598 | 2,393 | 2,451 | -7.9 | -5.6 |
| 20,000 | 3,160 | 2,968 | 2,968 | -6.1 | -6.1 |
| 25,000 | 4,412 | 4,170 | 4,170 | -5.5 | -5.5 |

Office of the Secretary of the Treasury
Office of Tax Analysis

September 4, 1969

Table 5

Present Law Tax, Tax Under H. R. 13270,
Tax Under Treasury Proposals
Before Senate Finance Committee and Percent Tax Change

Married Couple with Two Dependents

Deductible Non-business Expenses of 20 Percent of Income

| AGI | Present law tax | H. R. 13270 tax | Treasury proposal before Senate Finance | Percent tax change: P. L. to H. R. 13270 | Percent tax change: P.L. to Treasury proposals |
|---|---|---|---|---|---|
| $ 3,000 | 0 | 0 | 0 | 0 | 0 |
| 3,500 | $ 56 | 0 | 0 | -100.0% | -100.0% |
| 4,000 | 112 | $ 65 | $ 81 | -42.0 | -27.7 |
| 5,000 | 230 | 200 | 214 | -13.0 | -7.0 |
| 7,500 | 552 | 516 | 516 | -6.5 | -6.5 |
| 10,000 | 924 | 866 | 868 | -6.1 | -6.1 |
| 12,500 | 1,304 | 1,228 | 1,228 | -5.8 | -5.8 |
| 15,000 | 1,732 | 1,636 | 1,636 | -5.5 | -5.5 |
| 17,500 | 2,172 | 2,056 | 2,056 | -5.3 | -5.3 |
| 20,000 | 2,660 | 2,508 | 2,508 | -5.7 | -5.7 |
| 25,000 | 3,708 | 3,492 | 3,492 | -5.8 | -5.8 |

Office of the Secretary of the Treasury
Office of Tax Analysis

September 4, 1969

Table 6

Long Run Revenue Effects of H.R. 13270 as Passed by the House and Proposed Treasury Changes by Major Provisions

| | Long Run Revenue Effects | |
|---|---|---|
| | House Bill | Current Treasury Proposal |
| | (...... $ millions ......) | |
| **Reform provisions** | | |
| Individuals | | |
| Contributions | 20 | 20 |
| Farm losses | 20 | 50 |
| Accumulation trusts | 70 | 70 |
| Deferred compensation | 25 | -- |
| Capital gains | 635 | 425 |
| Natural resources | 70 | 70 |
| Interest deductions | 20 | -- |
| LTP | 85 | 60 |
| Allocation | 460 | 480 |
| Real estate | 330 | 330 |
| Tax-free dividends | 80 | 80 |
| Gasoline tax deduction | -- | 390 |
| Total | 1,815 | 1,975 |
| Corporations | | |
| Foundations | 100 | 25 |
| Unrelated business income | 20 | 20 |
| Multiple corporations | 235 | 235 |
| Financial institutions | 460 | 410 |
| Natural resources | 530 | 530 |
| Foreign income | 65 | 50 |
| Regulated utilities | 310 | 310 |
| Real estate | 1,005 | 1,005 |
| Disallowed interest | 70 | 70 |
| Capital gains rate | 175 | 175 |
| Total | 2,970 | 2,830 |
| **Tax relief provisions** | | |
| Individuals | | |
| Low income allowance | -625 | -920 |
| Eliminate phaseout | -2,027 | |
| Increase standard deduction | -1,373 | -770 |
| Maximum tax on earned income | -100 | -100 |
| Head of household treatment | -650 | -445 |
| Reduce tax rates | -4,498 | -4,705 |
| Moving expenses | -100 | -100 |
| Income averaging | -300 | -300 |
| Total | -9,673 | -7,340 |
| Corporations | | |
| Rate reduction | | -1,600 |
| Total | | -8,940 |
| **Tax incentive provisions** | | |
| Pollution control amortization (Corporation) | -400 | -180 |
| Rail freight car amortization (Corporation) | -100 | -- |
| Real estate rehabilitation (Individual) | -70 | -70 |
| Real estate rehabilitation (Corporation) | -260 | -260 |
| Total | -830 | -510 |
| **Other provisions** | | |
| Repeal investment credit | | |
| Individuals | 600 | 600 |
| Corporations | 2,700 | 2,700 |
| Total | 3,300 | 3,300 |
| **Grand total** | -2,418 | -1,345 |
| Individuals | -7,328 | -4,835 |
| Corporations | 4,910 | 3,490 |
| [illegible] | -- | |

Office of the Secretary of the Treasury, Office of Tax Analysis September 2, 1969

Senator ANDERSON. Senator Gore?

TREATMENT OF TAX-EXEMPT INCOME

Senator GORE. Mr. Secretary, I am concerned about the reaction in the market, and the disturbance of State, county, and municipal officials, with respect to the taxation under the House bill of certain income received by some taxpayers from tax-exempt securities.

One would gather from the reaction in the marketplace and in other places that the impression must be widespread that income from tax-exempt bonds is to be taxed directly. You and I know that not to be the case. I do not know that I need to question you about this.

I wonder if you, as Secretary of the Treasury, would like to address some remarks to this phenomenon.

Secretary KENNEDY. Yes, I would, Senator.

The question of taxation of municipal securities has been one that has been considered many, many times, as you well know.

In this effort it was not to impose a direct tax against the municipal securities, but to have them included as part of the limit on tax preferences or the allocation of deductions.

In our original proposal, we did not include tax-exempt income in the limit tax preferences. We did, however, propose that it be in the allocation of deductions.

At that point I saw very little impact on the market, and in discussing with market people the impact was not felt to be of any great extent, the dollar amounts are not large.

In the House, however, and in the House bill the tax-exempt income was included in the limit on tax preferences, too, and there was market reaction to that.

There is uncertainty, a question of whether there will be further taxation, and we are proposing to go back to our original recommendations that tax-exempt income not be included in the limit on tax preferences. But in the allocation of deductions we continue to include it, and I do not think that the market impact there will be as large.

Senator GORE. Could I ask you a question at this point?

Secretary KENNEDY. Yes.

Senator GORE. Under the House bill now before the committee, income from municipal bonds is not taxed to banks or insurance companies or savings and loan associations; is that correct?

Secretary KENNEDY. Not to corporations.

Senator GORE. Nor to corporations.

Secretary KENNEDY. That is right.

Senator GORE. Income is not taxed directly to either an individual or a corporation.

Secretary KENNEDY. The word "directly" I am not sure of. What it would do under the House bill would be that if taxpayers had only income from tax-exempt securities, as an individual to the extent of half of that they would have to pay tax.

Senator GORE. Isn't there some limitation on that? Must not a majority of the taxpayer's income be from tax-exempt sources in order to be included?

Secretary KENNEDY. Let me have Mr. Cohen explain the detail of it because he will do it much clearer than I will.

Senator GORE. Is that not true, Secretary Cohen?

Mr. COHEN. Senator, that is correct, that a majority of a person's income, when you calculate it after adding back his tax preference amounts, must be from preference items before the limit on tax preferences would apply.

Under the House bill—for example, you are speaking of tax-exempt interest—when it is fully applicable at the end of 10 years, if a person had $100,000 salary, and $100,000 of tax-exempt interest, and no other items of income, the limit on tax preferences would not affect him.

If he had $200,000 of tax-exempt interest and $100,000 of salary it would affect him and would require him to pay tax on at least $150,000.

Senator GORE. As a matter of fact, if he had $201,000 from tax-exempt sources, and $200,000 in salary, he would be covered by the LTP provision.

Mr. COHEN. Yes.

Senator GORE. The reason I pose this question to you and to the Secretary is that I can hardly explain the impact in the marketplace of this limited application. Would you have some views on that, or maybe Secretary Walker would.

Dr. WALKER. I think it is true that it may be difficult to explain it in terms of the pure dollar amount. But by including it, as the House did in the LTP, and despite the fact that you have to get up above a certain level to be taxed, it can be viewed as a direct taxation for the first time of State and local government securities, which could cause investors to worry that greater taxation, full taxation, might take place at a later date.

So that in purchasing securities today they would be skittish about the possibility of the rug being pulled out from under them later. It is the nose in the door argument, and it has—it does have its effect on markets, there is no doubt about it.

Senator GORE. It is the toe in the door.

Dr. WALKER. Toe in the door; nose in the tent.

Senator GORE. Under the tent. [Laughter.]

You are relatively new here; you had better get your terms correct because pretty soon we are going to be talking about the widows, and I want you to be straight on that.

Well, maybe this does explain it, and I have wondered—I do not know—I just wonder, when limited in this strict way, how many taxpayers would be affected presently by this inclusion in LTP.

Mr. COHEN. Senator, I would have to take into account one other factor. We aggregate the various preferences, oil and gas to the extent that they are included, real estate, accelerated depreciation, farm losses, and so on, so it is the relationship of a person's aggregate preferences to his total income that is important.

Thus, a person would not need to have half his income solely from tax-exempt interest in order to get into this thing. The tax-exempt interest would have to be aggregated with farm losses, with accelerated depreciation from real estate, and so on. It would have more of an impact than would occur solely in cases where a person has more than half his economic income from tax-exempt interest alone.

Senator GORE. Well, could you give me an estimate of the number of taxpayers affected if limited to those who receive a majority of their income from tax-exempt sources?

Mr. COHEN. I cannot at the moment give you the estimate of the number of people. My recollection, sir—but I would like to check it for accuracy—is that about $25 million in tax in the aggregate would be involved by including tax-exempt interest in the list of preferences.

Senator GORE. And only $25 million revenue?

Mr. COHEN. That is my recollection of the figure. It depends upon the mix of preferences. If we add depletion back, which the House did not, this changes the mix somewhat, but in general terms $25 million is involved in including all tax-exempt interest—that is, after the 10-year phase-in. In 1979, at current levels of the economy—that is after the provision in the House bill would become fully effective, it would involve—I think, $25 million, but I will check that for the record.

Senator GORE. Can you give us no estimate at all as to number of taxpayers—it could not be very large if only $25 million in revenue is involved.

Mr. COHEN. Assuming they are upper bracket people as they almost inevitably would be, I would think it would not be large. I will see if we can get it from other information.

Senator GORE. I will hold up.

Senator MILLER. Would the Senator yield?

Senator GORE. Yes.

Mr. COHEN. We estimate there are only 14,000 people affected by the LTP, so that it would be a very small number, in contrast to 75 million income tax returns from individuals that are now being filed.

Secretary KENNEDY. That is the total.

Mr. COHEN. The 14,000 estimate is that 14,000 people under the bill would be affected by the limit on tax preferences.

Senator GORE. From all sources?

Mr. COHEN. From all sources.

Senator GORE. So it would be an even smaller number insofar as municipal bonds are concerned?

Mr. COHEN. Yes.

Senator GORE. So what we are really talking about here is not the amount of revenue but the principle of requiring all taxpayers to pay some taxes.

Mr. COHEN. Senator, I am a little skeptical about the significance of the 14,000 figure. We think that about 14,000 people will pay additional tax directly under LTP. An additional 35,000 people, roughly, will pay more tax under our limitation on the use of the alternative tax on capital gains. This limitation on the alternative tax was designed to produce the equivalent of including the alternative tax in LTP. Also the computation of the alternative tax limit involves the LTP items. Thus, it is fair to say that about 50,000 people will be affected by the minimum tax proposals of the Treasury.

Senator GORE. Oh, sure.

Mr. COHEN. And only part of those, of course, would be affected by tax-exempt interest to any material extent.

Senator GORE. Senator Miller asked me to yield.

Senator MILLER. I thank my colleague.

You mentioned $25 million revenue if tax-exempt interest was included in the LTP.

Would you give us an estimate of the total amount of annual interest paid on the securities?

Mr. COHEN. I can give you an estimate. There are approximately $140 billion of tax-exempt municipal securities outstanding at the moment, and I would guess the average rate of interest is no greater than 4 percent, which would give you $5.6 billion, and I would guess more than half of that is held by corporations, probably two-thirds are held by corporations, so probably less than, approximately, $2 billion is received by individuals.

This is a rough guess. I have a recollection that it is less than that, but in any event it is less than $2 billion.

Senator MILLER. What I wanted to bring out, which I think follows along Senator Gore's line of thinking, is that when we realize there are nearly $2 billion of tax-exempt interest paid to individuals ($4.9 billion total estimated for 1969, with $2.9 billion going to corporations and State and local governments), and we are only proposing possibly to tax $25 million of that $2 billion——

Mr. COHEN. No; $25 million in additional tax.

Senator MILLER. We are proposing to get a tax of $25 million out of that $2 billion payout.

Mr. COHEN. Yes. My recollection is that the bond interest received by individuals is more in the neighborhood of $1.8 billion than $2 billion, but it is in that general neighborhood.

There are other categories besides general corporations and individuals. There are some other types of holders.

Senator BENNETT. There are foundations.

Mr. COHEN. Foundations, but they would not hold much by way of tax-exempt interest today. The tax-exempt organizations would not generally hold tax-exempt interest.

Senator MILLER. And the total amount of annual interest is how much, again?

Mr. COHEN. The total amount of tax-exempt interest I was estimating in the neighborhood of $5.5 billion, and I was estimating that $1.5 billion of that amount might be received by individuals.

Senator MILLER. Then the point is—and I think this follows along the point of the Senator from Tennessee—that because we propose to take $25 million in tax revenues from $5.5 billion of tax-exempt interest, we have a problem with the market, such a problem as to cause the Department to not recommend that this interest be included in LTP.

Secretary KENNEDY. That, Senator, plus the constitutional question.

Senator MILLER. I thank my colleague.

Mr. COHEN. I might say, Senator, by way of being a little more precise, the limit on tax preferences in the House bill was estimated to yield long run when fully effective $85 million, and by our recommendations $60 million, and there are several differences between the bill and our recommendations, one of which is the treatment of tax-exempt interest, and another is—the other side of the coin—that we have recommended putting oil and gas back in, depletion for everyone, and intangible drilling expenses for the investor, so the amount allowable to bond interest may be more than $25 million.

Senator GORE. Well, I realize that we will have a session on this and have a chance to go into it, but it is a matter that concerns me. I do not quite understand the tax effect of your recommendation for including income from tax-exempt bonds in the allocation of deductions provision.

Will you explain the tax effect of your recommendation.

Mr. COHEN. Yes.

If I may, for simplicity sake, eliminate the first $10,000, we have an exemption for $10,000 in the amount of tax-exempt income so that people would not have to bother with the calculation if they had less than $10,000 of tax-exempt income. We think that will take care of most of the cases.

Senator GORE. Is that a function of the rate?

Mr. COHEN. No. It is only that if——

Senator GORE. You said this morning that the $600 personal exemption was a function of the rate. I wonder what kind of function this is.

Mr. COHEN. Well, this is a function of trying to eliminate relatively small adjustments—for widows primarily.

[Laughter.]

Senator GORE. All right. I knew we would get to it.

[Laughter.]

Mr. COHEN. For the sake of simplicity, I will eliminate the $10,000 exemption at the moment.

Take the case that I put earlier of a person who has $100,000 salary income and $100,000 of tax-exempt interest, and he would normally have a level of personal deductions at that range of in excess of 20 percent.

His personal deductions would probably be either $20,000, if we apply the 20 percent solely to his taxable income, or $40,000 if we apply it to his entire income, but let us assume that he had $20,000 of personal deductions for real estate mortgage interest, for State income taxes, for his real estate taxes, for charitable contributions, medical expenses, and so on.

These are nonbusiness deductions. If half his income, as in this illustration, comes from tax-exempt interest, we would say that he is paying half of his personal deductible expenditures out of his tax-exempt income, and half out of his salary. So we would allow him under our proposal and the House bill to charge against his $100,000 salary only half of his personal deductions. If they were actually $20,000, he could deduct only $10,000 of his nonbusiness expenditures, against his $100,000 salary.

So his net taxable income would be $100,000 minus $10,000, or $90,000, whereas under existing law it would be $100,000 minus $20,000, or $80,000.

Under existing law he can take all his personal deductions against his taxable income without regard to his tax-exempt interest.

Senator GORE. Does this amount, then, directly or indirectly, to a tax upon income from municipal and State bonds?

Mr. COHEN. We do not think so, Senator. This issue was involved in the taxation of life insurance companies under the Life Insurance Tax Act of 1959, and taken to the Supreme Court in the *Atlas Insur-*

*ance Co.* case, and the Supreme Court held there that this allocation of deductions was not a tax upon the tax-exempt interest but it was only a requirement that tax-exempt interest bear its share of the expenses involved.

Senator GORE. But, however we turn it, your recommendation does have a tax consequence.

Mr. COHEN. It has a tax consequence, that it does. It reduces the amount of the deduction that the person can take.

This is done not only with respect to tax-exempt interest but also with respect to the untaxed one-half of long-term capital gains and with respect to other preferences.

Senator GORE. So for the taxpayer who receives more than half of his income, that is beyond the widow's mite, from tax-exempt securities, your recommendation would require him to pay a larger tax.

Mr. COHEN. It would apply—the allocation-of-deductions rule is not dependent upon a person having more than one-half of his income in preferences. It would apply even if he had 20 percent of his income from tax-exempt sources.

We just subtract $10,000. Rather than half his income in the allocation of deductions, we take into account all his tax-exempt income above $10,000.

So, in my particular case, you see, the tax-exempt income amounted to exactly one-half of his total income, $100,000 salary, $100,000 tax-exempt interest. That would not involve a preference even under the House bill. He would owe no tax under the limit on tax preferences but he would still suffer an allocation of his deductions.

Senator GORE. What would be the tax consequence in that case?

Mr. COHEN. Well, if he had $20,000 of deductions, ignoring the $10,000 exemption, half of his deductions would be allocated to his tax-exempt interest, and give him no tax reduction benefit, and the other half, or $10,000, of his deductions could be used to offset his salary income, so he would pay tax on $90,000 of net taxable income.

Senator GORE. So his additional tax bill would depend upon his bracket in the case which you cite. If he is in the 70-percent bracket, then he would pay $6,300 more.

Mr. COHEN. Well, he would pay $7,000 more, I think, because he now has $20,000 in deduction available under existing law.

Under the new rule he would have $10,000 of allowable deduction and he would lose $10,000 of deductions; he would pay tax on $10,000 more, and at a 70-percent rate it would cost him $7,000.

I might say that the revenue consequence of the allocation of deductions rule is very much higher than the consequence of the limit on tax preferences.

Senator GORE. That was my next question, and I would be very pleased to have you give some statistics on it.

Mr. COHEN. Oh, yes.

In the House bill the limit on tax preferences was estimated to raise $85 million, whereas the allocation of deductions rule would raise $460 million, and under our recommendations to you today the limit on tax preferences would raise $60 million, $25 million less than the House bill, but the allocation of deductions rule would raise $480 million or $20 million more than under the House bill.

So for the aggregate of the two of our recommendations would come out about the same as under the House bill.

Senator GORE. Would you narrow this to tax exempts? You estimated that under the limited tax preference provision there would be revenue gain of $25 million. What would the revenue gain be if you included tax-exempt interest in the allocation of deductions?

Mr. COHEN. I will just make a rough guess that it would be on the order of $50 million, perhaps more than $50 million, between $50 million and $100 million; much more than under the limit on tax preferences, and I will try to give you that more precisely.

Senator GORE. Fine.

I want to come back to another subject, but I have utilized my allocation of time.

Thank you, Mr. Chairman.

Mr. COHEN. They tell me that I was nearer to the right figure the first time, that it would be about $50 million.

Senator GORE. Thank you.

Senator ANDERSON. Senator Williams.

ASSISTING STATES AND LOCALITIES IN MEETING THEIR FINANCING PROBLEMS

Senator WILLIAMS. Mr. Secretary, just a couple of questions here.

In recommending your changes with respect to tax-exempt interest, it is my understanding that it is also a part of your recommendation that we eliminate from the House bill the proposal which would subsidize the State interest; is that correct?

Secretary KENNEDY. Yes, Senator.

The House bill provided that the municipality or State can elect taxable or tax-exempt, and then there would be a subsidy element on the part of the Treasury to offset the difference.

We want to come up with a proposal for assisting the States and municipalities in meeting their financing problems, and we suggest that consideration of this area be postponed until we come up with that rcommendation.

Senator WILLIAMS. Do you have any estimate as to what it would cost the Treasury to subsidize present tax-exempt bonds to the extent that it is recommended in the House bill?

Secretary KENNEDY. Mr. Cohen, do you have a figure on that?

Mr. COHEN. Senator, that is a matter of some discussion and debate.

On one calculation, in which we have to estimate the revenue that the Treasury would obtain from taxable State bonds, you could say that if the bonds became taxable and, say, were marketed at an 8-percent rate taxable instead of, say, 5.8 percent nontaxable, they would then be bought to a very large extent by tax-exempt institutions, charities, college endowment funds, pension trusts, so that we would get no revenue from them.

On the other hand, those institutions now purchase other taxable bonds, and it would seem that if they are going to buy taxable State and local bonds, those other taxable bonds would be held by other investors and we would still get the same increase in taxable revenue.

If we calculated it the latter way you can estimate the revenue at somewhere between 30 and 40 percent of the interest.

If you calculate it on the basis that these are going to be held by tax-exempt institutions one can argue that we would get no tax.

Overall, if you assume we are going to get a level of 30 to 40 percent tax then you would conclude that there would be no loss. But if you say that we will get no tax because the bonds will be held by tax-exempt institutions then everything you pay by way of subsidy would be a loss.

Senator WILLIAMS. What I was wondering was just how the income that you may pick up as a result of that would compare with the payments that you have to make. This plan was worked out, as I understand it, on the premise that by doing it you would pick up $25 million in revenue. I am wondering if this other were triggered in as a part just where we would end up, and which way we would go, plus the complications that would arise.

Mr. COHEN. Well, under the bill the Secretary can fix the amount of the payment of interest at a level between 30 percent of the interest and 40 percent of the interest.

If one started out with 30 percent to see whether this would affect the issuance of taxable bonds, it would then be possible to issue an 8 percent taxable bond, which would be cheaper for the State if it would have to pay more than 5.6 percent as interest on tax-exempt bonds.

Then if you figured that we would collect in additional revenue 30 percent of the taxable 8 percent interest from the taxpayers it would be a wash. The Treasury would pay 2.4 percent of the 8 percent interest, leaving 5.6 percent to be paid by the issuer, and the Treasury would collect from the bondholder an assumed tax of 2.4 percent, that is, 30 percent of the 8 percent interest.

Dr. WALKER. Senator, I think the current predominance of opinion among economists is—this cannot be proved—but the viewpoint is rather strongly held, that the amount of tax loss to the Treasury through the issuance of tax-exempt securities is greater than the subsidy to the State and local governments as a result of the tax exemption privilege.

They, therefore, argue that the Treasury could pay the subsidy and come out net ahead on the operation. That is not provable. That is just the theory.

Senator WILLIAMS. As one who has never yet seen a subsidy that we ever started and came out ahead making money paying it out, I congratulate you on the proposal to eliminate that. I hope we do not see it again because I gather that this is to a large extent guesswork.

## IMMEDIATE ACTION NEEDED ON INVESTMENT CREDIT

Now, Mr. Secretary, there is a section in this bill that has passed the House a couple or three times, and it has been reported by the committee, the Finance Committee, but the Senate has not accepted it yet, dealing with the repeal of the investment tax credit.

The suggestion has been made that, being realistic, it may take 8 to 10 weeks to get this bill moving and, perhaps, it will be well along in November by the time we can get it through the Senate and passed.

The thought has been presented that since you have to print these tax forms so far in advance maybe it would be well for the committee

to work out an agreement with the Treasury here to take action on this investment tax credit and dispose of that problem, perhaps as a part of the interest equalization tax or something, so that the American industry would know what is going to be done, and on repeal whether it would be repealed or not, and if repealed, whether there would be any exemptions or what they would be, and so forth, so that both industry and you would know.

What would be your thought on that? That has nothing to do with the bill itself here. I am just speaking of expediting that so that you can get your tax forms printed and the American taxpayers can go on and compute their taxes, because I am afraid it is going to be closer to the end of the year by the time we get this bill on the President's desk.

Secretary KENNEDY. As you know, Senator, we have been anxious to see action taken with regard to the investment tax credit. As far as I am concerned, the earlier the better.

If it could be done, pulled out of here and put on some other bill, we would have no objection. As a matter of fact, it would clarify some points. But I think it should be taken into account as part of the tax reform package.

Senator WILLIAMS. Oh, sure.

Secretary KENNEDY. It should be taken into account as a part of the whole tax reform measure without changing the tone of the bill as you see fit to rework it.

But I should think that it would help us in getting the forms out, and would end some uncertainty on the part of business decisions.

Senator WILLIAMS. When is the latest date that you can have the form ready for printing, as a rule? When do you think you will have that? That is September-October, is it not?

Secretary KENNEDY. Well, I should think that we would have to be getting to the forms fairly soon. I would not know the exact date at this point, Senator. But we, of course, could make certain assumptions and go ahead and print forms, which would be costly. I do not like to do that.

I think it would be better to have the action set so we do not have to upset a form. The other changes are largely changes that could be done administratively without any change in the form.

Senator WILLIAMS. That is what I understand, that is the main——

Secretary KENNEDY. Most of the other changes, that is. There may be some changes in the bill which would affect the forms; I would have to take a look at that.

Senator WILLIAMS. This is the main one that really needs——

Senator KENNEDY. On the corporation end, I think the forms are unaffected by the bill, that is true, is it not?

Mr. COHEN. Yes; except for the multiple corporation provision. The principal forms, Senator, should go to press in September, October at the latest. But, of course, it is always possible to have a special form, such as the investment credit, printed somewhat later than the others or we could issue instructions with respect to it. But it certainly would be more convenient to have it done in regular course in September or October.

Senator WILLIAMS. Well, this suggestion has been made by a number of the committee members here, and I was mentioning it to you before,

it is not done with any thought of separating that point in our mind as we consider this overall problem, but more or less in recognition of the fact that this is at least one section that should be disposed of, in fact, should have been disposed of——

Secretary KENNEDY. It is a separate section that could be handled separately without affecting any part of the bill.

CHANGES IN COMPUTATION OF REAL ESTATE DEPRECIATION RATES

Senator WILLIAMS. One other point. Would you explain for the record here just how you propose to change the computation of depreciation rates, both as related to commercial properties and also——

Secretary KENNEDY. Real estate.

Senator WILLIAMS. Real estate.

Mr. COHEN. Yes, sir.

In general, for new housing projects, we would retain the 200 percent declining balance and the sum of the years-digits depreciation methods that are in existing law.

With respect to new, nonhousing construction, we would cut it back to 150 percent declining balance depreciation, and with respect to used buildings we would not permit accelerated depreciation but would require straight line. But with respect to used buildings of a housing nature we would permit a 5-year writeoff of the costs of rehabilitating low- and middle-income housing.

This would create preferences for housing as against other types of construction, such as office buildings, and it would create a preference for rehabilitation.

Senator WILLIAMS. Under existing law they are all subject to the double declining balance method, is that not correct?

Mr. COHEN. Well, all new construction——

Senator WILLIAMS. New construction.

Mr. COHEN (continuing). Whether housing or business structures may take double declining balance, and all used property may take 150 percent declining balance.

Senator WILLIAMS. This is a drop of 50 percent portion in each instance.

Mr. COHEN. Yes, it is.

Senator WILLIAMS. Fifty points.

Mr. COHEN. Yes.

In addition, we are tightening up with respect to the recapture of depreciation on sale to the extent of the excess of accelerated depreciation over straight line.

Senator WILLIAMS. That is pretty much in line with the formula in the House bill, is it not?

Mr. COHEN. That is what is in the House bill.

Senator WILLIAMS. The same as the House bill.

Mr. COHEN. Yes, sir.

LIMITATION ON DEDUCTION OF INVESTMENT INTEREST EXPENSE

Senator WILLIAMS. Now, I notice that in your statement you referred to the limitation on the deduction of investment interest expense. You change, you make a different recommendation, as to how we compute that from the House bill, do you not?

Mr. COHEN. Yes, we did.

We have spent a good deal of time with respect to that and are concerned about it, but we have not been able satisfactorily to work it out, and reluctantly we recommend to you that in this bill at the present time this provision be deleted.

Senator WILLIAMS. Would you explain an example of how this works under existing law and how it would be changed?

Mr. COHEN. The provision in the bill would prevent interest on investment property from being used to reduce tax on earned income, but it would not prevent the interest deduction from being utilized against investment type income, and this is one of the difficulties that we see in it. A person who already has income from investments would not be inhibited materially by it, and in most cases not inhibited at all, but a person with earned income would find that his interest deduction would be disallowed. We have experimented with various means of trying to prevent that difference, and make it equally applicable to earned income and investment income, but we have not been able to develop a system that we think is sufficiently satisfactory to recommend to you.

Senator WILLIAMS. You do not think the provision in the House bill would work?

Mr. COHEN. We think it would work with consequences that would be inequitable.

It would work in the sense that it would affect some people and not others that we are inclined to think ought similarly to be affected by any provision in this direction.

We have done some things, though, Senator, of a general nature to have an impact in this area.

For example, we have now recommended to you that, in addition to accelerated depreciation on real estate, depletion and farm losses you include in the list of tax preferences for purposes of the limit on tax preferences and allocation of deductions, net equipment leases. Some of these problems have occurred with respect to interest deductions in that area.

There have also been problems in the past about prepaid interest which we have taken care of by a ruling that has been issued, and we have also put into—if I may just add one other important provision—we have put in the list of preferences interest on loans during the period of construction of real estate, which would go in as a preference along with accelerated depreciation on real estate. We think these would have an impact.

Senator WILLIAMS. Well, considering all of those factors that you enumerated, is it not possible through the elimination of the House provision that those who have been using that method with sizable incomes can now continue to escape taxes entirely?

Mr. COHEN. Well, they can escape taxes, Senator, if you think that interest is not an appropriate deduction. But interest has always been regarded as an expense.

If one borrows money to obtain an investment on which he gets dividends or rental income, he really should pay tax only on his net profit, the excess of his dividends or rental incme over the interest that he pays, and that is our system of net taxable income.

I think that in the main the abuse in this area has been from deducting interest against ordinary income in order to make an investment that will later be sold at a capital gain.

Now, our allocation of deduction proposal will take care of the situation with respect to a person who year after year regularly realizes capital gains without having ordinary income.

It would not solve the problem if the person can hold his investment long enough so that he piles all his capital gains into 1 year rather than realizing them regularly, and the effort of the interest provision in the House bill is to try to fill that particular gap. We think that a better method or some improvements in that are needed before we could recommend it.

### 154 WEALTHY INDIVIDUALS PAYING NO INCOME TAX

Senator WILLIAMS. I am not debating the merits of it. There are questions in my mind, but the point—the reason I am making this—considerable discussion was over the fact that, as I recall, around 154 taxpayers with sizable incomes who were paying no taxes and, as I see it, about half of those were escaping their taxes through this formula. If we eliminate the House provision, would it not, in effect, mean we are only dealing with half the number now?

Mr. COHEN. We have examined carefully those 154 cases and you, of course, realize——

Senator WILLIAMS. I might say those cases came from the Treasury Department, they were not my cases.

Mr. COHEN. Yes, sir. We have studied them at great length, I assure you.

About half of the 154 cases involved situations in which the interest deduction is the principal personal deduction, and it raises a question of whether a person with $200,000 of adjusted gross income, which brought him into the group of 154, who has, say, $200,000 of an interest payment that he makes, whether that person has a net taxable income on which he should pay tax.

Now, if his $200,000 of interest is paid on money he borrowed to make an investment which produced his $200,000 of income, then it seems to me that he is not to be considered as taking advantage of the loophole in the law.

He has net income of zero for that year. But there are cases in which a person with $200,000 of income from one source goes out and borrows money on which he pays $200,000 in interest to buy another asset, to see it appreciate in value, so that he can sell it at a capital gain.

If the man should sell his asset at a capital gain in the particular year we are going to require him to come under the allocation of deductions rule, and thus cut down his interest deduction so he will have a tax to pay.

But if he holds that property which he has bought for a long period of time without selling it, then our allocation of deductions rule won't take care of him until the year in which he sells it, and that is what this special interest rule in the House bill is designed to combat.

Senator WILLIAMS. Well, as I stated earlier, I am not debating the merits of it at this point. But much was said about 154 not paying any taxes, and we are now told that approximately half of them are

legitimately done and will continue to do it, and I am just wondering if somebody—if this is a correct approach—perhaps it is—that you are suggesting today, somebody got a little overenthusiastic when they came out with 154.

Mr. COHEN. Well, I think there was undue enthusiasm over the category of the 154. About 50 of them involved people with the unlimited charitable contribution deduction, which the bill ends.

I might say that those 50 people, though, contributed almost $78 million to charity, so if we are trying to induce charitable contributions it led to about $1.5 million per person in that group going into charity, but it left them paying no income tax.

But in the case of the other half, some of those interest deduction cases may have involved prepaid interest. We have looked at many of the returns, but we cannot tell without an audit whether the person was prepaying interest for 10 years. The right to do that has been stopped by an Internal Revenue Service ruling about a year ago.

Senator WILLIAMS. It could have been blocked under existing law if the administration in power had been as much opposed to it as they now tend to say.

Mr. COHEN. The administration did move finally in October of 1968 to rule against it.

Senator WILLIAMS. My time is up.

Senator ANDERSON. Senator Fulbright.

Senator FULBRIGHT. Thank you, Mr. Chairman.

I did not quite understand, Mr. Secretary, a moment ago your reasoning with regard to the question of a tax on State bonds, municipal bonds—the line of questions Senator Gore was pursuing when I first came in.

ALLOCATION OF DEDUCTIONS

You say that this use of the allocation of deductions did not amount to a tax? You said it would cost them $7,000. What else do you call it if it is not a tax?

Secretary KENNEDY. I will let the expert answer it, but my thought on it is that what you do is eliminate the deduction allocable to the tax-exempt income rather than make the income itself taxable. You say part of their expense was paid with the tax-exempt income, which has the effect of eliminating that part of the deduction, which increases the tax.

Mr. COHEN. Senator, it is my recollection that under the Life Insurance Tax Act of 1959, when it passed the Congress, this very question was raised as to whether the requirement for an allocation of deductions of insurance companies amounted to a tax on the interest received, and so a provision was put in the bill saying that nothing in the bill should require the payment of any tax on tax-exempt interest.

That issue was taken to the Supreme Court in the *Atlas Insurance Co.* case, and it was posed directly: Was this a tax on tax-exempt interest or was this only a reduction in the expenses in order to allocate those expenses between tax-exempt and taxable sources?

The Supreme Court held that it was not a tax on a tax-exempt interest but was simply an allocation of the deduction.

I suppose the issue could be put this way, as some of the Senators have pointed out: If a person were to invest all his money in tax-

exempt interest, nothing in the law would impose a tax on the person unless you put the tax-exempt interest in the limit on tax preferences.

You only get to this point of allocation of deductions when the person has, in addition to tax-exempt interest, some other taxable income, and the question is, how much of deductions can he offset against this taxable income.

But there is no tax at all to pay if all his income is from tax-exempt interest unless you include the tax-exempt interest specifically in income in some form.

Senator FULBRIGHT. Then it is conceded, or does the Treasury believe, that it is unconstitutional to levy a tax directly on State bonds?

Secretary KENNEDY. We have no opinion of counsel or the Attorney General to that effect.

We have seen the question raised, so there is a doubt in the minds of many lawyers. I think in the case of the New York Port Authority there is an opinion of counsel on their actual bonds that it would be unconstitutional to tax them.

Now, that is an attorney's opinion. I know of no case that has been decided on that.

Senator FULBRIGHT. They never have been directly taxed since there has been an income tax, have they?

Secretary KENNEDY. No, except for this indirect case.

Senator FULBRIGHT. Except as you have indicated.

Secretary KENNEDY. This insurance company provision.

CONSTITUTIONALITY OF TAXING MUNICIPAL BOND INTEREST

Senator FULBRIGHT. Mr. Cohen, do you have an opinion as to whether or not it is constitutional or not, to levy a tax directly on municipal bonds?

Mr. COHEN. Senator, regardless of my opinion, I think lawyers through many years have been widely divided on this problem.

I would like to make a comment: I believe there was a decision on this in 1894 in Pollack against Farmers Loan & Trust Co., in a case in which the Court held unconstitutional, five-to-four, an income tax, leading eventually to the 16th amendment.

There were two questions before the Court on the first one, the Court divided four-to-four on the constitutionality of tax on dividend income. But on the second question it was unanimous, eight-to-nothing, that a tax on tax-exempt interest would be a direct tax on the obligations of the States. They set down for reargument the constitutionality of the tax on dividend income, but the Court ruled unanimously that an income tax on tax-exempt interest would be unconstitutional.

The issue now is whether intervening decisions of the Supreme Court, including a decision that said it is constitutional to tax the salaries of employees of State and local governments, have changed the course of decisions so that the Court would today overrule the decision in the first Pollack case and sustain an income tax on tax-exempt interest.

I might say also that some issues of municipal bonds, including those, for example, of the Port of New York Authority, carry an opinion of counsel in the advertisements that not only is the interest

exempt from tax under existing Federal law, but is exempt from tax under the Constitution of the United States. So that opinion is held by a good many able lawyers.

Senator FULBRIGHT. Do you hold that opinion? I think it could be very significant. What do you think about it?

Mr. COHEN. Well, we are not recommending it, Senator. I think in order not to evade your question, one thing to say is that a tax under the limit on tax preferences would not involve precisely the same consideration as an outright inclusion of the interest in income, because this provision would only apply to cases in which a person had more than half his income from preferences as a group, not just tax-exempt interest but other preference items as well, so that I think that this could be sustained even if a direct tax could not be.

Senator FULBRIGHT. You do not care to answer it, and I am bound to draw the conclusion that you do believe it is constitutional.

Mr. COHEN. I believe it is what?

Senator FULBRIGHT. That you believe it would be constitutional to tax; the court would so rule if it had the question before it.

You remind me of a question I tentatively raised this morning. You cited a case in the Port of New York in which the lawyers recommending the sale to the people said it was not only immune from taxation under the law but also the Constitution.

CHANGE IN TAXATION OF MUNICIPAL BOND INTEREST SHOULD NOT BE RETROACTIVE

If we are going to depart from that, I again raise the question that I think it is good public policy not to make this change retroactive, that those who have bought those particular securities in reliance upon them, it is not only a question of good faith, I mean in breaking what they believe to have been a solemn promise on the part of the people who represented these purchasers—most purchasers are not as astute about taxes as you are. They just accept such a statement as to what it means to ordinary people, and I think it raises a serious question.

It does not bring in very much money, it is not crucial, but you are changing what has been a consistent public policy since the initiation of the income tax.

I am arguing again on this and one or two other sections as to the timing of them. I think, in spite of your very sophisticated arguments, that the ordinary fellow is going to say that a tax is being imposed upon his income. He won't be sufficiently educated to follow your argument. He will think that you breached a part of his contract.

When you pile that on in addition to the fact that most of the existing bonds of communities—take the University of Arkansas, with which I am very familiar, it is in my home town, bonds which only 2 or 3 years ago were selling, you know, on a 3½-percent basis, now the people who bought those in reliance upon their tax-exemption cannot get over 70 cents on the dollar—I think 70, 75 cents on the dollar—they already have taken nearly a 30-percent loss or they would, if they had to sell them.

If they do not keep them until maturity, they take that much capital loss in addition to putting this tax on them.

I was just submitting for your consideration the suggestion that it would be a little more honest if you would say, "Well, we are going to change it, but we are not going to apply it to those people who have already bought the bonds in reliance on statements with regard to the Port of New York."

I think that would be better public policy.

Mr. COHEN. Would you do that with respect to people who already held the bonds so that no new purchaser could take advantage of that?

Senator FULBRIGHT. I believe that would still be better than just making it apply flatly on those who have already bought them and held them. They are obviously faced, as I say, either with holding them until maturity, which they may not be able to do, or with a big loss. I think the effective date should be upon enactment of the bill. Then everybody would know what the rules are.

If you are going to make a change of this kind or even a more serious change as recommended by others, why, it ought to be prospective.

Senator GORE. Will the Senator yield?

Senator FULBRIGHT. Yes; I yield.

Senator GORE. The Senator is raising the question of retroactivity, ex post facto.

Senator FULBRIGHT. Yes, that is what I am raising. People are resenting the principle in addition to whatever it may cost them.

Mr. COHEN. Senator, the House bill with respect to the limit on tax preferences includes outstanding and future bonds, and with respect to the allocation of deductions, it includes only future issues, so it makes the choice one way in one provision and another way in another provision.

Senator FULBRIGHT. I agree.

One reason I introduced a little amendment that I read you this morning was because of that feature of it; but the further reason was, the main one to me was this, what I would call, breach of faith.

I mean sometimes if there is an imminent security crisis, the country has to do it. But I do not see why you have to do it in that fashion. I think it amounts to not much money to the Treasury, and if you are going to change it, it ought to be only prospective.

Mr. COHEN. I have one concern as to which I am not an expert, but if you did draw the line between the present and the future issues, would you harm the future issues in relation to existing ones?

If the market would distinguish between the two, if it would distinguish at all on account of this provision, it would set up two categories.

Senator FULBRIGHT. Well, it might; but at least anybody who buys them in the future buys them with an understanding that this is what it is. That is all.

Mr. COHEN. I think the main reason why we did not make the distinction was that the precedents existed in the life insurance tax provision in 1959, where this distinction was not made and also because we are simply allocating deductions, not directly taxing the interest.

Senator FULBRIGHT. That is a further and even more indirect and subtle way than this way.

I am not sufficiently familiar with that case to argue with you about it, but this question of the constitutionality is a serious question, at least, this is in the minds of a number of my constituents.

They are not for the change in any case, but, if it is to be done, then it should be only prospective.

Mr. COHEN. We have heard from many of them.

Senator FULBRIGHT. That is what I understand, and I think it is important not to shake the public's confidence in the honesty of our Government any more than is necessary, particularly in the financial field.

GRADUATED DEPLETION ALLOWANCES

I do not know that anybody has raised this question, but it is a matter of importance in my State, and it is a matter that many of my constituents are interested in. It happens, too, that many of them are small producers as contrasted to the great giants that operate all over the world.

Has the Treasury ever given consideration to the question of graduation, the principle of graduation with regard to depletion allowances? In other words, a larger depletion allowance for a small, relatively small, producer in contrast to the great international giants. Has the Treasury ever considered that?

Mr. COHEN. Yes, we have given condsideration to it, Senator.

Senator FULBRIGHT. Have you rejected it, or what has been your view about it?

Mr. COHEN. Our thought was that we would prefer the flat 20 percent to a graduated system.

I understand that a proposal has been made to retain the 27½ percent on the first $1 million, and graduate it down to 15 percent above $5 million. That would still allow $275,000 of depletion at the 27½-percent rate, which is a very substantial amount of tax-free allowance. I think to get to the point of having graduated allowances together with graduated rates raises a question as to the even-handed effect of the tax provisions.

We do have graduated rates, we even have graduated rates with respect to corporations, which are taxed at only 22 percent on the first $25,000 of income and 48 percent of the balance; and if we have graduations to any appreciable extent with respect to the allowances of deductions we will be doubling up on the graduation.

Senator FULBRIGHT. Well, then, the answer is you have considered it, but you reject the idea of graduation on depletion.

Mr. COHEN. Yes. We would prefer——

Senator FULBRIGHT. I have not heard any discussion of whether you had even considered it.

Mr. COHEN. Yes, we have considered it.

Senator FULBRIGHT. I am not proposing it. I was just wondering about it, because some of my constituents have asked me about this, because they feel they are being penalized largely because of the effects, we will say, of the depletion upon these very large companies we read about who have enormous foreign production and who one way or another pay an extremely small rate of tax on very large earnings.

You know the major companies do that. So I raise the question to see what the reasoning was.

Senator BENNETT. Mr. Chairman, we have gone an hour and 15 minutes for three questioners.

The CHAIRMAN. I was not here myself, but I thought we would more or less go on the basis of a gentleman's understanding, even though it is not formal.

Senator FULBRIGHT. I did not know anything about it. I will ask one more question and then I will yield.

REDUCTION IN CORPORATE TAX RATES

You have suggested, I believe, a reduction in corporate rates. It is not clear to me where you take that reduction, on the top or bottom. In other words, does it come off of that second 26 percent, or is it off of the first 22 percent?

You know, does it reduce it from 22 to 21? How does it affect the small corporations or does it just affect the large ones?

Mr. COHEN. It would affect the 48-percent rate, but we were not recommending that the 22-percent rate be reduced to 21.

Senator FULBRIGHT. Why not? Why wouldn't the little ones be entitled to it rather than the large ones?

Mr. COHEN. I think it has been our judgment that the 22-percent rate is quite low as it is, in relation to individual income tax rates.

Senator FULBRIGHT. So it would be off the 48 to 47.

Mr. COHEN. Yes, sir.

Senator FULBRIGHT. All right, I yield, Mr. Chairman. I did not know that anyone was very anxious. I was perfectly willing to yield at any time.

Senator BENNETT. The point that now bothers me, is that it now is 4:30. There are four members of the committee who have not had a chance to question. The Secretary is tired. I assume we will try to be through by 5 o'clock, and prospectively, Mr. Chairman——

Senator FULBRIGHT. All right.

Senator BENNETT. I hope before we meet tomorrow or Monday, if we do not meet tomorrow, that we set a pattern and hold to it.

The CHAIRMAN. Well, the Senator makes a point that we are going to have to adhere to, to go along through these hearings.

I do not want anybody to be denied the opportunity to ask any question he would like to ask the Secretary of the Treasury or his assistants, but with 300 witnesses scheduled to come before this committee we are going to have to limit ourselves in the questions we ask. The Secretary is scheduled to be here again tomorrow if he is needed, so we are going to have a further opportunity to obtain what information we want from the Secretary.

But I do think that with regard to future witnesses we are going to have to limit ourselves very severely if we are going to conclude these hearings by the time we desire.

How long do you think we ought to set for the Secretary?

Senator BENNETT. I think 5 or 6 minutes will take care of me, but I assumed we were going around again under the 10-minute rule that we violated, all of us, this morning.

The CHAIRMAN. Well, then, suit yourself, you set your own time, and I will try to hold myself to it.

Senator BENNETT. I have only two questions.

Senator FULBRIGHT. I would like to suggest that the reason questioning may be so long is because the bill is so complicated.

Senator BENNETT. Well, I recognize that, and I recognize the temptation to follow an idea out of the window, as one should. But we try to follow two or three ideas out of the window in the course of one round.

INCENTIVES TO CHANNEL MORE FUNDS INTO THE HOUSING MARKET

Mr. Secretary, I would like to direct your attention to the incentives that the bill provides which, I assume, you support, to financial institutions for the purpose or channeling more of their loanable funds presumably into the housing market.

How do you propose to phase this incentive in? Do you have a definite plan?

Secretary KENNEDY. Even the 5 percent, Senator, is tentative because we are going to do a lot of studying to make sure of that amount to see what it would do. But that seems to be a reasonable amount, and the phasing in I will ask Mr. Cohen to answer.

Mr. COHEN. There would be no phase-in with respect to the commercial banks, Senator, because while their effective tax rate would go up it would not go up as substantially as that of the mutual savings banks and the savings and loan institutions.

What we would have in mind is to take them up gradually, over a 5-year period from their present effective rate to that effective rate which would be provided for in the bill.

It would be in equal annual steps over a 5-year period for mutual savings banks and savings and loan associations.

Senator BENNETT. You have a program, the bill has a program, which you support to try to provide, is it a 5 percent deduction of the interest earned on mortgages, and what is the relative tax effect of this on the three types of institutions that would participate in it? It is different, is it not?

Mr. COHEN. Well, it depends upon the extent to which they make loans for residential housing or student loans or small business loans. But assuming that they use this incentive to the maximum in each instance, they would then have to pay tax at a 48 percent rate, or at a 46 percent rate when the rate reduction is fully effective, on at least 60 percent of their income, and if we multiply the 48 percent rate times 60 percent of their income, the effective tax rate will be around 29 percent.

Now, at the present time the commercial banks are paying a tax, I believe, at an effective rate of about 23 or 24 percent. It is that effective rate rather than 44 or 45 percent for corporations generally, because commercial banks have the special bad debt reserve and because they have considerable tax-exempt interest income.

The savings and loan associations are, in general, paying taxes at roughly a 15-percent effective tax rate under present law.

Mutual savings banks, I think, are paying a tax in the neighborhood of 6 percent, and so——

Senator BENNETT. Is that the current effective rate or the effective rate that would hold after the bill was passed?

Mr. COHEN. Those are the current effective rates, and they would be raised when the phase-in was completed under our proposal.

Senator BENNETT. So the impact would be most heavy and severe on the mutual savings banks and the savings and loan associations.

Mr. COHEN. Yes, it would, taking into account the fact that they are paying such a low effective rate at the moment, but this would also have the advantage, particularly for the mutual savings banks which—I understand have requested it—of removing any investment restrictions contained in the tax law.

They would still have whatever restrictions that exist under the banking law, but it would leave them free under the tax law to operate in such manner as they wished. However, they would only get this special benefit to the extent that they elected to make real estate, residential mortgage loans, and the other preferred loans.

Senator BENNETT. Then you would phase this in in comparatively equal steps over the 5-year period?

Mr. COHEN. Yes, Senator.

Senator BENNETT. Those are my questions, Mr. Chairman.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

The CHAIRMAN. Pardon me, I do not know the order in which the Senators came into this room. I will hold myself until the last.

Senator BYRD. Mr. Secretary, let me state a dilemma, as I see it, the committee faces, and then ask a question.

### CHANGING THE STATUS OF TAX-FREE BONDS

Certainly, we do not want to be penny wise and pound foolish. Now, the dilemma, as I see it, in regard to tax-free bonds is that the tax-free status has been used by a limited number of individuals in a high-income tax bracket who were, with high income, able to escape taxation, and that is bad. My own feeling is that all citizens, certainly those with substantial income, should pay taxes.

Now, in order to get at those then we have to change the status of the municipal and State bonds which, in turn, has a bad effect on every State, every city, every county throughout our Nation and thus on every taxpayer, local taxpayer, in each of the communities.

Now, my question is this, and I do not know the answer, I am not suggesting an answer to it, my question is this: Are we gaining enough either in principle or in dollars by attempting to change the tax-free status of the municipal bonds?

### TAX-FREE BONDS AND LTP

Secretary KENNEDY. In answer to your question, Senator, I think that definitely we would not get enough if the tax-free bonds were included in the limit on tax preferences.

The allocation of deductions where we are proposing tax-exempt interest be included is a different matter, that is an effort to take tax-exempt income, along with other types of income so that in combination they could not use the tax preferences to avoid payment of taxes through claiming personal deductions fully against taxable income.

Now, the impact on the market from a dollar standpoint should not be very great because the tax, as you have indicated, is not large in

amount. The foot is in the door, so to speak, and it does have an effect on the market.

Surely we do not want to hurt the States and municipalities because they have financing needs of every kind. We have got to take care of them, and that is one reason why we were looking into other forms of financing assistance.

They are hurt not only with this but by tight money periods. Part of the market reaction is because the money market has been very tight, funds have been scarce, and during periods of tight money the spread almost disappears between tax-exempt and taxable bonds. So issues sold during that time carry very high yields, and the locality does not get any advantage of it. They get their money but at a high rate, and the Federal Government does not get anything out of it because the interest is not taxable.

There have been moves to make changes in the past, many of them. I recall in 1953 and 1954 when I was in the Treasury, in the revenue bill of 1954, as it turned out, we were proposing to tax only housing bonds that had Federal Government guarantee, and it was decided to back out of that situation and not require the tax because of the effect on the municipal market.

This was so despite the fact that at that time the spread was almost zero between taxable and tax-exempt bonds.

ALLOCATION OF DEDUCTIONS PROVISION

Now, the allocation of deductions provision is an effort to prevent the offsetting of taxable income with personal deductions which could have been paid from tax-preferred income, and thus require all taxpayers with tax-exempt income to pay some tax. It is not quite true to say they will have to pay some tax because, if all their income is from municipal bonds they will have no tax deduction because they have no taxable income, we still do not tax that. There are very few cases in this category. I do not know how many cases there are, but there are very few.

Senator BYRD. In order to hit at those few individuals, and I would like to see them hit, in order to hit at those individuals, aren't we adversely affecting all the taxpayers, because if you increase the cost of local government that has got to be paid by the same individuals who pay a Federal income tax, and in many cases by individuals who do not even have enough income to pay a Federal income tax. That is the point that crosses my mind.

I gather from your answer that you feel that we will gain enough in principle, even though we do not gain enough in dollars to warrant doing this.

Secretary KENNEDY. Well, if I felt that the provision on the allocation of deductions would hurt the market seriously I would not want to see it in there because I agree with you that it is a burden to finance the locality. The additional cost to the municipality would appear as a tax cost. The taxpayers' protest is not only against Federal taxes, it is against the whole tax burden. State and local taxes have gone up very fast, and I think taxpayers include these taxes in their general dissatisfaction with taxes. It is the whole ball of wax and not just the Federal taxes.

Senator BYRD. Let me change the subject now. One purpose of this legislation is to close loopholes. Are there groups of citizens who are exempt by law from Federal income tax? Take an example, employees of the United Nations. Do they, American citizens, do they pay an income tax?

Mr. COHEN. Pardon me, sir; I did not hear.

Senator BYRD. The employees of the United Nations, American citizens, do they pay an income tax?

Secretary KENNEDY. No, they are exempt, as are the employees of the World Bank, and the International Monetary Fund.

Senator BYRD. In other words, we have two groups of citizens who are exempt by law from paying an income tax, employees——

Secretary KENNEDY. Yes, but they are compensated in such a way that their net income is the same as noncitizens employed by the institutions who are exempt from U.S. tax.

Senator BYRD. United Nations, employees of the United Nations and employees of the World Bank.

Secretary KENNEDY. That is right.

Senator BYRD. In other words, they do not pay an income tax.

Mr. COHEN. There are certain exemptions. I think at the time the United Nations headquarters was created in New York there was a treaty signed, and under that treaty there are some persons of that kind that were exempted from tax, but I had the impression that American citizens who are employed by the United Nations are subject to tax.

Senator FULBRIGHT. That is correct, Mr. Secretary.

Mr. COHEN. Yes, sir; I think that is correct.

Senator FULBRIGHT. Citizens are.

Mr. COHEN. Our citizens in the employ of the United Nations are subject to tax.

Senator BYRD. That was my question.

Mr. COHEN. Yes, that is my recollection.

Senator BYRD. All right. How about the World Bank?

Senator FULBRIGHT. If the Senator will yield, I think I know. What they do, the Bank pays the tax for them, but actually they pay a tax as a citizen of the United States, do they not, Mr. Secretary? They are not exempt in the sense that the Senator asked the question.

Mr. COHEN. Yes. The only exemption, if you call it that, is not for a person, but we do exempt from income tax the first $20,000 of salary or compensation earned abroad by U.S. citizens who earn it outside the United States.

Senator BYRD. I am not speaking of that. I am speaking now of an employee of the World Bank. Does he pay an income tax or does he not pay an income tax, a U.S. citizen.

Mr. COHEN. I think that he does, but I think, as Senator Fulbright says, that it is reimbursed to him.

Senator FULBRIGHT. He is reimbursed.

Senator BYRD. Then he does not pay an income tax. [Laughter.]

Mr. COHEN. I could go to work for an organization that would say it would pay my income tax, but the payment of that tax is then additional compensation to me, and you may have a continuing escalating

calculation until you get down to zero. But then I am being taxed on all my income just as anyone else is.

Senator BYRD. Let me read you this from the Internal Revenue Code, which says this, "Compensation of employees of foreign governments or international organizations."

Mr. COHEN. Are you reading from section 893?

Senator BYRD. 893.

Mr. COHEN. Yes, sir.

Senator BYRD. "Wages, fees, or salary of any employee of a foreign government or of an international organization"—which is the World Bank, I would assume——

Mr. COHEN. Yes.

Senator BYRD (continuing). "Including a consular or other officer, or a nondiplomatic representative, received as compensation for official services to such government or international organization shall not be included in gross income and shall be exempt from taxation under this subtitle."

Mr. COHEN. If you will read a few words more.

Senator BYRD. "If such an employee is not a citizen of the United States."

Mr. COHEN. That is the point, if such an employee is not a citizen of the United States.

Senator BYRD. Then, to answer my question, the employees of the World Bank do pay an income tax.

Mr. COHEN. If they are U.S. citizens.

Senator BYRD. If they are U.S. citizens.

Mr. COHEN. Yes, sir.

Senator BYRD. The World Bank then pays that income tax back to them, is that it?

Mr. COHEN. Indirectly, yes. They pay additional compensation to them so that their after-tax income is equivalent to the income of employees who are not U.S. citizens.

Senator BYRD. But then you do not charge them, the Internal Revenue Service does not charge them, on that additional compensation.

Mr. COHEN. I think it does.

Senator BYRD. Well, Mr. Secretary, could you get me a memorandum on how they are taxed. If we are trying to close up loopholes, this is a loophole we would want to consider.

Mr. COHEN. I think it does not affect U.S. citizens, but we will check into it and provide you with a letter or memorandum on it.

### RESTRICTED STOCK PLANS

Senator BYRD. Now, Mr. Cohen, I am somewhat concerned with what appears to be an inconsistency in your statement. On pages 38 and 39, you urge that that portion of the House bill—section 321—dealing with restricted stock plans should be adopted. As I understand it, the treatment to be afforded restricted stock under this provision is based on the fact that restricted stock plans are similar to nonqualified pension plans, and that the House bill adopts, at your recommendation, the forfeitability concept used in the nonqualified pension plan area—isn't that essentially correct?

Mr. COHEN. Yes.

Senator BYRD. Yet on the same page (39), you recommend that section 331 of the House bill—dealing with other deferred compensation arrangements—should not be adopted. The reason given for this latter recommendation is: "We believe that with further study of this problem—deferred compensation—in the context of the tax treatment of all deferred compensation, including amounts paid under both qualified pension and profit-sharing plans and nonqualified plans, a better solution in principle can be developed."

If the area of nonqualified plans is under study to "develop a better solution" why is it that you recommend that restricted stock be treated in the same manner as transfers to nonqualified plans?

Would it be much better to include restricted stock in your study and then make recommendations on the whole area? Otherwise, you may be here a year from now requesting another change in the taxation of restricted stock.

Mr. COHEN. We believe the question of restricted stock requires immediate attention and does not require further study. In the first place, there has been an increasing tendency toward use of these plans ever since the tightening of the rules relating to qualified stock options in 1964. Yet there has never been congressional consideration given to the rules applicable to nonqualified stock options or restricted stock.

In the absence of provisions in the Internal Revenue Code, regulations have grown up which, from the employee's position, combine tax benefits—deferral and capital gain treatment—which together represent a departure from the general rules applicable to compensation for personal services. Exceptions to these rules have not been allowed by Congress except upon satisfaction of certain stringent requirements, as in the case of a qualified stock option plan or a qualified pension, profit-sharing, or stock bonus plan.

Second, there is an existing uncertainty with respect to the treatment of restricted stock ever since the Treasury Department, under the prior administration, issued proposed regulations designed to change the above-described treatment. Although these regulations have an effective date of June 30, 1969, they have not been made final because of the changes that would result under the pending bill, which we believe preferable to the pending regulations.

We believe it is important to bring restricted stock plans in line with other form of compensation before the use of these arrangements spreads further. This action should not be delayed pending consideration of a possible further change in the rules relating to deferred compensation.

Senator BYRD. What is the projected revenue impact of the changes made by the House bill in regard to restricted stock? Is it negligible or significant?

Mr. COHEN. The overall revenue impact of the change made by the House bill is negligible because, assuming restricted plans remain unchanged, corporate taxes would be reduced by the deduction for the increased compensation. However, the fact that undue tax benefits to employees are now balanced by imposing a greater tax on the employer does not mean that no change is required. Our self-assessment tax system depends upon equitable rules under which each persons pays a

fair share of his income in tax. Permitting certain forms of compensation arrangements to be taxed at capital gains rates while others are taxed as ordinary income creates serious inequities in the individual income tax.

Senator BYRD. Is it reasonable to defer the payment of taxes on restricted stock which is not transferable during the period the restrictions remain outstanding so that the employee will at least have some funds with which to pay his taxes?

Mr. COHEN. Where the only restriction is that the employee may not sell the stock for a stated number of years, there is no reason to defer tax. The employee has a vested right to the stock and should be taxed upon having received property just as in the case of any compensation arrangement. Restrictions which lapse at some future time serve no essential business purpose but are used principally to affect the tax consequences. They may properly be disregarded for income tax purposes under these conditions. Employees are taxed in other arrangements on the full value of property over which they may not have full control, as in funded nonqualified pension or profit-sharing arrangements, group life insurance plans, and other such benefits.

Senator BYRD. Do you think there should be a distinction in treatment between restricted stock awarded as a bonus for which no compensation is paid and a restricted stock purchase plan which is an integral part of an employer's compensation program?

Mr. COHEN. We do not think any distinction along these lines could be justified. If the arrangement involves a bonus or other compensation it should be taxed as ordinary income at the time the employee's interest becomes nonforfeitable, and this should be true whether or not other compensation is also paid.

Senator BYRD. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Curtis.

Senator CURTIS. I shall try to put my questions precisely and I would hope the answers would be precise.

## REVENUE GAIN OF THE TREASURY RECOMMENDATIONS ON BONDS OVER PRESENT LAW

What is the revenue gain of the Treasury recommendations on State and municipal bonds over the present law?

Mr. COHEN. Well, I think in our recommendation it is about $45 million. I said earlier $50 million. We now have a little more precise estimate of $45 million.

Senator CURTIS. And the House recommendations would be $25 million more?

Mr. COHEN. $35 million more.

Senator CURTIS. Now, as I understand it, there are provisions in this bill to encourage activity to meet certain objectives such as the building of houses and the improvement of substandard housing; is that correct?

Mr. COHEN. Yes, that is true with respect to housing.

Senator CURTIS. Yes.

RAILROAD BOXCARS AND THE INVESTMENT CREDIT

Now, maybe you are not permitted to answer this question right now, but in reference to the repeal of the investment credit, I am very much concerned about the boxcar situation for railroads. Oftentimes there is grain piled all over the ground in my State because they cannot get cars to ship it out.

Would not this fall in the same sort of a category?

Mr. COHEN. Senator, we have considered this at some length because the House bill provides, in the light of the prospective repeal of the investment credit, a 7-year amortization of the cost of new boxcars. At the present time, the guideline life of railroad cars, I believe, is 14 years. The actual life is estimated in general to be, I think, 30 years, but the Internal Revenue Service now allows depreciation on a basis of 14 years under the double declining balance method, and under this bill a railroad would be permitted to amortize one-seventh of the cost each year for 7 years. That would cost $100 million in revenue.

Now, the problem we face is whether or not such a provision is really going to alleviate the shortage of boxcars at harvesttime in the part of the country that produces the grain. We are aware of the problem that you suggest.

Senator CURTIS. The carriers do not think it will.

Mr. COHEN. Pardon me?

Senator CURTIS. The carriers do not think it will.

Mr. COHEN. Neither do we, Senator. We are inclined——

Senator CURTIS. The rapid amortization.

Mr. COHEN. But we are not inclined to think that the investment credit would solve the problem either.

The problem is that there are not sufficient boxcars at the time to be available in the particular areas that want them. Any provision which would increase the number of cars by 50,000 which, as I understand it, is the shortage at harvest time, and allocate those boxcars at that particular time to the grain areas would tend to solve the problem, but in order to succeed you have got to increase the aggregate number of boxcars and allocate them into the areas where they are needed at the particular time. Our concern is whether this method is worth $100 million in revenue—whether it would solve the boxcar shortage problem. It would be of benefit only to the profitable railroads which have a tax liability.

Senator CURTIS. Your $100 million, that does not take into account any recouping by reason of additional employment, income taxes of individuals who build these cars, and so on.

Mr. COHEN. No, that would not take that into account. I do not know that such factors would produce any additional revenue because the salaries would be deductible by the employers and included in the income of the employees who would probably be in a lower tax bracket.

Senator CURTIS. Full employment does make more revenue.

Mr. COHEN. Oh, yes; I appreciate the overall impact on the economy.

CAPITAL GAINS ON LIVESTOCK

Senator CURTIS. Now, what changes do you propose with respect to capital gains on livestock as contrasted to the present law?

33-865 O—69—pt. 1——42

Mr. COHEN. There are several provisions. The holding period that is required now is 1 year. The House bill would change it to 1 year after the animal is normally put into service.

As we discussed earlier, if the holding period generally is kept at 6 months, we would be prepared to accept 6 months after the time when the livestock is normally put into service.

Now we would require the maintenance of what we call an excess deduction account, which would be invoked in the case of persons, under our recommendation, who have more than $25,000 of adjusted gross income from nonfarm sources. It would therefore not affect the average farmer because he does not have $25,000 of income from off the farm.

If he had losses for a year in excess of $15,000, any capital gains that he would otherwise have on the sale of the livestock would have to be reported as ordinary income until he had made good that excess loss. It is a recapture provision comparable to the recapture of depreciation on personal property.

Senator CURTIS. Roughly, how much revenue is involved?

Mr. COHEN. On the excess deduction account for farm losses, $50 million under our recommendation. It would affect, I think, 9,300 persons, and those persons have an average farm loss of about $44,000.

Senator CURTIS. Then it is safe to say that with respect to the, with the exception of the holding period, there is no change in the capital gains treatment of livestock unless they are using farm losses to offset other income.

Mr. COHEN. I think that is, in general, true. The problems come from using farm losses to offset other income.

Senator GORE. Would the Senator yield? I do not think the Secretary has given a correct answer there.

Mr. COHEN. The answer was as to the effect generally, Senator, and it is not true in the specifics, but I was trying to give a generalized answer.

There is an effect from the change in the capital gain rule generally that would apply to other taxpayers, also. The excess deduction account provision to provide for capital gains being changed to ordinary income would apply only to persons with more than $25,000 of outside income, so it would apply to 9,300 persons.

Senator GORE. That is adjusted gross, though.

Mr. COHEN. Pardon me?

Senator GORE. That is adjusted gross, outside income.

Mr. COHEN. It is nonfarm adjusted gross income. That would include all business deductions. That is not gross income, that is adjusted gross income, so any nonfarm business expenses could be taken off.

The only thing that would not be taken off would be personal deductions. It would apply to a taxpayer only if he had $25,000 of nonfarm adjusted gross income, and then it would only affect him if he had capital gains from the sale of livestock or orange groves or whatever. He would only have to restore to ordinary income at the time of sale amounts of previous losses that had exceeded $15,000 in any year.

Also, there is another provision that net farm losses on a cash basis would be trgeated as an item of tax preference, so that if the net farm loss together with other preferences represented more than half of a prson's income, the person would be affected by the limit on tax preferences.

Senator CURTIS. Now, one other question, and I am not trying to exhaust the agricultural thing at this time, because before we are through with this bill we will go into it further. What changes in present law do you recommend in the field of, in the area of, lumber cutting so far as the lumber people are concerned?

EFFECTS OF THE BILL ON TIMBER

Mr. COHEN. Well, the incorporated lumber companies would be affected by a raise in the corporate capital gains tax rate from 25 to 30 percent, and that is an increase of 20 percent in their tax.

Senator CURTIS. That is for them and not for all capital gains.

Mr. COHEN. That is for them.

Senator CURTIS. Taxpayers.

Mr. COHEN. That is for all corporations.

Now, this would be applicable to all corporations on all their capital gains; it would include timber since timber receives a capital gain treatment under present law.

Senator CURTIS. Yes.

Mr. COHEN. Now, individuals under our recommendation would still be entitled to a limited amount of capital gains at the old 25-percent rate, just as the corporations would be entitled to the 25-percent capital gains rate on the first $50,000 of income under our suggestion.

But if individuals have very large capital gains in relation to their ordinary income, whether they were from the sale of timber or from securities or real estate, the tax could go up, in effect, to 32½ percent.

Senator CURTIS. That would come under the LTP.

Mr. COHEN. It would just go up to the 32½-percent rate under this bill—half of the capital gains would be included in ordinary income and the top rate would be 65 percent.

Senator CURTIS. That is under your sections dealing with the limited tax preference.

Mr. COHEN. Well, it is based on that concept, but we have provided a separate rule for the capital gains so that it could be more readily calculated—the theory is the same.

Senator CURTIS. Those are all the changes in reference to timber?

Mr. COHEN. Yes, sir; except there is, I think I mentioned earlier, one thing in the House bill dealing with the dividing line between short-term holdings and long-term holdings. Under the bill it was changed to 1 year, and we are recommending that the holding period be changed back to 6 months, but we would calculate that 6 months from the start of the year just as is in existing law.

There is also a change in the bill as to the starting point for the holding of timber, and we would suggest returning to the precise provisions of the existing law.

Senator CURTIS. You are still talking about timber?

Mr. COHEN. Still talking about timber. There is a special holding period rule with respect to timber.

Senator CURTIS. Now, dollarwise, what increase in burden would you place on the timber, according to your recommendations, not the House?

Mr. COHEN. I would have to give you that, Senator. I can tell you that the increase in the capital gains tax on corporations would

range from $150 to $175 million, but what proportion of that is with respect to timber I cannot at the moment tell you, but I will submit it for the record.

Secretary KENNEDY. Submit it for the record.

(The information supplied by the Treasury Department on this matter follows:)

In 1965, the last year for which data is available, corporations reported $2,486 million of long term capital gains taxed at the 25 percent alternative rate. The lumber and wood products industry and the paper industry reported $443 million or 18 percent of this total. We thus estimate that approximately 18 percent or $31 million of the $175 million increase in capital gains tax on corporations would be paid by the timber industry in 1970 if the alternative capital gains rate for corporations is increased to 30 percent.

Senator CURTIS. Other than that, is there something else?

Mr. COHEN. There would be some increase in capital gains on some sales of timber by individuals if their capital gains were very large in relation to their ordinary income. But since we would permit at least $140,000 of capital gains for a married man, the average farmer who would be cutting timber off of his land would not be affected.

FARM COOPERATIVES

Senator CURTIS. Now, Mr. Secretary, do the provisions in the House-passed bill relating to farm cooperatives raise any additional revenue over present law?

Secretary KENNEDY. No. The provisions of the House-passed bill relating to farm cooperatives do not raise any additional revenue over present law. Its primary purpose is to assure the individual patron that the cooperatives will make increased payments within a definite period of time.

Senator CURTIS. Is it true that under present law all of the income of the farm cooperatives is taxed to someone; that is, either to the member, patron, or the cooperative iteslf?

Secretary KENNEDY. Yes. Under present law, all of the income of the farmer cooperative is taxed either to the patron, shareholder, or the cooperative itself.

In determining taxable income under present law, cooperatives are permitted a deduction (or exclusion) for patronage dividends paid in money, qualified patronage allocations, or other property (except nonqualified allocations). They also are permitted a deduction (or exclusion) for qualified per unit retain certificates (that is, certificates issued to patrons to reflect the retention by the cooperative of a portion of the proceeds of the marketing of products for the patrons, computed on the basis of units of products marketed). A patronage allocation or per unit retain certificate is qualified—and therefore not taken into account by the cooperative—only if the patron consents to take it into account at its face value as income in the year in which the certificate is issued. Thus, in general, a cooperative is not taxed on patronage allocations or per unit retains only if they are taxable to patrons.

If a patronage allocation or a per unit retain allocation is not a qualified allocation, it must be included in the income of the cooperative in the year allocated, and the cooperative may take a deduction

for this amount only when the nonqualified allocation is redeemed in cash or merchandise. If at that time the cooperative is not able to make use of the deduction, a refund may be obtained of the taxes paid on this amount in the year the allocation was issued.

Senator CURTIS. Part of my time was consumed in yielding to the distinguished Senator from Tennessee, so I will ask one more question.

I was in the House of Representatives when we chose to tax the salaries of State officials.

Mr. COHEN. That would have been 1939.

Senator CURTIS. Yes. My recollection is that that bill carried a waiver permitting the States to tax the salary of Federal officials. I have not checked back on the books——

Mr. COHEN. That is correct.

Senator CURTIS. I am just reaching back 30-odd years.

Mr. COHEN. I think that is correct, Senator.

TAXING INTEREST ON FEDERAL BONDS

Senator CURTIS. Are you willing to do the same thing in reference to tax on municipal bonds, to give the States authority to tax the interest on Federal bonds?

Mr. COHEN. I think if we were taxing the interest on the State securities that this would be appropriate.

Senator CURTIS. If we did it directly.

Mr. COHEN. If we did it directly, I think it would be appropriate.

I might say, Senator, that in the effort to simplify the income tax returns of States, it would be a great deal simpler if they could use the same base as is used for Federal purposes, but today when you try to conform the State law to the Federal law you always have to make an adjustment for the two types of bond interest.

Senator CURTIS. My final question can be answered yes or no, and I will ask why, and the why can be put in when you revise your statement because of time.

ABOLISHMENT OF UNLIMITED CHARITABLE DEDUCTION

Does the Treasury Department favor the abolishment of the unlimited charitable deduction?

Mr. COHEN. Yes, we do.

Senator CURTIS. All right.

In your—when you revise—I won't take time for a philosophical discussion now, but I would like to know why.

Mr. COHEN. Well, I think I can state it very simply. We did not recommend precisely the provision that is in the bill, but we felt we should do so under the principle that everyone should pay some tax, and while as these funds benefit charity and education, we still thought that the charitable or contribution deduction should not be available to the extent that a person did not contribute something to the support of the Federal Government.

Senator CURTIS. Going down to 50 percent is quite a bit.

Mr. COHEN. We recommended a different rule, which I will elaborate. We wanted to be sure it could not be used to the extent that a person could eliminate tax on 20 percent of his income, and I think roughly the bill reaches the same result in a different way.

Senator CURTIS. Yes.

Mr. COHEN. I will expand that in the record, sir.

Senator CURTIS. Thank you.

(The Treasury Department subsequently supplied the following additional information:)

TREASURY POSITION ON UNLIMITED CHARITABLE CONTRIBUTIONS DEDUCTION

Under present law, the charitable contributions deduction for individuals generally is limited to 30 percent of the taxpayer's adjusted gross income.

An exception to this general limitation allows a taxpayer an unlimited charitable contribution deduction, if in eight out of the ten preceding taxable years the total of the taxpayer's charitable contributions plus income taxes exceeded 90 percent of his taxable income.

The unlimited charitable contributions deduction has allowed a small number of high-income persons to pay little or no tax on their income. Approximately 100 persons utilize the unlimited charitable deduction and this was the major factor in eliminating taxes for 49 of the 154 individuals with adjusted gross income in excess of $200,000 who paid no tax in 1966. In the great majority of these cases, the bulk of contributions consists of appreciated property, primarily securities. Because no tax is imposed upon this appreciation and because the individual is able to deduct the full value of the contributed property from income, the 100 unlimited givers usually pay little or no tax on their current income, even though such income is actually retained by the taxpayer.[1]

The Treasury believes that while it is important to encourage charitable giving, it is unacceptable to allow a few individuals the option to choose between supporting the Government and supporting charity. Some contribution to the support of the Federal Government should be required from all persons with substantial income. Thus, we originally recommended to the Ways and Means Committee that the present unlimited charitable deduction be limited so that it could never relieve the taxpayer of paying tax on at least 20 percent of adjusted gross income. At the same time we recommended that the present normal limit on charitable contribution deductions be raised from 30 percent to 50 percent. The House accepted the latter recommendation and voted to terminate the unlimited charitable contribution deduction. The net effect of the changes voted by the House is quite similar to that which we recommended (since under the House rule other personal deductions can be taken in full) and, accordingly, we have now recommended its acceptance. The result in the House bill, taking into account the increase in the general limitation on the deduction to 50 percent, is that charity can remain an equal partner with respect to an individual's income, but charitable contributions no longer will be allowed to reduce an individual's tax base by more than one-half. In view of the fact that it takes a number of years for a taxpayer to qualify for the unlimited deduction, we believe it is appropriate to remove the unlimited deduction gradually over a 5-year period.

The CHAIRMAN. Senator Miller.

Senator MILLER. Thank you, Mr. Chairman.

COOPERATIVES

I would like to touch on the subject of cooperatives briefly. As I understand it, your position is to support the House bill insofar as the payout within 15 years provision is concerned, but you recommend deleting the extra 30 percent and the phase-in over a period of time.

Mr. COHEN. That is correct, Senator.

[1] For example, in a recent year an individual who qualified for the unlimited charitable deduction had net income of $9.7 million before deduction for charitable contributions. He did not contribute any of the components of this income to charity. Instead, he contributed securities which originally cost him $460,000 and which had greatly appreciated in value to more than $9.7 million. As a result of the deduction generated by this donation, he paid no tax on his $9.7 million of income and no tax on the appreciation that was reflected in the present value of the donated securities.

Senator MILLER. Now, looking at the House rationale of the 15-year payout, on page 168 of the House report, at the middle of the page, it recites the following:

The consent of the patron to be taxed on a qualified patronage allocation or qualified per-unit retain may be made in one of three ways: For members of the cooperative, consent may be given merely by becoming or continuing as a member after the cooperative has provided in its by-laws that membership in the cooperative constitutes such consent. Such a consent cannot be revoked as long as the patron is a member. A second form of consent, which may be used both for members and non-members, is a written consent given by the patron before the end of the year in which the patronage occurs. This consent applies in subsequent years until revoked in writing. A third form of consent, also applicable both to members and non-members, applies in the case of a patronage dividend if no other consent has been obtained. The cooperative gives the patron a qualified check for part of the patronage dividend. The check contains a statement that its endorsement and cashing constitutes consent of the patron to include the full amount of the allocation referred to in the check in income.

Then further down on that page the House Ways and Means Committee gives its rationale by saying:

Qualified patronage allocations and qualified per-unit retains may be considered as amounts distributed by the cooperative to its patrons and re-invested in the cooperative as capital. However, under the methods of consent described above, the patron often does not have an independent choice between investing each patronage allocation or per-unit retain allocation in the cooperative or retaining it for his own use.

I can understand that statement very well because it has been cited, for example, in some cases that if you have a bylaw in a cooperative and a member comes in, a prospective member comes in, and becomes a member, automatically he is bound, and he is bound until he withdraws from the cooperative.

However, I think that there are a great many cooperatives, and especially some of the smaller ones, where we might avoid some hardship which could exist from the 15-year payout requirement and, at the same time, satisfy the control concept which appears to be lacking at least in some instances, as recited by the House Ways and Means Committee, and I was going to ask if an amendment to section 531(a) of the bill, which would appear at page 310 of the bill, the cooperative section—might be appropriate. Section 531 starts at page 310, 531(a), and it goes into the 15-year payout, and I am wondering if at the end of that you might satisfy the principle involved here with a proviso which would read substantially as follows:

Provided, that the foregoing—

The 15-year payout requirement—

provided that the foregoing shall not apply where a majority of the cooperative's patrons have voted at an annual meeting or by annual written authorization in favor of retention by the cooperative of patronage allocations which otherwise would be required to be distributed to the patrons.

I make this suggestion because I do recognize the principle that the House Ways and Means Committee was trying to satisfy.

I think the suggested proviso would substantially satisfy, especially in the case of your smaller cooperatives, and I can see hardship looming up in the case of many cooperatives under a harsh 15-year payout requirement. I am wondering if this might satisfy the Treasury Department.

Secretary KENNEDY. I think, Senator, that is worth looking into very carefully, and we will come back to you, but it sounds to me like it has some merit. I will ask for Mr. Cohen's thought on this matter.

Mr. COHEN. I think, generally, Senator, we are inclined to agree that that would be acceptable as long as it is understood this would be an annual vote or an annual authorization. But we would like to consider it further. Our present inclination is to think that that would be acceptable.

Senator MILLER. Then you will let us know later, and if you have any suggested language other than this, we are certainly open for it.

Mr. COHEN. Yes.

Senator MILLER. I am trying to satisfy a principle which is involved here and, at the same time, avoid what could be undue hardship.

Mr. COHEN. Yes.

FARM LOSSES

Senator MILLER. I notice that the Treasury Department in the case of farm losses generally goes along with the House approach, except that the House bill provides that nonfarm adjusted gross income in excess of $50,000, and farm losses in excess of $25,000 in the area under attack, and your approach is to put the area subject to attack of $25,000 nonfarm income, and $15,000 farm losses; is that correct?

Mr. COHEN. That is correct, Senator. We made this recommendation to the House Ways and Means Committee in April, but without any requirement of outside income, and made it applicable in the case of losses exceeding $5,000.

The committee put the outside income limitation in and raised the loss level to $25,000, and we are suggesting $15,000 as the loss limit, and $25,000 as the outside income limit.

Senator MILLER. Why do you change your mind from the House side of the Capitol to the Senate side of the Capitol?

Mr. COHEN. Well, we tried to reach agreement in the Ways and Means Committee in a number of respects.

I think that we were concerned from the standpoint of not being unduly burdensome on farmers generally, and we think that from a revenue standpoint we can go up to $15,000 without serious effect. The change would exempt from the operation of the rule a great many persons with small farm losses.

In addition, I might say, that in the hurry with which we were operating in April—I might say I took office on March 11 and we presented these proposals on April 22—we had not had time to run the computer on them. We later did run a computer so that we now know a good deal about the difference between a $5,000 or $10,000 or $15,000 or $25,000 limit, and on the basis of the computer run we are now satisfied that $15,000 would prevent the larger amount of the abuse. We did not have that detailed information on April 22.

Senator MILLER. What is the rationale of $25,000 nonfarm income? Why not make it $15,000 on nonfarm income or why not make it unlimited nonfarm income where it represents wages and salaries earned by the farmer and his wife who have to work off the farm probably to make ends meet in many cases?

Mr. COHEN. Well, I think, perhaps, the thought, Senator, would be that only if a person has more than $25,000 of outside income is he

likely to be operating the farm for the tax advantages that would be involved.

If a person has less income than that from outside sources his rate of tax is sufficiently low that he cannot be using the tax benefits to finance the venture.

On the other hand, when one goes above some limit his tax rate becomes so high that, in essence, he finances his losses out of his tax saving. The limit is a matter of judgment, and no one can say 25,000 as against 30 or 20, but we made an effort to put the limit at a range where the tax rates would begin to get high enough that you could conclude that the farm loss is affected by his tax considerations.

Senator MILLER. Well, there is a principle involved, isn't there?

Mr. COHEN. Yes.

Senator MILLER. Regardless of the amount that you set, but I take it that what you are looking at is looking at the area which makes it really worthwhile from an administrative standpoint——

Mr. COHEN. Yes.

Senator MILLER (continuing). To draw the line.

Mr. COHEN. Yes.

In this instance we are talking about the difference between ordinary income rates and capital gains rates, and they tend to become more important as you go up the tax brackets, and we were also trying to——

Senator MILLER. I would like to make a comment on that point.

I realize that is a factor, but I suggest to you there are other situations where capital gains are not particularly involved, and this represents an unfair competition between the farmer, on the one hand, who has to rely 100 percent on his income from his farming operation, and another farmer down the road who does not have to worry too much about that because he has outside income that he can write-off the farm losses against. He does not have to fight for higher prices or for lower cost production like the first farmer does, and this constitutes a very irritating means of unfair competition which, I must tell you, many farmers, regular farmers, commercial farmers, and especially smaller ones deeply resent.

Mr. COHEN. Well, this provision is applicable only in respect to the difference between ordinary income and capital gains. This deals with the possibility of having deductions against ordinary income followed by capital gains on the sale of livestock or orange groves. Beyond that we would include the farm losses as a preference in our limit on tax preferences and our allocation of deductions provisions.

Senator MILLER. To what extent would you include those?

Mr. COHEN. Pardon me, sir?

Senator MILLER. What extent would the farm losses be included in the LTP, the full extent?

Mr. COHEN. Full extent.

Senator MILLER. No $15,000 minimum on that?

Mr. COHEN. No, sir; that is right. And, moreover, there is a provision in the bill to strengthen the hobby loss provision materially and that would have an effect on this question of competition between the commercial farmer and someone who would be in it for the tax advantages.

Senator MILLER. Now, I would like to wind up my questioning on this subject of tax-exempt interest which is troubling everybody.

First of all, let me start out this way: how much additional revenue do you estimate we will receive from the allocation of deductions provision?

Mr. COHEN. In total for all the items that go in it?

Senator MILLER. Yes.

Mr. COHEN. It would be, under our proposal, $480 million, and under the House proposal, $460 million.

Senator MILLER. All right.

Now, of that $480 million, how much would be attributable to the tax exempt interest?

Mr. COHEN. $45 million. I guessed earlier, $50 million, and the figure that has been handed to me since shows $45 million.

Senator MILLER. Well, $45 million or $50 million will suffice.

Mr. COHEN. Yes; roughly.

Senator MILLER. Now, earlier I believe you testified that the amount of revenue that would be obtained from individuals by putting tax-exempt interest into the LTP would be in the neighborhood of $25 to $30 million; is that so?

Mr. COHEN. Yes. I am now told that out of the $85 million for LTP in the House bill, $35 million is estimated to relate to tax-exempt interest, a little bit higher than I gave it to you.

Senator MILLER. All right.

#### TAX-EXEMPT MUNICIPAL BOND INTEREST

I do not like to return, Mr. Secretary, but in your testimony you stated this morning that there was a possibility of adverse repercussions in the market if we put this into LTP but, at the same time, you recommend that we use the allocation of deductions rule and no 10-year phases at all.

As I see it, you have recommended a provision that will drain out $50 million of revenue through tax-exempt municipal bond interest, but you are not willing to recommend what will only take out $35 million. It seems to me that the market effect, and I think some of my colleagues are concerned about it, the market effect on the allocation of deductions would be more severe, although I cannot get too excited about either one, frankly, but it would seem that the market impact of doing what you recommend would be more severe than to put the tax-exempt interest in the LTP like the House has done.

Secretary KENNEDY. I think, Senator, it is largely a matter of the psychological impact from the inclusion of tax-exempt interest in the LTP because that is considered more of a direct tax.

In the allocation of deductions, the market has not taken that to the same extent as a foot in the door of taxation of tax-exempt securities. Dollar wise, you are perfectly right, but in either case it is not a very large figure in relation to the total of income.

Senator MILLER. That is why, as I say, I cannot get very excited about either one, and I have a feeling that while I understand the touchiness of people on this subject, and especially on some of the Members of Congress who have been recommending abolition of tax

exemption of this, I can understand the concern of it, but when we get down to a little tiny point like this, maybe somebody is talking about the head of the camel under the tent—I have always felt if the head of the camel should get under the tent let it get under the tent, and that is where it will stay, and especially where we have this public reaction to some people who are not paying any income tax on a substantial amount of income.

Well, do I understand, Mr. Chairman, we will have an opportunity to continue questioning tomorrow?

The CHAIRMAN. Yes. We will meet again at 10 o'clock tomorrow.

Senator MILLER. I have several questions in the area of percentage depletion, and I would rather carry them over until tomorrow.

The CHAIRMAN. I think, Senator, the time has just about expired for today. I have inquired of Senator Fannin what his thought would be, and his feelings are about the same as mine—that we have put the Secretary through a pretty exhausting grilling today, and Senator Fannin would be willing to withhold until tomorrow, and I am willing to withhold mine until tomorrow, unless you want to ask another question or two, Senator Miller. So then we will start with Senator Fannin tomorrow.

Senator MILLER. I have several questions on that subject, and I will use my full 10 minutes tomorrow or a little more, so I would rather wait until tomorrow.

The CHAIRMAN. Fine. We will count on you for your turn the next time, and then we will go to Senator Fannin.

We will adjourn until 10 o'clock tomorrow.

Thank you, Mr. Secretary and Mr. Cohen and your assistants. You have been most helpful and most cooperative, and I think you have earned your money today. I recommend you for a pay raise, in fact.

Secretary KENNEDY. Even after taxes? [Laughter.]

(Whereupon, at 5:20 p.m., the hearing was recessed, to reconvene at 10 a.m., tomorrow, Friday, September 5, 1969.)

# TAX REFORM ACT OF 1969

FRIDAY, SEPTEMBER 5, 1969

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, D.C.*

The committee met, pursuant to recess, at 10 a.m., in room G-308, New Senate Office Building, Senator Clinton P. Anderson presiding.

Present: Senators Long, Anderson, Gore, Talmadge, McCarthy, Hartke, Fulbright, Byrd, Jr. of Virginia, Williams, Bennett, Curtis, Miller, Jordan of Idaho, and Fannin.

Senator ANDERSON (presiding). When we terminated, we were ready for Senator Fannin's questioning.

Senator FANNIN. Thank you, Mr. Chairman.

### CAPITAL GAINS TAX

Mr. Secretary, we all know there is a great need for capital today, and of course there will be in the future. And over the years capital gains have provided a great deal of this capital, especially for small business enterprises.

Are we not in this legislation really taxing capital in many instances?

## STATEMENT OF HON. DAVID M. KENNEDY, SECRETARY OF THE TREASURY; ACCOMPANIED BY CHARLS E. WALKER, UNDER SECRETARY OF THE TREASURY; EDWIN S. COHEN, ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY; AND JOHN S. NOLAN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY—Resumed

Secretary KENNEDY. Yes. The House bill creates an imbalance because it gives a preference to consumption as against capital formation. That is the reason, Senator, that we decided to make the recommendation that we go back on capital gains to a 6-month holding period and to the 25-percent maximum rate, except for certain large capital gain cases.

Senator FANNIN. I certainly commend you for that, and I feel especially in small businesses—I happened to have been in a very small business—we were dependent upon this source of capital.

Secretary KENNEDY. Well, not only for small but for all businesses. We are in a country where we have capital-intensive industries; we are in a country where in order to compete with the rest of the world

we have to have plant and equipment, and our businesses have to have the most modern equipment because we are in the most highly sophisticated fields.

Senator FANNIN. Thank you, Mr. Secretary.

Do you not feel that there is a significant difference between taxing income derived from trading in assets and taxing—for instance, an individual who has built up a business and makes a one-time sale of that business? Is there not a need for a provision to protect a businessman who, say, has to grow up during the years and may not even exceed the depreciation, may not even exceed what has come about as far as inflation, but still he is taxed where his purchasing power has not increased?

Secretary KENNEDY. Well, I think that is right, and that is what the capital gains tax intends to do, to help them build a business or to hold their investments for a period of time.

Senator FANNIN. Well, I was just wondering, Mr. Secretary, you still might want to amplify. After capital has been held for a period of time, say 3 or 4 years, I think time is an element involved, would it be proper to deescalate the percentage of capital gains tax?

Secretary KENNEDY. There have been such proposals for longer holding periods. Maybe Mr. Cohen would like to comment on that.

Mr. COHEN. Senator Fannin, we have put in a 5-year averaging provision with respect to the capital gains tax proposal that is contained in our recommendations filed with the committee yesterday. It will be a considerable help, for example, to a person who would have a very large gain once in a 5-year period, for example. We have given consideration—and I think the House Ways and Means Committee has given consideration—to the possibility of a further reduction for long-term holdings. Not simply a more than 6-month holding but a lower percentage for a holding of, say, 5, 10, or even 20 years has been mentioned. In the total circumstances of our present recommendations, we did not feel that such a provision was needed; but it certainly is a matter that should be further considered.

Senator FANNIN. Well, in fairness then you feel deescalation would be proper. I said 3 years. It might be 10 years, or, as you say, 15 or 20, but certainly it seems unfair to me that a person should hold an asset for that length of time and maybe not have any appreciation as far as purchasing power but still be taxed on it.

Mr. COHEN. Yes. The Ways and Means Committee gave consideration to a more graduated form of capital gains taxation in which there were four or five different categories of holding periods: More than 6 months, more than 2 years, 5 years, 10 years, and so forth, with the rates scaled down for longer holding periods, in fact, that system was actually in effect in the 1930's. But it was considered a bit too complicated for the tax returns because there were so many categories of capital gains. Hence it was deleted in favor of the present system in 1942, principally out of regard to simplicity.

Senator FANNIN. Of course, simplicity seems to have been forgotten in this bill. Complexity seems to take over, but especially I am talking about the House version, and I think you have done a great deal, of course, in improving it.

Has any study been made to determine the actual operations of the 12-month provision as compared to the 6-month provision on capital gains? In other words, a comparison there. I am concerned that we may be reducing rather than increasing revenue to the Government. We may also be affecting liquidity as far as banks are concerned or others are concerned?

Mr. COHEN. Well, Senator, our recommendation to the committee was that there be no change in the holding period.

Senator FANNIN. I realize that, and I am very much in favor of that.

Mr. COHEN. We did give consideration to the provision in the House bill. We have information with regard to holding periods in the year 1962. The Treasury Department and the Internal Revenue Service made a study of holding periods with respect to securities where, I think, the holding periods were particularly important, and found that there is some increase in sales in the 6th and the 7th month but you do find considerable sales also in the 8th, 9th, 10th, 11th, and 12th month.

My recollection is that under the House bill, there would be a revenue gain of approximately $150 million from extending the holding period from 6 to 12 months, this was arrived at by first assuming that there would be no change in the pattern of realizations, and then giving 50 percent effect to it. We were assuming there would be some slowing down in realizations between the 6th and the 12th month to reduce the revenue effect by half.

On the other hand, it could be argued that there would be such substantial delays in realization or curbs on investments that we would get no revenue from it.

Senator FANNIN. Well, that is what I was concerned about.

Mr. COHEN. I think our ultimate consideration was that the revenue that would be derived from the House provision was not commensurate with the possible adverse impact from discouraging investment and from decreasing the activity and freedom of the market. I think we were concerned that an increase from 6 to 12 months in the holding period for investments would have a serious adverse effect on mobility of capital.

Senator FANNIN. Well, thank you very much.

FOUNDATIONS

I was wondering, on another subject, we have had considerable discussions about foundations. Do you think there will be more damage than gain through foundation divestiture of all stock held above a 20-percent ownership?

Mr. COHEN. We thought, Senator, that this was, in balance, a desirable move. I think there can be judgment as to whether the line should be 20 percent, 25 percent, or whatever, but we were inclined to feel that the foundations ought not to be used as a shelter for retaining control of a business organization, and we made a recommendation that the normal amount that could be considered should be 20 percent because that did not seem to involve elements of control of the business, but we provided that the amount could go up to 35 percent if there was not, in fact, control.

Senator FANNIN. I agree.

Mr. COHEN. The House bill went a little further than that. We thought of doing it on the basis that the managers of the foundation should be independent from the managers of the corporate business. You could prohibit interlocking directorates, for example. But it was concluded that this was not an appropriate solution, and so we came back with this recommendation.

Senator FANNIN. Well, having quite a few illustrations of how damaging this could be, I am just wondering if there is not some other approach. I know you have stated your objective in preventing self-dealing and self-contributing to control of the corporation, I know it has been stated to hold the profits down and things of that nature, but still are we not talking about the exceptions? Are there not many illustrations to be given where there would be a great inequity created where the foundation is abiding by the law and regulations, and are contributing greatly to specific educational programs or charity, and here we are placing a barrier in their path, and I do not see what you are gaining. It does not seem to me to be justified.

Mr. COHEN. Well, we did not see where the inequity would be involved, Senator. Since Congress has given complete freedom from taxation to foundations it is a question of whether that freedom should be used to control operating business corporations for an indefinite future. Is it a wise policy for American business to have operating corporations which are competing with other privately held, corporations in the control of tax-exempt organizations? Obviously, they will not have the same pressures operating upon them in the conduct of their businesses as those that are held by taxable shareholders. There has been a good deal of complaint about this, and from the standpoint of equity in the tax structure, we did not think the control should be allowed to be retained for more than a transitional period in foundations.

Senator FANNIN. Well, I just cannot agree in these instances that just because there is some control that there is necessarily a situation involving unfair competition.

Now, the money that is made by the corporation is paid out; that is, it is given to these charitable organizations or to schools, or whatever it might be, that are eligible. So where do we really have the area of competition entering the picture?

Mr. COHEN. Well, I think these organizations are under different degrees of pressures from their shareholders, from those that are publicly held or privately held corporations whose shareholders are subject to tax.

The tax benefit is given because it is in the public interest. The public interest is satisfied from the devotion of income to the public need.

Senator FANNIN. I understand.

Mr. COHEN. But if this continues, we will have a very substantial portion of business activity in the control of nontaxable, permanent, perpetual foundations.

Senator FANNIN. But you are requiring them in this bill to distribute an amount equal to 5 percent of the market value of its assets to charity regardless of its income, so you are putting some requirements there and, of course, this could mean in some instances even an invasion of capital, could it not?

Mr. COHEN. Yes. It was realized that that could be true if the foundation had, say, only a 4-percent return, it would still be required to distribute 5 percent.

On the other hand, it had been considered that with equity investments in particular, the total of appreciation in values and recurring income would exceed 5 percent.

Senator FANNIN. Well, understand that I am not in disagreement so far as placing the business in an advantageous position over another free enterprise program, but I am concerned with so many of the companies that are not really more competitive because of being operated by a foundation and I think there are many in that position. I do not know how we are going to have a formula that could take care of the ones that are operating, as I say, on the same basis practically as the free enterprise organizations I am just wondering if there was some other formula that you can come up with. I trust you will give further study to it if you can.

Mr. COHEN. We certainly will, Senator. There are illustrations of fairly large complexes of corporations that are in the control of private foundations, and this is a matter that has been given considerable study.

Senator FANNIN. I understand.

MUNICIPAL BONDS

On the question of municipal bonds, much has been made in the papers of the Nixon administration's willingness to allow some large individuals to escape taxation by the use of municipal bonds. In view of this, I am wondering about the Treasury Department's attitude toward this problem, which is one that troubles the American people who feel that every American should pay some tax.

Secretary KENNEDY. There is no question, Senator, but that if a person's entire income were from tax-exempt municipal securities, and the interest would not be included in the LTP, that they would be free of Federal taxation. As I pointed out yesterday, however, that is a very rare case.

On the other hand, we have the balancing consideration of two items: One was the impact of this kind of a provision, on the municipal bond market, and we concluded that that was too disruptive and really costly to try to take in those very few cases. I do not know precisely how many cases there are, but they are very few.

The other consideration, of course, was the constitutional question which we discussed yesterday. However, the market impact was the controlling factor.

Senator FANNIN. I have heard from the Governors on that. All the Senators have. They are mighty concerned about the actual impact of this. But the individual will have a greater burden as a result of this action. I know your position has been different than the House position, but I am concerned about it. Would not the provision of the House bill, in taxing individuals on municipal bonds income, limit the market for these bonds, to a great extent, to banks or financial corporations? In other words, I know that you are as well versed as anybody in the country on the effect the proposed change would

33-865 O—69—pt. 1——43

have on the banks; and I am wondering if the provision in the House bill would affect the liquidity of the market, considering that the banks may want to sell these bonds at an advantageous time, but not be able to find a market? Would that not create a problem for the banks?

Secretary KENNEDY. To counteract that or to meet that problem in part, the House bill provided an option for municipalities to issue either tax exempt or taxable securities.

Senator FANNIN. Yes, I understand.

Secretary KENNEDY. And there would be a permanent appropriation to provide a subsidy to cover the difference in interest on the taxable bond.

We feel that municipal and State financing is very important and necessary, and that there might be a better way to handle the need than to have two classes of municipal securities, one tax-free and the other taxable, and so we are in the process of trying to come up with a proposal for marketing and purchase of these securities.

Senator FANNIN. Well, is there not a hazard in having taxable bonds and then having the Federal Government in control of subsidizing the difference in the interest rates that would be involved?

Secretary KENNEDY. Well, there are many problems involved in this. The principal one is to design the amount of the subsidy so that the Treasury will be just about recompensed by the additional revenue from taxation of the persons that have the securities. It would be the debt of the municipality, and they could use the debt for whatever purpose they decided; we would not be guaranteeing the principal or determining the validity, but we would be paying the differences between the tax exempt rate of interest and the taxable rate of interest, which was estimated to be between 30 and 40 percent.

Senator FANNIN. But to some extent this would be another, I think, invasion of the State prerogatives. At least to the point where you would be in control of the amount that would be subsidized, you can to some extent make requirements that might be burdensome as far as the State is concerned.

Secretary KENNEDY. You would have a real concern if we were paying the subsidy and there was a default on the obligation. That worries me as a former banker.

Senator FANNIN. Yes.

Secretary KENNEDY. And I would want to be sure that an obligation was sound if we were putting our name on it. So there is that feature that at least the Secretary of the Treasury would be concerned about. Default on an obligation that had some subsidy by the Federal Government would be quite a thing.

Senator FANNIN. Do I have any more time? Is my time up?

The CHAIRMAN (presiding). I believe you have a few more minutes if you want to go ahead.

## INVESTMENT TAX CREDIT

Senator FANNIN. There is the last question, which is on investment tax credit. I have been very concerned although I realize the need for doing something about this, Mr. Secretary. I know that previously

you had made a statement that you were hoping that some other means could be provided to give an incentive to it, and that would allow us to modernize and to be competitive with the other countries of the world. We know that in many countries they are in one way or another assisting in modernizing the plants that are involved in competition with us.

I would like to know how the Treasury views the situation of businesses which have made long-term commitments for the purchase of capital equipment based upon the previous policy of an investment tax credit.

Secretary KENNEDY. Well, I will let Mr. Cohen answer that. I think we are being perfectly consistent in utilizing the phaseout when they had a temporary suspension before, and the phaseout rule does give, I think, adequate protection to those companies.

Mr. COHEN. Senator, the investment tax credit repeal provision allows a transition rule so that any binding contracts entered into before April 18 of this year will continue to carry the investment tax credit when the equipment is installed. There are a number of other transition rules also. For example, if a plant is more than half completed, even though there is no contract for the purchase of the remainder of the equipment, the remainder of the equipment will also carry the investment tax credit.

On the other hand, it is true that if someone had planned a program but had made no commitment for it and was not in midstream with respect to it, he would not get the investment tax credit.

On the other hand, too, we would propose a reduction in the corporate tax rate, and there are reductions in the individual tax rate so that the person or the corporation will have the benefit of reduced tax rates in the future.

### IMPORTING AND EXPORTING OF JOBS

Senator FANNIN. Well, Mr. Cohen, I agree that we have a great problem with it. We have heard some of the railroads—I know especially in my State we are concerned about refrigerated cars and the shortage of cars, but I am very much concerned about the long-term effect on jobs. Our competitive position is very, very important. We are exporting jobs every day, and we are not following through with what is being done by our competitors in the other countries of the world where they are modernizing. And, certainly, we can look to the copper industry as to what is happening with respect to imports and exports. All this involves a tremendous number of jobs. That is what I am worried about.

Mr. COHEN. Senator, we thought the two points of corporate tax reduction will improve our competitive position abroad, and I want to assure you that we are giving constant consideration, intensive consideration, to the problems of exports so that we can encourage exports as much as possible in our tax and regulatory policies, and not be in a position of exporting jobs. It is a matter of very high priority in our considerations.

Senator FANNIN. Well, thank you, Mr. Cohen. I know the Secretary and you did state that you were looking for other means of handling

this problem, and I know that you will follow through, and I commend you for that. But I am still concerned as to just what the overall tax policy should be. We are in a precarious position, and each day we are becoming less competitive, and so I do hope that we will have something done.

Now, I know that in the press this morning it was stated that the 2 percent that you would give, the one and one, which would be involved in the tax on corporations, would more than offset the 7 percent, and I was trying to evaluate that. I could not get it. I just could not figure out 2 percent where you see 7 percent. I realize——

Mr. COHEN. They are applied to a different base of course. The repeal of the investment tax credit would involve a revenue increase to the Treasury of about $3.3 billion, of which $2.7 billion would come from corporations. Thus, with respect to corporations there would be an additional tax from the repeal of the investment credit of $2.7 billion.

The 2 percent reduction in the corporate income tax would save the corporations $1.6 billion. So there is still a net additional tax increase to the corporations from these two moves alone of $1.1 billion.

Senator FANNIN. Well, thank you, Mr. Cohen. I am glad you brought that out. It is very important. Thank you.

EXEMPTION TO FOUNDATIONS AND ALL CHARITABLE ORGANIZATIONS

Mr. COHEN. Yes, sir.

May I make one further comment with respect to our colloquy regarding the foundations and the control of businesses? I think I might have added by way of analysis that the law, as we saw it, gives the exemption to the foundations and all charitable organizations if they are organized and operated exclusively for charitable and educational purposes. The question is whether foundations which are in operating control of businesses are being operated exclusively for charitable and educational purposes or whether they do not necessarily become involved in the control of businesses when they own at least a majority of the stock of the business.

On the other hand, if they have a broad investment portfolio, they will not be involved in the control and management of business operations.

Senator FANNIN. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Let me explain the manner in which we will proceed so Senators can make their plans. I know some of them are very busy and some have things they must do.

Senator Talmadge has not had his first opportunity to interrogate the Secretary of the Treasury nor has Senator McCarthy. Senator Jordan has not had his second turn nor has the chairman. So I would propose that we would call on Senator Talmadge, then Senator McCarthy, and then we will call on Senator Jordan, and the chairman will take his turn.

Senator Talmadge?

Senator TALMADGE. Thank you, Mr. Chairman.

GASOLINE TAXES

Mr. Secretary, yesterday you recommended that the deduction of State gasoline taxes should be repealed. You stated that it was essentially a user charge. What is the average deduction for gasoline taxes on the income tax returns?

Secretary KENNEDY. I understand that the tax saving resulting from the deduction averages about $15.

Mr. COHEN. I had understood, Senator, but I will check it in the statistics of income, that the deduction was in the range of $75, and if you apply a 20-percent tax rate, you show a tax savings of about $15.

Senator TALMADGE. It seems to me that this particular recommendation will negate some of the advantages of the tax reduction, particularly in the low-income brackets. In my own State of Georgia, and I imagine it is somewhat similar to other States in the Union, we have a highly mobile society today. I know people that drive a hundred miles round trip daily to get to and from work, and they use 7 or 8 gallons of gas a day, and that will amount to taxes of from 50 to 70 cents daily. If they cannot deduct that on their tax return, it seems to me it would be quite burdensome on people of that nature.

I doubt the wisdom and the propriety of eliminating this tax deduction, and I certainly cannot support a provision of this kind. It would seem to me highly doubtful that this committee or this Congress would do so.

Do we levy taxes on any other tax obligations?

Mr. COHEN. Yes. It is my recollection, Senator, that in the Revenue Act of 1964, the Congress eliminated deductions for all taxes except certain specified taxes. One was the State income tax, another was a general State sales tax. But the Congress had earlier eliminated deductions except in a business setting of cigarette taxes and other taxes. Telephone taxes are not deductible; that is, the tax that is paid by the telephone user or consumer is not deductible. The only deductible taxes other than real estate taxes, and I think personal property taxes and State income taxes, would be general sales taxes and the gasoline tax. The gasoline tax is the only special type of tax that is still deductible.

Senator TALMADGE. Let me see if I understand you now. We do not levy taxes on the ad valorem taxes they pay to States and municipalities.

Mr. COHEN. Real estate taxes and personal property taxes are deductible.

Senator TALMADGE. And we do not levy taxes on the sales taxes they pay to the States.

Mr. COHEN. General sales taxes.

Senator TALMADGE. Nor the income taxes that they pay to the States.

Mr. COHEN. Nor income taxes.

Senator TALMADGE. It seems to me that this gasoline tax would clearly fall in that category because utilization of gasoline today is vital to the average American who is earning a living. I can see how

they might do without cigarettes, and, in fact, maybe perhaps they all should. I can see perhaps how many people can do without telephones. It is a convenience, but in many instances it is hardly a necessity. But if a man lives 50 miles from his job, it is absolutely imperative that he have an automobile or some means of transportation to go to and from work. And it seems to me that this particular tax would be imposing a burden on his right to earn a living for his family.

Mr. COHEN. Well, Senator, if the man is a salesman or is required to travel in connection with his work, he would be allowed the deduction for the gasoline taxes as he would be——

Senator TALMADGE. As a business expense.

Mr. COHEN. Yes; as he would be allowed the deduction of the cost of the gasoline.

Senator TALMADGE. That is right. But what about a carpenter that lived 50 miles from his job?

Mr. COHEN. Well, should we allow him the deduction of the cost of the gasoline or just of the gasoline tax? The question is whether there is a difference between the gasoline tax and the cost of the gasoline. Now, the gasoline tax is justified to be imposed upon the use of gasoline because it is, in essence, a user charge. Those tax revenues are devoted to the improvement of the roads and do not go into the general revenue. Therefore, the issue is whether those taxes, the gasoline taxes, should be treated differently than the cost of the gasoline. One could say that commuting expenses represent a business expense.

Senator TALMADGE. Well, let us take the carpenter now that is going 50 miles each way to his job to work on a building. At the present time he cannot even deduct his gasoline, can he?

Mr. COHEN. That is correct, sir.

### DEDUCTION OF THE TAX ON GAS

Senator TALMADGE. Do you recommend that he cannot even deduct the gasoline tax he pays on that gasoline?

Mr. COHEN. Well, if he rides the bus or the train he can deduct no part of that expense, and the only question is whether, if he rides in an automobile, he should be able to deduct only the gasoline tax. We have never allowed him on a commuting expense basis to deduct any part of his cost of the gasoline or his depreciation and repairs on his automobile. If we were to treat that as a business expense, the entire expense should be deductible not just the tax. But the bulk of this, I think, will not be in the form of commuting expense but will be in the form of pleasure use of automobiles.

### AUTOS: PLEASURE OR BUSINESS?

Senator TALMADGE. I doubt if most automobiles are used for pleasure. I have an idea most of them are used for business.

Mr. COHEN. Yes; but I said earlier, Senator, we would not disturb the allowance of the gasoline tax when they are actually used in business. The problem that you have posed is a case of the use of it in commuting, and we do not count that as a business expenditure.

Senator TALMADGE. Let us get back to this carpenter now. I thought you told me it would not be deductible. It is still a business. He lives 50 miles from where he is working on a building.

Mr. COHEN. Yes.

Senator TALMADGE. He drives 50 miles in one way in the morning and 50 miles out that afternoon.

Mr. COHEN. Yes.

Senator TALMADGE. A hundred miles a day.

Mr. COHEN. Yes, sir.

Senator TALMADGE. Let us say his automobile gets 15 miles to the gallon.

Mr. COHEN. Yes, sir.

Senator TALMADGE. That is about 7 gallons of gas he is using daily there to go to and from work, to make his living. Assume that the average gas tax in the country is about 8 cents a gallon, maybe even higher. Now, he could deduct no part of that, could he? Neither the cost of the gas nor the tax?

Mr. COHEN. That is correct. We do not allow him to deduct the gas or his tires or his automobile expense. The theory of the law—whatever its merit—has been that when a man lives away from his regular place of business that his expense of getting there is a personal expense.

Senator TALMADGE. Do you not think he ought to be at least entitled to deduct the taxes that he pays on that gas?

Mr. COHEN. Well, our view, Senator, is that there is no practical difference between the tax that he pays on that gas, and the cost of the gas itself, so long as those taxes are dedicated to the improvement of the highway. There is no more reason to permit him to deduct the gasoline tax than there would be for him to deduct the cost of the gasoline or the commuter who goes by bus or train to deduct some pro rata part of his expense.

### DISTRIBUTION OF GAS TAX

Senator TALMADGE. Not all of that gas is dedicated to highways. Most gasoline funds of most States go into the general funds appropriated by the legislature. Some of it goes for public health, some for education, some for maintenance of courts, a variety of purposes.

Mr. COHEN. I understand from our statistical data that less than 5 percent of the net State motor fuel tax receipts are allocated to nonhighway uses, 3.9 percent. Now that varies from State to State, Senator, but most of the highway taxes—about 95 percent of the funds collected from the gasoline tax—are spent for the purpose of building and maintaining the highways.

Senator TALMADGE. I know it is quite a job—when I was Governor of Georgia, we dedicated it for highway purposes but we had considerable opposition and I know some States put it into the general funds, subject to legislative appropriation as they see fit, and some of it does not go for highway purposes.

Mr. COHEN. Yes.

Senator TALMADGE. Now, another question.

Mr. COHEN. Could I just make one other point, Senator?

Senator TALMADGE. Sure.

## LOW INCOME ALLOWANCE

Mr. COHEN. You are speaking of the lower income person. We have had that in mind to a considerable extent with our low income allowance for a family of four: they would have no tax at all up to $3,500 in this bill; a single person, no tax with income up to $1,700; and we are liberalizing the standard deduction.

We are also giving rate reductions which in the lower brackets will be well above 5 percent, and so except in the most unusual case there will be a significant tax reduction.

Senator TALMADGE. Let us take a case now if we want to use this hypothetical carpenter that I was talking about. Assuming he works 250 days a year, you are talking about an item of about $125, as to whether it will be deductible or nondeductible in a year's time. That is a considerable amount of money for those people.

Mr. COHEN. If he were in a 20-percent bracket, that deduction would involve about $25 in tax for him, and his reduction in tax from the reduction in rates would exceed that amount.

The average gasoline tax deduction of a nonbusiness character, not speaking of business character, but speaking of the average gasoline tax deduction, is $72 based upon our 1966 statistics.

Now, I picked an average case. Obviously there is more of a problem in the case you put of a person who is commuting and who lives a substantial distance from his home and uses his automobile every day. He is the one who is most affected by this.

## FOUNDATIONS

Senator TALMADGE. If I still have additional time, I want to get on another subject. What resources are tied up in tax-exempt foundations? I seem to recall about $24 billion; is that correct?

Secretary KENNEDY. We can check it.

Senator TALMADGE. Insofar as I know, a foundation is the only thing in the world that is permanent in scope. Individuals die, corporation charters expire and must be renewed, all life on earth and vegetation die. Has the Treasury given any thought to the fact that sometime the life of the foundation ought to expire?

Mr. COHEN. Yes; we have given considerable thought to it, Senator, and this was explored at great length in the Ways and Means Committee. One possibility would be to require that a foundation distribute all its assets in 20 years or 25 years.

Senator TALMADGE. Or maybe apply the rule in Shelley's case.

Mr. COHEN. Well, I do not know whose life would be used to measure it, but it would certainly be possible to use a 50-year rule if we wanted to.

But on examining such a rule, we were concerned about a number of aspects.

For instance, if a foundation were limited to a 20-year life, and you wanted it run and managed as well as it can be, who will take on the responsibility of running it in the last 5 or 8 years? There is quite a management problem of getting people to run them when they have a deadline for the termination of their life. And we were concerned

with that. I have had some experience with businesses that have been ordered either by the management or by Government authorities to terminate and go out of existence at the end of 5 years' time, and the management then all want to go, and you cannot very well blame them.

There are a number of other problems in that regard.

As Senator Fannin mentioned a moment ago, the requirement that we put in the bill for a distribution of 5 percent of the value has been criticized because many foundations are not going to earn more than 4 percent.

Senator TALMADGE. True. Some less.

Mr. COHEN. Some will earn less.

On the other hand, if you take into account what might be anticipated as long-term appreciation in assets, we thought overall that 5 percent would require distribution of some amount of principal——

Senator TALMADGE. Do you think that 5 percent or even 2 percent will impede the growth of resources that are tied up in foundations that are tax exempt? What concerns me is that if these foundations continued to grow, continue to pyramid, and continue to expand, I can foresee the time that they will drastically erode the tax resources in our country, and a substantial part of the wealth of the Nation will be tied up in foundations.

Mr. COHEN. We have been concerned about it, Senator, and we thought at least at this stage that one should make certain that the public has an assured benefit of at least 5 percent of the value of the assets.

You could go in different directions. The law now requires a distribution of current income, dividend and interest income. That can be avoided by investing in assets with growth potential rather than current income.

You could require distribution not only of income but of realized gains. The result would be a situation in which the foundation would be reluctant to realize its gains but would continue to hold its assets in the original form with the gain unrealized because not until it realized the gain would it be required to distribute it to charity.

We thought this would cause a locked-in effect, that charities would not then turn over their investments.

Therefore, rather than include realized gains in the items that have to be distributed currently to charity, we thought it best to make a rough approximation, and to require at least a 5-percent distribution. This would not be a death sentence to a foundation. It imposes some burden above what might be the recurring income, and yet it would keep them from growing constantly and would assure that the public obtains current benefits for charitable and educational purposes.

Senator TALMADGE. Thank you, Mr. Chairman and Mr. Secretary. I suspect my time has expired.

The CHAIRMAN. Senator McCarthy?

## TAXATION OF SINGLE INDIVIDUALS

Senator McCARTHY. Mr. Chairman, I would like to examine the record before asking some additional questions. But I do have one question about the taxation of single individuals. Have you recommended a new schedule?

Mr. COHEN. Yes; we have a new schedule, Senator, and it is designed, as we said in our statement, to asure that at no point in the scale would the tax on single persons be more than 20 percent greater than the tax on married persons with the same income.

Senator McCARTHY. The effect of that is to bring about rather substantial tax reductions when you get above $10,000 of income? At the bottom of the scale the difference is not very significant.

Mr. COHEN. I have a chart here that illustrates it, if I might show it to you.

This chart, Senator McCarthy, shows, for various income levels, the additional percentage tax which a single person would pay in relation to a married person of the same income. You will see that under current law, at a level of about $25,000 a single person pays more than 40 percent additional tax as compared with the tax paid by a married couple with the same income. That would be substantially true also under the House bill for single persons under age 35.

Under the House bill, single persons 35 and over would follow this yellow line and at one point would go slightly above 20 percent, but there would be a very substantial difference between the single person under 35 and the single person over 35.

The green line on this chart is what we would propose. The single person would never pay a tax of more than 20 percent above what a married couple would pay on the same income. That would be true for persons under 35 as well as for persons over 35.

Now, the major effect, as you indicated, is in the middle income brackets. There is relatively little effect at the bottom of the scale and relatively litle effect when one goes to the $250.00 or $500,000 level.

Senator McCARTHY. Thank you, Mr. Cohen. Those are the only questions I have now.

The CHAIRMAN. Thank you, Senator McCarthy.

Senator Anderson, I believe, wanted to ask some questions.

FOUNDATIONS

Senator ANDERSON. Could you tell me why you are concerned about a foundation owning 20 percent or more of a business if it is not engaged in self-dealing and distributes all of its income for charitable purposes?

Mr. COHEN. Your question relates, Senator, to the reason why we have provisions requiring private foundations to divest themselves of control of private corporations.

Senator ANDERSON. Yes.

Mr. COHEN. I can best summarize it by saying that we think that the tax exemption is given to private foundations and the deduction is given for estate and income tax purposes to the contributors because foundations will be devoted exclusively to charitable and educational operations. It seems to us that when they are in control of operating businesses, and particularly when they are in control of a number of operating businesses, they necessarily become involved in the management of those corporations.

One way to prevent this might be to say that you could not have an interlocking relationship, that the persons operating the corporation would have to be different persons from those that are controlling the

foundation. Therefore, those who are in charge of the foundation would be devoting themselves exclusively to the selection of the beneficiaries of the charity or to determination of grants. They should not be involved in the management of the business.

We were concerned because it is not the same as interlocking directorates in public corporations. In private organizations this would be a very difficult thing to determine because even though the persons may be different, they would be friendly, presumably. Thus, it would not be satisfactory simply to say that the donor, if he is the president of the corporation, could not be on the board of trustees of the foundation. He could have his secretary, his lawyer, his banker, his broker, or his golfing companion, on the board of trustees of the foundation. Rather than go in that direction, we decided to limit the percentage of the voting stock which the foundation could own. We distinguish between voting stock which permits the foundation management to control the private corporation, and nonvoting stock which would not give it that opportunity.

We thought that, in general, we could permit up to 20 percent stock ownership without difficulty and permit an additional 15 percent, or up to 35 percent, if there is not, in fact, control by the foundation of the operations of the business corporation.

Senator ANDERSON. Thank you. But Sears, Roebuck has a very heavy investment in stock ownership of a pension fund. How would this apply?

Mr. COHEN. This provision would not apply in that case because it applies to foundations and not to pension funds.

Secretary KENNEDY. Sears' pension trust is owned and controlled by the employees because they vote the stock and it is not controlled by the company.

The CHAIRMAN. Senator Jordan?

Senator JORDAN. Thank you, Mr. Chairman.

### 7-PERCENT INVESTMENT TAX CREDIT

I would like to talk a little bit about the repeal of the 7-percent investment tax credit. As I understand, the 7-percent investment tax credit was inaugurated in the early 1960's to stimulate the formulation of new plant and new facilities for production. There is no doubt about it, we have quite a different situation now. We have an overheated economy. But it is quite possible that this situation can change again. Did you give any consideration to the suspension of the 7-percent tax investment credit rather than the outright repeal which you recommend?

Secretary KENNEDY. Yes, Senator, we did. This matter of tax legislation is not an easy one, and we cannot turn the credit on and off fast enough for anti-inflation and deflation problems.

But apart from that general problem, some of us believed, and I was included in that group, that this tax incentive was not the best flow-through mechanism in the economy. It does not do the job as well as a general reduction in rates which we are now proposing or a change in depreciation schedules. From the standpoint of encouraging our industry to be competitive with world industry, it does not do the job

because a good part of this tax credit goes for completely domestic purposes, including regulated industries whose rates are geared to their earnings and who pass it on to the public—the railroads, the airlines, et cetera, are a good example of that situation. A general corporate rate reduction would be better, in my judgment.

The other significant point, in the competitive field internationally, is that other countries' tax laws are much different from ours. They put emphasis in a different area, with value added taxes which they can abate with respect to their selling price abroad or charge on the import side. I think we must give consideration to some measure like this that will meet the GATT rules and take care of our competitive situation.

In the last several years, the balance of our trade has changed so drastically that now a large share of our exports come from a very highly sophisticated area where we excel in research and development as compared with the general lines that we formerly had in production. The investment tax credit did not stop that move.

Senator JORDAN. It has been turned on and turned off and turned on again. Various problems of transition arise. Have you given any thought to the problem of transition that comes from an abrupt shutoff?

Secretary KENNEDY. Yes, Senator, we have, and the rules of transition are quite similar to those used when it was temporarily suspended before.

Do you want to comment on the transition rules, Mr. Cohen?

They do give, I think, sufficient leeway to take care of those who are already committed to going ahead with their program.

Senator JORDAN. I wish you would summarize it if you will.

Secretary KENNEDY. Mr. Cohen will do so.

Mr. COHEN. Senator, in the fiscal year ended June 30, 1970, the fiscal year that we are now in, we estimated the revenue increase from the repeal of the investment credit at about $1.35 billion. The ultimate long-term effect when the investment credit is fully repealed, we would estimate it at $3.3 billion. Therefore, the $1.3 billion in this fiscal year would indicate that it has only about 40 percent effect in this fiscal year; 60 percent of it will still be obtained. It indicates that it goes into effect gradually.

I believe that in the next fiscal year, fiscal 1971, that the revenue increase is estimated at $2.5 billion, and that it does not reach the full $3.3 billion for some 8 or 9 years.

Senator JORDAN. So there is a transition period when allowances are made for those injustices that might arise from too abrupt a transition.

Mr. COHEN. Yes. Existing contracts or plants, which were more than half completed, or similar situations, will continue to enjoy the investment credit for some time in the future.

In addition, there is a carryover for 5 years, phased out gradually over the 5 years, of all the unused credits. That would apply to equipment which has been installed heretofore but which the companies have not been able to use because their income tax was not sufficiently high to make it available.

Senator JORDAN. As I understand the administration position, you allowed no exceptions whatever. We have a Small Business Admin-

istration setup for the purpose of encouraging the formation of small businesses and we try to give them a break now and then in order to keep them competitive, but you would make no exception for allowing small businesses to use this device to make them more competitive.

Mr. COHEN. We would prefer to do anything that is to be done for the benefit of small business by other types of provisions. There are many provisions in the law now favoring small business by way of deductions rather than a credit of this kind.

We think the credit allows more than 100 percent for the investment in the equipment, and it is available only to the profitable concern. I think there are other ways, Senator, of dealing with the matter of small business.

Senator JORDAN. All right.

In this instance you allowed no exception whatever.

DEPLETION ALLOWANCES FOR MINERALS

I turn now to a discussion of natural resources where you do allow an exception, and I want to probe with you the reason you do this.

As I look at the table, you pretty well accepted the House recommendations with respect to depletion allowances for minerals. And yet there are five categories here, five instances where you made no reduction, you accepted the House position on that, and that is with respect to gold, silver, oil shale, copper, and iron ore from domestic deposits.

Now, every other mineral is subject to a reduction in depletion allowances of about 25 percent, with these exceptions. You made no exception whatever in the repeal of the 7-percent investment tax credit. Why did you go along with the House, and I grant you these are not exactly comparable situations, but I cannot understand why the House isolated these five commodities from the action of the bill and you accepted their interpretation of it, their recommendations.

Mr. COHEN. Senator Jordan, there was extensive consideration of this in the executive sessions of the Ways and Means Committee, and we had present representatives of the Department of the Interior. These exceptions were made in particular, on the basis of a recommendation of the Department of the Interior that these metals were in short supply or that special incentives were needed at this time.

I think the oil shale is in an experimental state at the present time. Gold and silver are in short supply. Copper is in short supply, and I recall the Department of the Interior recommending to the Ways and Means Committee that there be no reduction with respect to iron ore because of the decreasing deposits in the United States at the present time.

Senator JORDAN. All right. What do we do with a situation like this: lead and zinc are likewise in short supply. Now we have very few silver mines. My State leads the Nation in the production of silver. Silver comes as a byproduct in our State of the mining of lead and zinc.

Lead and zinc are subject to a reduction in the depletion allowance. Silver is not.

Lead and zinc in some applications are competitive with copper. Copper is in short supply. At one time we were the leading country of

the world in the export of copper. Now we are the leading country in the world in the import of copper. But copper and lead and zinc are all noncorrosive metals. They are in competition in a number of instances. How can you reconcile giving one a tax break, one metal, and not giving similar treatment to those metals that might be in competition? Are you not setting up another inequity in this tax reform act that you are recommending?

Mr. COHEN. I do not think anyone intended to set up an inequity, Senator. I am not that familiar with the competitive relationships of zinc or lead with copper. I would be glad to take that up with the Department of the Interior and see what their recommendations would be. We will be glad to consider it further.

Senator JORDAN. Well, I think they should be in the same category. The same rules should apply across the board on metals that have similar characteristics that are competitive in industry. These metals come from the same ore bucket from the bottom of a mine. How are we going to allocate the depletion allowances in a zinc, lead, silver mine under these circumstances?

Mr. COHEN. Senator, we would be glad to consider it further and discuss it with the Department of the Interior, and with you. I am not familiar with the technical aspects of the operations.

Senator JORDAN. Lead and zinc, we are in short supply of lead and zinc. We have to import lead and zinc to this country, the same as we import copper, and they are competitive, and I think they should have the same treatment, whether it is to leave them as they are or whether it is to subject them to the 25-percent reduction. They should have a uniform treatment. That is my plea.

That is all the questions I have today, Mr. Chairman.

The CHAIRMAN. Thank you, Senator.

Let us see, I think everyone has had his second opportunity to interrogate the witness except the chairman.

I do want to ask about this matter. It seems to me, Mr. Secretary, that simplicity is one of the things we are trying to achieve in tax law, and I think Mr. Cohen made the statement, quite correctly so—perhaps it occurred to him on the spur of the moment; he did not use precisely the words he wanted to use—that for the most part these 368 pages can at least to some extent be regarded as a subsidy for lawyers and tax accountants to put more American brain to work trying to unravel all of the complexities of the American tax code of the Internal Revenue system and find the loopholes rather than moving in the other direction.

SIMPLIFICATION OF TAX LAW BY INCREASING THE STANDARD DEDUCTION

Now, the one thing that would help make this law less complicated for the average taxpayer, or for a lot of them at least, would be a proposal that was I think originally Chairman Mills' idea that we increase this standard deduction from 10 percent up to 15 percent and put it into effect as rapidly as we can stand the loss of revenue.

Now, the House looked at a situation where about 58 percent of the people were using this 10-percent standard deduction, and they would move that up to about 73.8 percent of the people, by their handling of the low-income allowance and by shifting to 15 percent.

Now, the way you are proposing to handle that, as I understand, would not lead to nearly that many people being shifted over. As I understand it, they would shift about 11.8 million taxpayers over to the standard deduction, and your recommendations here, while they would save some revenue for the Government, would not shift nearly that many over.

How many do you estimate you are going to shift? About 5 million, I believe.

Mr. COHEN. Yes; that is my understanding.

The CHAIRMAN. No; I am told it is 4 million.

Mr. COHEN. Well, it is 4 million. I do not know whether that includes others who may shift because of the low-income allowance, but the standard deduction changes will cause 4 million to shift.

The CHAIRMAN. Our staff tells me that that includes both. That you would shift 4 million over to the standard deduction, and the House bill would shift 11.8 million over. Under the House bill there are 7.8 million, almost 8 million taxpayers who would simply add up their income and take a 15-percent deduction. But under your proposal, while it would save the Government some money—about $770 million—there would be a difference of almost 8 million taxpayers in the number that would use the standard deduction.

Now, in terms of moving toward simplification, if we did it the way the House had in mind, there are 8 million people who would not have to worry with all this complexity but who would continue to struggle around with it if we would do it the way you are suggesting.

If we can find some way to meet your revenue problem, would it not be desirable to take the House language rather than yours with regard to standard deduction as soon as we can?

Mr. COHEN. Well, Senator, I think we are talking about more than $770 million difference. There is a much larger difference with respect to the low income allowance. These two must be aggregated. I think that in the aggregate, we are talking about a $2.5 billion difference.

The CHAIRMAN. Well now, my staff has been working their pencils while you were working with yours, and they tell me it is $2.3 billion.

Mr. COHEN. Yes; that is what I would come to.

The CHAIRMAN. Most of them having to do with the low income allowance.

Mr. COHEN. Yes; that is the figure I was approximating at about $2.5 billion. But it is $2.3 billion roughly by our figures also. So we were faced with the problem of a $2.3 billion revenue loss.

That is also, you will recall, the amount of the revenue loss that was produced when the Ways and Means Committee, by a committee amendment after the bill was reported out in addition to the change in the low income allowance and the standard deduction, also gave the rate reductions in the lower brackets.

The CHAIRMAN. Right.

Mr. COHEN. Our problem was to choose between the two changes. There is no doubt that from the standpoint of the operation of the Internal Revenue Service and simplicity the extension of the standard deduction would be the preferable of the two, if you have to choose between them.

On the other hand, I might say, some people do not believe in a further extension of the standard deduction because it overrides the

personal deduction provisions. For example, charitable contributions are of no benefit as a deduction to a person who takes the standard deduction basis.

The CHAIRMAN. But if you have to choose between them, do you not really—and is this not true of most of you experts down in the Treasury—that their general attitude is that the best tax system would be one where everybody paid based on how much he made regardless of what his source of income may be? I mean is that not sort of a tax ideal among tax purists that the people ought to pay about the same amount of taxes on the same amount of income regardless of source?

Mr. COHEN. Well, I think the charities would say that we ought to give an incentive to charitable deduction and permit a deduction for charities. And the States would like to see a deduction for State and local income taxes.

The CHAIRMAN. Well now, I understand that, but your 10-percent standard deduction, what you yourself are recommending to us, is contrary to that, is it not?

Mr. COHEN. Oh, yes; these are all matters of balance. If you have a 10-percent standard deduction, which was put in in 1944, that is a concession to the simplicity of the system as against incentives for charitable contributions, for example.

The CHAIRMAN. Well, some time ago we came up with a situation where a person could, in effect, achieve a double deduction by giving money to charity. You are familiar with these double deduction situations, so that a fellow can actually make a profit, instead of investing in the stock market, by giving to charity. So we tried to eliminate the double deduction. When a man gave to charity it ought not to be for a profit incentive; it ought to be because he wanted to give some part of his resources to help someone else.

It would have been cheaper just to have appropriated money to charity than to have to give a double deduction for the people who were using it, would it not?

Mr. COHEN. Oh, yes.

The CHAIRMAN. And you recall a situation when we tried to wipe those out.

Mr. COHEN. Yes; we tried further in this bill, too.

The CHAIRMAN. Now, if you are moving toward tax simplification, you almost have to move toward a system where you give a person a standard deduction and he pays the same amount of tax regardless of source of income, do you not, and regardless of what he does with it?

Mr. COHEN. Yes.

Now, Senator, the most significant difference in the bill is with respect to the problem of the homeowner. The homeowner, when he itemizes deductions, is given a benefit in relation to his tax payments for his home mortgage interest and his real estate taxes, whereas if he rents an apartment he can deduct no part of his rent, and if you increase the standard deduction, this is a benefit to the apartment house dweller. If you simply reduce the rates, you are giving equal benefit to the homeowner and the apartment dweller. And the problem was which way to go. If you reduce rates and do not change the standard

deduction, you are giving equivalent benefits to the homeowner and the apartment house dweller. If you increase the standard deduction and do not reduce the rates as much, you are giving more of the benefit to the apartment house dweller and not to the homeowner.

The CHAIRMAN. Now, if the apartment house dweller organizes himself as a cooperative, as over in Watergate East where I have an apartment—it just wastes the place because it is so poorly furnished and decorated. But quite a few of the Nixon Cabinet live there. [Laughter.] You can get that interest deduction by simply paying that as a part of the payment for your share of the cooperative. So it can be organized so you can have about the same effect as paying rent; isn't that correct?

I am deducting interest over there right now.

Mr. COHEN. I think this undoubtedly is true with respect to cooperatives and condominiums. But these are not generally occupied by people in the low- and low/middle-income bracket. [Laughter.]

The CHAIRMAN. I did not claim to be a low- or middle-income bracket taxpayer. If you audited my tax return you notice I did not claim that at all.

So when you really get down to it, isn't this interest expense cranked into the rent that a man has to pay just as it is a part of a mortgage payment that a homeowner has to pay?

Mr. COHEN. Yes; it undoubtedly is true that the mortgage interest and real estate taxes on the apartment house affect the rent that he has to pay, and still none of it is deductible unless he is in a cooperative apartment house or a condominium.

The CHAIRMAN. Well, just take a working man, the average working man paying rent. It is not deductible, but anywhere from 40 to 50 percent of it may be interest on money. Isn't that a fair statement? In other words, if a landlord has to pay the interest, he has to borrow money, pay interest on the money, and he charges rent, which is enough to pay off his expenses, including interest expense, and try to make a profit on it.

So the interest expense is in that rent. You may not see it, but it is there.

Mr. COHEN. It is clearly in there, yes. It is reflected in there.

The CHAIRMAN. Even if he did not have to borrow money, if he is using his own capital, and he has the alternative of investing it somewhere, he must forsake money that he could have made if he did invest it or received dividends.

Mr. COHEN. Sure.

The CHAIRMAN. So my thought about this is we ought to try to find some way to resolve this difference in moving toward a standard deduction, and recognizing that a fellow who pays rent really has about the same basic problem as someone who is paying interest on the mortgage.

Mr. COHEN. Well, a number of people have advocated elimination of the deduction for home mortgage interest and for real estate taxes on the ground that they really are personal expenditures and ought not to be reflected in the income tax.

The CHAIRMAN. Yes, and homeowners just came in protesting to the skies, and we did not do anything about it. But maybe we can do something about the fellow who is paying rent rather than taking it away from the fellow who is paying interest on his mortgage.

Mr. COHEN. And the standard deduction would give a benefit to the fellow paying rent as compared to the fellow owning his home.

The CHAIRMAN. It is my recollection that most constituents have never been too angered if I do something about helping somebody else. They never get irate if I do something toward helping some other fellow, provided I do not do anything to them.

Wasn't that the problem that caused the House to come in with the last amendment that lost $2 billion in this tax bill?

Mr. COHEN. I think that is correct, Senator. Under the bill as originally reported to the House, they would have increased the standard deduction in the low- and middle-income brackets and made rate reductions above that, instead of having rate reductions all the way down the line. The last amendment extended the rate reductions all the way down the line, and also gave substantial increases in the standard deduction.

The CHAIRMAN. How long did the House have to work at it before submitting the last amendment trying to offset that problem, 44 hours, 48 hours, that is until the AFL-CIO pointed this out to them?

Mr. COHEN. Well, all I can say, Senator, it was within 24 hours of the time that I first heard about the problem.

The CHAIRMAN. All right.

Let us assume that you heard about it within 24 hours, not more than 48 hours. We have 7 weeks to think about this, and I would just like to suggest that we try to work together and see if we cannot come up with some answer that increases the number of people who would want to take the standard deduction and that would have them from further complexity of this tax law.

I did want to ask about the investment tax credit.

Mr. COHEN. Could I just add, Senator, that I have rued my joking reference to this bill as the Lawyers and Accountants Relief Act of 1969. I had made that remark casually in reference to the fact that in closing the loopholes we are dealing with complicated situations and, therefore, we have some complex provisions to deal with those complexities.

But I do feel that overall the bill produces a major simplification for millions of taxpayers. Those who have had special incentives are going to find this bill more complicated than existing law. But in taking 5 million people off of the tax rolls and extending the standard deduction and the low-income allowance and in a number of other areas the bill provides major simplification for the bulk of the taxpayers.

The CHAIRMAN. Well, it seemed to me that you made a statement that was true, but you just have to be careful about how you say some of those things. [Laughter.]

Mr. COHEN. I am learning that, Senator. [Laughter.]

The CHAIRMAN. I have gone into the matter a great many times myself.

Now, you do apparently approve the principle of the increase in the standard deduction because you are recommending it yourself as part of this bill.

Mr. COHEN. Yes, sir, Senator.

The CHAIRMAN. All right.

Now, another thing that people have a right to expect of us, if it can be done, is to do something about providing certainty for business people as to where they stand.

Now, President Nixon's nominee for the Tax Court called me out of the room yesterday to pay his respects. He will be before our committee after awhile. He was discussing his views and he made the point that one thing a businessman just cannot contend with is uncertainty. If he knows what his expenses are going to be and what his taxes are going to be he can crank all of that into his business operation and into his prices and, hopefully, if everything goes right, come out with a profit.

Now, when he does not know what the law is going to be and what his tax liability is going to be he is in a very difficult position.

We, on this committee, have tried to make it clear that we intend to repeal the investment tax credit. We have not wed ourselves to rejecting all amendments by any means, but we have said we are going to repeal it. I think Senator Williams raised the question yesterday of whether you have any objection to it if we would simply take the House language on repeal of the investment tax credit or something substantially similar to that, if we agreed with it, and simply added that as an amendment to some other bill. For this reason: this bill we are talking about here may not be on the President's desk before Christmas or at least may not be there much before Christmas, and you are going to have to be making out tax returns to show people what they are going to go on, and they need to make their plans: do they get the investment tax credit or don't they? A lot of them would feel it would be a good idea if they could get it, and some would feel it would be a good idea if they do not.

My impression is, it is much easier to pass a tax cut than it is to pass a tax increase, and if we went ahead and repealed the investment tax credit, it would make this more of a tax reduction bill.

What would be the attitude of the Treasury if we proposed to take some other revenue measure and simply pass on through our version of the repeal of the investment tax credit without waiting until Christmas to give businessmen their answer?

Secretary KENNEDY. I think, Senator, that your point is well-taken, and we would favor that action provided it did not interfere with the tax reform bill, and you have assured us that that will not.

I would like to see you take up the extension of the 5-percent surtax from January to June at the same time. But if that complicates it, it can be kept as part of this bill.

The CHAIRMAN. Yes. But at least we have until January to tell people what they are going to pay next year.

Secretary KENNEDY. That is right.

The CHAIRMAN. But the business taxpayer has to know what he is going to pay this year, and we are talking about——

Secretary KENNEDY. Yes; you are right on that. But with respect to the tax reduction we want some tax balance in the bill and we, in our calculation, will be assuming that this investment tax credit tends

to balance out this whole program. But this is internal and I do not think that is a problem.

The CHAIRMAN. Well, it is my impression that this is, this will be, a tax retroactive back to April——

Secretary KENNEDY. Right.

The CHAIRMAN (continuing). When we pass it.

Secretary KENNEDY. It is important that it be passed as soon as possible.

The CHAIRMAN. And we should not make it any more retroactive than we must.

Secretary KENNEDY. Right.

The CHAIRMAN. The 5 percent will be a prospective tax next year.

Secretary KENNEDY. Right.

The CHAIRMAN. It would seem to me that we should dispose of this issue as early as we could, and I do not think it would prejudice the right of anyone who wants to offer his suggestions of tax reform on this bill.

Secretary KENNEDY. Right.

The CHAIRMAN. I am confident of this bill, having passed the House by a 90-percent margin, is going to pass the Senate in one respect or the other after everyone gets through putting his suggestions in here.

Secretary KENNEDY. I think that would be a good legislative procedure.

The CHAIRMAN. I just wanted to get your views on it because I think we ought to give people their answer on it. Frankly, it has been my impression if you must vote a big tax on somebody any politician is better off voting for it early in his term than late in his term so he can get the bad news behind him and hope the longer it is, the sooner they forget about it or at least come to accept it, the better off you are. We must dispose of this investment tax credit thing, and I think we ought to do it as soon as we possibly can.

Senator WILLIAMS. Mr. Secretary, I certainly want to join in with the chairman supporting of the proposal that we dispose of the investments tax credit at an early a date as possible. I think it would have been better if we had done it sooner but I think we should do it as quickly as possible.

Now, in this bill before us as I understand it parts of the recommendation you made yesterday tend to offset the adverse effects to business community by the repeal of the investments tax credit—that was the basis of your suggestion for reducing the corporate tax rate 2 percentage points.

Secretary KENNEDY. That is right. The corporate rate reduction should be phased in so it won't affect our anti-inflation program.

Senator WILLIAMS. That is right. Phased in.

Now my question is how was it the plan of the administration that this 2 percent be implemented. Would it come from the surtax or from the basis 25,000. The reason that I raise that question is if we repeal the investments tax credit it does affect small business as well as large businesses.

Secretary KENNEDY. That is right.

Senator WILLIAMS. There has been a proposal that in repealing the investments credit we should exempt a certain amount of the expenditures from the repeal of the investments credit. My own feeling is if we repeal it we ought to do away with it entirely, with no exceptions on it. But at the same time, I think we should recognize that we are handicapping small business as well as large and I am wondering if it wouldn't be a good idea on this 2 percentage points to apply at least one of them in each category.

Secretary KENNEDY. I think you could split it that way, a half of 1 percent the first year and half of 1 percent next year. I think it would work out all right. Do you have any feeling against that, Mr. Cohen? We may want to think about it but that seems to me to be a reasonable thing to favor the small.

Senator WILLIAMS. It wouldn't affect the revenue?

It would add some equity if we would be taking care of at the same time, the small business as well as the large, and I thought it may give us a better argument to offset the requests for an exemption from repeal of the investments credit.

Secretary KENNEDY. I think it is all right.

Mr. COHEN. I think so, Senator. The rate on the first $25,000, as I recall it, dropped from 30 percent to 22 percent 4 or 5 years ago.

Senator WILLIAMS. That is right.

Mr. COHEN. And I take it your suggestion is to drop it to 21.

Senator WILLIAMS. 21 and 25, in the two jumps.

Mr. COHEN. Two jumps.

Senator WILLIAMS. Phased in on the same basis as what you are proposing.

Mr. COHEN. I think that this would cost about $70 million in revenue. So that in relation to the total revenue impact of $1.6 billion it would be relatively small.

Senator WILLIAMS. Well, we are dealing with repeal of the investment credit which is about three and a quarter billion dollars all told. I thought we would put some equity and it would be much cheaper to do it this way than it would be to exempt the small business from the repeal features of the investment credit.

Mr. COHEN. Yes; that is true. It could be done.

Secretary KENNEDY. That is right.

Senator WILLIAMS. I don't know whether the Treasury has prepared this or not, but if not, perhaps it could be prepared and put in the record. I think it would help all of us and the taxpayers as well to understand it. Have you compiled a table showing not only the rate of the existing law and the amount of tax that the taxpayers pay in various brackets but also the dollar figures for the House bill and the dollar figures for the administration bill all the way down the line for the various categories for a comparison? If you have that, I would suggest we put it in the record at this point. If you don't perhaps you would rather supply it for the record.

Secretary KENNEDY. We would be glad to put that in the record.

(The Department of the Treasury subsequently supplied the following information:)

TABLE 1.—EXISTING LAW, MARRIED PERSONS RATES

| Taxable income bracket | Tax | Plus percent of bracket amount |
|---|---|---|
| 0 to $1,000 | 0 | 14 |
| $1,000 to $2,000 | $140 | 15 |
| $2,000 to $3,000 | 290 | 16 |
| $3,000 to $4,000 | 450 | 17 |
| $4,000 to $8,000 | 620 | 19 |
| $8,000 to $12,000 | 1,380 | 22 |
| $12,000 to $16,000 | 2,260 | 25 |
| $16,000 to $20,000 | 3,260 | 28 |
| $20,000 to $24,000 | 4,380 | 32 |
| $24,000 to $28,000 | 5,660 | 36 |
| $28,000 to $32,000 | 7,100 | 39 |
| $32,000 to $36,000 | 8,660 | 42 |
| $36,000 to $40,000 | 10,340 | 45 |
| $40,000 to $44,000 | 12,140 | 48 |
| $44,000 to $52,000 | 14,060 | 50 |
| $52,000 to $64,000 | 18,060 | 53 |
| $64,000 to $76,000 | 24,420 | 55 |
| $76,000 to $88,000 | 31,020 | 58 |
| $88,000 to $100,000 | 37,980 | 60 |
| $100,000 to $120,000 | 45,180 | 62 |
| $120,000 to $140,000 | 57,580 | 64 |
| $140,000 to $160,000 | 70,380 | 66 |
| $160,000 to $180,000 | 83,580 | 68 |
| $180,000 to $200,000 | 97,180 | 69 |
| $200,000 and over | 110,980 | 70 |

TABLE 2.—H.R. 13270 AND TREASURY PROPOSAL, MARRIED PERSONS RATES (EFFECTIVE 1972)

| Taxable income bracket | Tax | Plus percent of bracket amount |
|---|---|---|
| 0 to $1,000 | 0 | 13 |
| $1,000 to $2,000 | $130 | 14 |
| $2,000 to $3,000 | 270 | 15 |
| $3,000 to $4,000 | 420 | 16 |
| $4,000 to $8,000 | 580 | 18 |
| $8,000 to $12,000 | 1,300 | 21 |
| $12,000 to $16,000 | 2,140 | 23 |
| $16,000 to $20,000 | 3,060 | 27 |
| $20,000 to $24,000 | 4,140 | 30 |
| $24,000 to $28,000 | 5,340 | 34 |
| $28,000 to $32,000 | 6,700 | 37 |
| $32,000 to $36,000 | 8,180 | 40 |
| $36,000 to $40,000 | 9,780 | 42 |
| $40,000 to $44,000 | 11,460 | 44 |
| $44,000 to $52,000 | 13,220 | 47 |
| $52,000 to $64,000 | 16,980 | 49 |
| $64,000 to $76,000 | 22,860 | 50 |
| $76,000 to $88,000 | 28,860 | 52 |
| $88,000 to $100,000 | 35,100 | 54 |
| $100,000 to $120,000 | 41,580 | 58 |
| $120,000 to $160,000 | 53,180 | 60 |
| $160,000 to $200,000 | 77,180 | 61 |
| $200,000 to $240,000 | 101,580 | 62 |
| $240,000 to $300,000 | 126,380 | 63 |
| $300,000 to $400,000 | 164,180 | 64 |
| $400,000 and over | 228,180 | 65 |

TABLE 3.—EXISTING LAW, SINGLE PERSONS RATES

| Taxable income bracket | Tax | Plus percent of bracket amount |
|---|---|---|
| 0 to $500 | 0 | 14 |
| $500 to $1,000 | $70 | 15 |
| $1,000 to $1,500 | 145 | 16 |
| $1,500 to $2,000 | 225 | 17 |
| $2,000 to $4,000 | 310 | 19 |
| $4,000 to $6,000 | 690 | 22 |
| $6,000 to $8,000 | 1,130 | 25 |
| $8,000 to $10,000 | 1,630 | 28 |
| $10,000 to $12,000 | 2,190 | 32 |
| $12,000 to $14,000 | 2,830 | 36 |
| $14,000 to $16,000 | 3,550 | 39 |
| $16,000 to $18,000 | 4,330 | 42 |
| $18,000 to $20,000 | 5,170 | 45 |
| $20,000 to $22,000 | 6,070 | 48 |
| $22,000 to $26,000 | 7,030 | 50 |
| $26,000 to $32,000 | 9,030 | 53 |
| $32,000 to $38,000 | 12,210 | 55 |
| $38,000 to $44,000 | 15,510 | 58 |
| $44,000 to $50,000 | 18,990 | 60 |
| $50,000 to $60,000 | 22,590 | 62 |
| $60,000 to $70,000 | 28,790 | 64 |
| $70,000 to $80,000 | 35,190 | 66 |
| $80,000 to $90,000 | 41,790 | 68 |
| $90,000 to $100,000 | 48,590 | 69 |
| $100,000 and over | 55,490 | 70 |

TABLE 4.—HOUSE BILL H.R. 13270, SINGLE PERSONS UNDER 35 RATES (EFFECTIVE 1972)

| Taxable income bracket | Tax | Plus percent of bracket income |
|---|---|---|
| 0 to $500 | 0 | 13 |
| $500 to $1,000 | $65 | 14 |
| $1,000 to $1,500 | 135 | 15 |
| $1,500 to $2,000 | 210 | 16 |
| $2,000 to $4,000 | 290 | 18 |
| $4,000 to $6,000 | 650 | 21 |
| $6,000 to $8,000 | 1,070 | 23 |
| $8,000 to $10,000 | 1,530 | 27 |
| $10,000 to $12,000 | 2,070 | 30 |
| $12,000 to $14,000 | 2,670 | 34 |
| $14,000 to $16,000 | 3,350 | 37 |
| $16,000 to $18,000 | 4,090 | 40 |
| $18,000 to $20,000 | 4,890 | 42 |
| $20,000 to $22,000 | 5,730 | 44 |
| $22,000 to $26,000 | 6,610 | 47 |
| $26,000 to $32,000 | 8,490 | 49 |
| $32,000 to $38,000 | 11,430 | 50 |
| $38,000 to $44,000 | 14,430 | 52 |
| $44,000 to $50,000 | 17,550 | 54 |
| $50,000 to $60,000 | 20,790 | 58 |
| $60,000 to $80,000 | 26,590 | 60 |
| $80,000 to $100,000 | 38,590 | 61 |
| $100,000 to $120,000 | 50,790 | 62 |
| $120,000 to $150,000 | 63,190 | 63 |
| $150,000 to $200,000 | 82,090 | 64 |
| $200,000 and over | 114,090 | 65 |

TABLE 5.—HOUSE BILL H.R. 13270, SINGLE PERSONS 35 AND OVER RATES (EFFECTIVE 1972)

| Taxable income bracket | Tax | Plus percent of bracket amount |
|---|---|---|
| $0 to $1,000 | 0 | 13 |
| $1,000 to $2,000 | $130 | 15 |
| $2,000 to $4,000 | 280 | 17 |
| $4,000 to $6,000 | 620 | 19 |
| $6,000 to $8,000 | 1,000 | 21 |
| $8,000 to $10,000 | 1,420 | 24 |
| $10,000 to $12,000 | 1,900 | 26 |
| $12,000 to $14,000 | 2,420 | 28 |
| $14,000 to $16,000 | 2,980 | 30 |
| $16,000 to $18,000 | 3,580 | 33 |
| $18,000 to $20,000 | 4,240 | 35 |
| $20,000 to $22,000 | 4,940 | 37 |
| $22,000 to $24,000 | 5,680 | 39 |
| $24,000 to $26,000 | 6,460 | 40 |
| $26,000 to $28,000 | 7,260 | 41 |
| $28,000 to $32,000 | 8,080 | 43 |
| $32,000 to $36,000 | 9,800 | 45 |
| $36,000 to $38,000 | 11,600 | 46 |
| $38,000 to $40,000 | 12,520 | 47 |
| $40,000 to $44,000 | 13,460 | 48 |
| $44,000 to $50,000 | 15,380 | 51 |
| $50,000 to $60,000 | 18,440 | 53 |
| $60,000 to $80,000 | 23,740 | 55 |
| $80,000 to $100,000 | 34,740 | 57 |
| $100,000 to $120,000 | 46,140 | 60 |
| $120,000 to $160,000 | 58,140 | 62 |
| $160,000 to $200,000 | 82,940 | 63 |
| $200,000 to $300,000 | 108,140 | 64 |
| $300,000 and over | 172,140 | 65 |

TABLE 6.—TREASURY PROPOSAL, SINGLE PERSONS RATES (EFFECTIVE 1972)

| Taxable income bracket | Tax | Plus percent of bracket amount |
|---|---|---|
| $0 to $500 | 0 | 13 |
| $500 to $1,000 | $65 | 14 |
| $1,000 to $1,500 | 135 | 15 |
| $1,500 to $2,000 | 210 | 16 |
| $2,000 to $4,000 | 290 | 18 |
| $4,000 to $6,000 | 650 | 20 |
| $6,000 to $8,000 | 1,050 | 22 |
| $8,000 to $10,000 | 1,490 | 24 |
| $10,000 to $12,000 | 1,970 | 26 |
| $12,000 to $14,000 | 2,490 | 28 |
| $14,000 to $16,000 | 3,050 | 30 |
| $16,000 to $18,000 | 3,650 | 32 |
| $18,000 to $20,000 | 4,290 | 34 |
| $20,000 to $22,000 | 4,970 | 35 |
| $22,000 to $26,000 | 5,670 | 37 |
| $26,000 to $32,000 | 7,150 | 42 |
| $32,000 to $38,000 | 9,670 | 47 |
| $38,000 to $44,000 | 12,490 | 52 |
| $44,000 to $50,000 | 15,610 | 54 |
| $50,000 to $60,000 | 18,850 | 58 |
| $60,000 to $70,000 | 24,650 | 60 |
| $70,000 to $80,000 | 30,650 | 60 |
| $80,000 to $90,000 | 36,650 | 61 |
| $90,000 to $100,000 | 42,750 | 61 |
| $100,000 to $120,000 | 48,850 | 62 |
| $120,000 to $150,000 | 61,250 | 63 |
| $150,000 to $200,000 | 80,150 | 64 |
| $200,000 and over | 111,650 | 65 |

Secretary KENNEDY. We also have some very interesting figures here in summary form that I would like to discuss at this time.

The point was made yesterday about changing the mix and that we were taking taxes away from the individuals and giving it to the corporations. I have some figures here on that which I think are very

interesting. I think Senator Gore made the point, and I would like to just run through these, if I may.

Senator WILLIAMS. Surely.

Secretary KENNEDY. The division, under the present law, of taxes between individuals and corporations, is that individuals pay $77.9 billion, which is 69.4 percent of all income taxes. Corporations pay $34.4 billion or 30.6 percent of the taxes.

Under the House bill individuals would pay $70.6 billion, 64.3 percent. Corporations would go up from $34.4 to $39.3 billion, or to 35.7 percent.

Now, under our proposal individuals would pay $73.1 billion, which is 65.9 percent, and corporations would pay $37.9 billion or 34.1 percent. I thought those percentage figures would be of some interest.

Under the House cuts, for example, the individual share is reduced from 69 percent down to 64 percent. The Treasury would put it at 66 percent. So it is not too far apart percentagewise.

Mr. COHEN. Senator, I might say there are some tables at the back of my statement in the pamphlet as printed on page 90 and following.

Senator WILLIAMS. I have seen those; yes.

Mr. COHEN. They are our tables in general but we can supply additional ones.

### CAPITAL GAINS TAX

Senator WILLIAMS. No. Under the bill as it came from the House, and also, Mr. Secretary, under your proposal, you increase the tax on capital gains features but, as I understand it you reduce the availability of capital losses; is that not correct?

Secretary KENNEDY. That is correct.

Senator WILLIAMS. Under existing law the individual can claim, of course he can offset his capital losses against capital gains in any amount, but if his capital losses exceed his capital gains he can write off up to $1,000 against his regular income. Now, as I understand it under the bill and under your proposal he can only write off one-half of that; is that correct?

Secretary KENNEDY. He can still write off a thousand dollars but it would take $2,000 of a long-term capital loss to give him the $1,000 he could write off.

Senator WILLIAMS. That is right; if he has only $1,000 loss he can only write off $500.

Secretary KENNEDY. Yes; that is correct.

Senator WILLIAMS. I was wondering since you are extending the tax

as far as the gains are concerned if that $1,000 that you are cutting in half is realistic to give a man a chance. A fellow who is going to have capital gains next year is not worried too much whether he writes off a loss this year or carries it forward. But you do have some people who will go into the market for the first time in their lives, and they will get burned very severely, take a heavy loss, and so far as they are concerned they are never going in again.

I think there should be some provision maybe for recovering this. I know that we provide almost an indefinite writeoff of this $1.000 but what would be the effect on revenue or the objections, if we raised that to an equivalent now to $2,000, if you write off a thousand, to raise that to, we will say $5,000 and let him write off up to the $2,500 or offset it in the same manner as your formula.

Mr. COHEN. I can't give you the answer to that, Senator, but we have a study underway to determine what the revenue effect would be of increasing the thousand dollar limit to $2,000 or $3,000 or $5,000. To some extent it would be based upon an estimate as to what the effect would be in causing people to realize more losses than they now realize. But we are going to try to provide an estimate for the committee.

Senator WILLIAMS. Yes, I wish you would. We have time here to deal with that and I am not suggesting a fantastic figure but I think that we have some built-in safeguards against being abused here in that under the rules they can only write off half of it anyway.

Mr. COHEN. Yes.

Senator WILLIAMS. Which is certainly different from existing law.

Mr. COHEN. And certainly the $1,000 limit which I believe was put into the law in the early thirties at the time of the depression could now be raised to some higher amount in view of the inflation that has occurred since then.

Senator WILLIAMS. Well, it is really reduced under this proposal because while an individual can write off up to a thousand dollars on that basis a married couple only gets half of it, each one five hundred apiece isn't it?

Mr. COHEN. If they file separate returns.

Senator WILLIAMS. Separate returns.

Mr. COHEN. Yes; but if they file a joint return it will be the same limit as under existing law.

Senator WILLIAMS. That is correct.

Mr. COHEN. We rather think that permitting a deduction for only one-half of the losses is quite consistent with taking into income only one-half of the gains.

Senator WILLIAMS. I am not quarreling with that feature.

Mr. COHEN. Yes.

Senator WILLIAMS. I am not quarreling with you, but I am just wondering if we shouldn't recognize that when we extend that feature we are really cutting half of it down and maybe the figure, the thousand dollar figure should be likewise raised at some point somewhere so I would like to have the benefit of your estimates on it.

Secretary KENNEDY. We will look into it, Senator, because that is worthwhile.

Senator WILLIAMS. Yes.

Just a couple of more minutes here.

TAXING THE RICH

There is considerable publicity given to the fact that the rich are not paying enough taxes. I certainly support and have long advocated the fact that everybody should pay his proportionate part of the taxes. I realize there have been some abuses under existing law where those some of us feel should pay taxes have been escaping and this bill is channeled in the direction of correcting those inequities. If we need further correction we are going to do it but at the same time I am wondering if there is not too much emphasis placed on that and too many people feeling getting the impression that all we have to do to solve the inflation problems of this Government, or raise the revenue is to put a higher tax upon the rich. In order to illustrate just how far we have gone on that, and just how unrealistic such proposals are, I am going to ask these questions:

Assuming that individuals kept working just as hard as they are now for the benefit of turning all of the money over to the Federal Government, which we know is not a good assumption but on that assumption, how much extra revenue would you get if you put a hundred percent tax on every income above a hundred thousand dollars in America?

Mr. COHEN. Well, they are now paying about $7.7 billion of tax; that is, the aggregate for all those who have adjusted gross income of more than a hundred thousand dollars.

Senator WILLIAMS. Assume for the moment that you just completely confiscated the income of everyone in America earning over a hundred thousand dollars; how much extra revenue would we get?

Senator CURTIS. I think Senator Williams means if the income that is in excess of a hundred thousand dollars.

Senator WILLIAMS. That is correct; was confiscated.

Senator CURTIS. The first $100,000 would be at present rates; you would get less than a billion dollars.

Mr. COHEN. You would not increase the tax on the first $100,000.

Senator WILLIAMS. No; leave it as it is but all over a hundred thousand just say turn it all over to the Government.

Senator CURTIS. I think it is less than a billion dollars.

Senator WILLIAMS. Would you put in the record——

Mr. COHEN. I certainly shall.

Senator WILLIAMS (continuing). Just what you would get on the basis of a hundred thousand and on the basis of $50,000. I think it would be well to put in the record.

Mr. COHEN. Yes, sir.

Senator WILLIAMS. As I recall it it was around 400 to 500 million.

Mr. COHEN. Well, I can understand that, Senator. There is about $19 billion of income in the aggregate by everyone who has more than a hundred thousand dollars of adjusted gross income. But if you exempted from that the first hundred thousand dollars it would be far less than that.

Secretary KENNEDY. Pardon me.

Senator CURTIS. I think it is less than a billion dollars.

Secretary KENNEDY. That may be.

Senator CURTIS. If you applied the same rule down to 25,000 you wouldn't have, you would have less than 4 billion.

Senator WILLIAMS. For the record would you put in the record——

Mr. COHEN. I certainly shall.

Senator WILLIAMS (continuing). Just what you would get on the basis of a hundred thousand and on the basis of $50,000. I think it would be well to put it in the record.

Mr. COHEN. Yes, sir.

Senator WILLIAMS. As I recall it it was around 400 or 500 million.

Mr. COHEN. Well, I can understand that, Senator. There is about $19 billion of income in the aggregate by everyone who has more than a hundred thousand dollars of adjusted gross income. But if you exempted from that the first $100,000 it would be far less than that, and I will provide that figure for you shortly.

Senator WILLIAMS. You provide the figure for the record because I am confident that the first figure that you mentioned was incorrect.

Mr. COHEN. Yes, I am confident this figure is based upon a hundred percent tax on the total income which is not what you had in mind.

(The information referred to follows:)

SEPTEMBER 8, 1969.

We understand the question to be "How much would revenue be increased if the taxable income in excess of $100,000 per return were taxed at 100% and no change occurs in the amount of before tax income nor in the amount of deductions?"

The answer is $965 million.

If we assume that the beginning of the 100 percent rate was at $50,000 for single returns and separate returns (consistent with $100,000 for joint returns) the additional revenue would be $1125 million rather than $965 million.

Repeating these calculations for $50,000, the results are as follows:

(a) A 100 percent rate on taxable income (present law) over $50,000 would yield $8.3 billion on the basis of the present tax base.

(b) The yield would be $3.8 billion if the 100 percent rate started at $25,000 for singles and separate returns.

The CHAIRMAN. Senator Gore.

GRADUATED TAX RATES

Senator GORE. Mr. Secretary, I mentioned a matter yesterday and said I would return to it. I am deeply disturbed at the major assault upon the principle of progression in the income tax that is represented by your recommendations and by the bill. For instance, one of my secretaries told me this morning that his marginal rate would reach 40 percent. Yet by your recommendation and this bill Roger Blough's salary would be taxed at a marginal rate of 50 percent.

Now when we get to the ridiculous extreme that there is only 10 percentage points difference between the tax on the salary of one of my secretaries and the tax on the salary of Roger Blough, who earns perhaps $600,000 or $700,000 then we have just about abandoned the principle of progressivism in our system of income taxation.

Which one of you would reply to that?

Secretary KENNEDY. I don't know what the salary of your secretary is. It must be very high. [Laughter.]

Senator GORE. No, I am sorry, it is not. It is not permitted to be very high.

Secretary KENNEDY. What do they go up to——

Mr. COHEN. Under the table that we are suggesting, Senator, for a single person——

Senator GORE. Yes.

Mr. COHEN. A single person would reach, would exceed the 40-percent bracket at $26,000.

Senator GORE. Well, one of my secretaries draws that much, and yet—now at what level would Mr. Roger Blough's salary reach 50 percent?

Mr. COHEN. Well, I don't know whether Mr. Blough is married or not.

Well, a single person would reach the 50-percent level at about $38,000.

Senator GORE. And all above $38,000 would be taxed at 50 percent?

Mr. COHEN. All earned income above that amount under the bill.

Senator GORE. Do you think anyone, any man on salary really earns $600,000? You can answer it if you want to. I don't. Only a corporate insider can ever draw that kind of a salary.

Mr. COHEN. Well, I don't know that that is true. There are certainly people who are not corporate insiders who earn very large amounts of money in the form of compensation. I will cite you just as an instance the amount that a movie star will get for making a movie.

Senator GORE. Well, you are diverting a bit. I said in salary. Of course there are accountants and there are tax lawyers who, in fees, have earned income of this amount. My statement was that I did not believe anyone except a corporate insider drew a salary of such an amount.

Mr. COHEN. Well, I am confident that anyone with a salary of that size would be, in general terms, within your definition of corporate insider, because he would be an executive of the company.

Senator GORE. Yes. Well, we really are talking about the definition of earned income. I wanted to get back to the principle of progressivism, since, in 15 years time, if this bill becomes law, we will have succeeded in large measure in eliminating the progressive character of the U.S. income tax.

Mr. COHEN. Senator, I wouldn't agree with that.

Senator GORE. I said in large measure.

Mr. COHEN. I wouldn't agree with that.

Senator GORE. May I go on just a moment.

Mr. COHEN. Surely.

Senator GORE. You have just given an example. You just made the calculation that a single person working in my office at a salary of $26,000 would reach the marginal rate of 40 percent.

Mr. COHEN. But you don't figure the progressive nature of the tax based upon the marginal rate obviously. You figure it upon the total effective rate, how much tax is she paying compared with the taxes being paid by a person earning $600,000.

Senator GORE. Well, I will proceed with an example.

Mr. COHEN. Yes, sir.

Senator GORE. You have just given me and helped me develop the example. A secretary drawing $26,000 would reach the marginal rate on his last $1,000 of 40 percent, and you told me that a single man drawing a much larger salary would reach the 50 percent rate at a salary of $38,000, which would mean there would be 10 percentage points difference.

Now, on $562,000 of his salary, he would pay only 50 percent. So my secretary would pay 40 percent and Mr. Roger Blough 50 percent.

Now, I say to you that that is a violent assault upon the principle of graduation in income taxes completely contrary to the Cordell Hull yardstick of taxation according to the ability to pay, and I am going to fight you on this 50 percent limit.

It is not fair, it is not right, it violates the principle of progression. In 15 years time we will have reduced the marginal rate on Mr. Blough's salary from 90 percent to 50 percent. What other taxpayers except those in that category have had such a tax reduction?

Mr. COHEN. Senator, I would say that when you are talking about marginal rates you are not giving full effect to the progressivity of the system. The secretary to whom you referred would pay an effective rate of tax on a salary of $26,000 of 25 percent. She would pay then roughly $6,000 or $7,000 a year, whereas the person with the high earned income would be paying close to 50 percent effective rate of tax. So the other person would be paying twice the effective rate of tax, would have twice the burden of the secretary.

I don't think you get the full impact when you are looking solely to the marginal rate. But if I might say to you, if one wanted to one could put a limit upon the amount of income that could be subject to this 50 percent limit.

If you think $600,000 is not really earned income one could say no one could count more than $200,000 as earned income; there are a good many corporate executives today, I guess, with total benefits in that range.

But I think the concept here has been that the rate of the present law of 70 percent, is now so high that a corporate executive is led to spend his time trying to figure if he can make some form of investment or participate in some kind of joint venture or equipment leasing transaction, farm operations or what not, in which he can take an ordinary deduction and spend only 30 cents on the dollar, because he reduces his tax by 70 cents for every dollar he invests. If he can turn the investment into a capital gain he will pay tax only at 25 percent or under the bill 32½ percent. He may also try to enter into a special deferred compensation arrangement to postpone his income until after his retirement has occurred. Hence, Treasury is not getting the full 70 percent tax from a great many of these persons; those who have analyzed the system have pointed to the fact that, in general, the effective rate of tax in these upper brackets is lower than it is in the middle income brackets.

Now, if you reduce the earned income ceiling rates to 50 percent, then the executive has an entirely different prospect. If he puts some money into an investment with an ordinary income deduction he can only deduct against it a 50-percent tax; so he has to spend 50 cents of his own money for every 50 cents that he can save in taxes by this type of investment in oil, farms, equipment leasing, or whatever. I think it enables us to tighten up much more strictly than we have in the present law on such things as restricted stock, and we have recommended tightening up very susbtantially on this device.

You could tighten up, as you have already, but even further, on stock options and other programs of that kind. The 50-percent level assures the executive that you are not going to take more than half of every dollar that he earns from his work. You enable him to say, "I would rather have a dollar now and pay 50 cents to the Government and have

a dollar that I can put in the bank to do with as I wish, to invest or not invest as I wish." He will have less incentive to engage in the transactions that have been so widespread, and in which his talents are wasted by his effort to determine what mechanisms he can use to reduce this effective rate of tax.

I think this is just a recognition of the fact that the man should be encouraged to spend his time and efforts in the job for which he is best equipped.

Senator GORE. That is a very interesting comment. You are saying that they are wasting some of their effort or utilizing some of their effort to cut their effective tax so you just want to make it easy for them, because you are going to give it to them anyway. The corporate executive doesn't have to look for ways to get capital gains, he doesn't have to take a risk and make an investment. You are just automatically going to cut his rate to 50 percent.

Mr. COHEN. That is a high rate, in my judgment, Senator.

Senator GORE. It is what?

Mr. COHEN. I think the 50-percent rate is in itself a very high rate.

Senator GORE. Well, so is 40.

Mr. COHEN. Well——

Senator GORE. So is 40. But my secretary reaches 40 and Mr. Roger Blough reaches 50. Do you call that progressivism?

Mr. COHEN. I think it is a question of degree of progressivism. As I pointed out to you with respect to your secretary, her effective rate would be only half of what it would be for the person in the higher bracket.

Senator GORE. It happens to be a he, it could be either a he or a she. I guess it is better to use a she, perhaps a widow. You used her yesterday, you remember.

Mr. COHEN. Yes; I did. [Laughter.]

I may retreat now. But I think that, all I wanted to point out, Senator, is if you use a married person these effective rates are different.

Senator GORE. Well, now you again referred to effective rates. A great deal depends upon the assumptions unless you take an actual taxpayer. I gave you a hypothetical taxpayer yesterday, and I have asked my staff to take the example, No. 2, and apply the effect of the allocation of deductions. I don't know that you still have the example that I gave you.

Mr. COHEN. Yes; I have it, Senator.

Senator GORE. It is No. 2.

Mr. COHEN. Yes.

Senator GORE. Assuming a salary of $400,000, tax exempt income of $300,000, the effective rate under your recommendation in this bill would be 28 percent. But if you apply the allocation of deductions and assuming a deduction of 20 percent, then the effective rate becomes 26.57 percent. You are doing things to people with this bill and with your recommendation, and you are doing things violently to the great mass of our people. You are making it easy for people with very large incomes to pay very low effective rates, and this, I say to you, is not right, and I am going to fight you on it and we are going to have some votes on it.

Whether I win or whether you win, we are going to have some votes, some record votes on this. In a period of 15 years we have reversed the

system of graduated income tax until now we are concentrating the tax upon the great majority of the people, and we are bringing about a reconcentration of the wealth of this country through modifying the tax rates and deductions, and the interest rate structure.

Mr. COHEN. Senator, I don't think this is the overall effect of this bill. I think, in particular, the great advantage that those in the top brackets have had has been in the capital gains provision with a limit of 25 percent on the tax. Under the House bill or under our proposal it will not be possible for a person in the top brackets to have large amounts of capital gains in relation to their ordinary income and pay only 25 percent tax. I think that is what has interfered with the progressivity of the system. But for those with incomes of a hundred thousand dollars or over, this bill causes an increase in taxes, not for each person but as a group. Those with a hundred thousand dollars and over would have as a group a 3-percent increase in tax, whereas every other bracket has in the neighborhood of a 5-percent reduction and some going up to a 56-percent reduction in the lower brackets under our proposals.

Senator GORE. Well, I am advised by the staff that my time is up. I would obviously need more time to debate this.

Mr. COHEN. Yes.

Senator GORE. I would like certain information for the record. Instead of reading it, I will ask the staff to hand it to you if you will be so kind.

Now, when I again have an allocation of time I wish to go into the preferential tax treatment of income earned abroad which neither this bill nor your recommendation does more than touch with a powder puff.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

(Information supplied by the Treasury Department follows:)

LIMITATIONS ON USE OF DATA FOR "AVERAGE" TAXPAYERS TO SHOW EFFECTS OF TAX REFORM MEASURES ON HIGH-INCOME TAXPAYERS

A table such as the attached Table 1, based on income and deduction amounts for an "average" taxpayer at specified income levels is satisfactory for showing the effects of a tax change like an increase in the standard deduction. This is because those who benefit from such a change fall into the middle and lower middle income groups which are relatively *homogeneous* in income and deduction characteristics and thus are well represented by an average.

On the other hand, the same table is inappropriate for illustrating [illegible] changes which affect high-income individuals who within an income class are *heterogeneous* with respect to types of income and deductions.

The use of averages is even more inappropriate when tax reform proposals affect high-income taxpayers with tax preferences which are enjoyed to an extraordinary degree by relatively few.

By way of illustration, the Limit on Tax Preferences (LTP) has no effect on the "average" taxpayer at any income level. This, of course, is consistent with the intent of this proposal: It is meant to affect only those individuals who, as a result of having extraordinary preferences relative to their other income, presently pay disproportionately low effective rates of tax on their incomes. Similarly, the repeal of the unlimited deduction of charitable contributions and the Treasury recommendation to limit the amount of capital gains eligible for the alternative rate affect nobody "on the average." The effect of these and other recommendations is felt only by those few who benefit most from present law preferences. Obviously, an illustration of these tax effects is only meaningful when it is based on data concerning specific tax preference groups.

**TABLE 1.—TAX CHANGE AND CHANGE IN AFTER-TAX INCOME UNDER HOUSE BILL 13270 AND UNDER HOUSE BILL 13270 MODIFIED BY TREASURY RECOMMENDATIONS TO THE SENATE COMMITTEE ON FINANCE [1]**

[Married couple with 2 dependents, typical personal deductions and typical composition of income [2]]

| AGI | Present law | | House bill 13270 | | | | | House bill modified by Treasury recommendations to the Senate Committee on Finance | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Tax | After-tax income [3] | Tax [4] | After-tax income [3] | Tax change | | Percent change in after-tax income | Tax [4] | After-tax income [3] | Tax change | | Percent change in after-tax income |
| | | | | | Amount | Percent | | | | Amount | Percent | |
| $3,000 | 0 | $3,025 | 0 | $3,025 | | | | 0 | $3,025 | | | |
| $3,500 | $65 | 3,464 | 0 | 3,529 | −$65 | −100.0 | 1.9 | 0 | 3,529 | −$65 | −100.0 | 1.9 |
| $4,000 | 128 | 3,908 | $65 | 3,971 | −63 | −49.2 | 1.6 | $81 | 3,955 | −47 | −36.7 | 1.2 |
| $4,500 | 190 | 4,351 | 130 | 4,411 | −60 | −31.6 | 1.4 | 165 | 4,376 | −25 | −13.2 | .6 |
| $5,000 | 253 | 4,782 | 200 | 4,835 | −53 | −20.9 | 1.1 | 236 | 4,799 | −17 | −6.7 | .4 |
| $6,000 | 390 | 5,652 | 345 | 5,697 | −45 | −11.5 | .8 | 363 | 5,679 | −27 | −6.9 | .5 |
| $7,500 | 602 | 6,945 | 563 | 6,984 | −39 | −6.5 | .6 | 563 | 6,984 | −39 | −6.5 | .6 |
| $10,000 | 1,021 | 9,083 | 958 | 9,146 | −63 | −6.2 | .7 | 960 | 9,141 | −61 | −6.0 | .6 |
| $12,500 | 1,432 | 11,198 | 1,347 | 11,283 | −85 | −6.9 | .8 | 1,350 | 11,280 | −82 | −5.7 | .7 |
| $15,000 | 1,920 | 13,428 | 1,816 | 13,532 | −104 | −5.4 | .8 | 1,816 | 13,532 | −104 | −5.4 | .8 |
| $17,500 | 2,410 | 15,495 | 2,278 | 15,627 | −132 | −5.5 | .9 | 2,278 | 15,627 | −132 | −5.5 | .9 |
| $20,000 | 2,985 | 18,160 | 2,807 | 18,338 | −178 | −6.0 | 1.0 | 2,807 | 18,338 | −178 | −6.0 | 1.0 |
| $25,000 | 4,163 | 22,269 | 3,931 | 22,501 | −232 | −5.6 | 1.0 | 3,931 | 22,501 | −232 | −5.6 | 1.0 |
| $30,000 | 5,516 | 26,201 | 5,205 | 26,512 | −311 | −5.6 | 1.2 | 5,205 | 26,512 | −311 | −5.6 | 1.2 |
| $40,000 | 8,744 | 33,546 | 8,260 | 34,030 | −484 | −5.5 | 1.4 | 8,260 | 34,030 | −484 | −5.5 | 1.4 |
| $50,000 | 12,524 | 43,678 | 11,812 | 44,390 | −712 | −5.7 | 1.6 | 11,812 | 44,390 | −712 | −5.7 | 1.6 |
| $75,000 | 23,380 | 60,922 | 22,076 | 62,226 | −1,304 | −5.6 | 2.1 | 22,076 | 62,226 | −1,304 | −5.6 | 2.1 |
| $100,000 | 33,290 | 96,276 | 33,177 | 96,389 | −113 | −.3 | .1 | 32,860 | 96,706 | −430 | −1.3 | .4 |
| $200,000 | 74,689 | 212,339 | 83,381 | 203,647 | 8,692 | 11.6 | −4.1 | 76,9[illegible]6 | 210,062 | 2,277 | 3.0 | −1.1 |
| $500,000 | 208,082 | 574,288 | 251,225 | 531,145 | 43,143 | 20.7 | −7.5 | 220,3[illegible]1 | 562,009 | 12,279 | 5.9 | −2.1 |
| $1,000,000 | 429,074 | 1,261,166 | 546,500 | 1,143,640 | 117,526 | 27.4 | −9.3 | 461,129 | 1,229,111 | 32,055 | 7.5 | −2.5 |

[1] Tax amounts from joint return tax rate schedules. Surcharge a[illegible].
[2] Personal deductions and income composition based on data from [illegible]tistics of Income 1966."
[3] After-tax income exceeds AGI less tax by the amount of tax preferences excluded from AGI.
[4] Tax preferences are included in tax calculations.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

Note: Important—See attached memorandum on limitation of the use of data for "average" taxpayers to show the tax reform effects on [illegible]igh incomes.

33-865 O—69—pt. 1——45

TABLE 2.—HISTORICAL TAX LIABILITIES (FAMILY OF 4 FILING A JOINT RETURN USING AVERAGE CHARACTERISTICS FOR THE APPROPRIATE INCOME CLASS)

| Adjusted gross income class | Year/proposal | | | | | |
|---|---|---|---|---|---|---|
| | 1954 | 1964 | 1965 | 1965 surcharge | House | Treasury |
| $10,000 | $1,425 | $1,097 | $1,021 | $1,123 | $958 | $990 |
| $20,000 | 4,674 | 3,177 | 2,985 | 3,284 | 2,807 | 2,807 |
| $100,000 | 46,185 | 34,363 | 33,290 | 36,619 | 33,177 | 32,860 |
| $200,000 | 95,323 | 76,074 | 74,689 | 82,158 | 83,381 | 76,966 |
| $500,000 | 247,766 | 211,378 | 208,082 | 288,890 | 251,225 | 220,361 |
| | Percentages of 1954 tax liabilities | | | | | |
| $10,000 | 100 | 77 | 72 | 79 | 60 | 60 |
| $20,000 | 100 | 68 | 64 | 70 | 60 | 60 |
| $100,000 | 100 | 74 | 72 | 79 | 72 | 71 |
| $200,000 | 100 | 80 | 78 | 86 | 87 | 81 |
| $500,000 | 100 | 85 | 83 | 92 | 101 | 89 |

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

The CHAIRMAN. Senator Miller will not be able to attend the afternoon session and his colleagues have yielded to him so he can ask his questions at this time

PERCENTAGE DEPLETION

Senator MILLER. Thank you, Mr. Chairman.

Mr. Secretary, I would like to get on the subject of depletion and also related to that depletion of other items in that category.

As I understand it, the percentage depletion was originally arrived at as a replacement for discovery depletion and that in the case of oil the 27½ percent represented a compromise between one house which wanted 30 percent and the other house which wanted 25 percent so they arrived at 27½ percent.

I understand further that certainly the overriding purpose of Congress was to provide an incentive for the exploration and development of natural resources for the overall benefit of the general public. Am I correct in that understanding?

Secretary KENNEDY. I think that was the basis on which the legislation was passed.

Mr. COHEN. I think there was another basis, too, Senator Miller. Although I have not studied the history, I think this came about because of the income tax law going into effect in 1913. Persons were able to take depreciation and depletion based upon March 1, 1913 value with respect to assets owned on that date. When the rates of tax suddenly shot up during World War I, that right to use the 1913 value was of great benefit, to those that owned mines on March 1, 1913, but left those who discovered mines afterwards with a much higher tax. The discovery value, I think, came in as a means of alleviating that situation for mines opened up after March 1, 1913.

Senator MILLER. Yes.

Then when this was devised as a replacement for discovery you had both that original concept and the incentive concept in the minds of Congress.

Mr. COHEN. That is correct. Right.

Senator MILLER. Now, do I understand that the position of the Department before the Congress on this subject would lead to this

result: in the case of two corporations, let's say corporation A has percentage depletion from oil and gas which amounts to $25 million. Corporation B also has $25 million percentage depletion. Corporation A, pursuant to the intention and purpose of Congress, plows back that $25 million in exploration and development. But Corporation B, contrary to the intention of Congress, abuses the provision which Congress has enacted, and uses that $25 million to pay dividends to stockholders, and yet you are advocating precisely the same treatment for both corporations.

Is that correct?

Mr. COHEN. Yes, Senator; that is correct under our present proposal, under our recommendations made to you yesterday.

Senator MILLER. Yes. You recoginze that corporation B in my example is abusing the tax law, do you not, because it is not carrying out the purpose for which that provision was devised by Congress.

Mr. COHEN. Senator, I have been intrigued by this concept and have had numerous discussions about it, both within the Goverment and outside, and I think that the argument that is made on the other side is that the incentive is intended as a reward. This is different from intangible drilling expenses, which is an actual permission to deduct currently the expenses involved. But a percentage depletion is to some extent a reward.

It changes the degree of risk of exploration because you know that if you are successful you will have tax-free benefits from it to the extent of the depletion allowance.

Therefore, it can be argued that the incentive has been given as a reward for past action and not on the condition that this reward be plowed back into further exploration.

Now, if you are going to reduce the percentage depletion to 20 percent this is likely to have considerable impact, although none of us can predict with complete certainty, and if on top of that you were to require a plow back of the moneys you would, I think, decrease the incentive.

Senator MILLER. You understand, I am not suggesting anything reducing the percentage depletion. I am merely pointing out that there is an abuse as between corporation A and corporation B. It is an abuse because corporation B is not carrying out the intention of Congress, and the proposal of the Treasury is not to do anything about the abuse. What I am suggesting is that instead of treating both corporations exactly the same, as you propose, we get at the abuse, and say to corporation A, "You are permitted to have your percentage depletion," but to corporation B, "Because you are abusing the law, you are not going to have percentage depletion unless you plow it back within a reasonable period of time," say a couple of years.

But what bothers me is that I can see abuses here, and you can call them loopholes, too, because I don't think Congress intended such abuses, and we are not doing anything about it. We are just treating both corporations exactly the same.

I could also give you an example of individuals, individual A and individual B, and they are both in business, and individual A has a million dollars percentage depletion and individual B has a million dollars from depletion. Individual A carries out the intention of Con-

gress by plowing that back into exploration, and individual B decides he does not want to carry out the intention of Congress because the law covers him, so he takes the million dollars and buys a building with it.

Why can't we do something about the abuse, instead of using what I call a meat ax approach and treating them all alike.

Mr. COHEN. Senator, I am not sure this was the intention of Congress. It could be the intention of this Congress, but I am not sure it was the intention of the Congress 40 or 50 years ago when they allowed discovery value for a mine. I think that was designed as a reward to the man who had been a successful prospector, but I don't think it was given only on the condition that he take his discovery value depletion and plow it back into search for additional mines.

Senator MILLER. Well, sir, let me quote from a recent speech——

Mr. COHEN. Yes, sir; I am aware of this speech.

Senator MILLER (continuing). Down in Texas.

"One of the principal arguments in favor of percentage depletion after the cost of investment has been fully recovered is that it is needed as an incentive in development of our natural resources."

If this is true, and I am inclined to think it is true, now, have you changed your mind in expressing some doubt about the intention. I might say that I thought this was pretty much the position of President Nixon until the last election indicated that he was opposed to cutting the percentage depletion and he stated why, one reason being that he was concerned about the development of our natural resources pursuant to the intention. And I might also add that so was Vice President Humphrey opposed to cutting it and he had another reason which I would like to discuss with you in just a moment.

But what bothers me is that we are treating everybody alike in this thing and I have a feeling that there are abuses that are going to continue which we can put a stop to by the plowback approach, and I don't want to get into intangible drilling and development costs. That is another subject. I am just talking now about percentage depletion.

But it seems to me that if a corporation or an individual takes their percentage depletion and carries out the intention of Congress by developing the natural resources for the benefit of the general public, that they ought to be treated differently from the one that doesn't.

Mr. COHEN. I think the argument on the other side, Senator, is that if your goal is to attract capital for exploration, and a lot of capital is needed for exploration in the capital-intensive industry of oil and gas, it is difficult to get the capital if the incentive is given only so long as people keep their money invested constantly in exploration. If they cannot withdraw it, if the capital is not mobile, it will be difficult to raise.

Senator MILLER. May I make a point on that. I don't think anybody is advocating that. I am only talking about the plowing back of the 27½-percent depletion. They are still going to have a profit if it is a profitable operation which, in the case of a corporation, would be 50 percent. They don't have to plow that back in, nobody is advocating that. They can pay out dividends to stockholders with that. I am talking about the plowing back of the percentage depletion.

Mr. COHEN. Senator, I feel somewhat as though I were on a college debating team, switching from one side to the other in the argument,

because you are reading from my speech, and [laughter] I am intrigued by the possibilities of the plowback theory.

However, there are many reasons for not raising the plowback principle at the same time that there is such a major change being made in other respects in the industry. The total additional taxes that are applicable to mineral industries as a result of this bill and our proposals would be upward of $650 million without regard to the repeal of the investment credit or the corporate rate reductions which would net against it, and to go further with the plowback theory at this time would seem to me to be running risks of imbalances that ought not to be run now.

Senator MILLER. I think you have a point there. However, I don't believe it is responsive to what I am getting at. I am not suggesting that we adopt the percentage depletion reduction. I am suggesting we leave it alone. But in the case of those individuals and corporations who are abusing the law that we cover them by the plowback situation. If they don't want to plow it back, let them pay tax on it. That is what I suggest.

Senator GORE. Would the Senator yield that I might give another example.

Senator MILLER. Yes; indeed.

Senator GORE. I am aware of a merger of two corporations, which I will prefer not to identify. Corporation A had accumulated a large reserve, a multi-million-dollar reserve largely from percentage depletion. It was a mineral corporation.

Corporation B purchased a controlling interest, and proceeded almost immediately to milk or siphon off this reserve and use it for entirely different purposes.

Senator MILLER. Well, my colleague from Tennessee has brought up another version of what I referred to as the abuse of the intention of Congress on this.

Senator BENNETT. Will the Senator yield to me?

Senator MILLER. Yes.

Senator BENNETT. Well, I hope you will forgive me for getting into the argument. In my State of Utah over the years there have been literally thousands of mines started that produced a little and then quit.

Now, if a mine runs out are you going to force the owner of the mine to go on, even if as he sees the mine it is beginning to run out? Are you going to force him to go on digging more holes looking for more metal just because he has been actually mining a depletable ore body, and you have given him under the percentage depletion arrangement a chance to represent the fact that his ore body was depleted, but you say to him, "you can't get this benefit unless you take this money and go somewhere else and dig another hole."

Senator MILLER. I would like to respond to it.

Senator BENNETT. I would like you to.

Senator MILLER. I am not talking about the percentage depletion, except insofar as it exceeds the cost depletion. If he paid a million dollars for the mine, that is for the ore or ore rights in the mine, and he takes whatever the, let's say it is 15 percent, percentage depletion on production over a period of 7 years, or say 5 years, he has recovered the cost of that property, we are not alking about that.

He is entitled to that.

Senator BENNETT. The miners in that State, Senator, don't go out and buy mines. They take a shovel and go out and dig them, and so the percentage depletion applies to all of the ore that they take out of the mine.

Senator MILLER. Well, to the extent that they have recovered their costs, there is no problem. They are left alone. It is only when they recover their costs, it is a little more graphic in the oil industry, but it is true in the case of all depletable assets, and nobody is talking about a plowback until they have recovered their costs of their depletable asset. But beyond that point, it is my understanding Congress intended this percentage depletion as a percentage for people to explore and develop, put down another mine shaft, develop the ore resources or the mineral resources for the benefit of the people of this country, and if one corporation is going to do it and the other corporation is simply going to pay out the dividends to stockholders, I think there is a difference there.

Senator BENNETT. Well, you can go on digging shafts, we don't know what we will find at the bottom of the hole, and I can't believe that it is the purpose of the tax law to force a man to exhaust whatever value this percentage depletion represents by continuing to dig holes or wells until he runs out of money, because in the end, if you are going to force him to continue that would be the ultimate result. He would not be able to dividend or share this income with his stockholders.

He has got to keep digging more holes until he finally digs enough dry holes so that he runs out of depletable assets, and out of money.

Senator MILLER. Well, I wouldn't want to carry it that far, I say to my colleague, with all deference, because in a case where somebody just figures they don't want to continue to dig any more or mine any more or develop any more, you wouldn't have to run out of money. He would just pay the tax on it and that is all, and certainly that would be a prudent thing to do in some cases.

I would like to ask——

The CHAIRMAN. Might I just put one point in there since the Senator has been interrupted, I would like to put one point. No one is making any point at all about that farmer sitting out there who owns something. If someone comes and discovers mineral resources on his farm, there is a difference, between depleting an investment and depleting a resource, and I would like to ask this: Has it ever occurred to you, one, that as far as this sort of farmer is concerned, if you are not going to allow him percentage depletion then his only alternative is just to sell all of his minerals—or a fraction of it—as a capital gain. He would then pay taxes on half and would be done with it.

Now the man who buys it then takes cost depletion which would be a lot more than 27½ or any percentage here, it could be 50, 70, or 80 percent. How high does cost depletion run in some cases—might it be a hundred percent?

Mr. COHEN. It could be if it were a losing operation or if a very unprofitable operation.

The CHAIRMAN. So that as a practical matter if you don't allow a farmer who has something valuable discovered beneath his property

something to adjust for the fact he has a depleting resource, his only alternative is to sell the whole thing as a capital gain and then pay a tax on half of it, or a maximum tax of 25 percent, isn't that the alternative.

Mr. COHEN. That could be the argument, Mr. Chairman, for giving the benefit to the owner of the land.

The CHAIRMAN. Well, this point is when this thing was put into effect nobody ever came up and made the argument for the poor old farmer, he is just sitting out there. But he has a better argument than any of them if you are going to make him pay as ordinary income when you remove his resources from his land, that if you don't give him some kind of depletion allowance his only alternative is to just sell it as a capital gain and he would be forced to, no alternative.

Mr. COHEN. There can be a different set of values though with respect to the person who is the lessee of the land with rights to remove the minerals.

The CHAIRMAN. Very possible.

Senator MILLER. I had one last question, and that is this: Following the action of the House Ways and Means Committee, I read in the paper where some industry spokesman forecast that if this overall reduction in percentage depletion across the board, without any recognition of differences between those that are abusing the law and those that are not, went through that this would result in an overall increase to the consuming public, an overall increase in the price they would have to pay for their automobile gas, their home heating fuel, and various petrochemicals.

Does the Treasury have a position on that? Has the Commerce Department or some other department of the Government made a study of what the impact on the consumers will be?

Mr. COHEN. We have considered it, Senator, and it is very hard to tell what the result will be in this regard, because you don't know what the effect will be on intangible drilling expenses. For example, there might just be more drilling and not as much additional tax as we have estimated. However, considering many factors, the calculation indicates that if all of the net costs in the price of the products were passed on to the consumer, the price increase would be around four-tenths of a cent a gallon.

Dr. WALKER. I think we should add a caution there, as I tried to do in the discussion with Senator Fannin yesterday. There is a question as to the relative effectiveness of the market power of this industry in passing on these price increases. I am not saying they could or they couldn't. But it doesn't seem to jibe with the industry statements that they need tax preferences because of a low rate of profit relative to capital. Otherwise they could now increase prices and increase the profitability of the industry. I am not taking a position one way or the other but saying this is a very complicated matter as to whether there would be a pass on of costs or not.

Senator MILLER. I appreciate that comment but I think all of us are very much aware of the fact that over the last few years there have been increases in the cost of automobile gas, and I think we are getting tired of it, and I don't like to see it go up any more unless it is absolutely essential. If the Treasury's proposal is such that this would

cause an increase, whereas by some other approach to this problem to cut out the abuses we can do that without increasing the cost to the consumer, I think we ought to pursue that.

I would like to ask further, what is the Interior Department's approach on this plowback or have they given a position.

Mr. COHEN. We don't have an official statement from them, Senator. They have been interested in it, and I think Secretary Hickel has indicated an interest in the plowback theory in some informal public statements, but I don't know of any formal position they have taken.

Senator MILLER. Do you suppose you could get a position from Interior.

Mr. COHEN. Yes, we can certainly inquire of them. We have been consulting with them, and they have been interested in it. But I don't know that they have studied it sufficiently to have taken any firm position.

Senator MILLER. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen, I would like to ask the pleasure of the committee. We can come back here, let's say, at 2 o'clock, if that suits the Senators. If someone cannot be here, if, Senator Byrd, you cannot be here we will go ahead.

Senator BYRD. If you can give me 6 or 7 minutes I can conclude it. I can't be here this afternoon.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

We are discussing oil depletion. I wonder if the Treasury would give its thinking in regard to the proposed change for coal depletion of 10 to 7 percent.

Mr. COHEN. Senator, the thought was that if depletion were to be reduced from 27½ to 20 percent on oil and gas, that except with respect to the five minerals that are in short supply, a similar percentage reduction would be made with respect to the other 105 minerals that are given a percentage depletion under the law. There are a total of 110 minerals that are given percentage depletion, and 27½ percent when reduced to 20 percent is a reduction of about 27½ percent. So the bill calls for an across-the-board reduction in percentage depletion of about 27½ percent for each depletable mineral except the five I mentioned, I think this is why coal had been reduced from 10 to 7 percent.

Senator BYRD. Then I take it there was an arbitrary reduction in so far as coal is concerned, and it was not—there was no study made to indicate that coal was entitled to only 7 percent.

Mr. COHEN. I wouldn't say, Senator, that it was arbitrary. It was across the board without any special consideration being given to the percentage applicable to coal in relation to the reduction applicable to the other 105 minerals.

Senator BYRD. In other words, you determined what change should be made insofar as oil is concerned and applied that same change to all the other commodities, the other minerals, with a few exceptions?

Mr. COHEN. Yes.

Senator BYRD. It was based entirely on what was done to oil.

Mr. COHEN. Well, that was the major consideration because the major amount of depletion is with respect to oil and gas.

Senator BYRD. Well, I would certainly call that an arbitrary cutback insofar as the coal depletion is concerned. I am not saying whether it should be cut back, I don't know whether it should or shouldn't, but it seems to me some study should be made of it before we arbitrarily say because oil should be cut back then we ought to cut back coal to the same extent.

Anyway, I have established to my satisfaction that it was an arbitrary change.

FOUNDATIONS

Now, would you supply for the record, to go back to Senator Talmadge's question earlier today in regard to the foundations, would you supply for the record the total assets or the assets of all the private foundations for the last available year, which I assume would be 1968, and then if you would do that also for 1958 and 1948 and 1938. What I'm getting at is it seems to me it would be important for the committee to know just how extensive have been these accumulations of assets by the private foundations.

I know you don't have the figures now and I am not asking for them now but if you would supply them for the record.

Mr. COHEN. In general, Senator, I think Senator Talmadge was correct. I think he mentioned some $23 billion in assets and our rough estimate here is that assets are in the neighborhood of $20 billion. However, we will supply the data for the record to the extent that we can.

(The material referred to follows:)

ASSETS OF PRIVATE FOUNDATIONS, 1930-68

| Source of data | Year | Number | Assets (in millions) |
|---|---|---|---|
| Twenty Century Fund, "American Foundations and Their Fields | 1930 | 122 | $950 |
| Harrison and Andrews, "American Foundations for Social Welfare," p. 58 | 1944 | 505 | 1,820 |
| F. E. Andrews, "Philanthropic Giving," p. 93 | 1950 | 1,007 | 2,570 |
| W. B. Cherin (editor), "American Foundations and Their Fields," 7th ed | 1954 | 4,164 | 4,520 |
| Russell Sage Foundation, "Foundation Directory 1" | 1959 | 5,202 | 11,520 |
| Russell Sage Foundation, "Foundation Directory 2" | 1962 | 6,007 | 14,510 |
| 1964 Treasury Department Survey, "Treasury Department Report on Private Foundations, p. 74 | 1962 | 15,000 | 16,260 |
| Russell Sage Foundation, "Foundation Directory 3" | 1964-65 | 17,303 | 20,314 |
| The Foundation Center Annual Report, 1968, p. 11 | 1968 | 22,000 | 20,500 |

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

FARM LOSSES

Senator BYRD. Thank you, sir.

Now, just one other category. In regard to farm losses, now I am not speaking about hobby farming, I am speaking about professional farming, professional farmers, and of course they cannot determine the weather, they have no control over excess heat or excess cold at the wrong time of the year, can't determine the rainfall except in the West where they have irrigation. They can't determine what damage would be done by hail and all that.

Do I understand accurately that the provision in this bill will not apply unless both items occur, No. 1, that the annual nonfarm income exceeds $50,000 and the farm losses exceed $25,000. I am talking of taking the House bill now to establish the principle.

Mr. COHEN. The outside income——

Senator BYRD. Outside income.

Mr. COHEN. Nonfarm gross adjusted income has to be more than $50,000 and the losses have to exceed $25,000. That rule only deals, however, with the right of a person to take capital gains on the sale of livestock or orange groves. It does not deal with deductibility of the losses themselves.

Senator BYRD. It does not deal with the deductibility of the losses themselves.

Mr. COHEN. That is correct.

Senator BYRD. It only deals with capital gains.

Mr. COHEN. It only deals with the right to get capital gains on the sale of livestock or on orchards. It deals with the difference between ordinary losses and capital gains, and just cuts back on the right of the owner of a farm to be able to sell his livestock, for example, at capital gains if he has had very large deductions from ordinary income in the cost of raising the cattle.

Senator BYRD. Then it does not apply to a general farmer who, for one reason or another has his crop destroyed and loses $40,000, say?

Mr. COHEN. No provision of the bill would deny the farmer the right to deduct actual economic losses. Even the capital gain rule would not apply if the farmer kept his books on the methods of accounting that were applicable to other industries. The problem arises from the basis of accounting that enables him to deduct his costs of raising cattle or developing a grove on the cash basis in the year incurred rather than treating them as a cost of the cattle or grove to be offset against the gain on sale of such farm assets.

Senator BYRD. So this provision then applies only if he sells his assets?

Mr. COHEN. Only if he sells his assets, that is correct.

Senator BYRD. That clears up the point.

Mr. COHEN. There is another provision in the bill though. In the list of preferences we include farm losses to the extent that they are due to the use of the cas' method of accounting.

Senator BYRD. Does the $25,000 figure apply in that case?

Mr. COHEN. No; it does not apply in that case. But, for example, if an executive had a $100,000 salary, and his farm losses amounted to as much as $50,000, the provision would not affect him. But if his farm losses on a cash basis were $70,000, so he is paying tax on only $30,000, we would insist that he pay tax on at least $50,000, which is half his income after he adds back his farm losses.

Senator BYRD. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

The CHAIRMAN. All right, then, we will now stand in recess until 2 p.m.

Thank you very much, Mr. Secretary.

(Whereupon, at 12:50 p.m., the committee was adjourned, to reconvene at 2 p.m., of the same day.)

AFTERNOON SESSION

Senator GORE. The committee will come to order.

DEFINITION OF EARNED INCOME

Secretary Cohen, this morning we were discussing earned income. Do you understand the bill to refer to earned income by the present legal definition in the code?

Mr. COHEN. I think that it uses, Senator, the definition of earned income that is used with respect to income earned outside the United States.

Senator GORE. Which includes salary, bonus, commission, fees.

Mr. COHEN. Any form of compensation for services rendered.

Senator GORE. What other forms do they take? Commissions, fees, bonuses, salary?

Mr. COHEN. Well, you have pensions. The problem that exists in addition to the type of compensation is with respect to a person who is in a business and who has income from a mixture of capital assets in which he has an investment and from services. There is a special rule with respect to income from businesses in which capital is a material income-producing factor. There has been such a rule in the statute for a good many years dealing with a proprietorship, for example, in which the man is not a salary-earning employee but just has profits from his business; you have to determine what percentage of his income from the business is going to be counted as earned income and what is to be counted as income from an investment.

50-PERCENT CEILING ON EARNED INCOME

Senator GORE. Well, for purposes of the 50-percent ceiling on earned income what would be the definition with respect to the self-employed, or to proprietorship of a business?

Mr. COHEN. I think that in the bill we would use precisely the same definition as has been used in determining earned income of a sole proprietor in a business overseas. The definition is in section 911(b), and it includes wages, salaries, or professional fees, other amounts received as compensation for personal services actually rendered. It does not include that part of any payment to him by a corporation which represents a distribution of earnings and profits rather than a reasonable allowance as compensation for personal services. The latter point would be involved where a person was a sole stockholder of a corporation and received a payment designated as compensation which exceeded a reasonable amount for his services. This provision gives the Commissioner of Internal Revenue the authority to say that the amount above the reasonable portion would be treated as a dividend and would not be earned income.

The section goes on to say that in the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, under regulations prescribed by the Secretary or his delegate, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 30 percent of his share of the net profits of the trade or business, shall

be considered as earned income. That is the provision that I was referring to.

Senator GORE. Let us come to something specific. Let us take the case of a subchapter S corporation that turns out to be very profitable. Let us take the case of one with which I am familiar. Three partners started out as a partnership and later formed a subchapter S corporation. They draw salaries. They devoted a good deal of time and attention to the business, and their salaries usually, plus the bonus, approximate the earnings of the corporation. I see nothing in this rule, in this definition, to affect that. If the corporation makes a half million dollars a year they can easily draw $150,000 a year in salary and bonuses.

Mr. COHEN. As long as it is reasonable compensation for services. Now, you have to make that determination with respect to a corporation generally. It would not be necessary ordinarily to make the calculation with respect to a subchapter S corporation, I think, because the individuals are subject to tax on all of the income of the corporation whether they take it out as compensation or whether it is just taxed to them as their undistributed share of the corporation.

Senator GORE. The salary part is not so regarded, is it?

Mr. COHEN. No; the salary will be a deduction. But, for example, if I owned all the stock of a subchapter S corporation, the company made a hundred thousand dollars of net profits before salary, I don't think it makes any difference in that case, whether I take the hundred thousand dollars out as salary or whether it is just taxed to me as my undistributed share of the company's profits. I will still pay tax on ordinary income of a hundred thousand dollars.

There are cases in which it could make a difference. For example, if it is not a subchapter S corporation. In such a case, the Commissioner of Internal Revenue may assert that $100,000 is an unreasonably high salary for me. He might say that my reasonable compensation is only $50,000; the other $50,000 will not be a deductible expense to the corporation but will be treated as a dividend to me. I will still pay tax on it, but the company won't be able to deduct that other $50,000. Thus, for the regular corporations there is a requirement for determination of reasonable salary because no deduction may be taken beyond a reasonable salary.

Senator GORE. Well, now, take the hypothetical case I give you, which is not far from an actual case. Three taxpayers are the sole owners of a subchapter S corporation. They devote about an equal amount of time to the business. They draw a salary of a hundred thousand dollars each. The corporation has earnings after salary, net of $200,000. And before the end of the fiscal year, let us suppose that the owners declare for themselves a bonus for personal services of $50,000 each. This represents $150,000 for personal services. I see nothing by this definition or by the terms of the bill that would require them to pay a rate in excess of 50 percent.

Mr. COHEN. The requirement is contained in the language of the definition of earned income in section 911(b) that earned income does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allow-

ance as compensation for the personal services actually rendered. So the 50-percent rate would be limited to an amount which is considered a reasonable allowance for personal services actually rendered, and this is no greater problem than exists with respect to corporations that are not under subchapter S.

There are already provisions in subchapter S with respect to underpayment of salaries. The problem exists in the situation where one of the stockholders of the subchapter S corporation you mentioned gives half of his stock to his children. Now, assuming that is a valid and completed gift, under subchapter S if the individual doesn't draw that salary or bonus, these amounts would be taxed to the children because they are the stockholders.

Now, to control this opportunity for shifting income, subchapter S has a provision regulating a person who is managing the venture, like the father in my example, to alocate to himself a reasonable salary or compensation for his services rendered. Thus, problems exist in a number of different directions in subchapter S and in closely held companies, and while problems would exist in this case with the 50-percent limit on earned income, they would not be novel problems. The bill itself would limit the benefits of the 50-percent ceiling to amounts which are reasonable for the services rendered.

For example, if the individual in question is not really running it but is only a stockholder and someone else is running it he would get no benefit from it. There is always a difference of opinion as to reasonableness of salaries, but that is a problem we have to live with in the law as it now reads.

Senator GORE. Well, I bring up the subchapter S corporation, which I judge may be, if not isolated at least minor in the bróad scheme of things, to illustrate the invitation which this provision affords for a mushrooming of corporate salaries of all sorts.

Now, I think this bill is an open invitation for corporate officials, particularly those who are in a position of control, to engage in an orgy of corporate salary executive increases and bonuses, and you have no rule, at least no feasible rule, for a major corporation to use in deciding whether or not the officers of one of the big steel companies—well, say, Bethlehem Steel—you have, so far as I know, no yardstick of reasonableness that would prevent the top 10 of Bethlehem Steel from receiving enormous bonuses which would really be denying a larger dividend to the stockholders, but which, in fact, would be given to the officers, plus their salary and bonuses, on which they would have to pay only a 50-percent tax rate.

Mr. COHEN. Senator, I am aware of the problems you raise, but there are some limits on reasonableness. The corporation may not deduct on its income tax return more than a reasonable salary.

Senator GORE. Or bonus.

Mr. COHEN. Or bonus.

Senator GORE. Or commission.

Mr. COHEN. Pardon?

Senator GORE. Or commission or fees.

Mr. COHEN. Yes. But the deduction to the corporation in section 162 with respect to compensation says that the corporation may deduct a reasonable allowance for salaries or other compensation for personal services actually rendered. That is the basic rule.

Senator GORE. Has the Treasury in its history ruled a salary or bonus of Bethlehem Steel or IBM or United States Steel to be unreasonable?

Mr. COHEN. I can't tell you with respect to those specific companies, Senator, but there have been a number of controversies involving this provision. I think in the case of publicly held corporations where the officers are not shareholders to any large extent this problem has not been raised, but there have been public suits over compensation of officers of large corporations, particularly where it is pursuant to a contract entered into when the company was in an unprofitable position. The company might have hired an executive and said, "You can have 5 percent of the profits for the indefinite future." Then those profits might have grown enormously, and in some instances the arrangements have been challenged in stockholder suits.

I don't think the Internal Revenue Service can judge whether the executives of the largest corporations are properly compensated at a $200,000 level or a $400,000 level. I do think that, in my experience, the finance committees of directors of large corporations do look to see what is customary and standard in the industry, and I think if it were an unconscionable amount in relation to what is paid by other companies in that industry the Internal Revenue Service itself would challenge it.

Senator GORE. I think if we leave this provision in you will see a wave of unconscionable salary increases for corporate executives.

Mr. COHEN. Well, as I suggested this morning, if the committee should desire it could say that it will put a ceiling of the dollar amount that could be regarded as earned income under this provision.

Senator GORE. What would you suggest?

Mr. COHEN. Well, I am not prepared to——

Senator GORE. My secretary gets to the 40-percent bracket on $26,000 salary. Now how far above that would you think the ceiling ought to be?

Mr. COHEN. Well, you and I differed as to what all of the considerations were this morning, but——

Senator GORE. I didn't think we did.

Mr. COHEN. Well, I thought we were differing a bit. I think I was trying to urge on you that the important thing is the effective rate of tax rather than that marginal rate of tax. But let me say——

Senator GORE. We didn't disagree on that. These are two ways of looking at the same problem.

Mr. COHEN. Yes.

Senator GORE. But I am referring now to the marginal rate on that $26,000 that my secretary earns. There is an applicable rate of 40 percent.

Mr. COHEN. Yes.

Senator GORE. On the $38,000 that a corporate executive earns, he reaches the 50-percent bracket and thereafter you have no progression, no graduation. It stops right there. Only 10 percentage points different.

Mr. COHEN. Let us take a married person because——

Senator GORE. Let us take the one I have given you first.

Mr. COHEN. I will. I think you get it in a better setting with respect to persons in that range if you consider married persons because I

think most of those upper bracket persons that would be affected by the 50-percent limit would be married persons. You can take it either way, but I noted that under the bill a single person would exceed the 50-percent bracket at $38,000, but the married person would not exceed it until $76,000.

Senator GORE. Well, let us take that, then.

Mr. COHEN. That is $76,000 of taxable income and a person in that category would normally have on the average about 20 percent of his income offset by personal deductions so there is a person in the $80,000 to $100,000 gross income range.

Senator GORE. Well, let us take your example. Senator Bennett has now entered the committee room and it is his turn, but if he will pardon me I would just like to complete this, and then I will yield to him.

Let us take this case. Suppose this lonely secretary does get married, but her husband has no income, he keeps house. Now, when would their joint income reach the 40-percent bracket?

Mr. COHEN. The 40-percent bracket would be reached at $32,000 in the new rate schedule and that would be with deductions somewhere in the $35,000 to $40,000 compensation range ordinarily.

Senator GORE. Well, staying again with this example which you provide——

Mr. COHEN. The tax though at that level, sir, is about $8,200 in relation to roughly $40,000 of compensation, that is somewhere above 20 percent effective rate.

Senator GORE. Well, assuming the example you gave, a married couple without deductions would reach the 40-percent bracket with an income of $32,000. The corporate executive, married, likewise without deductions, for purposes of this example, would reach the 50-percent bracket at what level of income?

Mr. COHEN. Well, he reaches it at $64,000 but he goes over it at $76,000. So that is the reason I gave you the figure of $76,000.

Senator GORE. So between $32,000 and——

Mr. COHEN. It goes over 40 percent at $18,000 for a single individual or $36,000 for a married person, and it goes over 50 percent at $76,000 for a married person, as compared to $38,000 for a single person.

Senator GORE. So from $36,000 to $76,000 there is progressivity of 10 percentage points.

Mr. COHEN. Yes, sir.

Senator GORE. And from there progressivity stops entirely. We then repeal the law of progression, the principle of the graduated income tax. I say to you this is utterly indefensible. I will oppose that but will not deny you the privilege to reply in any way you would like.

Mr. COHEN. Well, Senator, if you wished to carry out complete progressivity of the rates, you could go all the way to a hundred percent. We do get to the point where with respect to services, for the reason that I mentioned this morning, inordinately high rates may cause a person to spend more time trying to figure out some of the incentives in the law than he does concentrating on his work, and you have a substantial disincentive effect for a person who is earning money if you are taking 70 cents out of every dollar that he earns.

Senator GORE. If we are going to give recognition and preference to

earned income for the high brackets, I am going to insist that earned income for the low brackets, for all brackets, have it, too.

Senator Bennett.

TAX EXEMPT ORGANIZATIONS

Senator BENNETT. Thank you.

You have been dealing with these global problems, let us go down and talk about some rather unimportant ones, simple ones. I know that in the bill as it came from the House the exemption in the present law which exempts churches from making tax returns has been eliminated. They have to file an annual return stating specifically the items of gross income, receipts and disbursements, and such other information as the Secretary or his delegate may by forms or regulations prescribe. Don't you think this is a rather purposeless so far as the Government is concerned, but rather drastic change in the tax law? Don't you think this is something under which this committee could well return to the existing law?

Mr. COHEN. Well, we are putting a tax in this bill, Senator, on the unrelated business income of churches. There have been a number of instances in which churches are carrying on active business operations. Now we would plan by regulation to exempt large groups of organizations from this requirement. We would not want to put the churches to the expense and difficulty of filing those returns. The law provides that the Secretary or his delegate may relieve any organization required under this provision to file an information return from filing the return if he determines that such filing is not necessary to the efficient administration of the Internal Revenue laws.

Senator BENNETT. That is putting a lot of responsibility on the Secretary because I can conceive of a situation where one group which calls itself a church is exempted but another group is not. Shouldn't you require the churches to file returns on their unrelated business income rather than their entire income?

Mr. COHEN. They will have to do that, sir. If a tax is put on their unrelated business income, then it is clear they will have to do that.

Senator BENNETT. Then why should they have to account to you for their income which is related solely to their activity as a church?

Mr. COHEN. Well, I don't think we want that information, but I am not familiar with all of the reasons that went into this. We certainly don't want a flood of useless tax returns which we are not going to act on, but I assume that this was asked for in order that we would have the power to request returns of particular types of organizations that might be needed to enable us to determine whether an activity was exempt or not exempt.

Senator BENNETT. This committee has an interesting precedent to look back to. When we wrote the social security legislation, the committee decided that the division between church and State was so clear that we could not compel ministers to come under social security. I think that separation still exists. I don't think we should compel churches to file returns of their income which has nothing to do with taxable activities, and I would hope that you could help us prepare language which might satisfy you. I would think the Secretary would not want this responsibility as an individual because there might be

circumstances under which he might ask for information and thus be accused of an antichurch bias or a bias against one church as compared to another.

Mr. COHEN. We would be happy to review this, Senator. We have no desire to get information beyond what is necessary for the administration of the law.

Senator BENNETT. You are interested in information where a tax might conceivably be involved.

Mr. COHEN. Yes.

DEPLETABLE RESOURCES

Senator BENNETT. That is fine.

My other subject takes us back to this depletion problem about which we had so much discussion this morning. There is another aspect of depletion which is not involved directly in the law but is certainly related to it, and that is the definition of the cutoff point. I understand you inherited a set of semifinished regulations which would have set a pattern of cutoff points, and this has left the depletable industries, many of them, up in the air. I hope we don't have to in this bill attempt to write a pattern of cutoff points, but the pressure will be on us unless these regulations or in some cases some slightly different regulations are issued. We got into that cutoff point problem when we were talking about oil shale. That is vital in the oil shale problem. Can you give us any information as to what prospect there is that these regulations will be available?

Mr. COHEN. Well, we have been so occupied with the tax reform bill itself, Senator, that we have not been able to complete our work on this as yet, but we would expect to be able to advise the committee before we get into executive session of what position we will take with respect to the existing situation. I don't think that we would be able to give you our recommendations for the long-range future at that time. We would like to consider the cutoff problem in the future and present our recommendations to you, but we think that is a matter that requires more study than we have had now.

Senator BENNETT. I think you are always entitled to a second look.

Mr. COHEN. Yes.

Senator BENNETT. No question about it. But for the benefit of these industries, including the oil shale industry, I hope you can save us from the pressure we will get from an attempt to write cutoff patterns into the depletion section of the law.

Mr. COHEN. What I hope to be able to do would be to tell you before the close of the public hearings or before the start of the executive session what our position will be with respect to pending cases and the current year, and if we are to make recommendations for long-range changes, we would make them to you at a later date.

Senator BENNETT. I think if you could handle the current pressing cases, that would go a long way to relieve us of the pressure.

I have no other questions.

I suddenly find that the Republicans have taken over the committee. We will declare a dividend. [Laughter.]

Senator CURTIS. Mr. Chairman, is a motion in order? There are one or two sections I would like to strike out of the bill. [Laughter.]

I have a few questions, but I want to say to you gentleman that I have admired the way you have responded to questions. You have been most helpful and most cooperative. I really mean it. Your appearance here has been fine.

FARM LOSSES

The first question is this: Take the case of a farmer who has substantial nonfarming income and who devotes his principal efforts to farming, fully striving for a profit, but he suffers continuous losses. How is he affected by the bill that the House passed?

Mr. COHEN. You are assuming that he is a professional farmer and doesn't have a hobby loss?

Senator CURTIS. His primary business is farming. He may live on the farm, or he may reside in the town which is becoming more prevalent, but his sole business, so far as his time and attention is concerned, is in his farming or ranching business.

Mr. COHEN. We can assume he is in business for a profit?

Senator CURTIS. Yes; he is fully striving to make a profit and we will assume he does have outside income and he suffers some heavy repeated farm losses.

Mr. COHEN. It wouldn't affect true economic losses due to drought or tornado or cyclone or whatnot.

Senator BENNETT. Low prices?

Mr. COHEN. Low prices, yes; anything that is a true economic loss.

The problem in the farm area, Senator, has come from the fact that there has been a favorable method of accounting intentionally given to the farmers to enable them to treat as a deductible expense purchases of fertilizer, feed, and so on.

Senator CURTIS. Aren't they truly expenses of doing business?

Mr. COHEN. Well, if they are expenses of producing a crop, the expenses ought to be included in the same tax return in which the income from the sale of the crop is included.

Senator CURTIS. Yes.

Mr. COHEN. In the case of expenses to raise cattle, the question would be whether he can properly deduct against his outside income the expense of raising the cattle and then sell the cattle at a capital gain.

Now, our provisions in this bill, assuming——

Senator CURTIS. First, what does the House bill do?

Mr. COHEN. Well, the House bill does essentially what we recommended.

Senator CURTIS. I see.

Mr. COHEN. But it puts in another limitation. The House bill provides, that if a farmer has more than $50,000 of adjusted gross income off the farm, nonfarm income, and he suffers losses from the operation of the farm in excess of $25,000, then the losses above $25,000 will be recorded in an excess deduction account (EDA). If he has capital gains thereafter in subsequent years from the sale of the livestock——

Senator CURTIS. Or the land?

Mr. COHEN. No; generally not the land, just from the sale of the livestock or if he were to sell an orange grove which he had grown and deducted expenses of growing the trees. To the extent that he has

a capital gain on the subsequent sale, it will have to be treated as ordinary income until these excess losses that are in this particular account have been made good.

Now, this provision does not disallow his deduction for the losses that he is incurring. It just says that if he has high outside income and he has extraordinary losses year after year, he can take the losses now, but later when he sells the cattle, he must treat a portion of his capital gains as ordinary income.

Senator CURTIS. Now that is true even though his primary business activity is farming?

Mr. COHEN. Yes; that is correct.

Senator CURTIS. Now, do we treat any other occupation that way?

Mr. COHEN. Well, Senator, I was asked that question on the House side. Someone said to me, "Isn't that discriminatory, you don't do that with respect to the owner of bowling alleys," and I said that the difference is that bowling alleys don't have little bowling alleys, which are born with a zero cost because all the expenses have been deducted, and which can be sold at a capital gain. We do this with respect to other businesses where a business buys a depreciable asset, deducts depreciation against ordinary income, and then sells the asset at a profit for a price above the depreciated cost. We would insist upon recapture of the depreciation. To the extent of the depreciation deducted, the profit would be ordinary income, rather than capital gains. That is in existing law.

Senator CURTIS. You are talking about what is in this bill or present law?

Mr. COHEN. Present law.

Suppose you go out and buy an asset for, say, $3,000 and begin to depreciate it over its normal useful life. After having written off $1,000 of depreciation so that its basis is down to $2,000, you sell it for $3,000. Since you have deducted $1,000 against ordinary income, you would have to treat that $1,000 profit on the sale as ordinary income. The difference with respect to cattle that you raise yourself, born on the farm, all the expenses of the feed and care of the herd has been written off against ordinary income so that the new-born animal comes into life with a zero cost. Under present law, the herd may be culled in situations where the law allows a capital gain, and the cattle sold will yield the farmer a capital gain, although he has deducted the expense allocable to the raising of the cattle against ordinary income.

The House provision wouldn't affect the farmer who is growing crops or vegetables. He is deducting expenses, true, but, when he sells his vegetables or his crops, they are ordinary income and he is not getting a capital-gain benefit.

The House provision would only apply where capital gain is being taken on the sale of the livestock or orange groves.

Senator CURTIS. How are capital losses treated in reference to livestock?

Mr. COHEN. I think they would be ordinary losses. Under existing law, if you raise cattle for sale to customers, you would have ordinary income. It is only in the cases where you are culling a herd, do you get capital-gain treatment.

If you raise cattle for the purpose of sale it would be treated the same as in the case of crops.

Senator CURTIS. Then it is true that the farmer whose primary business is farming, who is striving for a profit, and who has substantial outside income can be penalized for not making a profit?

Mr. COHEN. Well, he is not penalized for not making a profit under this provision. He can deduct his losses in full as far as this provision is concerned, and he comes out even in the end, as we see it. We see this as no penalty. We see this as not allowing him the special capital-gains rate on the sale of the livestock to the extent that he has had particular benefit from the deduction earlier of the expense of raising the livestock.

Now, there is another provision that is involved to which you may be referring, Senator.

Senator CURTIS. The hobby farm provision.

Mr. COHEN. No; beyond that with regard to the hobby farmer. The farm loss is calculated on a cash basis. We are not speaking of the real economic farm losses such as from drought or low prices, as Senator Bennett says, but of losses because of the use of the cash method of accounting. We treat this as one of the total, one of the list of preferences in our limit on tax preferences.

For example, if a man had a hundred thousand dollars of outside income, this would not disturb him unless his preferences amounted to $50,000, so if his farm——

Senator CURTIS. Capital gains.

Mr. COHEN. No; we are not speaking of gains now, we are speaking this time of net farm losses in a year.

The other provision speaks in relation to capital gains. This speaks only in terms of the farmer's net loss and would not involve capital gains. This time I am assuming a man with a hundred thousand dollar income. If he had a $50,000 farm loss, and no other preferences from depletion, accelerated depreciation on real estate investment and so on, we would not disturb him unless his farm loss exceeded $50,000, half his income.

But if his farm loss was $60,000 and his net income was $40,000, we would say that he would have to pay tax on one-half of his income or $50,000 that year. We would give him a 5-year carryforward so that if this just happened one year and on the average he were under 50 percent for 5 years he wouldn't be affected.

Senator CURTIS. What is the minimum figure you go down?

Mr. COHEN. With respect to this provision we only make the adjustment if it exceeds $10,000. In the case of the small farmer, say someone with under $20,000 of outside income, it would not affect him at all.

Senator CURTIS. By his economic losses you mean the ordinary and necessary expenditures made to carry on the farming or ranching operation.

Mr. COHEN. We don't think this is likely to be applicable in many cases, Senator. With respect to the provision about capital gains that I mentioned to you before, we recommend that it apply where outside income is $25,000 and the farm loss exceeds $15,000. The computer run

that we have made indicates that the provision would apply only to 9,300 persons in the country and that those 9,300 persons have an average farm loss of almost $45,000 apiece.

Senator GORE. Would the Senator yield?

Senator CURTIS. Yes.

Senator GORE. I am fairly familiar with the tax returns of a farmer who was reared on a farm and still does have a farm but who engages in other activities and has other income. He has had fairly profitable years, but in 1 year because of a combination of drought and brucellosis and a few other bad, unlucky streaks, he had a loss of $51,000. How would your rule affect that?

Mr. COHEN. Well, we would allow a 5-year carryforward, and I would assume that on a 5-year basis it would not affect him.

Senator GORE. Well, assume a man quit after such a year.

Senator CURTIS. Does he have a carryback as well as a carryforward?

Mr. COHEN. No; he only has a 5-year carryforward as we have drawn it.

Senator GORE. There are not too many people who can stand a $51,000 loss—he might go out of business.

Mr. COHEN. Our excess deduction account would not apply in such a case unless he had subsequent capital gains from the sale of the cattle.

Now, I don't know in the case that you put, I don't know whether when he went out of business he had a capital gain on the sale of a herd or not, but if he did——

Senator GORE. This particular farmer didn't go out of business but he may have.

Mr. COHEN. Well, the excess deduction account only applies to the extent that after taking a $51,000 loss, a person in a subsequent year has a $51,000 capital gain from the sale of cattle.

Senator CURTIS. Does this apply to corporations as well as individuals?

Mr. COHEN. The capital gain provision involving the taking of ordinary losses and then realizing capital gains would apply to corporations as well as individuals. The limit on tax preferences only applies to individuals.

Senator CURTIS. The tax preferences comes into play when he has outside income?

Mr. COHEN. Yes.

Senator CURTIS. So a corporation can create a separate entity for a farming operation?

Mr. COHEN. Well, the corporation couldn't deduct the farming expenses against its ordinary income and then claim capital gain on the sale of the cattle any more than an individual could. The same rules would be applicable both to corporations and to individuals.

FARMERS NOT MAKING MONEY

Senator CURTIS. I think, and I am not applying this to the Treasury, that among nonfarming people there is a great misunderstanding about

the economic status of farmers at the present time. They are not making money. Some of them are living off the depreciation allowances. I have in mind one rancher, who is a rather large operator.

He operates a ranch that would sell for around a half million dollars. He keeps his books accurately, and if he allowed himself a salary for last year, he would get no return on his property investment.

Also, we do not always operate in a rising price situation. I know of ranchers in their middle fifties who had cattle that they may have purchased or otherwise acquired that were worth $300 a head and now are worth about a hundred dollars a head. There may be a few isolated cases of very grave abuses by people using farm losses, but I think there is a very great misunderstanding as to the economic position of agriculture.

Mr. COHEN. Well, this provision, Senator, is intended to apply to the abuse cases, and I think that this is indicated by the fact that our computer runs show that the excess deduction account provision applies only to 9,300 people.

Senator CURTIS. Does the bill do anything with the general provisions for the capital gains treatment?

Mr. COHEN. This provision changes the holding period in that the holding period, now 1 year, would start running from the time that the animal is normally placed in service rather than from the time of birth.

Now, the present law has a 1-year holding period from the time of birth, and I said to Senator Miller yesterday when he inquired that since we had recommended returning to the 6-month holding period for securities and real estate and other assets, we would be willing to accept 6 months after the time the animal is normally placed in service rather than 1 year after that time.

Senator GORE. Would the Senator yield?

Senator CURTIS. Yes.

Senator GORE. I apologize for asking the Senator to yield but this is an informative session and I am particularly interested in this.

I would like to know what you mean by "in serivce." I take it in the case of cattle you would mean when the animal is impregnated or used for the purpose of breeding. What do you mean in the case of a walking horse, in the case of a saddle horse, in the case of a purebred racer?

Mr. COHEN. Well, I am, Senator, over my depth when we get to discussing this with respect to specific types of animals. What we were trying to do was to solve the problem of determining whether the animal is really held for sale, in which event the profit would under existing law be treated as ordinary income. If the animal is held for breeding purposes, the profit would be entitled to capital gain treatment.

Senator GORE. As you know, or as you may or may not know, my State is the center of the walking horse industry. The State just north of me is the center of purebred racers. Many of both these groups have called upon me and I would really like to know precisely the meaning of this term "in service."

MEANING OF THE TERM "IN-SERVICE"

Mr. COHEN. Well, the actual language in the statute says, in the case of property used in a trade or business which can be sold at a capital gain, "such term also includes livestock, regardless of age, held by the taxpayer for draft, breeding, or dairy purposes, and held by him for 12 months or more from the date of acquisition." That is existing law.

The bill would change that language to say, "such term includes livestock, regardless of age, held by a taxpayer for draft, breeding, sporting, or dairy purposes, but only if held by him for at least 365 days after such animal normally would have first been used for any of such purposes." So in the statute, the question would be at what age would the animal normally be first used for draft, breeding, sporting, or dairy purposes.

Now in breeding, this would be when the animal is normally bred, and in sporting, I assume it would mean when the animal is first normally used for sporting purposes.

Senator GORE. Well, now, does that mean riding a horse for sporting pleasure or in a race for competition?

Mr. COHEN. I think that it would normally mean in competition but not in training.

Senator GORE. I apologize to the Senator.

Senator CURTIS. That is all right.

Mr. COHEN. But the point was that up until that moment of time there is no means of knowing whether an animal has been raised for one purpose or the other. Now, in the securities market, for example, there is a comparable problem with respect to the investment banking firms that may underwrite certain securities. The securities they acquire on an underwriting will, if sold, produce ordinary income and ordinary loss deductions, but if they bought the security for investment purposes, any gain or loss would be capital gain or loss. There is a problem of knowing for what purpose the particular asset has been held, because unless you have some rule, the taxpayer will regard it as an investment asset, if he sells it at a gain in order to have a capital gain. He will naturally regard it as a business asset if he has a loss in order to be able to deduct the loss as an ordinary loss.

What we are trying to see is whether there is some way in this livestock area to determine the purpose for which the animal has been held, and you can't do that until there is a commitment.

At some point the owner has to make up his mind whether he wants to hold the animal for sale or to hold him for breeding or sporting purposes. And until the animal reaches the right age, the owner doesn't have to commit himself.

HOBBY FARMING

Senator CURTIS. Now, I have a question that is somewhat related. What is hobby farming and what is it you propose to do about it?

Mr. COHEN. The hobby-loss provision in the existing law is a highly technical one and applies——

Senator CURTIS. Are there any changes in this bill?

Mr. COHEN. Yes. What we have done is to provide for a rebuttable presumption. The bill provides that if the deductions attributable to an activity exceed the gross income from such activity by $25,000 or more; that is, there is a loss of $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.

Senator CURTIS. What would be an example of hobby farming?

Mr. COHEN. Well, in a case in which there are farming losses in excess of $25,000 in 3 out of 5 consecutive years, the fact that there are such continuing losses would create a presumption, a rebuttable presumption, which the taxpayer could overcome by showing that he intended to make a profit, but due to drought or low prices or other misfortune he had not been able to make a profit.

Now, we have said in our recommendations to you, Senator, that in order to make clear that the provision is not intended to apply to legitimate business operations we recommend that the term "profit" be specifically defined to include not only immediate economic profit but also any reasonably anticipated long-term increase in the value of property.

For example, if you were raising a herd of cattle, you could take into account the increase in the value of your herd and not just the sales that have currently been made.

Senator CURTIS. Is this intended to reach the taxpayer who chooses to live in the country, has quite an acreage, and likes to see cattle and sheep grazing around; and so he goes into the operations on a very uneconomic basis hiring help to take care of it, but under normal circumstances couldn't expect it to pay?

What you are saying is that if he does this for pleasure, that is what a hobby is, he can't charge the losses off against other income. Is that all it is?

Mr. COHEN. Yes, that is correct, Senator. Presumably the business farmer, the professional farmer, cannot continue to survive year after year unless he is going to have a profit. But the provision is not directed solely to farming. We are talking about what may be a country estate, as you say, in which farming for profit is not the real purpose. It would also apply to racing cars and other activities.

Senator CURTIS. What about the professional man in the city, he gets an idea that he can make a killing in the cattle field and he goes into it on a one-shot basis for 1 year and he burns his fingers. Instead of making a lot of money he loses a couple of hundred thousand dollars. He quits. Is he a hobby farmer or is he affected by any of these rules—and frankly I am not too concerned about it, I am concerned about a genuine farmer—but for my information I want to know, is that individual precluded from charging his losses against other income?

Mr. COHEN. Well, there are at least three ways in which he might be affected under this bill. There have been a lot of syndicate participations sold in this area in which, with respect to cattle and livestock, people have been induced to enter on the basis of being able to deduct the expenses against ordinary income and have a capital gain on the

sale of the livestock. That has been limited severely by the provision of the House bill.

We think that if such a man had losses of more than $15,000, his right to take his capital gains ultimately should be eliminated until he made good those excess losses.

Also if his loss in any year exceeded a half of his income, his other income, he would be cut back unless on a 5-year carry forward he could be excepted. But if the man to which you refer were not affected by those provisions, the answer would depend upon whether he reasonably intended to make a profit or not. I don't think this presumption would apply because he doesn't have a record of at least 3 years of $25,000 loss or more and we would be back to the basic issue that the Internal Revenue Service has of whether this transaction was entered into for profit or whether it was just a pleasure item.

Senator CURTIS. I have run over my time but I would like to propound two questions and you can supply the answers for the record.

FOUNDATIONS

What evidence do you have, if any, that foundations whose assets are such that the House bill would require divestiture, including foundations that are the sole owners of businesses, operate less in the public interest for truly charitable purposes than foundations generally.

I don't want you to answer it now but if there are any special abuses in this area, I would like to know it.

I am not trying to shut you off, and in fairness to my colleagues I will not ask you to answer. But what does your proposal prescribe in the case of a foundation which is the sole owner of an operating corporation being required to divest if such divestiture would run into an antitrust suit?

I know of an instance or two where I just don't think it could be sold other than to a rather monopolistic situation but if you will answer that I would appreciate it.

Secretary KENNEDY. We will try to supply the information, Mr. Chairman.

Senator CURTIS. That is all.

(The Department of the Treasury subsequently supplied the following information. Testimony continues on p. 737.)

The House bill provides for a period of time to divest existing business holdings, 10 years subject to the satisfaction of interim 2-year and 5-year requirements. We believe that this time would ordinarily be adequate to find a buyer without the necessity of having to sell to a competitor. However, we would be glad to explore the need for additional time if this is required in specific situations which are brought to the committee's attention.

The adverse consequences of foundation ownership of business interests have been described in the Treasury's General Explanation of its Tax Reform Proposals to the Ways and Means Committee beginning at page 5326 in Part 14 of Hearings before the Committee on Ways and Means, House of Representatives, 91st Cong., 1st Sess., on the subject of Tax Reform.[1]

A description of specific abuses will be found in the 1965 Treasury Department Report on Private Foundations beginning on page 30.[2]

---

[1] Page 726 of this book.
[2] Page 729 of this book.

[EXCERPT FROM THE TREASURY DEPARTMENT'S GENERAL EXPLANATION OF ITS TAX REFORM PROPOSALS TO THE WAYS AND MEANS COMMITTEE, 1969]

### 3. FOUNDATION OWNERSHIP OF IMPROPER BUSINESS INTERESTS

*Present law*

Present law contains certain restrictions upon the direct operation by a foundation of a trade or business that is not related (aside from the need for funds) to its charitable purposes. In general, a foundation may not be organized or operated for the primary purpose of conducting an unrelated trade or business. Furthermore, the income from the regular conduct of an unrelated trade or business is subject to tax under the provisions of the unrelated business income tax. In general, there are no limitations upon conducting an unrelated trade or business through the ownership of a controlling interest in a separate corporate entity.

*The problem*

Adverse consequences resulting from foundation ownership of business interests arise in two distinct contexts: (1) foundation ownership of controlling interests in businesses and (2) foundation ownership of *any interests* in donor controlled businesses.

(1) *Foundation Controlled Businesses.*—Foundation ownership of controlling interests in businesses is detrimental to charity, unfair to competitors, unhealthy for the national economy and inimical to the prescribed limitations on activities by charitable organizations. Charity suffers because substantial responsibilities are imposed upon foundation management to the detriment of their fundamental responsibility to further charitable activities. For example, a heavy investment in a business often imposes a responsibility to provide additional financing in times of difficulty. Such a use of funds may make good business sense, but run counter to the interests of charity which would indicate use of the funds for charitable purposes. These additional responsibilities may, in some cases completely overshadow the responsibilities of exclusive devotion to charity, thereby tending to cause that management to lose sight of the fundamental nature of a foundation as a charitable organization. The Treasury Department Report on Private Foundations (p. 30) contains several examples of foundations owning controlling interests in numerous diverse businesses and in businesses of substantial size. In addition, the Sixth Installment of Congressman Patman's study of foundations entitled *Tax Exempt Foundations and Charitable Trusts: Their Impact on Our Economy*, contains substantial information on the extent of business involvement by 596 surveyed foundations. Some of the results of that survey are summarized in Tables 3 and 4. In many of these cases it appears that the obligation of exclusive devotion to charity is interfered with by the obligation to successfully operate substantial business interests. On the other hand, the responsibilities to a business in which the foundation has invested heavily can be sharply contrasted with the responsibilities involved in the proper management of a passive investment portfolio. In this latter case, the only responsibility is to retain or dispose of the investment as the financial interests of charity dictate. It would seem that the interests of charity are best preserved by limiting income production to investment portfolio management thereby eliminating the additional responsibilities to a business in which the foundation is heavily invested.

Taxpaying competitors suffer because control permits a tax exempt organization to provide advantages not available to a business owned by taxpayers. A foundation can supply capital to its corporation from a source undiminished by tax. Thus, a foundation is in a position to make loans and contributions to the capital of its corporation out of its income in larger amounts than would be possible without its tax exemption. To this extent the tax exemption of the foundation contributes to the competitive ability of the owned corporation to the detriment of businesses owned by taxpayers.

The national economy suffers because foundations provide a unique vehicle for the permanent separation of business management from shareholder scrutiny. Where the foundation and business management are the same, there are no shareholders to judge the adequacy of business management, approve or disapprove of management activities and, in general, provide a governing or supervisory force. The existence of such autonomous corporations, divorced from periodic shareholder scrutiny, would not appear to be in the best interests of a healthful national economy.

Finally, the statutory restrictions upon activities by charitable organizations are eroded by ownership of a controlling interest in a business. For example, while a foundation may not directly engage in substantial efforts to influence legislation, foundation owned businesses may do so. Thus, inherent difficulties arise when the obligation of exclusive devotion to charity and the operation of ordinary commercial enterprises are vested in one managing body.

On the other hand, these undesirable consequences are substantially reduced or nonexistent in cases where, no matter what the magnitude, the foundation's stock ownership does not constitute control of the business entity. For example, the responsibilities imposed upon foundation management in connection with the ownership of a substantial block of preferred, nonvoting, stock in a corporation would seem to closely approximate the responsibilities of foundation management to any passive investment. Similarly, the danger of the existence of autonomous corporations, the likelihood of financial assistance and the possibility of indirect impermissible activities, such as lobbying, are substantially reduced or eliminated where control of a corporation remains in persons or entities other than the foundation. Where control resides outside the foundation there would be no reason to require divestiture of investments which the foundation management, in their judgment, considers beneficial to charity.

Furthermore, for many persons in a position to benefit charity through the establishment of a private foundation, a substantial block of stock is the only property available for that purpose. Where such an interest, can be reduced within a reasonable period of time to eliminate the problems of controlled businesses, the interests of charity would be unduly penalized by a rule absolutely foreclosing foundation receipt of such property.

*Proposal*

The seemingly conflicting interests of the detriments from controlling business interests on the one hand and the benefits to charity from the ability to receive such property on the other can be reconciled by a rule which would permit the receipt and holding of controlling business interests for a substantial period of time with a requirement of reduction by sale or contribution to a publicly supported charity at the end of that period. Under this rule, a foundation would be permitted to receive the contributions of any interest in a business, without limitation, but would be required, at the end of five years, to reduce its holdings to a point where it did not hold stock representing a controlling interest in a business. Existing foundations would be given 5 years from the effective date of this legislation to reduce their holdings. Control would be conclusively presumed by the ownership of more than 35 percent of the total combined voting power of the corporation. A stock interest of between 20 and 35 percent of the combined voting power would be required to be divested *only* if the foundation, in fact, exercised control. Under this rule no limitation would be placed upon the maximum business interests owned in the form of nonvoting stock or voting stock below 20 percent of the combined voting power.[1] Both interests in corporations and unincorporated businesses would be subject to this rule.

However, the percentage limitations, in the case of an unincorporated business, would apply to interests in the capital or income rather than the total combined voting power of stock. The detriments to which this rule is addressed arise only in connection with the exercise of control by a foundation over a business. Therefore, stock owned by the substantial contributor to a foundation, the creator of the foundation or other related persons would not be attributed to the foundation for purposes of this test. (See, however. the donor controlled business rule for attribution of stock held by a donor of stock to a foundation.)

Since the purpose of a five-year holding period is to permit *contributions* of business interests, it would not apply to the purchase of business interests in excess of the limitations. Such purchases would be prohibited. The five-year holding period will preserve the flow of funds to foundations by permitting the funding of foundations with business interests. On the other hand the required divestiture will insure that the undesirable consequences of business control by private foundations are eliminated.

Existing foundations whose governing instruments, as presently drawn, compel

---

[1] The donor controlled business rule, however, could have an effect on these holdings, as explained below.

them to hold specified business interests would be exempt from these rules, but only if local law prevents suitable revision of such instruments.

(2) *Donor Controlled Business.*—The ownership of an interest in a business which the donor controls involves distinct problems from those raised above. Severe conflicts of interest and doubt as to the real value of the interest transferred to the foundation arise in this context. In its most aggravated form the foundation is utilized as a device to maintain family control over a business while achieving income, gift and estate tax reductions for the donor. The family remains vitally interested in the corporation by virtue of its retained stock interest and, possibly, employment relationships. Where the family also controls the foundation an objective appraisal of the best interests of charity is interfered with by the conflicting interest of family members who own shares, look to the business for their livelihood, or both. For example, the decision as to the desirability of selling the donated investment can not be approached with the same degree of objectivity as the desirability of selling an investment in which the family has no stock or employment interest. Furthermore, the salary and dividend policy often involves conflicts between the interest of charity for lower salaries and higher dividends and the interests of the family for higher salaries and lower dividends. As in the case of self-dealing, the very situation imposes upon even the most scrupulous foundation manager a difficult, if not impossible, task of objectively protecting charitable interests and opens for the unscrupulous avenues for personal benefit to the detriment of charity. Even where conflicting interests are not present, by virtue of lack of control over the foundation, the real value to charity of the transferred business interest may be extremely doubtful.

In cases where the donated property consists of an unmarketable minority interest in a close family corporation, the extent to which charity will benefit *at all* remains almost entirely in the hands of the donor. The foundation can not realize any value through the sale of the interest and the extent to which it derives value through the distribution of earnings is wholly dependent upon the dictates of the donor.

On the other hand, as is the case with the donation of controlling interests in businesses, an interest in a close family corporation may be the only property available for funding a foundation. Where such an interest can be disposed of within a reasonable period of time to eliminate conflicts of interest and realize value for charitable purposes, the interests of charity would be unduly penalized by a rule absolutely foreclosing foundation receipt of such property.

*Proposal*

In order to permit the donation of property which will be beneficial to charity and yet preclude continued conflicts or donation of property of doubtful value arising in the context of interests in donor controlled business a foundation would be given five years within which to sell or contribute to a publicly supported charity *any interest* in a business controlled by a donor (or certain related persons.)

Foundations holding business interests of this type at the effective date of this legislation would be given 5 years from the effective date. A business would be considered controlled by the donor if his holdings of voting stock (and those of persons related to him) when combined with any voting stock of the foundation, constituted more than 35 percent of the total combined voting stock of the corporation. Since the problems here involve ownership of interests in business controlled by the donor, both voting and nonvoting stock owned by the foundation would be subject to the rule. Thus, divestiture of nonvoting preferred would be required if the donor controlled more than 35 percent of the voting power of the corporation. The same rules would apply to combined ownership of more than 35 percent of the capital or profits of an unincorporated business.

Finally, under both the foundation controlled and donor controlled business rules, extensions of the five year holding period could be secured from the Internal Revenue Service. Such an extension would not be granted solely upon the grounds of inability to sell the business interest since divestiture by contribution to a publicly supported charity would be available. However, extensions would be granted in cases where divestiture of the improper interest would have serious consequences on the market for the stock.

[EXCERPT FROM THE TREASURY DEPARTMENT REPORT ON PRIVATE FOUNDATIONS, 1965]

*(1) The existing situation*

A number of private foundations have become deeply involved in the conduct of active business enterprises. Ordinarily, the involvement takes the form of ownership of a controlling interest in one or more corporations which operate businesses; occassionally, a foundation owns and operates a business directly. Interests which do not constitute control may nonetheless be of sufficient magnitude to involve foundations in the affairs of businesses.

*Example 1.*—The A foundation holds controlling interests in 26 separate corporations, 18 of which operate going businesses. One of the businesses is a large and aggressively competitive metropolitan newspaper, with assets reported at a book value of approximately $10,500,000 at the end of 1962 and with gross receipts of more than $17 million for that year. Another of the corporations operates the largest radio broadcasting station in the State. A third, sold to a national concern as of the beginning of 1965, carried on a life insurance business whose total assets had a reported book value of more than $20 million at the end of 1962. Among the other businesses controlled by the foundation are a lumber company, several banks, three large hotels, a garage, and a variety of office buildings. Concentrated largely in one city, these properties present an economic empire of substantial power and influence.

*Example 2.*—The B foundation controls 45 business corporations. Fifteen of the corporations are clothing manufacturers; seven conduct real estate businesses; six operate retail stores; one owns and manages a hotel; others carry on printing, hardware, and jewelry businesses.

*Example 3.*—The C foundation has acquired the operating assets of 18 different businesses, including dairies, foundries, a lumber mill, and a window manufacturing establishment. At the present time it owns the properties of seven of these businesses. Its practice has been to lease its commercial assets by short-term arrangements under which its rent consists of a share of the profits of the leased enterprise. By means of frequent reports and inspections, it maintains close check upon its lessees' operations.

*Example 4.*—The D foundation owns a crude oil refining company to which it assigns a book value in excess of $32 million.

*Example 5.*—The E foundation controls a corporation which operates a large metropolitan department store. For its fiscal year ended January 31, 1963, the store reported gross sales of $78,395,052, gross profit of $32,062,405, and paid wages and salaries of $17,488,211. It stated the book value of its assets at that time to be $55,091,820.

*Example 6.*—Among the business interests owned by the F foundation is a substantial holding in a corporation which constructs machines for the manufacture of concrete blocks. The corporation has approximately 800 employees; its annual sales have ranged from $12 to $15 million in recent years.

These striking illustrations of foundation participation in business are not isolated phenomena, peculiar to a limited group of very unusual private foundations. On the contrary, the available information indicates that the involvement of foundations in business activities is frequent. Of approximately 1,300 private foundations recently surveyed by the Treasury Department, about 180 reported ownership of 10 percent or more of at least one class of the outstanding stock of a corporation. One hundred and nine foundations in this group own 20 percent or larger interests; [12] 40 hold 100 percent interests. Forty-three foundations reported that they possess 10 percent or larger interests in two or more corporations. A recent report on foundations states that, of 543 foundations studied, 111 owned 10 percent or more of at least one class of stock of a corporation.[13] Together these

[12] Further information about the business ownership of those foundations which have assets valued in excess of $10 million is set forth in Appendix A.

[13] Patman Report, 1st installment, supra, p. 8.

111 foundations held interests of not less than the described magnitude (most were in fact considerably larger than 10 percent in 263 separate corporations. In other cases, of course, foundations own and operate businesses directly.[14]

(2) *Evaluation*

Examination of any broad sampling of the commercial ventures of foundations reveals that several kinds of undesirable results frequently follow from them. In the first place, taxable businesses are often placed at a serious competitive disadvantage. Congress recognized this problem in 1950, and, by the Revenue Act of that year, aimed at solving it. The statute which resulted subjects the so-called unrelated business income of foundations and certain other exempt organizations to tax at ordinary rates and removes the immunity formerly enjoyed by "feeder" organizations—entities primarily engaged in business, whose sole claim to exemption is the turning over of profits to exempt entities.

Fourteen years of experience under these rules, however, has demonstrated that organizations which pay careful heed to the exceptions prescribed by the 1950 act and retained in the 1954 code can frequently shield their commercial enterprises from tax. Because of the fact that the unrelated business income tax does not, for example, apply to rents derived from property with respect to which the lessor has no outstanding indebtedness, foundations are able to lease business assets owned free of debt to operating subsidiaries, siphon off most or all of the business profits by means of rent which is deductible by the subsidiary but not taxable to the parent foundation, and thereby accumulate large reservoirs of untaxed capital which can be used to support the future operations of the business. Another exception to the unrelated business income tax immunizes rents stemming from a lease whose term is not longer than 5 years even if the lessor has an outstanding indebtedness with respect to the leased assets.

The foundation, referred to in example 3, is typical of the private foundations which have tailored their acquisitions of businesses to make use of this exception. In the ordinary pattern of these acquisitions, the foundation contracts to purchase the stock of a business corporation for future payments, liquidates the corporation, leases its assets to a newly formed operating company for a 5-year term,[15] and applies the rents—usually fixed at 80 percent of the before-tax profits of the business—to the discharge of the stock purchase obligation. The ability of the foundation to receive the proceeds of the business operations in the form of tax-free rent enables it to pay a much higher price for the corporation than a nonexempt purchaser could afford.[16] A third and rather elaborate exception to the unrelated business income tax immunizes rental income which foundations realize in certain sorts of situations not qualifying for the first two exceptions.[17] All of these foundations compete with similar businesses owned by nonexempt taxpayers, who must pay for their acquisitions, finance their operations, and support their expansion programs with the funds which remain after taxes have been paid.

---

[14] The transfer of businesses to foundations and other exempt organizations has been encouraged by decisions of several courts that, under the arrangements ordinarily employed for these transfers, the transferers are entitled to treat the proceeds which they receive as capital gains. E.g., *Union Bank* v. *United States*, 285 F. 2d 126 (Ct. Cls.) ; *Anderson Dairy, Inc.* v. *Commissioner*, 40 T.C. 172 ; *Commissioner* v. *Brown*, 325 F. 2d 313 (C.A. 9th). The Supreme Court now has under consideration the question of whether or not, after such a transaction, the former owners of the business receive capital gains treatment where the exempt organization makes no downpayment other than from the assets of the business itself, has no fixed personal obligation to pay a purchase price, and is required simply to turn over a specified proportion of the future earnings of the business. *Commissioner* v. *Brown*, *supra*, certiorari granted June 8, 1964. Whatever the outcome of that case, however, it seems clear that substantial inducements for the transfer of businesses to foundations will remain.

[15] The foundation may or may not control the lessee corporation ; the C foundation's practice is to lease to an independent corporation. In either event, the connection of the foundation with the business remains a close one. Since the lease bases the determination of rent upon the profits of the business, the foundation has a direct financial reason to be concerned with the conduct of the enterprise. Because of this interest, the foundation customarily reserves and exercises a right to maintain close supervision over the management of the business. The C foundation typically retains the additional right to approve the holders of a majority of the lessee's stock.

[16] Transactions of this kind have received widespread attention—and recommendation—in tax literature and other publications. See e.g., "Boosting Profits : Have You Put a Price on Your Business? You May Be Able To Double It—By Selling to a Charity," Prentice-Hall Executives Tax Report, June 24, 1963, p. 6 ; "Recent Cases Show How Best To Sell a Business to a Tax-Exempt Organization," Journal of Taxation, November 1963, p. 302.

[17] Internal Revenue Code of 1954, sec. 514(b)(3)(B).

Moreover, even if the laws governing the taxation of unrelated business income of foundations and feeder organizations contained no avenues permitting business profits to escape tax, commercial enterprises conducted or controlled by private foundations would still possess significant competitive advantages over those owned by taxable entities. Because contributions to foundations may be deducted by the contributors for Federal income tax purposes, the capitalization of foundation businesses is accomplished with tax-free dollars, rather than after-tax dollars. A corporation which wishes to allocate $1 million of its gross earnings to the establishment of a taxable business subsidiary, for example, would be able to contribute only $500,000 of capital to the subsidiary after Federal income taxes have been paid; but the same corporation could create a foundation to operate the business, deduct its capital contribution, and have a full $1 million available for the business operation. Again, the tax immunity of dividends, interest, and other proceeds stemming from passive sources enables foundations to supply capital to their business endeavors with exempt income. Neither of these benefits is available to nonexempt commercial enterprises. Both benefits contribute materially to the ability of a foundation to subsidize its businesses during periods of difficulty and to expand them during periods of growth.

*Example 7.*—When modernization of its textile mill facilities appeared desirable in 1958, the G foundation had sufficient funds available to make an additional $4 million capital contribution to its operating subsidiary.

*Example 8.*—The H foundation has been able to sustain the operations of one of its department store subsidiaries with a 1956 loan of $1,400,000 (at 4½ percent interest) and a currently outstanding loan of $200,000 (which bears no interest).

*Example 9.*—The I foundation has advanced more than $3 million to support the business of one of its foreign subsidiaries.

*Example 10.*—A recent report on foundations sets forth details of the numerous loans which the J, K, and L foundations made during the period from 1951 through 1961 to various of the business corporations in which they held controlling or substantial interests.[18] The total of this indebtedness on December 31, 1956, was $1,897,605. These foundations appear to have entered into at least 36 separate loan transactions with their corporations during the designated period, many involving sums in excess of $100,000.[19]

Another advantage which foundation businesses have over their taxable competitors is their freedom from the demands of shareholders for current distributions of earnings. A remarkable number of foundation-owned enterprises proceed from year to year realizing substantial profits, but making negligible or no distributions to their parent organizations.

*Example 11.*—The A foundation, referred to in example 1, received no dividends for either 1961 or 1962 from its newspaper corporation, its lumber company, or its S, T, or U real estate corporations, despite the fact that all of those companies earned substantial profits during both years.

*Example 12.*—The M company, a department store, entered its fiscal year ending in 1961 with a retained earned surplus of almost $4 million. During that year and the 2 following years it enlarged this surplus with earnings of $365,819, $193,450, and $149,320, respectively. It paid no dividends to its parent foundation during any of these years.

*Example 13.*—The dividends which the E foundation, referred to in example 5, has received from its department store subsidiary for the years 1960 through 1963 have ranged from less than 1 to 1½ percent of the book value of its equity in the corporation, as reflected on the corporation's February 1, 1962, balance sheet. In each of these years the store's after-tax net income has been considerably more than twice as much as the total dividends paid.

This common willingness of foundations to defer indefinitely the realization of profits from their commercial operations—an attitude frequently not shared by

---

[18] Patman Report, 2d installment, supra, pp. 41–45.

[19] The recommendation of Part II–E(2) of this report—that restrictions be imposed upon foundation lending practices—deals with problems fundamentally different from that of unfair competition, and would have limited effect in the area of the present inquiry. Foundation loans to affiliated businesses could frequently be brought within exceptions to that recommendation (as, for example, private placements or obligations secured by first mortgages), and if, in a particular situation, the proposed limitations appeared troublesome, the foundation might well simply decide to furnish funds to its business by means of a capital contribution, rather than a loan.

the shareholders of other businesses—makes it possible for the profits to be invested in modernization, expansion, and other programs which improve the competitive posture of the foundation-owned business.[20]

The various advantages of foundation-held businesses can make them formidable and successful competitors.

*Example 14.*—The X evening newspaper, owned by a foundation, has one competitor, the Z morning newspaper. Z has been in operation for a number of years and has very substantial financial resources. X, however, appears to have made competitive efforts which neither Z nor other newspapers of comparable size elsewhere in the country have been able to duplicate. X utilizes seven wire services; other newspapers of similar size have from one to three. X publishes seven separate editions each day; Z publishes five; no comparable evening newspaper in the country publishes seven. X's normal subscription rate is $2 a month; Z's has been forced down to $2.25; those of newspapers in comparable cities range from $2.20 to $3. X recently purchased the only other evening newspaper in the city. Its advertising rates appear to remain substantially lower than those of any similar newspaper in the country.

In addition to having adverse effects upon competitors, foundation involvement in business may occasion other, equally objectionable results. Opportunities for abuses of the kind with which parts II A and B of this report deal specifically are frequently greatest where a foundation conducts or controls a business. Temptation for subtle and varied forms of self-dealing proliferate in such a situation. Remote relatives may be employed in the business; friends may be assisted; business acquaintances may be accommodated. However broadly drawn the restrictions upon self-dealing may be, many of the conflicts of interest arising in this area are likely to be sufficiently obscure or sufficiently beyond the realm of reasonable definition to escape the practical impact of the limitations. Making certain that none of the 800 employees of the F foundation's manufacturing business receive special benefits because of a relationship to one of the foundation's donors, or that none of the D foundation's $32 million oil refining business involves the transfer or use of money or property to or by parties related to the creator of the foundation, would entail enormous administrative burdens in itself, even if the danger of less definable abuses were not present.

Again, the problem of deferral of charitable benefits has been particularly pronounced in the foundation business setting. We have already noted the competitive advantage which foundation-controlled businesses commonly derive from the willingness of their owners to forego distributions of current profits. That some unconcern with the present realization of business earnings, manifested by many foundations, often delays the progress of funds to charity even when accumulation has no reasonable relation to business needs. The restrictions of existing law upon accumulations of income by businesses become operative only where a corporation is "formed or availed of for the purpose of avoiding the income tax with respect to its shareholders"; where the shareholders of the business are themselves tax exempt, the limitations may not apply. Similarly, the statute which prohibits unreasonable accumulations of income by foundations applies only to accumulations within the foundation itself; it does not prevent retention of earnings in a separate, though controlled, entity.[21] As a consequence, many foundations have permitted large amounts of income to accumulate in their business subsidiaries.

*Example 15.*—In 1962 the Y foundation had amassed almost $9,700,000 of undistributed earnings in one of its business subsidiaries, and more than $5,800,-000 in another.

*Example 16.*—By the end of 1963 the O foundation had accumulated profits of $3,808,957 in its department store subsidiary.

When these funds will find their way to charity is, at best, a matter of conjecture. The moderate pressure provided by the payout requirement recom-

---

[20] The requirement recommended in the preceding section of this report—that foundations make annual charitable disbursements at least equivalent to a prescribed percentage of the value of their assets—would not remove this advantage of foundation businesses. In many cases foundations will be able to comply with this requirement by making payments from contributions, income derived from nonbusiness assets, or proceeds arising from the liquidation of other holdings. Such foundations will have no greater reason to make demands upon their commercial subsidiaries for the distribution of business earnings.

[21] Even if the accumulation restrictions of existing law were extended to these situations, their enforcement would require an arduous, case-by-case examination of each separate set of facts.

mended in the preceding section of this report—which, after all, merely fixes a basic floor for foundation performance in distributions—affords only a partial solution to the aggravated deferral problem which exists in the foundation business context.

The problem has another facet. A number of foundations have revealed a willingness to commit charitable funds to business operations which are failing or, at least, producing consistent losses.

*Example 17.*—The P foundation continues a printing and lithographing business which lost $66,000 in 1959, $36,000 in 1960, $142,000 in 1961, $150,000 in 1962, and an additional amount in 1963.

*Example 18.*—Twenty-four of the 53 business corporations controlled by the B foundation referred to in example 2, in 1956 lost money in that year, and most of those 24 showed net earnings deficits from previous years' operations. Fifteen of the 45 corporations which the foundations controlled in 1963 either had net losses in that year or had net operating loss carryovers to that year.

*Example 19.*—A construction subsidiary of the F foundation referred to in example 6, lost $22,020 in 1960, $17,133 in 1961, $41,023 in 1962, and $49,408 in 1963. At the end of 1962 the corporation's earned surplus account showed a net deficit of $199,818.

In all of these situations, charity bears the loss.

Participation by foundations in active business endeavors may also give rise to a problem of a different character. As the Introduction to this Report has pointed out, the private foundation is uniquely qualified to provide a basis for individual experimentation and the exercise of creative imagination. The framework of institutionalized charities can, in the nature of things, afford only limited scope for the development of individual insights, the testing of new approaches, the exploration of uncharted areas. But the private foundation—easily established, inherently flexible, and available even to those with relatively restricted means—can be utilized for precisely these ends.

Indeed, many would argue that the private foundation derives the principal justification for the favorable tax treatment accorded it from its particular suitability for use by those who are concerned with, and devoted to the development of new areas for social improvement. This special virtue of the foundation assumes that the individual or group in control will, in fact, be devoted to the development of these new areas; that the primary concern will be with social aims. But where a foundation becomes heavily involved in business activities, the charitable pursuits which constitute the real reason for its existence may be submerged by the pressures and demands of the commercial enterprise. The directors of a foundation which owns 26 widely diverse businesses must of necessity devote a very considerable portion of their time and energies to the supervision of business affairs; and charity's claim upon their attention may well suffer. Business may become the end of the organization; charity, an insufficiently considered and mechanically accomplished afterthought. Little may remain to distinguish the directors of such a foundation from the self-perpetuating management of a publicly owned business corporation, without the balance supplied by watchful shareholders. Unrestricted involvement in business may, then, undermine the very ability of the private foundation to make its unique contribution to our society.

It is quite true that, occasionally, beneficial consequences have stemmed from the business activities of a particular foundation. The Internal Revenue Service has, for example, discovered several instances in which foundation businesses have been profitable, their proceeds have been applied to charitable operations without undue delay, and private benefits for the foundation's donors or controllers have been avoided. In these situations it may well be true that charity has been advanced, and no one else harmed, by the ability of the foundation to carry on business endeavors.

On the other hand, the fact that the large majority of private foundations do not own businesses—and that their charitable endeavors suffer no noticeable disadvantage from the lack of business ownership—suggests persuasively that foundations have no real need to engage in business. Other sources of income and other kinds of investments, less inimical to the accomplishment of their charitable objectives, are available to them. Indeed, the Treasury Department has encountered widespread opinion, among foundations themselves and those familiar with their affairs, that business participation is altogether inappropriate for private foundations. Hence, the obvious, fundamental, and common abuses

which attend the involvement of foundations in commercial endeavors would appear far to outweigh the minor and occasional benefits which particular foundations have sometimes derived from business ownership.

D. FAMILY USE OF FOUNDATIONS TO CONTROL CORPORATE AND OTHER PROPERTY

*(1) Two widely practiced tax devices*

Foundations have commonly been established as convenient vehicles for maintaining control of a private corporation within a family while substantially diminishing the burden of income, gift, and estate taxes for the family. Two somewhat different techniques have been used to accomplish this result. Some taxpayers have contributed voting stock in a corporation which their family controls to a foundation which the family also controls. In this way, they obtain income- and gift-tax deductions for the donation, eliminate the impact of the estate tax upon the value of the contributed stock, and achieve tax-free transfer of dominion over the corporation to the younger members of the family by subsequently shifting control of the foundation to them. Other taxpayers have caused family corporations to be capitalized or recapitalized with substantial blocks of nonvoting stock. By contributing that stock to a foundation, the older generation secures the current income and gift tax advantages of the contribution and then transmits the voting stock—now representing a diminished proportion of the value of the equity of the corporation and, therefore, largely or entirely sheltered from gift or estate taxes—to the younger generation.

The availability of these devices has received widespread attention in tax and business publications. An excerpt from the May 7, 1960, issue of Business Week magazine (p. 153) is illustrative:

"*Have you ever thought about setting up a 'family foundation'* "?

* * * * * * *

"However, before you get serious, there are two prime questions: First, are there certain philanthropies (religious, educational, medical, etc.) that you'd willingly devote considerable time and money to in later years? And second, *do you have a sizable family business that you want to pass control of to your heirs, despite crippling Federal estate taxes?* If your answers are 'yes' then a private foundation could be a way to give your 'estate plan' an entirely new outlook.

"*What is a foundation?* It's a nonprofit organization with its own capital fund, that uses its resources solely for public welfare. It can be a State-chartered corporation, or a trust, or an unincorporated association. *If properly set up (with special Treasury-approved tax status) it pays no Federal taxes at all; yet it can be kept entirely under the control of its founder and his family.*

"*The real motive* behind most private foundations is keeping control of wealth (even while the wealth itself is given away).

"Take the typical case: Say the bulk of your property is in a family business. When you die, if you have a high-bracket estate, the estate tax could cause a forced sale of part or even all of the business—your children might lose control of the company, as well as have to sell their shares at a poor price.

"A foundation can prevent this. You set it up, dedicated to charity. *Year by year, you make gifts of company stock to it, until the value of your remaining holdings is down to the point where eventual estate taxes could be paid without undue strain, or until the foundation's holdings constitute firm control of the company.* You maintain control of the foundation while you live; you direct its charitable activities—and so, indirectly, you control the shares in your company that have been donated. When you die, control of the foundation passes from you to your family or other persons you trust and thus they, in turn, keep reins on the business."

* * * * * * *

[The italics are those of the original.]

Recurrent advice of this kind appears to have led many taxpayers to establish and utilize private foundations for the purposes suggested. The recent Treasury Department survey described in Appendix A disclosed a large number of foundations whose principal asset consists of stock in a corporation in which the foundation's donors, officers, or related parties retain substantial interests. Of th

---

[a] A specific exception would also seem advisable for the incidental rental of assets (real or personal) used primarily in a foundation's charitable operations.

approximately 180 surveyed foundations[34] which hold 10 percent or more of at least 1 class of stock of a corporation, 121 reported ownership of family corporation stock.[35] Such ownership appears to be particularly concentrated among foundations of medium size—those whose total asset value is between $100,000 and $1 million. Of the 39 such foundations canvassed which have stock holdings of the noted magnitude, 32 own family corporation stock.

*Example 1.*—The A foundation holds approximately 21 percent of the common stock of the A corporation, possessing a book value of more than $2 million. Substantial contributors to the A foundation and related parties own approximately 60 percent of the corporation's common stock.

*Example 2.*—By both inter vivos and testamentary transfers, the B foundation has received substantial holdings of the non-voting common stock of two corporations which continue to be controlled by the B family.

*Example 3.*—The C and D foundations' principal donor owns all of the voting stock of the C corporation. Members of his family and he have given 106,000 shares of that corporation's class B nonvoting stock to the C foundation; they have given 80,000 shares of this stock to the D foundation.

(2) *Evaluation*

The use of private foundations to perpetuate family dominion over business creates situations which frequently contain, in their most aggravated form, problems of the sort which have been discussed in the preceding sections of this part. Plainly enough, the dangers of foundation involvement in business are at least potentially present in all of these situations. Moreover, because of the donor's retention of control over the dividend distribution policy of the corporation, the benefits which charity ought to receive from the contribution of stock to the foundation are frequently deferred indefinitely or absent altogther. Since the stock is closely held and ordinarily unmarketable, the foundation—even if it is not subject to the donor's influence—has little choice but to hold the shares and hope for dividends; and the donor often proves unwilling—or the corporation unable—to pay them. Yet, by arranging redemption of token amounts of the stock or by causing an atypical, but strategically timed dividend distribution, the donor may very well be able to sustain his claim that the stock has substantial value and entitles him to a large deduction on its contribution to the foundation.

*Example 4.*—The recent Tax Court case of *Pullman* v. *Commissioner*, T.C. Memo. Dec. 1964–218, affords an excellent illustration of these problems. The taxpayers there, in control of a clothing corporation, arranged the recapitalization of the corporation with 8 percent preferred stock, nonvoting common stock, and voting common stock. They then made gifts of the preferred stock to various relatives and donated large portions of the nonvoting common stock to a family foundation. They also donated small blocks of the nonvoting common stock to two independent charities, and had the corporation redeem these blocks shortly after the contributions at approximately book value. In its 19-year history the corporation had paid dividends of more than 8 percent only once: in 1959—which was one of the years in which a major contribution of stock was made to the foundation—8 percent was paid on the preferred stock and an additional 3 percent was paid on the nonvoting common stock. Nonetheless, despite the existence of the preferred stock, with its large prior claim upon the profits of the corporation and the consequent unlikelihood that the common stock would ever receive significant dividends, the Tax Court held that the transfers to the foundation qualified for charitable deductions only slightly smaller in amount than the book value of the transferred stock.

*Example 5.*—Members of the A family claimed deductions of almost $2 million for their contributions of A corporation stock to the A foundation, referred to in example 1. The stock of this corporation paid no dividends from 1948 through 1957, and none for 1962 or 1963.[36] While small dividends were declared in the years 1958 through 1961, they appear to have produced less than $5,000 a year for the foundation.

---

[34] A total of approximately 1,300 foundations were covered by the survey.

[35] The term "family corporation stock" is used here in a sense consistent with the recommendation outlined later in this section. The situations to which the text refers, hence, are those in which both the foundation and a donor (and/or related parties) own stock in a given corporation and, together or separately, they hold at least 20 percent of the corporation's voting power.

[36] The foundation received its stock in the latter 1950's, 1960, and 1961.

*Example 6.*—Beyond the immediate members of the B family, no market exists for the stock owned by the B foundation (referred to in example 2) in two family corporations, and the foundation has never received any dividend on either holding.

*Example 7.*—In only 1 of the last 6 years have the C and D foundations, referred to in example 3, received dividends on their large holdings of nonvoting stock in a corporation controlled by their principal donor.

Extreme delay or entire absence of benefit to charity, then, is common in family corporate cases.

Also present in these cases—often with unusual severity and complexity—are the conflicts of interest characteristic of the self-dealing problems discussed in part IIA of the Report. Where the donor exercises decisive influence over both the foundations and the corporation, he faces difficult divisions of responsibility. When the corporation encounters financial difficulties, for example, his duty to the foundation may dictate efforts to dispose of its shares without delay; but liquidation of the foundation's interest may occasion adverse market consequences and thereby run counter to his obligation to other shareholders or his own self-interest.

*Example 8.*—The E foundation suffered heavily from the divided loyalties of its creators and managers. In 1953 substantially all of its assets were invested in the preferred stock of a corporation 50 percent of whose common stock was owned by these persons. The corporation's prospects appear even then to have been far from bright. As matters grew worse, the foundation maintained its holdings. In 1962, at the time of the last available information, the preferred stock had never paid any dividends, the corporation was on the verge of bankruptcy, and the assets of the foundation had become virtually worthless.

The donor's retention of a personal interest in the corporation may place him at odds with the welfare of the foundation in other ways. If he is in a high personal tax bracket, he may wish to have the corporation accumulate its earnings so that he can realize his gains by future sale of his stock and confine his tax to the rate prescribed for capital gains; but the foundation may require present funds for its charitable program. He may wish the corporation to employ his relatives; it may be best for the foundation that they not be employed. The donor will generally find it in his interest to have the corporate salary levels of family members fixed as high as is consistent with the requirement of the tax law that deductible compensation be "reasonable," for it makes little difference to them whether they receive the earnings of the corporation as dividends or salary, and the corporation may deduct only the latter. The interest of the foundation, on the other hand, lies in keeping salaries as low as is consonant with the employment of competent personnel. The requirements of charity may dictate current expenditures by the foundation; the donor may be tempted to have the foundation retain its funds to meet the possible future needs of the business. In all of these situations it is unrealistic to expect the donor, as director of the foundations, to bring to bear upon problems which involve his personal interest the same judgment which an independent party, concerned only with the welfare of charity, would employ.

Problems of the same nature arise where the donor contributes to a private foundation an interest in an unincorporated business, or an undivided interest in property, in which he or those related to him retain substantial rights. Current tax deductions have been claimed, for example, for contributions of rights in the air space over the donor's land, water rights adjacent to a private beach which the donor owns, or fractional interests in vacant land which the donor controls. Here again, because of the donor's close continuing connection with the property, it is hardly realistic to expect the foundation to make independent decisions about its use and disposition of the property.

While the abuses generated by family dominion over foundation property in many respects are similar to those dealt with by other portions of this Report, the problems here are sufficiently intensified, complex, and possessed of novel ramifications to require a special remedy. This Report elsewhere recommends that foundations be required to pay out annually at least a minimum approximation of a normal return upon their assets; but that requirement cannot obviate the need for foundations to have sufficient independent command over their assets to enable them to realize—whether by sale, conversion to more productive investments, or otherwise—the means to exceed the minimum when

their charitable objectives demand it. Indeed, the payout rule may create pressures upon a foundation to liquidate other useful assets in order to preserve its holdings of unproductive family corporation stock; or the rule may be satisfied simply by the donor employing the foundation as a conduit for his ordinary annual charitable giving—while charity continues to derive no benefit from the foundation's family corporation stock. Similarly, rules concrete enough to possess real efficacy in the prohibition of specific self-dealing practices cannot cope successfully and decisively with the subtle and continuing conflicts of interest which arise in the family stock situation. Finally, a foundation which is itself under the influence of a donor and which holds stock in a corporation controlled by the donor will, even where its stock holdings amount to less than 20 percent of the corporate equity, almost necessarily find itself involved in the business affairs of the corporation: for the foundation's stock will be used in combination with that of the donor and related parties to govern the commercial enterprise.

Senator GORE. Senator Hartke.

Senator HARTKE. Thank you, Mr. Chairman.

IS THE REFORM BILL ANTI-INFLATIONARY?

Mr. Secretary, do you consider this tax measure as an anti-inflationary measure?

Secretary KENNEDY. I do if you take the whole package, Senator. The extension of the surtax through December of this year and through June of 1970 as we have recommended and the repeal of the investment tax credit have an economic impact that will be deflationary for the near term. The revenue reductions are such that they don't come into play until 1971 and later.

So that from the period that we are working under, in the atmosphere of today, this would be deflationary. However, it may turn out to be slightly inflationary because there is a long-run imbalance of $1.3 billion in the package we recommend.

Senator HARTKE. What I am asking is whether you consider this bill as an inflationary or an anti-inflationary bill, or neither.

Secretary KENNEDY. Well, the bill was determined, of course, to be neutral in effect except for the surtax. We are picking up revenue in fiscal 1970 and 1971.

Senator HARTKE. You are picking up revenue?

Secretary KENNEDY. That is right. The net effect is an increase in revenue.

Senator HARTKE. Until 1971 and 1972?

Mr. COHEN. Yes. There is a net increase in revenue of a substantial amount in fiscal 1970 and 1971. In fiscal 1972 it would be roughly neutral or within a half billion dollars or so, in our estimate, and then it would begin to lose revenue.

Senator HARTKE. So you look at this in substance as being an anti-inflationary device, is that correct?

Mr. COHEN. As the Secretary said, in the near term that would be so.

Senator HARTKE. Near term.

Mr. COHEN. In the middle term it would have a net reduction in revenue and in the long term, as we propose it, there would be a $1.3 billion revenue loss.

Senator HARTKE. All right. Can we define——

Secretary KENNEDY. We look at the bill as a tax reform bill.

Senator HARTKE. Can we define the near term, the middle term, and the long term?

Mr. COHEN. Well, I suggested that in this fiscal year and the next there will be a significant net increase in revenue. In the third fiscal year, which would be fiscal 1972, I think it is roughly neutral and thereafter for several years there is a net reduction in revenue. The net reduction becomes less and less until at the end of the 10th year, the reduction is 1.3.

I don't know how you define near term, middle term and long term but if you take it as 2 years near term and then 1 year in which it is neutral, it gives you in general the picture.

Senator HARTKE. You anticipate then that you will need some encouragement to the economy through tax measures by fiscal 1972, which is July 1, 1971.

Secretary KENNEDY. We were looking here at tax reform and we wanted the reform part of this package in about a neutral position.

Then we found that the bill was, in our judgment, imbalanced with respect to consumption and investment and we were willing to agree to a revenue loss of a billion, three, over the long pull in order to give a better balance for investment production.

Senator HARTKE. Wouldn't you be better off just to suspend the investment credit until such time as you deemed it necessary to alleviate this inflationary pressure?

Secretary KENNEDY. I explained previously, Senator, that you can't turn on and off a tax measure as much as you would like. I personally prefer a reduction in the corporate rate to the investment tax credit as a way to facilitate and encourage business. I would much prefer a change in the depreciation schedules to retention of the investment tax credit. I don't think the investment tax credit is the best kind of incentive.

Senator HARTKE. If you really want it to have an anti-inflationary device why wouldn't you make the cuts in the individual income taxes this year instead of holding them off until 2 years from now?

Secretary KENNEDY. I don't understand that question. It is just the reverse. I thought a reduction would be inflationary.

Senator HARTKE. That is what I am saying. In other words, why don't you make the cuts effective now, cutting back now right away, instead of some increase.

Secretary KENNEDY. We are not trying to encourage but trying to discourage inflation, Senator.

Senator HARTKE. I know, that is what I am saying.

Secretary KENNEDY. If you cut taxes it seems to me——

Senator HARTKE. I am not talking about the cut, I am talking about the cutback on the individuals, the reduction of the benefits. Really what I am talking about is the fact that you say 1971–1972 that you propose the amount of benefits which go to the individual should be reduced, isn't that right, by $1.7 billion?

Secretary KENNEDY. I was saying we are phasing in the rate reductions to individuals and the other——

Senator HARTKE. What year does that take effect?

Secretary KENNEDY. There is a whole series of years. Do you want to tell him about that?

Mr. COHEN. These benefits, the double benefits, Senator, that came in the House bill in the standard deduction cases would not have been effective until calendar 1971, and would have had their principal effect for the first time in fiscal 1972, with some effect in fiscal 1971. So the cutback was made, I think, not because of inflationary or anti-inflationary aspects but because of the commitment of the revenues to this extent.

Senator HARTKE. You are talking about revenue. Let me just ask the question again as I understand the situation.

These cutbacks really for benefits to the individual in the lower and middle income group take effect basically in 1971 and 1972. They do not take effect this year.

Mr. COHEN. Some do take effect in 1970.

Senator HARTKE. Yes; I understand, but the substantial reduction in the amount you are proposing in the House bill really takes effect in 1971 or 1972.

Mr. COHEN. Yes.

Senator HARTKE. That is what I said in the first place. What I want to ask you is: Do you consider this as necessary as an anti-inflationary mechanism?

Mr. COHEN. As far as I am concerned, I am not an economist, Senator, but I wouldn't consider that we took this approach because of its anti-inflationary tendencies. You have a reduction in revenue made by the House which we have suggested ought to be cut back; we have suggested less of a revenue reduction in 1971 and 1972 than the House has suggested, but it is still a revenue reduction.

Senator HARTKE. All right. Here, we are not confused, I hope, and I don't think we are, but the point very simply is that if the House bill became the law and was the law today the recommendation of the Treasury very simply reduces the amount of—increases the taxes and reduces the benefit to the middle-income and lower-income individual by $1.7 billion; is that correct?

Mr. COHEN. That is true in relation to the House bill.

Senator HARTKE. In relation to the House bill it is true.

Now, in the totality of what is involved is this almost $2 billion in reduction considered by the administration a deflationary device?

Mr. COHEN. It was not for that person because, Senator, any change which increases the revenue would be a deflationary move and any change that would result in a reduction in revenue might be said to be inflationary, but I don't think that you make the decision on each of the provisions in the law based upon the inflationary or deflationary tendencies alone.

Senator HARTKE. Can I address it then to the Secretary, because, as I understand, since you don't want to be an economist, the fact of the matter is that the fiscal affairs of this country and fiscal judgments are being made in terms of their inflationary or their anti-inflationary effect; isn't that true? We are using fiscal policy to affect——

Secretary KENNEDY. Precisely, Senator, and the package as we propose it is anti-inflationary over the period where we think that the balance should be in that direction. But the changes to which you refer were not made on that basis.

Those changes were made on the basis of equity within brackets and the balancing out of the program, and we followed about the same pat-

tern as the House in the distribution. I don't think there was any change in the way it was done, just the amounts were changed.

Senator HARTKE. In other words, by providing for an additional $1.6 billion for the corporate sector as contrasted to taking away from the individual sector will provide that type of balance in the total of the economy, is that what you are saying?

Secretary KENNEDY. I think that is generally what we are saying, because——

Senator HARTKE. In other words, the fiscal effect of your proposal upon the economic structure of the country is a balanced effect, but at the expense of the individual with benefits to the corporations?

Secretary KENNEDY. Well, I wouldn't agree with that, not for a moment.

In the House bill there was an imbalance in revenue of $2.4 billion. I felt that was too much. I also felt that the bill was overbalanced in favor of consumption as against investment and production, and from an inflationary point of view you know as well as I do that production facilities and the investment community is very important.

We were willing to have an imbalance to the extent of a billion and three hundred million, over a long period of time which is about half the imbalance that was in the House bill. In arriving at that decision, we looked at the schedules and there were inequities because people making the same amount of money, with the same jobs, side by each, would be getting a different tax relief, depending on whether they owned a home or were living in an apartment, and our proposal will bring those more into balance by making the change largely in the rates rather than in the standard deduction.

POSSIBILITY OF WITHHOLDING INCOME TAX ON INTEREST AND DIVIDENDS AT SOURCE

Senator HARTKE. Talking about the tax reform aspect of this bill did you consider other sources of revenue, other types of reforms which could produce substantial revenue? Let me be very specific with you. Would you favor an amendment which would require that the Federal income tax on interest and dividends must be withheld at their source?

Let me go ahead with that for a moment. There seems to be an unfortunate continuity of expression throughout all the Federal law which seems to give a different treatment to those individuals who work for a living as corresponding to those individuals who have their income from interest and dividends and investments.

For example, even in the social security law, as you well know, the earnings limitation only applies to individuals who work for wages. It does not apply to those people who collect their income from rent and from interest or from dividends.

Now, in the field of taxation the present law requires, as I said, only the withholding of the taxes on wages and salaries and there is no comparable requirement applicable to income from interest and dividends.

The revenue gain from this amendment would, according to every estimate I have, be significant. Under the present law there appears to be a great deal of unreported income from interest and dividends,

and according to the best estimates this amount is something in the neighborhood of $4 billion, and the tax on that alone, the revenue which would come as a result of changing that, would bring in about a billion dollars.

Now, I would like your comment upon that.

Mr. COHEN. Senator, this matter was considered on a number of occasions in the Ways and Means Committee, and was considered most thoroughly in 1961 and 1962, both by the House and the Senate and was rejected. Moreover, the Ways and Means Committee considered the matter of the extent to which dividends and interest are not reported, and found that since 1961 and 1962 when the Congress last gave consideration to it there has been a very large decrease in the reporting gap.

Now, I studied that matter at great length in 1961 and 1962, and I would be glad to take up with you at some point, if you would like, the problems involved in dividends and interest withholding. It is not a simple form of withholding such as that which can be had with respect to wages and salaries. The average individual works for one employer, he tells him what his personal exemptions are, and the employer then withholds on a rather individualized basis for each person by approximating the tax that that person would have to pay on his salary.

With respect to dividends and interest where the amounts come from various corporations and various banks, it would be impossible to give effect to the person's exemptions, and you run into the very grave difficulty that this committee ran into in 1962. The only way it could effectively be done is to withhold some flat amount across the board on dividends and interest, and that amount would be greater than the amount that would be due from any person who does not have sufficient income to pay tax; for example, a widow or child or someone of that kind, but the wealthy person would only have his tax withheld at the flat rate. It is a very grave administrative problem that this Committee, and the House Ways and Means Committee in 1962, most thoroughly considered.

Moreover, the gap has closed very significantly since that time, and I doubt that the revenue estimate that you have is correct, but I would be glad to go into it at length.

Senator HARTKE. What is your estimate as to the gap now?

Mr. COHEN. I do not have that, but I can give it to you, Senator, as it was estimated before the Ways and Means Committee. I think there the amount with respect to percent of dividends reported was estimated as 98 percent, or 98.5 percent. This was in accordance with a survey made by the Internal Revenue Service in 1964.

Senator HARTKE. How much was the dollar value of that 2 percent not reported?

Mr. COHEN. Well, dividends in the case of individuals, speaking roughly, I think are in the neighborhood of $15 billion. This is for individuals, and I am speaking off the top of my head, but 2 percent of $15 billion would be, I think, $300 million of dividends that might not be reported, and I think they estimate about a 40- or 50-percent average tax rate on dividends would be $120 million at a 40-percent average rate.

Now, with respect to interest, the figure was about 96 percent reported according to a survey. You always are going to have some leakage because no system is going to be perfect.

Senator HARTKE. How much is that?

Mr. COHEN. I think about $20 billion of interest for individuals, 4 percent of that would be roughly $800 million, and the rate would likely be 20 to 30 percent, not as big a rate with respect to dividends.

Senator HARTKE. Can you give, if those figures are not correct——

Mr. COHEN. $150 million to $200 million, so if we add the two together that might be, say, $300 million to $400 million according to that survey.

I don't mean to indicate to you, Senator, that these figures are perfect. They are based upon a survey, and I don't mean to indicate either that there are not problems, but there is no easy solution to this problem of withholding on dividends and interest.

Senator HARTKE. Well, presently the reporting of dividends and interest is made by all interest- and dividend-paying organizations not only to the individual but to the Treasury; isn't that true?

Mr. COHEN. I am sorry, sir, I didn't hear that.

Senator HARTKE. At the present time any organization is required to report to the individual and to the Treasury any interest and dividends which are paid?

Mr. COHEN. In excess of $10—in effect they report them all. That was provided in 1962, and has been to a great extent responsible for the increase in the reporting not only because the service has this information, but also because the taxpayer when he goes to make out his income tax return knows what it is.

Senator HARTKE. So it would be as you said you hold out a flat amount even if it were less or more than the actual amount it would also be computed on his tax return without any difficulty, would it not?

Mr. COHEN. If you withhold a flat amount. But the problem the Congress got into before was that a married couple over 65, who are retired, are entitled to at least $2,400 in income tax free, and if they had $2,000 of dividends and interest income and 20 percent was withheld from it, $400, they would then have to claim the refund at a later time. So the Congress decided, "Well, we will permit married couples over 65 to file exemption certificates with all the paying agencies," so that every company in which they had stock, or every bank in which they had a bank deposit would have to make up two lists. That is when it got so complicated; they put in a difference for corporate stockholders, and charities that have income from investments and the colleges wanted exemptions from withholding, and the system becomes complicated because as soon as you require the withholding agent to process all of those claims for exemption, you have a rather unwieldy system.

If you want to be tough and say, "Yes, we will take 20 percent out of every dividend and every interest item, and then we can just treat every dollar amount received as representing 80 percent of the income involved," that is a possible system. But that creates hardship upon retired persons, and charities and others, and the Congress was not willing to go to that extreme.

In wage and salary withholding we don't create such hardship because we take into account the fact that these two people over 65 would have $2,400 in exemptions.

Senator HARTKE. They can file the same way with the people, have the same type treatment.

Let me say this, there is no question this would produce additional revenue that is not in the bill, is that correct?

Mr. COHEN. Well, it would produce additional revenue. Whether it would represent a net savings in view of the additional cost is something else again.

Senator HARTKE. Cost to whom?

Mr. COHEN. Cost to the Government in administering it, cost to the withholding agents administering it. Of course, you don't have to reimburse them, but they object and they feel they should be reimbursed for the additional expense.

TREBLE DAMAGES

Senator HARTKE. Let us turn to another matter, the question of treble damages in regard to antitrust cases. Would you favor or support an amendment that would overrule the Internal Revenue Service decision that triple damages awarded in antitrust cases are deductible? In the 2 years this ruling has been in effect, I think that the Treasury has lost more than a billion dollars, and even greater tax losses can be anticipated in the future. And also the effect of such a ruling has a tendency to really retard the effectiveness of the antitrust laws as being a punitive measure and having a punitive effect upon those who violate the law.

What is your comment on that?

Mr. COHEN. Well, we have not discussed it, Senator, to the point of having an official position of the Treasury. I am familiar with the problem, and have my individual views but I don't think I should state them because we have not discussed this within the administration, so far as I know. At least I have not been a participant in any such discussion and the matter was not brought up for consideration before the House so far as I can recall.

There is a bill pending or at least the matter had been studied by the staff of the Joint Committee on Internal Revenue Taxation, and I think they have released a report, which I think was out some 2 years ago, in which, I believe, the recommendation was made to permit a deduction for the single amount of damages but not for the double or treble damages. That is my recollection.

Senator HARTKE. Don't you think it would be fair, I mean if a man or an organization is found to violate the law that he not be allowed to deduct that from his taxes?

Mr. COHEN. Well, if I were to comment I would be commenting only my individual views before I arrived at the Treasury and I would prefer not to.

Senator HARTKE. Would you have the Treasury give me an opinion on that in the future?

Mr. COHEN. Yes, we will be glad to.

(CLERK'S NOTE.—The Department of the Treasury subsequently informed the Committee that the Department was in the process of discussing this matter with

other interested agencies but would not expect to have the administration's position before the hearing is printed.)

### FARM LOSSES

Senator HARTKE. Next I want to get to the question of farm losses. The approach by the House is what is called excess deductions account in farm losses.

Mr. COHEN. Yes, excess deductions account.

Senator HARTKE. This provides that individuals and the corporation be required to list in an excess deductions account only that portion of the farm loss in a given year that exceeds $25,000.

Mr. COHEN. That is correct under the House bill.

Senator HARTKE. All right. However, an individual taxpayer would not have to add any amount to his excess deductions account unless his nonfarm adjusted gross income exceeded $50,000.

Mr. COHEN. That is correct, sir.

Senator HARTKE. And I know that you have suggested reducing this dollar amount but the problem is that the EDA approach permits the nonfarmer to continue to deduct artificial farm losses from his nonfarm income each year, and at the same time, permits him to defer recognition of capital gains until it is advantageous to do so. This means that the attempt to recapture previously lost tax dollars by converting what would be otherwise capital gain into ordinary income to the extent of any balance in an excessive deductions account, may look plausible in theory but in practice it simply will not do the job.

Why don't you go back to a provision which I introduced which would limit the amount of farm losses that can be used to offset nonfarm income on an annual basis rather than attempt to recapture revenue at some distant point in the future through this complicated process of converting capital gains into ordinary income, and wouldn't this really generate more money because after all the deferred tax really amounts to an exemption?

Wouldn't this really provide more revenue and be less complicated?

Mr. COHEN. Senator, there are at least two provisions in the bill dealing with farm losses, and you have referred to only one of them.

Senator HARTKE. That is right.

Mr. COHEN. The one that you referred to is designed to cover a problem that exists in a number of places in the law in which expenses or depreciation can be deducted against ordinary income and the assets later sold at favorable capital gain rates.

Senator HARTKE. Really this is what we are talking about. We are talking about hobby farmers so-called, isn't that true?

Mr. COHEN. We are not necessarily talking about hobby farmers in this provision.

Senator HARTKE. Not necessarily, but they are included in this group.

Mr. COHEN. They are included.

Senator HARTKE. Yes.

Mr. COHEN. But this would apply to professional farmers as well.

Senator HARTKE. I understand, that is right.

Mr. COHEN. This provision gets at the problem of capital gains on the sale of livestock, capital gains on the sale of an orange grove and so on, where the expenses of producing it have been deducted against outside ordinary income. Now, that is one provision. And, as you say, we don't get the revenue until the later year in which the livestock or the orange grove is sold. That is where we think the problem exists.

Not until he does sell it and report it as capital gain instead of ordinary income is that a problem to be solved.

There is another problem with respect to the hobby farmer, and we have a provision which treats this as one of the preferences, and we limit preferences under the bill to 50 percent of the man's income. I don't recall what limit you had in your bill; there have been bills pending, and I think there is one introduced by Senator Metcalf and others in this session, that would limit the loss from operation of a farm to $15,000.

Senator HARTKE. What is wrong with that bill?

Mr. COHEN. Well, suppose, as Senator Gore said a short while ago, there was an actual economic loss of $50,000. Suppose there is an actual economic loss from tornados, floods, low prices, drought, any number of factors, why should we disallow a true economic loss to the farmer or why should we disallow it in any event at strictly $15,000 a year?

There is an incentive put in the law with respect to farming, because the methods of accounting represent a concession to the farmer. There are similar methods that are concessions to the oil industry, and in the real estate field. We took all of them as a group, preferring not one to another, and said a man can take these various incentives that are given in the law, but he cannot use them to excess. We won't let him offset more than half his income, so he has the incentive, but he ought also to contribute taxes to the support of the Federal Government, so that he can use any one of these preferences, which one it matters not, but he can't use them beyond half his income.

Then we are not dealing exclusively with farming as against real estate or as against oil. The investor can put his money in one or the other and we are not legislating with respect to one any more than the others. That is the theory of the bill.

TIMBER AND THE CAPITAL GAINS TAX

Senator HARTKE. Let us turn to another measure because I am taking far too much time. What about the timber reform proposals which were made in the Treasury report on February 5, 1969? Are you familiar with those?

Mr. COHEN. Well, Senator, these were recommendations of the Treasury staff in the last administration, which had not been transmitted to the Congress during the last administration and were sent up on February 5. I think those are the ones you referred to.

Senator HARTKE. Yes.

Mr. COHEN. My recollection is that there were no recommendations for changing the law with respect to timber. There was a supplementary report at the back of the recommendations giving statistical data with respect to certain problems. In this bill I would say that the

major effect with respect to timber would be that, with respect to corporations, the capital gains tax which they are now paying when timber is sold would be raised from 25 percent to 30 percent. In our recommendation it would be raised to 30 percent with respect to capital gains above $50,000 and this would cover most of the major timber companies, so there would be a 20-percent increase in that burden from 25 percent to 30 percent. Similarly with respect to individuals, while we would recommend that capital gains be kept at the same for normal amounts, if a person had large amounts of capital gains on the cutting of timber in relation to his taxable income he would have a similar proportionate rise in his taxes. So there is an increase in the tax burden of the lumber industry.

Senator HARTKE. To some extent. Would you favor an amendment or support an amendment which would limit capital gains only to those taxpayers who sell their timber in a lump sum or sell their timber and lands together outright?

Mr. COHEN. Well, we have not been prepared to recommend at this time any further changes in view of increasing the burden 20 percent in this law. We are concerned about this problem and have been giving consideration to it, but at the present time our only recommendation to you is for the increase in the capital gains rate.

Senator HARTKE. You are acquainted with the fact that the capital gains treatment is allowed for the taxpayer whether he practices conservation methods or not, are you not?

Mr. COHEN. I am indeed, Senator.

Senator HARTKE. You do know that there is a distortion here in favor of just a few companies, about five companies really, throughout the United States. In fact, one of them accounts for the biggest portion of this revenue loss to the Treasury as a result of this preferential treatment which is given to timber companies, is that true?

Mr. COHEN. We are concerned about the fact that, substantially, the effective rate of the timber companies is not much above the capital gains rate, so that their reported profit is almost entirely capital gain and very little is ordinary income from profit from manufacturing.

Since I have taken office I have not had time to study this in the detail that I would like, but I understand it to be asserted in the industry that this is in fact the case—that the gain is with respect to the timber and not with respect to the manufacturing operation—but I have no opinion on it.

### TAXING CAPITAL GAINS AT DEATH

Senator HARTKE. The last matter which I would like for you to comment upon is the question as to whether or not you would favor an additional tax reform measure on taxing capital gains and which are now untaxed, at death. In other words, at the present time, as you well know, there is an estate tax upon the inheritance which goes to the person at the time of death but, at the same time, this value is established at an entirely different rate.

Now, do you favor any type of amendment which would change that situation? One of them is to provide either that the person who inherits the property would be required to go back to the original value at the

time of acquisition of the decedent or whether or not you would favor there would be some type of capital gains tax assessment upon the decedent not at the time of his death but when his final return is submitted. Do you understand what I am talking about?

Mr. COHEN. I do understand that, Senator. The matter was considered in the Ways and Means Committee and it was thought that this problem of the treatment of capital gains on property passing at death form an income tax standpoint was a problem linked with the problem of estate and gift taxes because the two problems would have to be considered together.

The Ways and Means Committee thought, and we agreed, that there was such a mass of material in the bill at the present time that neither the committee nor the Treasury staff nor the joint committee staff had adequate time to consider this matter in depth.

From an estate and gift tax standpoint, the committee report reflects this view, and the committee report says that:

> Estate and gift taxes are areas of the tax laws which your committee will undertake to study as soon as possible with the expectation of reporting out a bill on this subject in this Congress.

And that is my understanding of the procedure to be followed.

Senator HARTKE. Would the Treasury be prepared to have a position in this Congress?

Mr. COHEN. We expect to, sir.

Senator HARTKE. I thank the chairman.

The CHAIRMAN. Senator Fulbright.

Senator FULBRIGHT. Mr. Chairman, I hesitate to further prolong this hearing. The Secretary and the Assistant Secretary have been extremely forthcoming in their answers to these questions. The difficulty, I suppose, is in my own capacity to understand some of this.

May I ask, first, Mr. Chairman, what are the rules? Do I have 5 minutes or 10 minutes or what are the ground rules? I was reprimanded yesterday. I wondered what the rules today are.

The CHAIRMAN. I think we have been going on about a 20-minute rule, Senator, but your conscience will be your guide this afternoon. I would like to ask a few questions after you get through.

Senator FULBRIGHT. I certainly won't take longer than that.

### INDIVIDUAL RELIEF AS COMPARED WITH CORPORATE RELIEF UNDER THE TREASURY PROPOSALS

This matter has been covered, Mr. Secretary, and Mr. Assistant Secretary, but I am still a little bit at a loss to understand quite the reasoning behind the shift between the individual tax relief of the House bill versus the corporate relief and the change you recommend centering around your statement that the bill of the House shows a bias against investment in favor of consumption.

One way to get at it is, I think, the question of investment; of what is saved to the corporations by the decrease in their taxes.

Why do you believe that investment would be necessarily increased due to this? Why would it not go simply as greater dividends or salaries or whatever other way the corporation desires to use its increased profits which are saved by the decrease in its corporate tax as opposed, for example, to the investment tax credit.

You had this discussion with Senator Hartke and others, and I do not quite follow it. The investment tax credit is given only as a result of investment. There is no assurance, or at least I do not see any assurance at all that this saving of taxes by the corporations, by decreasing the rate, is going to go into investment.

Secretary KENNEDY. There is no assurance that the corporation will use the money for plant or capacity; they will use it for general purposes. But with a reduction in the tax rate the incentive for profits is greater, and most of the corporations have a dividend policy that they follow, which is a rather consistent one, and they will take the funds that they have and promote their business. That is the profit system at work at best, and in the investment tax credit they could take the credit only if they had profit to charge it against.

Now, it seems to me that the investment credit went only to certain corporations whereas this rate reduction will go across the board, and will help to modernize many of the facilities and so on that would not qualify for the investment tax credits.

The other factor helping investment is the capital gains tax treatment, and these were the two that we felt would, taken in combination, put a better balance in this tax bill.

Senator FULBRIGHT. I do not know whether I can follow that or not. There has been such a tremendous movement recently, not toward the increasing of production and new investment. We have an enormous industrial plant. The great movement in recent years has been conglomeration, which is simply bringing together the existing securities of corporations.

I had not noticed that the increased profits of these companies have been especially siphoned into increased investments. But you seem to give this as the principal reason for recommending a shift from the individual taxpayer to the corporations.

When I asked the Assistant Secretary yesterday where this 2 percent decrease goes, it went to the second level; that is, to the larger corporations, not the smaller. Is that not what you said?

Mr. COHEN. I did, Senator. But this morning the request was made as to whether we would be agreeable to extending, say, one point to the income below $25,000, and my recollection is that the figure was that this would cause an additional loss in revenue for $70 million. So the rate on the first $25,000 of income would be reduced from 22 to 21 percent, and we said that that would be acceptable.

That would involve, a 1-point reduction at the 22 percent level which would be approximately the same percentage reduction as a 2-point reduction at the 48 percent level.

Senator FULBRIGHT. Is this 1 percent on the 22 percent; is that instead of——

Mr. COHEN. Reduced from 22 to 21.

Senator FULBRIGHT. And no reduction on the 48; is that correct?

Mr. COHEN. No. The rates at present are 22 percent on the first $25,000.

Senator FULBRIGHT. Yes.

Mr. COHEN. Forty-eight percent on the balance, and we would suggest after the phase-in is finished that the rates be 21 percent on the first $25,000 and 46 percent on the balance.

Senator FULBRIGHT. It is one and one; I mean it is one on each side. I see. I did not know you had——

Secretary KENNEDY. That came up this morning, Senator, when you were out.

Senator FULBRIGHT. We discussed this yesterday.

Secretary KENNEDY. You were out at the moment. Dr. Walker wanted to make one comment, I think, in clarification of something that you said.

INVESTMENT TAX CREDIT

Dr. WALKER. Supplementing something that the Secretary said with respect to investment, both in terms of economic theory and more demonstrably in terms of the economic history of this country, particularly since 1960, there seems to be a pretty clear relationship between the tax level of business corporations and the amount that they invest.

You had commented that you did not think there had been so much of that investment. Actually since 1960 the investment of corporations or the investment in new plant and equipment has more than doubled from an annual rate of $36 billion to an annual rate estimated of around $72 billion at the present time.

Senator FULBRIGHT. But in recent years we have had the investment credit of 7 percent which is a very specific investment incentive.

Dr. WALKER. Precisely.

Senator FULBRIGHT. Incentive to investment as distinguished from just increasing their returned profits. I mean, that is a big difference.

You are talking about a period in which they have had the investment credit.

Dr. WALKER. No; but the question was whether a cut in taxes would would be an incentive to invest. Actually an investment tax credit was a cut in taxes at a certain period. You have the impetus in the tax bill of 1964, but I think it can be pretty clearly shown that, given the dividend policy that the Secretary referred to, there would be a stimulus to investment, and we asked for repeal of the investment credit because we did not think that that stimulus in and of itself was any longer necessary or desirable.

But the bill went further and raised corporate taxes much higher than that.

Senator FULBRIGHT. Not desirable for another reason. That is the inflationary effect, is it not? Isn't the primary and principal reason for repeal an effort to dampen inflation?

Dr. WALKER. The principal reason for the repeal of the investment credit was that priorities had shifted since 1961 and 1962 when it was proposed.

In addition, it would be helpful in the fight against inflation, and would be—an offset to the reduction of the surtax to half at the beginning of 1970.

Senator FULBRIGHT. I may have misunderstood it. I thought the repeal of the investment tax credit was almost wholly an action to cool off the economy. The inflation, our interest rates, are the most pressing immediate problem; is that not so?

Dr. WALKER. If it were solely for that purpose, the proper approach even though it is very difficult to do, would be to turn it off again, on

again. Our conclusion was that it was not an appropriate part of the long-run tax structure, the atmosphere of the 1970's, so it was permanently repealed, albeit at the same consistent with and reinforcing our anti-inflationary programs.

Senator FULBRIGHT. As a matter of fact, you will agree, Mr. Secretary, that the real inflationary problem is the nonproductive investment of such a large part of our resources in the war and going to the moon, and such idle experiments that have nothing to do with the reproduction of wealth. That is the real problem, is it not, that brought on these problems you are trying to deal with in small ways?

Secretary KENNEDY. We have had an expenditure on the part of the Government itself and, in addition to that, every municipal and State government and of the corporations expanding in a sense beyond their needs at the moment because, at the same time, we have had a war going on.

#### DEFENSE EXPENDITURES

Senator FULBRIGHT. Yes; at the same time a war, and it is not only the war directly, but it is the expenditure for armaments, that is, for military activities, which are associated with the war which have grossly expanded during this period in the last 5 years; have they not? They have doubled about, have they not?

Secretary KENNEDY. They have gone up substantially.

Senator FULBRIGHT. Approximately doubled, I think, since 1963.

Secretary KENNEDY. Yes.

Senator FULBRIGHT. To a sum that is so great that none of us can comprehend it.

Secretary KENNEDY. And we had a $25 billion deficit in the Government in one single year.

Senator FULBRIGHT. That is right, and that is, to my way of feeling, at least, primarily attributable to these activities that I am speaking of. These bear, I think, upon the reasoning, at least, for these shifts. I mean I can follow to some extent your reasoning about the shifts, but they are very small really, $1.7 billion, and $1.6 billion for the relief of corporations. This is such peanuts compared to nearly $80 billion which we are spending on nonproductive activities.

When we are talking about business and so on, it does have some prospect at least of increasing the tax base. I think the least profitable in that sense to the Treasury Department is the expenditure of Government funds on ammunition and such things as that.

This is where I get lost when you come in with these arguments, they seem like such puny——

Secretary KENNEDY. We are working on the other side of the budget, too, as you know, the expenditure side, and that seems to be longer——

Senator FULBRIGHT. We are not getting much cooperation from the administration on what the Senate is trying to do in that field. We just had a very long and drawn-out battle in which you thwarted us in trying to save you a substantial amount on the ABM.

We have a vote on Monday on the same matter involving several hundred million dollars and we get no support whatever from the administration.

Secretary KENNEDY. You have had a lot of support, Senator, from

this administration in the reduction of defense expenditures, and you can see more coming.

Senator FULBRIGHT. I do not see many signs of it. It does not turn up when we bring it up on the floor of the Senate.

Secretary KENNEDY. Well, item by item, perhaps not, but if you look at the total and——

Senator FULBRIGHT. Well, the total has not yet been very great that I can see. What do you estimate the total—what do you mean by that, saying it has been great?

Secretary KENNEDY. Well, the effort, of course, recently, to cut another $3.5 billion out of defense, and that is a substantial figure. They have already started to cut more than that. There is a timelag in these matters. There is the obligational authority and appropriations, and so on. The total is about $78½ billion.

Senator FULBRIGHT. You are talking about a cut from what the last administration was going to propose, are you not? Really, this cut is not a substantial cut yet, and we always are faced in this area with these——

Secretary KENNEDY. This was last year and a year ago.

Senator FULBRIGHT. What?

Secretary KENNEDY. There were too many laws put on the books or appropriations last year and the year before to permit what we are doing to occur immediately. What we are doing is turning the corner there and cutting the obligational authority more than the actual expenditures, but that will show up in a later period.

Senator FULBRIGHT. I am all for it.

Secretary KENNEDY. So am I.

Senator FULBRIGHT. I agree that this whole business, the war itself, is not attributable to this administration except that they have not stopped it yet. I mean, it is still going on. You did not start it, I agree with that, and you are not responsible for it, its origin.

Secretary KENNEDY. We are trying to stop it.

Senator FULBRIGHT. But when we talk about the tax bill, and I get down to this, that this reasoning given for this shift seems to me to be rather puny. The other side of it is really a social, I guess you call it, a social objective of trying to give relief to lower income people over a long period. There has been this enormous differential in the income among our citizens, I think, contributing to some extent—certainly not the only reason—along with the war and the unsatisfactory living conditions and other things, to these very distressing violent actions and turmoil that have afflicted the country and the big cities in particular.

There are many reasons contributing to that, and I am not persuaded yet that your reasoning for these shifts is justified in view of the relationship of this to the war and to these much greater reasons that affect consumption, inflation, and so on.

On this inflation and our competitive situation in the balance of payments with foreign countries, it seems to me, is minimal compared to this other thing we have already mentioned.

We can never become competitive by juggling figures, if we do not do something about the war and about the expenditures which add to the inflation.

I want for us to be as competitive as we can, and I think it is essential. But all I am trying to say here is the reasoning given for this change I am not sure is very persuasive in view of the other reasons which I am sure impressed the House for the need to try to lessen the gap between the very prosperous and the very poor.

SOME INEQUITIES IN THE TAX LAW

Secretary KENNEDY. Well, there was an inequity by putting the standard deduction up as high and then also giving the rate reduction there, so that you have two different people making the same amount of money, one in an apartment and the other purchasing a home, getting widely different benefits.

Senator FULBRIGHT. That is a persuasive reason. I think that is a good reason.

Secretary KENNEDY. It seems to me that is almost intolerable because to be working side by each——

Senator FULBRIGHT. That is the most persuasive reason, the inequity of the treatment of the people in similar circumstances.

The other inequity of the tremendous advantages that the very well off, the very rich, have in taxation is not only because of the rates and so on, but the capacity for the employment of the best lawyers and the best tax accountants to find ways to avoid taxes where the ordinary fellow just cannot do that. He just cannot take advantage of even those possibilities which exist in the law.

These are inherent, I guess, in our system. But I think it is our duty to try to do the best we can, and this simplification which has been mentioned is one of the ways to get at it.

These tax laws are very mysterious to the ordinary taxpayers, but that seems to be our system. I do not have any answer other than I certainly hope we can simplify them.

HOLDINGS OF TAX-EXEMPT ORGANIZATIONS

Let me see, I had something else. I did not get clearly in my mind this morning the size of the tax-exempt property. Senator Talmadge raised a question in a rather specific way that interested me, and I did not quite understand the answer.

I think Mr. Cohen gave the answer. You estimated that $24 billion is the value, the total value, of all the holdings of corporations or institutions which do not pay taxes; is that the estimate?

Mr. COHEN. No, sir.

Senator FULBRIGHT. That seems very low to me.

Mr. COHEN. It is greater than that.

This was an estimate of the amount held by the private foundations, and Senator Talmadge estimated it at $23 or $24 billion, and I understand from estimates that are here this morning that we would fix it at a little bit less than that, probably $20 billion, but we were going to check it more thoroughly. But that is not with respect to all exempt organizations.

For example, that would not include the endowment funds of colleges and universities or churches, which would be far beyond that. The private foundation would be an organization which, in general,

does not solicit contributions from the public, so you would not have your churches or your largest tax-exempt organizations, the various health organizations, such as the American Red Cross—of course, they would depend more upon annual contributions and less endowment, but this is only with respect to the so-called private foundations.

Senator FULBRIGHT. It seems to me that since this has become such an important matter that the Treasury ought to try to make an estimate for the benefit of the Congress of the total amount of property which normally would be subject to tax, but that do not pay any tax. I mean, this is a problem that has plagued other countries, going back to Henry VIII. One of the principal reasons causing him so much trouble was that so much of the total wealth was immune from the normal burdens of society.

Take in this city, which is a good example of it. Isn't it feasible for you to do that?

Mr. COHEN. But it is not feasible under existing circumstances because we do not have any returns from churches or educational organizations. It was a provision in the bill that would authorize the Secretary of the Treasury to exempt from the requirement of filing certain classes of institutions, and Senator Bennett asked me about that earlier, and I said it was my understanding that the Treasury would exercise this power so they would not, in general, require income tax returns of public charitable institutions, including the churches.

Not until you have had such information and had balance sheets from all these organizations would one know. We do not have that information.

Senator FULBRIGHT. Don't you think it would be useful to the Treasury as well as the Congress to at least know the approximate extent of the tax-exempt property, real estate, and so on, the amount, as to how serious is the drift of normally taxpaying property into the hands of institutions that pay no taxes, before the situation becomes too critical?

Mr. COHEN. Well, we would not normally be interested in the value of the assets. We would only be interested in income for income tax purposes.

One would want to know if one were interested, what were the income of the exempt organizations, but unless one were prepared to move forward to consider taxing it, I do not see that it would be a useful purpose served in accumulating the information.

Senator FULBRIGHT. Well, the useful purpose is this: I mean, whether or not it is in the public interest to continue to give tax exemption on more and more private property that would normally come into the coffers of the Government. Should spending for the public welfare be under the jurisdiction of the Government, or are we going to let private boards, set up by private individuals, to use their discretion as to how best to spend such funds.

If this gets clear out of proportion, it seems to me, we are undermining the very basis of our fiscal structure and of our whole Government.

I am not sure that the boards of all these institutions are necessarily much wiser than the Government. This is a denigration of the whole constitutional system we have.

Mr. COHEN. What we do know, Senator, is how much money is being deducted on tax returns at the present time, so we can tell how much money is flowing to these organizations from individuals and corporations.

For example, the statistics of income for 1966 indicate that something in the area of $9 billion of contributions were made to charitable organizations.

Some more was deducted by corporations and some more in estate tax returns, and the total amount of contributions at the present time flowing into exempt organizations that is deductible, not all exempt organizations but just those to whom contributions are deductible, we estimated being in the neighborhood of $15 billion.

Senator FULBRIGHT. $15 billion?

Mr. COHEN. $15 billion a year going to these public charities, to charities and educational organizations, partly on the individual income tax return, partly on corporation tax returns, partly in bequests and from other sources.

Secretary KENNEDY. Senator, from the standpoint of this bill, however, there is a provision, as you know, that would require these organizations on their business activities—and some of them are in business—to report and pay a tax. That loophole is being closed in this bill, and that is the important one because we are not taxing property here, we are taxing income.

Senator FULBRIGHT. Well, I think that may be wise.

Secretary KENNEDY. Yes.

Senator FULBRIGHT. I do not have a very clear idea of this matter, because I do not know whether it is getting out of hand.

If $15 billion a year should go on for 10 years that is $150 billion; for 20 years it would be $300 billion. Does this accumulate, is it growing, is there an enormous amount of property accumulating in these hands which will not be subject to taxes?

How do you interpret $15 billion a year?

Secretary KENNEDY. A lot will be expended in the way of salaries of people, too.

Senator FULBRIGHT. Is there any evidence of how much is being expended?

Secretary KENNEDY. Take colleges and universities. They are adding to their property and to their expense, and in every college I know they are having a hard time making a go of it even with their endowment funds.

Senator FULBRIGHT. They are.

Secretary KENNEDY. And that is one big area here.

Senator FULBRIGHT. Yes.

Secretary KENNEDY. They are out for drives. The University of Chicago, we have a drive on for $360 million. Some of it is in plant, some of it is in buildings, but a good share of it goes to salaries and other university activities.

You have a real problem of estimating values. What would be the value of a university? I know of one down in Illinois that is now for sale. They cannot give it away. They tried to find a buyer and actually, I think, if they find somebody who would take it they would let it go.

The same with churches. They would have a hard time making an estimate. I sat with the archbishop of Chicago, and he was talkin

about the various properties in their archdiocese, and he himself does not know what the various orders had, and it would take a lot of appraising and reappraising to try to come up with that kind of a figure. After you have got it, what would you have?

Senator FULBRIGHT. I do not know. I was only asking you. I do not really know about that.

Secretary KENNEDY. I know we would have a lot of dissension and a lot of kickback.

TAXATION OF FINANCIAL INSTITUTIONS

Senator FULBRIGHT. Lastly, I wondered if you would comment on this. The House bill changes the taxation for banks and savings and loan associations. I wonder if you would enlarge on that a bit. I did not hear your discussion. Maybe this has been covered. I wonder if you would just say a little bit about this.

Secretary KENNEDY. I will ask Dr. Walker to cover that, all three, savings and loans, mutual savings banks, and commercial banks.

Senator FULBRIGHT. One of the reasons I ask it is that banks are doing well and savings and loans not so well. Is that true or not?

Dr. WALKER. That is not true with respect to the level of taxes they pay. That is true, perhaps, in some respects as to their competitive situation.

Senator FULBRIGHT. Would you elaborate a bit behind the reasoning.

Dr. WALKER. It has been traditional in the tax law for a number of years to subsidize the mortgage lending activities of the savings and loans and the mutual savings banks through liberal bad debt reserves, reserves for bad debt losses on loans.

The result of the legislation in 1962, I guess it was, was to end up with mutual savings banks paying a net average income tax of around 3 to 5 percent.

Savings and loans in the general range of 15 to 16 percent average income tax, and commercial banks in recent years have been paying around 23 percent partly because of their very large holdings of tax-exempt securities.

The aim of the legislation in the House was to raise the taxes on these institutions over a period of time to a general range of about 27 to 34 percent, roughly, tax equality. Our major concern with this legislation was not to object to the decision of the House in raising the taxes of these institutions, which are relatively quite low compared with other businesses in this country, but the manner in which it was done by retaining in the statute very severe restrictions on the saving and loans and the savings banks with respect to their mortgage lending.

In other words, through the tax law saying, "If you want these tax advantages you have got to keep your mortgage loans up to a certain level."

We thought that it would be much better to promote mortgage lending, residential construction, through the tax laws by tying any such subsidy not to the institution but to the loan. This would encourage commercial banks, which do not now get the subsidy, to make a lot more mortgage loans than they have been making in the past.

As a result, our substitute proposal, which admittedly needs discussion—we will be very interested in what the industry witnesses say about this and the housing people say about this—would simply say that any of these three institutions to the extent it holds socially preferred type assets such as residential mortgage loans or perhaps guaranteed student loans, or perhaps loans guaranteed by the Small Business Administration, would get a deduction off of gross income, gross interest income, on those loans of, perhaps, five points, which would stimulate them to make the loans, with the proviso, however, that they would have to pay tax on, say, 60 percent of their total income, including tax-exempt interest income, and other, certain other, types of exempt income.

If you pay a tax at the regular corporate rate on 60 percent of your income, and your corporate rate is around 45 percent, you have, in effect, got a minimum tax area that is very close to the 30-percent level the House was shooting at.

So we were not quarreling with the effort to get them to pay more taxes, but we want to create a situation that would strengthen the institutions and strengthen their incentive to make these loans.

Incidentally—not incidentally, but importantly to the extent savings and loans and savings banks can broaden out their investments and not just stick with mortgages, they will be in a better position to fight off the outflows of funds they have in tight money periods like in 1966 and 1969. They are hemmed in very narrowly now to long-term mortgages, and they are captured in the rate of interest in the past, which are not high enough to pay savers today.

Senator FULBRIGHT. Tell me, what is the reason historically that all of these, but particularly I am speaking of commercial banks, I think I understand the savings and loans—savings banks are a little clearer—but why have commercial banks experienced less than the ordinary—less than half of the ordinary taxation of ordinary businesses?

Dr. WALKER. Commercial banks or savings and loans?

Senator FULBRIGHT. Commercial banks. You said 23 percent as opposed to 48 percent on the ordinary manufacturing and other business. Why is that?

Dr. WALKER. Well, the major reasons have been, they have been, the major market holding about 45 percent of the tax-exempt securities issued by State and local governments. That cuts their tax rate way down. In recent years they have been buying 80 or 90 percent of these new issues of State and local governments.

Secondly, they have had a special bad debt reserve treatment which grew out of the experience in the depression when so many banks failed and took terrific losses, and that experience indicated that a reserve for bad debts of approximately 2.4 percent was appropriate under Treasury regulations that allowed that.

Third, they have been able, and this is changed in the House bill, since they are dealers in debt and lenders of money, to treat their capital losses on securities—if they sell a Government bond to make a loan to a consumer or a home buyer or a businessman—to treat the loss on any such sale as a deduction against income, an ordinary loss, but a gain on any such sale as a capital gain.

This has led to a great deal of wiggling and wobbling around in

the market each year to decide since, this is a net operation, whether they want to make a loss or a gain for the year as a whole.

Senator FULBRIGHT. Is this situation with regard to the banks as the result of the experience in the depression or, put it prior to that time, did the banks have the similar advantages over other businesses or not?

Secretary KENNEDY. It is a result of the experience in the depression. The banks were going broke as a result of their bad-debt losses, and it was an attempt to build up capital to sustain them over periods of heavy loss.

Senator FULBRIGHT. I understand that. Before that happened, were they on the same basis as other businesses?

Secretary KENNEDY. I think they were.

Senator FULBRIGHT. I am just curious if that is so.

Secretary KENNEDY. We will have to look that part up particularly, but I am pretty sure that they were.

Senator FULBRIGHT. Then it seems to me with the development of the FDIC and, in a sense, the sponsorship and subsidy of the FDIC by the Government, that this reason for special preference for the banks is somewhat lessened, is it not?

Secretary KENNEDY. You mean the subsidy by the banks to the FDIC. Who pays the assessment?

Senator FULBRIGHT. Well, the Government organized it.

Secretary KENNEDY. They organized it, and it is assessed to the banks.

Senator FULBRIGHT. And they also have a contingency guarantee.

Secretary KENNEDY. That is right.

Senator FULBRIGHT. That stands there, is that not so, in addition to what is actually paid in?

Secretary KENNEDY. Well, that is in case of insolvency. That does not help you to get your loan collected.

Senator FULBRIGHT. That is what I mean.

Secretary KENNEDY. It is only in a bad case where you are going broke.

Senator FULBRIGHT. All I meant is, there is certainly some help.

Secretary KENNEDY. That helps, that is right, no question about it.

The CHAIRMAN. Thank you so much.

I want to ask the Secretary a few more questions. But if I might, I would just like to ask our friends from the radio and television to turn these lights off.

Secretary KENNEDY. Those two big ones here are the ones that hit me.

The CHAIRMAN. Yes. Mr. Secretary, there is one thing here that concerns me about what I think has not been a fair presentation of what is in the bill.

It is table 3 in your presentation here which is attached back on page 90.

IMPACT OF THE INVESTMENT CREDIT

Now, that chart undertakes to show how the various classes of taxpayers are affected. It does not take into account, compute into this set of figures, the impact of the investment tax credit.

Now, I understand the investment tax credit, of course, is primarily of advantage to corporations; is it not?

Secretary KENNEDY. To corporations; that is correct. But there are some——

The CHAIRMAN. So what we are doing with corporations with this bill with respect to investment credit, four of the big items would reflect the dividends that those corporations are able to pay, and even to the extent that it does not, it reflects retained earnings, which evenually the corporations could, perhaps, pay out.

One is wealthy because the corporation has more assets whether it pays more dividends or not.

So I would like to ask that your officials work with our staff to try to come up with the best guess to give us some idea of what this thing would mean if you put the investment tax credit into that chart.

Secretary KENNEDY. We can provide that. We will see what we can do.

The CHAIRMAN. I think it is going to show up, for one thing, that the category of taxpayers of the $20,000 and over—and even more it would be emphasized when we get above $50,000, and even more so above $100,000—that of these upper middle- and high-income bracket payers are being taxed a lot more and getting much less back on the overall impact of this bill than is indicated.

Secretary KENNEDY. Than this shows.

The CHAIRMAN. In other words, that category of taxpayer which may appear to be gaining some benefit in the $20,000 to $50,000 or $50,000 to $100,000 range might well not be gaining anything; in fact, might be a net loser by the time you crank into your computer where you would be when you see——

Secretary KENNEDY. Phase out the investment tax credit.

The CHAIRMAN (continuing). When you see what the investment tax credit will be. We will have to get the best estimate of how stock is held, who holds it, where the dividends go, how much of it would be to cut it out in dividends, and so forth. Give us some idea as to what this chart would mean if you take that big item of $3 billion a year into calculation.

Mr. COHEN. There are others; there would be other problems, too, Senator.

For example, the changes that produce additional taxes for banks and oil companies and other effects upon the corporate structure might be reflected. That will get you into the argument as to whether the corporate tax is shifted forward to the consumer or is it a burden entirely upon the shareholders of the corporation.

But we can do it on one or another assumption. But I assume that we could show the investment credit alone, but there would be also other substantial corporate increases and some decreases that we can show.

The CHAIRMAN. I think you would have to work on the assumption that it is not going to be shifted onto the consumers; and having done so, you might try to arrive at some balance to try to give your best guess as to what percentage of it they can roll forward.

Mr. COHEN. Yes; we would be happy to do it.

(The Department of the Treasury subsequently submitted the following information:)

TAX UNDER PRESENT LAW AND TAX CHANGE UNDER H.R. 13270 AND THE TREASURY PROPOSALS BEFORE THE SENATE FINANCE COMMITTEE ASSUMING FINAL INCIDENCE OF THE CORPORATION INCOME TAX IS BORNE 50 PERCENT BY STOCKHOLDERS AND 50 PERCENT BY CONSUMERS

| Adjusted gross income class (in thousands of dollars) | Present law tax (millions) | Change in H.R. 13270 tax (millions) | Treasury change before Senate Finance (millions) | Percent change | |
|---|---|---|---|---|---|
| | | | | H.R. 13270 from present law | Treasury from present law |
| 0 to 3 | $3,481 | −$431 | −$424 | −12.4 | −12.2 |
| 3 to 5 | 5,632 | −691 | −211 | −12.3 | −3.7 |
| 5 to 7 | 8,226 | −579 | −153 | −7.0 | −1.9 |
| 7 to 10 | 16,416 | −608 | −319 | −3.7 | −1.9 |
| 10 to 15 | 24,427 | −942 | −545 | −3.9 | −2.2 |
| 15 to 20 | 11,921 | −304 | −230 | −2.6 | −1.9 |
| 20 to 50 | 19,360 | −51 | −230 | −0.3 | −1.2 |
| 50 to 100 | 9,345 | +82 | −32 | +0.9 | −0.3 |
| 100 and over | 13,075 | +1,141 | +79[illegible] | +8.7 | +6.1 |
| Total | 111,884 | −2,383 | −1,[illegible] | −2.1 | −1.2 |

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

TAX UNDER PRESENT LAW AND TAX CHANGE UNDER H.R. 13270 AND THE TREASURY PROPOSALS BEFORE THE SENATE FINANCE COMMITTEE ASSUMING FINAL INCIDENCE OF THE CORPORATION INCOME TAX IS ALL BORNE BY INDIVIDUAL STOCKHOLDERS

| Adjusted gross income class (in thousands of dollars) | Present law tax (millions) | Change in H.R. 13270 tax (millions) | Treasury change before Senate Finance (millions) | Percent change | |
|---|---|---|---|---|---|
| | | | | H.R. 13270 from present law | Treasury from present law |
| 0 to 3 | $2,155 | −$623 | −$560 | −28.9 | −26.0 |
| 3 to 5 | 4,272 | −888 | −350 | −20.8 | −8.2 |
| 5 to 7 | 6,815 | −783 | −297 | −11.5 | −4.4 |
| 7 to 10 | 14,002 | −957 | −567 | −6.8 | −4.0 |
| 10 to 15 | 21,690 | −1,336 | −827 | −6.2 | −3.8 |
| 15 to 20 | 11,564 | −355 | −267 | −3.1 | −2.3 |
| 20 to 50 | 21,910 | +317 | +32 | +1.4 | +0.1 |
| 50 to 100 | 11,385 | +376 | +177 | +3.3 | +1.6 |
| 100 and over | 18,090 | +1,866 | +1,314 | +10.3 | +7.3 |
| Total | 111,884 | −2,383 | −1,345 | −2.1 | −1.2 |

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

TAX UNDER PRESENT LAW AND TAX CHANGE UNDER H.R. 13270 AND THE TREASURY PROPOSALS BEFORE THE SENATE FINANCE COMMITTEE ASSUMING FINAL INCIDENCE OF THE CORPORATION INCOME TAX IS ALL BORNE BY INDIVIDUAL CONSUMERS

| Adjusted gross income class (in thousands of dollars) | Present law, tax (millions) | Change in H.R. 13270, tax (millions) | Treasury change before Senate Finance (millions) | Percent change | |
|---|---|---|---|---|---|
| | | | | H.R. 13270 from present law | Treasury from present law |
| 0 to 3 | $4,807 | −$240 | −$288 | −5.0 | −6.0 |
| 3 to 5 | 6,992 | −495 | −71 | −7.1 | −1.0 |
| 5 to 7 | 9,637 | −376 | −8 | −3.9 | −0.1 |
| 7 to 10 | 18,830 | −260 | −72 | −1.4 | −0.4 |
| 10 to 15 | 27,164 | −545 | −264 | −2.0 | −1.0 |
| 15 to 20 | 12,278 | −252 | −193 | −2.1 | −1.6 |
| 20 to 50 | 16,810 | −419 | −491 | −2.5 | −2.9 |
| 50 to 100 | 7,305 | −213 | −242 | −2.9 | −3.3 |
| 100 and over | 8,060 | +417 | +284 | +5.2 | +3.5 |
| Total | 111,884 | −2,383 | −1,345 | −2.1 | −1.2 |

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

CORPORATE TAX RATES

The CHAIRMAN. You have arguments both ways. Some people contend that corporations shift all their taxes to the consumer. They will if they can, we understand that, because if they cannot roll their expenditures forward and pass it on to the consumer they are not making a profit and will have to go out of business. So they try to pass it all forward.

But the rule of thumb is that the big ones try to declare about 50 percent of their earnings out in dividends, and the other half they try to put into expansion.

Mr. COHEN. I might say this point of where the corporate tax burden falls is a significant item, Mr. Chairman, in determining what the effective tax rate is in the upper income tax brackets.

It has been said that the effective tax rate in the $100,000-and-up brackets is less than the effective tax rate in some lower brackets. But if you assume that the corporate tax burden is borne by the shareholders or even three-quarters of it is borne by the shareholders, you will find, I think, that the tax burden on the individuals in the upper income brackets is a progressive one; it is much higher than that of those in the middle-income brackets.

You have to make an assumption as to where the corporate tax burden really falls, and that is because the largest holdings of stock in the corporations will be held by those in the upper income brackets.

The CHAIRMAN. Right.

We have heard both sides of that philosophy expressed from your side of the table. Just a while back, someone was contending that a reduction in depletion allowances, which means an increase in the tax on oil companies, will cause, apparently, an increase in cost. Secretary Walker said if they could raise their price they would have done it already. That, then, gets us back to what Estes Kefauver conducted his investigation about—administered prices. He contended that many were setting the prices, not based on competitive factors as much as on an administered price basis: feeling that they were entitled to make a certain amount of money on their investment, and that is about what they were shooting for.

You can argue those factors, but I think we ought to try to take both of them into consideration.

There is not a doubt in the world that the oil companies would pay more taxes, and if they can they are going to try to push them forward onto the consumer. If they cannot, it is just because the competition in the industry is such that they cannot do it, and if they cannot do it, it is frankly going to be difficult to attract capital into the industry. That runs into the argument the Secretary makes that he thinks they can still attract enough capital. With all these factors, obviously we cannot be 100-percent right on both sides of that argument.

Either they can pass it on or they cannot pass it on, or else they can pass part of it on but cannot pass on the rest, which is probably more likely the answer.

CAPITAL GAINS PROBLEMS

Now, I am concerned about this capital gains problem in some situations where it seems very unfair to me.

Is it not true that with regard to an asset held over a period of many

years in many instances the capital gains tax is merely a matter of forcing the citizen to pay taxes as a penalty for the fact that the Government has failed to maintain the purchasing power of the dollar?

I have in mind, for example, where a person buys a piece of property which brings him very little income, little or none, and I look at what has happened in the past 30 years he has been holding it that long. If he bought a piece of property in 1939 worth $100,000, and he sold it today at a price that would bring him the same purchasing power that he paid for it at that time he would be selling at $263,800, and he would be paying a capital gains tax of $41,000.

That is assuming the State is not getting to him for some of that, too. So he would be paying a $41,000 penalty because the Government was not able to maintain a stable price level.

Now, as I understand, there was some talk about considering this factor in the House of Representatives when the Ways and Means Committee studied this matter.

Would you not be willing to concede that in a great number of cases—particularly when an asset has been held over a long period of time—that the capital gains would not represent income at all? In fact, in some cases, assuming he is not getting $263,000 for it, assuming he is getting only $200,000, in terms of constant dollars or purchasing power, he is actually losing money. You would be taxing him $25,000 on a loss transaction considered in real terms.

Secretary KENNEDY. I think, Senator, we would take a look at whether there could be some differential in rates about long-term holdings. That is what you are alluding to, I am sure.

The CHAIRMAN. That is right. And it may be that we can only do it with regard to property, but I do think it rather unfair that we should tax someone, place a heavy tax on someone, where he really did not make any money in real terms at all; he only made it in terms of inflation.

Secretary KENNEDY. I think we should study that and take a look at it.

The CHAIRMAN. How far we can go with that principle, I do not know, but if we are going to raise this capital gains tax rate, I think it is about time that we start doing something for the fellow who really did not make any money at all in real terms. It is just a fictitious profit, and in many instances an actual loss. We might be able to do something about it, and if we could I think it would be simple justice.

Now, with regard to what the House did on foreign depletion, what is your estimate of how much money you make out of that?

Mr. COHEN. I am sorry, Mr. Chairman; I did not hear that.

#### DEPLETION ALLOWANCES ON FOREIGN OIL

The CHAIRMAN. With regard to what the House did to eliminate depletion allowances on foreign oil, how much money do you estimate you are going to make out of that?

Mr. COHEN. Well, I think that we estimated that there would be a short-term revenue gain of perhaps $15 or $20 million, but that we thought there would be no revenue gain ultimately because it would have its principal effect in inducing the foreign countries to raise their

taxes. So that the net effect by the time they got around to changing their income taxes would be only to cost the American companies money in additional taxes abroad.

The CHAIRMAN. Well, if you think you are going to get a gain even for a year you are in for a disappointment, unless you are in a position to repeal the foreign tax credit, and if you do that it would be the most unfair thing you can do to one industry without doing it to all of them.

Are you aware of the fact that practically all of the modern countries that I know of, all of them, treat their foreign trading companies far more generously than we treat ours?

Mr. COHEN. Well, yes, sir. I understand that a number of the foreign countries neither tax the profits nor give any deductions for losses on foreign operations. They drop a wall around their own country and any operations outside of the country are not taxed.

We have given some consideration to that, but it has not been done in this bill, and nothing in this bill would affect the right of companies that have a net loss abroad from deducting that loss against American income.

I want to say we have opposed, Senator, we have opposed in our recommendations, this provision that would eliminate percentage depletion with respect to foreign oil and gas production. But we have recommended to you changes with respect to the foreign tax credit in order to prevent any duplication of credits or undue benefits from the difference in tax rates between the foreign law, which does not allow a percentage depletion, and our law which does allow it.

We suggest that differential should be taken into account in determining the foreign tax credit, and we think that would eliminate any present undue advantage there is in the law.

The CHAIRMAN. Let me just illustrate that situation. May I say this, that while talking on this subject, if we must choose between taxing a Louisiana oil producer and taxing some fellow producing in the Persian Gulf, I am for taxing the fellow in the Persian Gulf. Let us understand that.

But the question is, do you make anything or do you lose money by this, and I think it should be carefully calculated with that in mind.

Now, a spokesman of Standard Oil of New Jersey visited me sometimes ago, and he will be here to testify. I think his testimony would go something like this, that in an operation out of $16 billion of sales, they have about $9 billion of expenses, and they pay something in excess of $5 billion of taxes to governments.

They are left in the position then to have about $1.2 billion, which they must plow back in a substantial amount, I think they plow back about $400 million, and actually have to borrow about $600 million in order to keep up with competition and stay modern.

They borrow money rather than put more earnings into their program of their modernization and expansion and improvement, because if they do not declare enough money out of their earnings and dividends to keep it an attractive investment then stockholders are going to put their money in something else, and it will depress the value of the stock.

So, as I understand it, they are able to bring home about $700 million, to declare dividends, and after the stockholders pay taxes on that,

perhaps $400 million actually got through to the stockholders after taxes.

Now, in the process of all of this, you would make about $350 million profit by the tax you collect on their shareholders when the dividend is declared.

But if we raise the tax on the company, it won't take a year for the Arab countries to realize that all they must do is just raise the tax on American companies and it would go into their treasury rather than ours. The company would still be in the same position. The Organization of Petroleum Exporting Counties, and the Organization of the Arab Petroleum Exporting Countries, are so sophisticated nowadays that if someone like Gulf Oil Co. goes to bid for a lease in Thailand, the OAPEC or the OPEC, as the case may be, has a representative there to consult with the Thailand Government to say: "By all means, you must not let that company get terms any more favorable than they have with us, because otherwise they will be trying to use this as leverage to try to get a better deal from us."

So the result is those people are so sophisticated, so well advised by lawyers here and elsewhere, that I predict that you won't have this elimination of that overseas 27½ percent on the statute books 60 days before they will raise their tax on all these companies and recoup it for their country rather than ours.

When you do that you would then lose the tax you would be collecting on the dividends if those people had been permitted to take the money and bring it on home. Doesn't that make sense?

Mr. COHEN. That is why we are opposed to it.

The CHAIRMAN. In other words, I think you ought to follow this thing through. You think your gain would be negligible, it would not be but a negligible gain. After the Arabs got through—you wouldn't have any gain. They have some pretty smart people themselves, and they are smart enough to figure that out and say, "Here is where we could make a lot of money off these American oil companies and it won't cost those companies anything because if they did not pay it to us they would have to pay it to the American Government."

Isn't that about the size of it?

Mr. COHEN. Yes. In some countries, Senator, the law provides automatically that it goes up to sponge up any tax that we would collect, so that it would not even require any further action.

The CHAIRMAN. I did not know that. You mean some countries have their laws fixed so that anytime we raise the tax on one of our oil companies doing business in that country their tax automatically goes up to sop up anything that our Treasury would otherwise achieve.

Mr. COHEN. That is correct.

The CHAIRMAN. Now, the thought occurs to me that if we really want to get more money for American oil companies who are taxed overseas, and heaven knows who they are competing with, they are competing with the Japanese, they are competing with the Germans, the Italians, with the British, and they are competing with some very up and coming efficient concerns.

Now, if we want to tax them more heavily than other countries tax them, or if we want to get more money out of them, the most logical way to do it would be to tax the oil coming into this country, and you could do it by taxing the tickets that come in, the oil import tickets,

or you could do it by putting a border tax on it if you wanted to, or you could simply reverse what you have done on some of these tariff agreements under the reciprocal trade deal.

But if you did it that way at least you would be getting this Government some money.

All you are doing is losing this Government money with what is in the bill, is that not correct?

Mr. COHEN. With respect to that point, yes.

The CHAIRMAN. It seems to me some people are so anxious to whip the oil industry and make a big show out of it that they actually beat the poor horse to the extent of losing money. I wish you would try to calculate what happens, and let us know the answer if those foreign countries do what you think they will do, what the Interior Department thinks they will do, what they think the foreign countries will do, and what I think they will do if that happens. What happens to your revenue? I think you will find that you do not have a negligible gain, you have a very substantial loss, and it would not take very long for it to happen.

I would think that any member of OPEC or OAPEC would think that they were very inefficient and foolhardy indeed if they had not recouped that money for their treasuries within 60 days by the time we put it into effect. That would mean they did not have good lawyers, good accountants, or good legislators.

In many instances, they can just do it by Government decree, can they not? It does not mean the calling of a special session of the legislature, they just issue a decree.

Senator BENNETT. Mr. Chairman, before you go on to another subject, I am going to peel off and leave these friends of mine.

The CHAIRMAN. I promise you I will not browbeat the witnesses. I will protect the Republican employees as well as the Democratic employees in these closing moments.

Senator BENNETT. If you would permit me, I would just like to express to the Secretary and his staff my appreciation for their great patience, their very remarkable knowledge of the details of the bill and the law, and the problems, and to say for myself and my colleague that we have enjoyed this first real major appearance of this team before the committee. I look forward to further assistance and cooperation when we meet to write up the bill.

The CHAIRMAN. Senator, if you will just stick around for one moment, I am going to show equal charity to the Secretary.

I did want to ask you if you would provide us with some additional information in addition to that which has already been provided—Mr. Cohen submitted a statement, and in the statement was a table showing the revenue effect of the Treasury suggestions.

Several of the categories, however, have several different items in them; for example, capital gains, charitable contributions, natural resources, financial institutions, to name but a few.

Would you submit for the record a table showing the revenue effect of each of these suggestions so that we could separate them out?

Secretary KENNEDY. We shall.

Mr. COHEN. Delighted, Mr. Senator.

(The Department of the Treasury subsequently supplied the following information:)

EFFECT OF CURRENT TREASURY PROPOSALS ON CALENDAR YEAR LIABILITIES

[In millions of dollars]

| | 1959 | 1970 | 1971 | 1972 | 1974 | 1979 |
|---|---|---|---|---|---|---|
| **REFORM PROVISIONS** | | | | | | |
| Individuals: | | | | | | |
| Contributions | | 5 | 10 | 20 | 20 | 20 |
| Farm losses | | 5 | 10 | 20 | 30 | 50 |
| Accumulation trusts | | 5 | 10 | 20 | 30 | 70 |
| Capital gains | | 360 | 365 | 375 | 395 | 425 |
| Natural resources | | 70 | 70 | 70 | 70 | 70 |
| LTP | | 60 | 60 | 60 | 60 | 60 |
| Allocation | | 240 | 480 | 480 | 480 | 480 |
| Real estate | | 5 | 25 | 60 | 150 | 330 |
| Tax-free dividends | | | | | 80 | 80 |
| Gasoline tax deduction | | | 390 | 390 | 390 | 390 |
| Total | | 750 | 1,420 | 1,495 | 1,705 | 1,975 |
| Corporations: | | | | | | |
| Foundations | | 15 | 15 | 20 | 20 | 25 |
| Unrelated business income | | 5 | 5 | 5 | 5 | 20 |
| Multiple corporations | 30 | 70 | 125 | 170 | 235 | 235 |
| Financial institutions | | 280 | 310 | 330 | 380 | 380 |
| Natural resources | | 430 | 440 | 455 | 480 | 530 |
| Foreign income | | 50 | 50 | 50 | 50 | 50 |
| Regulated utilities | | 60 | 140 | 185 | 260 | 310 |
| Real estate | | 10 | 85 | 195 | 475 | 985 |
| Corporate mergers, etc. | | 10 | 20 | 25 | 40 | 70 |
| Capital gains rate | 65 | 150 | 150 | 150 | 150 | 150 |
| Total | 95 | 1,080 | 1,340 | 1,585 | 2,095 | 2,755 |
| **TAX RELIEF PROVISIONS** | | | | | | |
| Individuals: | | | | | | |
| Low-income allowance | | −920 | −920 | −920 | −920 | −920 |
| Increase standard deduction | | | −770 | −770 | −770 | −770 |
| Maximum tax on earned income | | −200 | −100 | −100 | −100 | −100 |
| Single persons' rate schedule | | | −445 | −445 | −445 | −445 |
| Reduce tax rates | | | −2,350 | −4,705 | −4,705 | −4,705 |
| Moving expenses | | −100 | −100 | −100 | −100 | −100 |
| Income averaging | | −300 | −300 | −300 | −300 | −300 |
| Total | | −1,520 | −4,985 | −7,340 | −7,340 | −7,340 |
| Corporations: | | | | | | |
| Normal tax reduction of 1 percent | | | −870 | −870 | −870 | −870 |
| Surtax reduction of 1 percent | | | | −800 | −800 | −800 |
| Total | | | −870 | −1,670 | −1,670 | −1,670 |
| **TAX INCENTIVE PROVISIONS** | | | | | | |
| Pollution control amortization (corporation) | | −15 | −40 | −70 | −115 | −120 |
| Real estate rehabilitation (individual) | | −5 | −10 | −20 | −40 | −70 |
| Real estate rehabilitation (corporation) | | −10 | −40 | −80 | −160 | −260 |
| Total | | −30 | −90 | −170 | −315 | −450 |
| **OTHER PROVISIONS** | | | | | | |
| Repeal investment credit: | | | | | | |
| Individuals | 400 | 600 | 600 | 600 | 600 | 600 |
| Corporations | 500 | 1,900 | 2,400 | 2,400 | 2,500 | 2,700 |
| Total | 900 | 2,500 | 3,000 | 3,000 | 3,100 | 3,300 |
| Extend surcharge: | | | | | | |
| Individuals | | 2,100 | | | | |
| Corporations | | 1,000 | | | | |
| Total | | 3,100 | | | | |
| Extend excise taxes | | 1,170 | 800 | 800 | | |
| Grand total | 995 | 7,050 | 615 | −2,300 | −2,425 | −1,435 |
| Individuals | 400 | 1,925 | −2,975 | −5,265 | −5,075 | −4,840 |
| Corporations | 595 | 3,955 | 2,790 | 2,165 | 2,650 | 3,405 |
| Excises | | 1,170 | 800 | 800 | | |

REVENUE ESTIMATES TAX REFORM (TREASURY PROPOSALS)—CALENDAR YEAR LIABILITY [1]

[In millions of dollars]

| | 1970 | 1971 | 1972 | 1974 | 1979 |
|---|---|---|---|---|---|
| Gasoline tax deduction | | 390 | 390 | 390 | 390 |
| Corporate capital gains | [2] 150 | [2] 150 | [2] 150 | [2] 150 | [2] 150 |
| Foundations—investment income tax | 15 | 15 | 20 | 20 | 25 |
| Unrelated business income | 5 | 5 | 5 | 5 | 20 |
| Contributions | 5 | 10 | 20 | 20 | 20 |
| Farm losses | 5 | 10 | 20 | 30 | 50 |
| Moving expenses | −100 | −100 | −100 | −100 | −100 |
| Railroad depreciation | (3) | (3) | (3) | (3) | (3) |
| Amortization of air and water pollution | [2] −15 | [2] −40 | [2] −70 | [2] −115 | [2] −120 |
| Corporate mergers, and so forth | 10 | 20 | 25 | 40 | 70 |
| Multiple corporations | 70 | 125 | 170 | 235 | 235 |
| Accumulation trusts | 5 | 10 | 20 | 30 | 70 |
| Income averaging | −300 | −300 | −300 | −300 | −300 |
| Deferred compensations: | | | | | |
| Restricted stock | (4) | (4) | (4) | (4) | (4) |
| Other deferred compensation | (3) | (3) | (3) | (3) | (3) |
| Stock dividends | (4) | (4) | (4) | (4) | (4) |
| Subchapter S | (4) | (4) | (4) | (4) | (4) |
| Tax-free dividends | | | (4) | 80 | 80 |
| Financial institutions: | | | | | |
| Commercial banks: | | | | | |
| Reserve | [2] 210 | [2] 210 | [2] 210 | [2] 210 | [2] 210 |
| Capital gains | 50 | 50 | 50 | 50 | 50 |
| Mutual thrift institutions | [2] 20 | [2] 50 | [2] 70 | [2] 120 | [2] 120 |
| Municipals | (4) | (4) | (4) | (4) | (4) |
| Capital gains: | | | | | |
| Capital loss provisions | 50 | 50 | 55 | 60 | 65 |
| 6 months, 1-year holding | (3) | (3) | (3) | (3) | (3) |
| Pension plans | (4) | 5 | 10 | 25 | 50 |
| Casualty loss | (4) | (4) | (4) | (4) | (4) |
| Sale of papers | (4) | (4) | (4) | (4) | (4) |
| Life estates | 10 | 10 | 10 | 10 | 10 |
| Franchises | (4) | (4) | (4) | (4) | (4) |
| Alternate rate | 300 | 300 | 300 | 300 | 300 |
| Natural resources: | | | | | |
| Production payment | 100 | 110 | 125 | 150 | 200 |
| Cut percentage depletion | 400 | 400 | 400 | 400 | 400 |
| Foreign depletion | (1) | (1) | (1) | (1) | (1) |
| Foreign income: | | | | | |
| Loss carryover | 35 | 35 | 35 | 35 | 35 |
| Restriction on mineral credits | 15 | 15 | 15 | 15 | 15 |
| Individual interest deduction | (1) | (1) | (1) | (1) | (1) |
| Regulated utilities [5, 6] | [illegible] | 140 | 185 | 260 | 310 |
| Cooperatives | [illegible] | (4) | (4) | (4) | (4) |
| Limit on tax preferences (LTP) | [illegible] | 50 | 60 | 60 | 60 |
| Allocation | [illegible] | 480 | 480 | 480 | 480 |
| Real estate: [5] | | | | | |
| Used property | [2] 15 | [2] 40 | [2] 65 | [2] 150 | [2] 250 |
| New nonhousing | (4, 2) | [2] 60 | [2] 170 | [2] 435 | [2] 960 |
| Capital gain, recapture | (4, 2) | [2] 10 | 20 | 40 | 100 |
| Rehabilitation | [2] −15 | [2] −50 | [2] −100 | [2] −200 | [2] −330 |
| Preliminary total | 1,400 | [2] 2,270 | [2] 2,510 | [2] 3,[illegible]85 | [2] 3,875 |
| Plus investment credit | 2,500 | 3,000 | 3,000 | 3,100 | 3,300 |
| Total | [2] 3,900 | [2] 5,270 | [2] 5,510 | [2] 6,185 | [2] 7,175 |

[1] Except as indicated these estimates are all at current levels, the time differences being solely to show the phasein.
[2] Estimates have been revised from estimates shown as part of Assistant Secretary Cohen's statement before Senate Finance Committee.
[3] Administration recommends deletion.
[4] Less than $2,500,000.
[5] Assumes growth.
[6] Excludes change to 150 percent for construction of public utilities, 1971, $10,000,000; 1972, $30,000,000; 1974, $50,000,000; 1979, $80,000,000.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, Oct. 2, 1969.

Secretary KENNEDY. I would like to say this, in response to Senator Bennett and to the hearing here on this matter, we consider this very important. We think that this tax bill is important to this country, and we are here at your disposal, not only at this open hearing but any time to furnish you with whatever information, help, or guidance we can and to work with your technicians.

You have a legislative job on your hands, but we have, of course, the administrative side of it, and we want to work hand-in-glove with you, and we appreciate this kind of cooperation.

The CHAIRMAN. Mr. Secretary, no matter how much we Democrats proclaim our desire to change this tax structure for the good of all citizens concerned, and even though we have a majority in the Congress, there is no doubt in my mind when this President of the United States signs the tax bill this is going to be his bill, whether he likes it or not.

Secretary KENNEDY. I pray it will.

The CHAIRMAN. It will be in line with your administration even if we draft it and insist on rejecting all amendments offered by Republicans, Senators and Congressmen. So for better or for worse, this is going to be an achievement of the Nixon administration, no matter how much we Democrats may claim it if it turns out all for the best, and I hope very much that it will be a good monument to your administration.

Secretary KENNEDY. I hope so, so that it will be for the good of the country.

The CHAIRMAN. And in the national interest I hope it will be something we can all join together and proudly proclaim for the good of the country.

I do think some of it needs changing. Some of the work was done hastily in the House, but I would hope in the time afforded us—we have 7 weeks—we can do a good job, and work with you and to consider all of your suggestions.

I do not know how you stood all the bright lights. I noticed you put on some dark glasses. I started to send for Senator Fulbright's baseball cap to provide you with some help in shielding you from them, but you have done 2 days of very hard work, and this committee appreciates all the help and the courteous way you have responded to questions, some of which have been a little bit intemperate from time to time. We appreciate the way you have been restrained in responding to speeches that some Senators felt inspired to direct to you.

Thank you very much, Mr. Secretary.

I thank both you and Mr. Cohen, Mr. Walker, and your other two fine assistants here for a very good job.

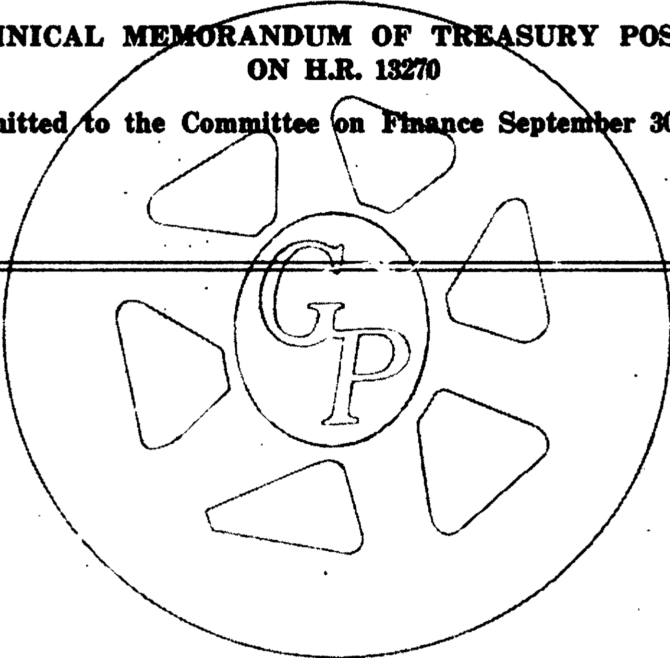
Secretary KENNEDY. Thank you, Mr. Chairman.

(Whereupon, at 5 p.m., the committee recessed, to reconvene at 10 a.m., Monday, September 8, 1969.)

## APPENDIX A

# TECHNICAL MEMORANDUM OF TREASURY POSITION ON H.R. 13270

(Submitted to the Committee on Finance September 30, 1969)



## TABLE OF CONTENTS


| Section | Subject | Page |
| --- | --- | --- |
| 101 | Private Foundations | 1 |
| 121 | Other Exempt Organizations | 17 |
| 201 | Charitable Contributions | 20 |
| 211-213 | Farm Losses | 34 |
| 231 | Moving Expenses | 37 |
| 301, 302 | Limit on Tax Preferences and Allocation of Deductions | 38 |
| 311 | Income Averaging | 51 |
| 321 | Restricted Property | 53 |
| 341 | Accumulation Trusts | 58 |
| 401 | Multiple Corporations | 64 |
| 411, 412 | Debt-Financed Corporate Acquisitions and Related Problems | 67 |
| 431, 432 | Foreign Tax Credit | 73 |
| 441-443 | Financial Institutions | 78 |
| 444 | Foreign Deposits in United States Banks | 86 |
| 451 | Regulated Utilities | 88 |
| 452 | Effect on Earnings and Profits of Accelerated Depreciation | 95 |
| 461, 511-516 | Capital Gains and Losses | 98 |
| 521 | Real Estate | 110 |
| 531 | Cooperatives | 113 |
| 601 | State and Local Obligations | 117 |
| 704 | Amortization of Pollution Control Facilities | 121 |
| 801-805 | Adjustment of Tax Burden | 125 |

**September 30, 1969**

**Technical Memorandum**
**of Treasury Position**
**on H.R. 13270, Tax Reform Act of 1969**

Sec. 101--Private Foundations

1. Tax on Investment Income

The House bill proposes a 7-1/2 percent tax on net investment income of private foundations. Treasury recommends that in lieu of this revenue-raising levy, a supervision tax be imposed to offset the cost of administering the audit program for foundations. It is estimated that 2 percent of net investment income would be sufficient for this purpose.

2. Computation of Investment Income

The bill now allows the full amount of a capital loss to be deducted from gross investment income. This is inconsistent with the method of computing taxable income of other taxpayers. Treasury recommends that the deduction for capital losses be limited to the amount of capital gains, with a five-year carryforward, thus providing the same treatment given to corporations.

The bill now allows a deduction for ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income. This provision should be clarified to make certain that it includes an allowance for depreciation (including accelerated depreciation) and depletion (including percentage depletion). Foundations should be allowed to claim such deductions to the extent they are related to gross investment income in computing the tax on net investment income in the same manner as other taxpayers.

The bill provides that, in computing net capital gain or loss, the basis of property held by a foundation on December 31, 1969, shall not be less than the fair market value of such property on such date. This treatment should be limited to the determination of gain. Losses should be determined in relation to adjusted basis. This is similar to the treatment now provided for property held on March 1, 1913.

3. Substantial Contributor

Several provisions of the bill depend upon whether a person is a substantial contributor to the private foundation. A substantial contributor is any person who (by himself or with his spouse) contributed more than $5,000 to the foundation in any one calendar year, or any person who (by himself or with his spouse) contributed or bequeathed the largest amount to the foundation in any one calendar year. The latter rule should be clarified to indicate that if two or more persons contribute the same amount, all such persons should be treated as the largest contributor if no other person contributes a greater amount. Since the spouse of a substantial contributor to the foundation is included in the group of disqualified persons, it is not necessary to apply the $5,000 minimum or the largest contributor rule to a husband and wife as a unit. Thus, the parenthetical "(by himself or with his spouse)" should be eliminated in both provisions.

4. Abatement of Taxes

In the case of a private foundation which voluntarily gives up its status as such or which has engaged in willful and flagrant violations of the law, the bill provides for a tax equal to the amount of tax benefit previously received by the foundation and its substantial contributors from the tax-exempt status of the foundation, limited to the value of the net assets of the foundation at a specified time. The bill gives the Secretary or his delegate authority to abate the unpaid portion of the tax if the private foundation distributes all of its net assets to a public charitable organization. In addition, if a private foundation which has not engaged in willful and flagrant violations of the law voluntarily terminates its status as a private foundation, the tax may be abated, provided the foundation has operated as a public charity for a continuous 60-month period prior to the date of such voluntary termination.

It does not seem logical that a private foundation which has not engaged in willful and flagrant violations should be subjected first to imposition of tax and later abatement of if it transfers its assets or converts to a public charity.

the contrary, Treasury believes that such a private foundation should be encouraged to transfer its assets to or convert to a public charity. Accordingly, Treasury recommends that the bill be amended to permit such a private foundation to terminate its status as such, following notice to the Commissioner, if it either transfers its assets to a public charity or operates as a public charity for a continuous 60-month period. In the latter case, the foundation would lose its private foundation status only at the end of the 60-month period, but no tax on termination of status would ever be imposed.

With respect to a private foundation which has engaged in willful and flagrant violations, the tax on termination of status currently applies under the bill, unless the Secretary abates the tax upon a showing that the foundation is distributing all of its net assets to a public charity. Provision should also be made for abatement of this tax if the State Attorney General takes appropriate corrective action to insure that such foundation's assets are preserved for charitable purposes.

5. Definition of Private Foundation

The bill excludes various categories of charitable organizations from the term "private foundation" where those organizations are subject to the discipline of continuing reliance on public support. One of the excluded categories is an organization which receives more than one-third of its support in the form of either gifts or receipts from the performance of its exempt function and meets certain other conditions.

Thus a definition of support should also be added to proposed section 509, since the definition of a private foundation may hinge upon the fraction of support received from various sources. Treasury recommends adoption of the definition currently in section 1.170-2(b)(5)(ii) of the Income Tax Regulations (which defines "support" in connection with the delineation of organizations qualifying for the 30 percent contribution rule of present law), modified to include in support any amounts received from the exercise or performance by an organization of its exempt purpose or function. Such amounts are already included in the numerator of the fraction described in proposed section 509(a)(2)(A) of the bill, and the bill should be clarified to include such amounts in the denominator as well.

6. Income Distribution Requirement

A nonoperating private foundation is required under the bill to distribute currently each year the larger of its net income or a minimum investment return based on a percentage (at present 5 percent) of the aggregate fair market value of the investment assets of the foundation. The minimum investment return is determined on a gross basis without deduction for investment expenses. A deduction should, however, be allowed for the tax on foundation income imposed by section 506 of the bill (or for the 2 percent supervision tax recommended by the Treasury).

For purposes of the income distribution requirement, the bill now allows a deduction for ordinary and necessary expenses paid or incurred for the production or collection of gross income or for the management, conservation, or maintenance of property held for the production of such income. This provision should be clarified to make certain that such deduction includes an allowance for depreciation (including accelerated depreciation) and depletion (including percentage depletion).

Qualifying distributions (subparagraph (g) of proposed section 4942) include any amounts, including administration expenses, expended directly to accomplish the foundation's exempt purposes; they also include contributions to another organization in furtherance of such purposes. Limitations on payments to other organizations are provided in order to assure that the money will be currently expended and will not remain under the control of the persons in control of the private foundation. Thus, contributions to a private foundation which is not an operating foundation, to a foreign organization which would be a private foundation if it were a domestic organization, and to an organization controlled by one or more disqualified persons with respect to the foundation are not qualifying distributions.

The Treasury believes that these exclusions are more restrictive than is necessary to accomplish the desired purpose. Thus, Treasury recommends that contributions to a foreign organization which would be a private operating foundation if it were a domestic organization should be

counted. Further, a distribution from one private nonoperating foundation to another such organization, or to any section 501(c)(3) organization which is controlled by one or more persons who are disqualified persons with respect to the foundation making the distribution, should be considered qualified if the recipient organization applies such cash or property directly to charitable activities within one year of receipt. Thus, contributions to such organizations should be counted if the recipient organization makes a distribution of such amount in addition to amounts required to be distributed under the income payout requirement (other than to another private nonoperating foundation or controlled organization) within such one-year period. This rule would not apply unless the contributing foundation obtains evidence demonstrating that the recipient organization has made the required distribution.

An operating foundation is defined in proposed section 4942(j)(3) as a foundation which (a) expends substantially all its income for activities in pursuance of its exempt function, and (b) either devotes substantially more than half its assets to its exempt function or receives support

from at least five private foundations under certain conditions. It appears that the definition of an operating foundatio now in the bill may in some cases (for example, when an organization has been funded only once and receives little support from other exempt organizations or the general public) provide an unwarranted exception from the minimum distribution requirements. In view of the suggested broadening of the definition of qualifying distributions to allow distributions from one foundation to another under the circumstances stated, the support part of the definition of an operating foundation should be deleted to prevent the possible unwarranted exception. Thus an operating foundation should be an organization which both (a) expends substantially all of its income, and (b) devotes substantially more than half its assets to its exempt functions.

The bill provides for a five-year carryover of distributions made in excess of the minimum distribution requirement. It was not intended that distributions for a taxable year beginning prior to January 1, 1970, would be counted for this purpose and the bill should make this clear.

7. Political Activities and Other Taxable Expenditures

The bill changes present law to prohibit carrying on propaganda or otherwise attempting to influence legislation, even though such activities do not amount to a substantial part of the activities of the foundation. No other changes in this provision of present law are made by the bill. However, for the first time the Code would contain a definition of activities covered by this prohibition. This has created some uncertainty because this definition is not all-inclusive. Treasury recommends that section 4945(c), as added by the bill, be amended to specify the types of activities which are to be prohibited irrespective of substantiality, which would be the same activities as result in denial of exemption under existing law if they are "substantial." As amended, this provision would read as follows:

> "For purposes of subsection (b)(1), the term 'taxable expenditures' means any amount paid or incurred by a private foundation for --

"(1) any attempt to influence legislation by attempting to cause members of the general public, or any segment thereof, to propose, support, or oppose legislation, and

"(2) any attempt to influence legislation through communication with any member or employee of a legislative body, or with any other government official or employee who may participate in the formulation of the legislation (except technical assistance provided in response to a written request by such member, government official, or employee),

other than through making available the results of nonpartisan analysis, study, or research. Paragraph (2) of this subsection shall not apply to any amount paid or incurred in connection with an appearance before, or communication to, any legislative body with respect to a possible decision of such body which might affect the existence of the private foundation, its powers and duties, its tax-exempt status, or the deduction of contributions to such foundation."

The bill requires that private foundations making gifts to other private foundations or to nonexempt organizations exercise some control over the expenditure of the funds. This provision was not, we believe, intended to make the private foundation an insurer of the activities of the recipient of the grant, provided the foundation uses reasonable efforts and establishes adequate procedures. The bill should be clarified to reflect this intent.

8. Foreign Organizations

The bill does not deal specifically with foreign exempt organizations which have U.S. income. Treasury recommends that the bill provide for a 2 percent supervision tax on U.S. source income of foreign organizations which would be private foundations were they domestic organizations. Further, a foreign organization should be denied exemption from U.S. income tax if it acts in a manner which would subject it or a disqualified person to tax under section 507 or chapter 42 if it were a domestic organization.

9. Return Requirements

The bill requires the Internal Revenue Service to make public, among other information, the names and addresses of all substantial contributors to exempt organizations. Treasury is concerned that this particular publicity will discourage contributions to churches, educational institutions, and publicly supported charities, and Treasury recommends that the provision be limited to contributions to organizations which are private foundations.

Treasury recommends that a return be required by an exempt organization which liquidates or which substantially contracts or terminates its activities. Very small organizations should be relieved from filing this special return.

10. Hospital Care

Under present law, hospitals may qualify as exempt organizations under section 501(c)(3) if it is determined that they are operated for charitable purposes. This has caused uncertainty, and the bill provides for the inclusion of hospital care as an activity which in itself qualifies under section 501(c)(3). Thus, section 101(j)(7) of the bill provides for adding the following wording to section 501(c)(3): "or for the providing of hospital care."

Specific inclusion of hospital care in the bill, particularly in the form quoted above, could create an inference that other charitable activities not specifically included may no longer be treated as within the scope of section 501(c)(3). It is essential to good administration that there be flexibility in this provision. The proper scope of exempt

functions under section 501(c) of the Code, and the most effective manner of describing them in the statute, are presently under study at Treasury and may be the subject of further legislative recommendations in this area at a later time. The Internal Revenue Service is expected to issue a ruling shortly clarifying the treatment of hospitals as section 501(c)(3) organizations. In view of these circumstances, and in light of the terms of the ruling when issued, the specific inclusion of "the providing of hospital care" in section 501(c)(3) of the Code by the bill should be reconsidered. At the very least, the Committee report should make it clear that the inclusion of hospital care is not intended to indicate that other activities which are charitable, educational, etc., in nature are not to be included under these general provisions of section 501(c)(3).

11. Effective Date

Under the bill, section 4942 does not apply to any organization which is prohibited by its governing instrument from making distributions of income unless the instrument can be changed. A similar rule should be provided for organizations which are not permitted to distribute any of their corpus; such a rule would excuse such organizations from the requirement of distributing 5 percent of the aggregate fair market value of their assets until it would be possible to amend their governing instrument.

Sec. 121--Other Exempt Organizations

Unrelated Business Income

Section 512(b)(3) of the Code currently excludes from the definition of unrelated business income rent from real estate and from personal property leased with such real property. The exception was intended to exclude "passive" investment income from the tax, but as interpreted broadly by the courts, all rents from personal property are excluded if the personalty has any connection with the lease of real estate. This has led to a situation in which an exempt organization may own substantial business assets, which together may constitute an operating business and which are leased to an independent management company. Most of the profits from the business can then be received by the exempt organization in the form of rent, affording a competitive advantage to the exempt organization contrary to the purpose of the unrelated business income provisions.

Two amendments to the bill are recommended to insure that income attributable to the active conduct of an unrelated business pays its fair share of tax. First, in order to make clear that only "passive" rental income is excluded from the unrelated business income, section 512(b)(3) should specify that rent from personal property is excluded only when the lease of personal property is incidental to the lease of the realty. The bill should also incorporate the test for "passive" rentals utilized in section 856(d)(1) (dealing with real estate investment trusts). Application of this rule would serve to tax real property rentals in any case where they are measured by reference to the net income from the property, but would exclude rentals based upon a percentage of gross receipts or sales.

Income Received by Exempt Organizations from Controlled Corporations

The House bill includes in the definition of unrelated business income all interest, annuities, rents and royalties received by exempt organizations from controlled corporations. As drafted, the bill would also tax receipts from controlled exempt corporations. Treasury recommends that this provision

apply to income from exempt organizations only in proportion to their unrelated business income.

Investment Income--Fraternal Societies, Employee Associations

The House bill treats the investment income of fraternal beneficiary societies or voluntary employees' beneficiary associations as unrelated business income unless it is set aside for a charitable purpose or for the provision of life, sick, accident or other benefits. Treasury recommends that it be made clear that income is set aside for providing these benefits to the extent it is used for the reasonable cost of administration of the benefit program as well as the payment of the benefits themselves.

In addition, the income so taxed should be defined to exclude gain on the sale of assets used directly by the organizations in the performance of their exempt functions to the extent the proceeds of sale are reinvested in assets used for such purposes within a period of three years. Thus, gain realized by a fraternal benefit society on sale of its clubhouse facilities and reinvested in replacement facilities within the specified period should not be treated as unrelated business income.

## Sec. 201--Charitable Contributions

1. <u>Contributions of Appreciated Property</u>

Under present law, the deduction of charitable contributions by individual taxpayers is subject to two separate limitations. A general limitation of 20 percent of adjusted gross income applies to all contributions. In addition, gifts to certain publicly supported organizations are permitted up to 30 percent of adjusted gross income. The bill increases the 30 percent limitation to 50 percent of a new contribution base (adjusted gross income plus allowable tax preferences).

The bill introduces new rules with respect to gifts of appreciated property. Gifts of appreciated property to certain organizations would either be limited to the taxpayer's basis in the property or would result in a tax on the unrealized appreciation if the taxpayer elected to claim the charitable deduction based on the fair market value of the property. This treatment would apply to gifts of appreciated property to private foundations, other than private operating foundations. Gifts to a private foundation would be excepted from the new rules where the foundation, within one year after its taxable

year in which the contribution is received, applies such contributions to a charitable purpose in a prescribed manner. The bill then provides for a separate 30 percent limitation on gifts of appreciated property which are not subject to the new appreciated property rules (such as a gift to a publicly supported charity of a present interest in appreciated securities constituting a capital asset in the hands of the donor-taxpayer).

Thus, some gifts of appreciated property to a private foundation would be subject to this new appreciated property rule and some would not. Furthermore, since the class of organizations subject to the new rule for appreciated property is narrower than those excluded from the old 30 percent (and proposed 50 percent) limit, gifts of appreciated property under the bill are subject to three percentage rules: the 20 percent limit, the new 50 percent limit, and a new 30 percent limit.

The bill applies the new appreciated property rule, limiting the deduction to basis or requiring the appreciation to be included in income, to gifts of three classes

of appreciated property--ordinary income property, tangible personal property, or a future interest.

These rules result in a confusing interrelation of three separate limitations applying in slightly different fashions to three classes of organizations. Treasury recommends that these rules be greatly simplified as follows:

(a) The 50 percent limitation should be expanded to cover any contributions made to organizations not subject to the application of the new appreciated property rule, which means adding to this group of organizations private operating foundations and other foundations if the contribution is passed through as a qualifying distribution within the succeeding year. Since contributions to such organizations directly benefit public charity, there is no reason for excluding them from the new 50 percent limit. This would mean that the remaining effective scope of the 20 percent rule, i.e., those donee organizations which would not come within the 50 percent rule as expanded, would be co-extensive with the new rule for taxing gain on appreciated property as that rule relates to the donee organization, i.e., a private foundation which is not an operating foundation or which does not channel the property to a publicly supported charity within one year. Hence, the Code should be restructured so that the 20 percent

rule is a rule of limited rather than general application, and the 50 percent rule is the general rule. This change will result in considerable simplification, since the scope of the 30 percent limitation on appreciated property will then be co-extensive with the 50 percent group of donees.

(b) The bill should be further revised to make the 30 percent limitation apply only to the aggregate amount of appreciation in all property contributed during the tax year, and not to the aggregate value of all property with any element of appreciation. To the extent a taxpayer has basis in the appreciated property, he should be eligible for the 50 percent limitation before applying the 30 percent rule to the appreciation element.

For example, suppose a taxpayer with a contribution base of $30,000 contributes to a public charity an appreciated security held for more than six months having a fair market value of $20,000, a basis of $5,000, and thus $15,000 of appreciation. The 50 percent limit would first be applied to limit the total charitable contribution deduction to $15,000. The 30 percent limit would then be applied to limit the amount of deductible appreciation element to $9,000. The

deductible contribution thus would be $14,000, being the total of the $9,000 appreciation element and the $5,000 basis. The taxpayer could carry over to the following year the remaining $6,000 of the gift, which would be deemed to constitute appreciation and thus would be required to be added to contributions of appreciated property, if any, made in the following year for purposes of applying the 30 percent limitation in such year.

As previously stated, the House bill applies the appreciated property rule (which limits the charitable contribution deduction to the amount of the taxpayer's cost or other basis in the property or, if he takes a charitable deduction based on the fair market value of the property, requires him to include the unrealized appreciation in income) to gifts of property which would give rise to ordinary income if sold by the taxpayer; and applies the rule also to gifts of tangible personal property, gifts of future interests in property, and certain gifts to a private foundation. Treasury recommends that the deduction not be so limited in the case of gifts of tangible personal property unless this section otherwise applies because, for example, the property is ordinary income

property in the hands of the donor. Thus, a gift to a publicly supported charity of a present interest in a work of art held for more than six months by a person other than the creator of such work of art, in whose hands the work of art is a capital asset, should not be subject to the rule.

2. Charitable Income Trusts with Noncharitable Remainder

The bill amends section 170(b)(1) to deny a deduction for a contribution of charitable income interest to a trust which has a noncharitable beneficiary unless both the "grantor trust" provisions of section 671-678 apply and the charitable interest is in the form of either a guaranteed annuity or unitrust. The bill also provides a "recapture rule" to apply when the donor ceases to be the owner of such interest for purposes of section 671. Similar provisions with respect to this type of gift are added by section 201(h) of the bill to the estate and gift taxes deduction rules.

These provisions are unduly stringent in denying a deduction for a gift of a long-term income interest to charity. Where the term is sufficiently long, the donor has in effect given away such a substantial portion of the value of

the property that it is appropriate to treat the transaction as an outright gift of an undivided interest in the property. Treasury considers that the proper dividing line is 20 years, the period of time when the present value of the income interest under the valuation tables in the regulations is approximately 50 percent.

Accordingly, Treasury recommends that these rules be liberalized and simplified by allowing a current deduction for the value of contributions of a guaranteed income interest to charity whenever the gift is for a period of more than 20 years whether or not the grantor trust rules apply. In this way, the complex "recapture" provisions could be eliminated and the rule could be made more equitable, with results as follows:

(a) Where the charitable income interest is in the form of a guaranteed annuity or unitrust for a period in excess of 20 years, a charitable deduction would be allowed in the year the trust is created for the present value of the contribution whether or not the income which goes to charity is includible

in the taxpayer's income (because of the application of the "grantor trust" provisions of section 671 through 678).

(b) Where the taxpayer is subject to the "grantor trust" provisions, but the contribution is not in the form of a guaranteed annuity or unitrust for a period in excess of 20 years, the taxpayer would be permitted a charitable deduction in the year the income is taxable to him under section 671 and distributed to the charity. He would not be allowed a deduction in the year the contribution to the trust was made.

The estate tax provisions of the bill deny an estate tax deduction for an income interest given to charity. In the case of an estate, however, the double benefit (the basis for denying the income tax deduction) does not exist; there is no income tax deduction in addition to the exclusion of the income from income tax. Accordingly, the bill should be amended to allow the estate tax deduction for a gift of an income interest to charity. Other changes should be made to the estate and gift tax provisions to conform them to the changes recommended in income tax treatment.

3. Deduction by Estate or Trust

The bill amends section 642(c) to provide that an estate or trust is to receive a deduction only for amounts actually paid for a charitable purpose. The estate or trust would no longer be allowed a deduction for amounts permanently set aside or to be used for a charitable purpose. The bill applie to amounts paid, permanently set aside, or to be used for a charitable purpose after the date of the enactment of the bill.

Treasury recommends that this provision apply only with respect to taxable years beginning after December 31, 1969. Further, in a case where an irrevocable trust instrument has been executed on or prior to August 1, 1969, Treasury recommends that the requirements of this section should not apply unless and until it is possible to amend the instrument. Similarly, the provision should not apply with respect to an estate or trust pursuant to a will in existence on August 1, 1969, which is not subject to change under state law at any time prior to the testator's death because of the testator's in competency or other disability. In any such case, however,

the charitable contribution deduction for the amounts permanently set aside or to be used for a charitable purpose should be limited to its present value, and no amount would be deductible when such amounts were actually paid for charitable purposes at a later time.

Further, Treasury believes that different considerations apply to an estate than to a trust with respect to amounts set aside for charitable purposes. Estate administration is normally of relatively short duration with safeguards not normally present during trust administration. Estates present many factors which may make it either impracticable or in some instances contrary to probate law to make distributions currently. Accordingly, Treasury recommends that section 201(f) of the bill be changed so that the proposed limiting of a charitable deduction to amounts actually paid will apply only to trusts and the provisions of section 642(c) allowing deductions for amounts permanently set aside will continue to apply to estates.

4. Disallowance of Estate Tax Deductions in Certain Cases

The bill amends section 2055(e) to provide that a charitable contribution deduction for estate tax purposes is not to be allowed for a charitable gift of a remainder interest in trust where there is a noncharitable income beneficiary unless the trust is either a charitable remainder annuity trust or a charitable remainder unitrust. This provision is to apply with respect to persons dying after the date of the enactment of the bill.

It is proposed that the effective date of the new estate tax provisions governing charitable deductions be deferred so that the new rules will apply only to persons dying after December 31, 1970. This will provide time for amendment of wills to comply with the new requirements. In cases where irrevocable trust instruments have been executed prior to August 1, 1969, it is proposed that the new requirements not be applied where the governing instrument cannot be reformed by amendment, judicial proceedings, or otherwise. This exception would apply, for example, in the case of an irrevocable intervivos trust under which the grantor reserves the income for his life, and upon his death the income is payable

to his surviving spouse, with the vested remainder passing to designated charities. Under the exception, the deduction would be allowed for the value of the remainder interest even though it is impossible to amend the governing instrument to comply with these rules. A similar exception should be provided with respect to wills in existence on August 1, 1969, which are not subject to change under state law at any time prior to the testator's death because of the testator's incompetency or other disability.

5. Charitable Remainder Trusts

Section 201(e) of the bill amends section 170(h) of the Code to deny an income tax deduction for a charitable remainder interest in a trust unless such interest is in the form of a charitable remainder annuity trust or a charitable remainder unitrust. This provision is made effective with respect to transfers in trust made after April 22, 1969, although the provision was not contained in the Treasury Department's recommendations announced that date. The provision should be made effective with respect to transfers in trust made after August 1, 1969.

Section 201(i) of the bill adds a new section 664 to the Code providing definitions of a "charitable remainder annuity trust" and a "charitable remainder unitrust." Under the bill, a "charitable remainder annuity trust" must pay a sum certain not less often than annually, and a "charitable remainder unitrust" must pay a fixed percentage of the net fair market value of the trust assets, valued annually, not less often than annually. Such a trust would be exempt from tax and would be subject to the private foundation rules other than the income distribution requirement.

A charitable remainder trust should, in general, be subject to all of the substantive requirements governing private foundations. Accordingly, consistent with the income distribution requirement for private foundations, these provisions should be amended to provide that the specified amount may be paid out either to an organization described in section 170(c) or any other person, and may not be less than:

(a) in the case of a "charitable remainder annuity trust," an amount equal to 5 percent of the fair market value of the trust assets (valued at the date of contribution), and

(b) in the case of a "charitable remainder unitrust," an amount equal to 5 percent of the net fair market value of the trust assets, valued annually.

## Sec. 211-213--Farm Losses

1. <u>Exemption from EDA Requirement</u>

Under the House bill, a taxpayer would not be required to add farm losses to an excess deductions account (EDA) if his nonfarm adjusted gross income does not exceed $50,000 for the taxable year. Treasury recommends that this figure be reduced from $50,000 to $25,000. Further, we recommend that in computing adjusted gross income for this purpose, taxpayers should be required to add back to adjusted gross income items of tax preference determined under the Limit on Tax Preferences proposal even though such amounts of tax preference are not subject to tax under LTP because they do not exceed the permissible limit.

The House bill excludes the first $25,000 of farm losses from EDA regardless of the taxpayer's nonfarm adjusted gross income. Treasury recommends that a taxpayer be required to add the full amount of farm losses (without an exclusion) whenever total farm losses exceed $15,000 and nonfarm adjusted gross income exceeds $25,000.

2. Hobby Losses

Section 213 of the House bill revises the "hobby loss" provisions of present section 270 to provide that losses from an activity will be disallowed if the activity is not carried on with a reasonable expectation of profit. An activity will be presumed to have been carried on without a reasonable expectation of profit if losses exceed $25,000 in any three out of five consecutive taxable years.

Treasury recommends that this provision be amended to make it clear that the reasonably anticipated profit must be an economic profit, not a "tax savings" profit, and that "profit" need not be determined on an annual basis.

It should also be made clear that those deductions which are allowable under the Code without regard to whether they are incurred in a trade or business or for the production of income, such as interest and certain state and local taxes, will continue to be deductible even where incurred in an activity not engaged in for profit. Similarly, it should be made clear that deductions incurred in an activity not engaged

in for profit (other than those described in the preceding sentence) shall be allowable to a proper extent where income is realized from that activity. The amount allowed should be that proportion of the total of such deductions which the income realized bears to the total deductions attributable to the activity, including deductions described in the first sentence of this paragraph. Thus, if the taxpayer with a hobby farm has interest and taxes of $100,000, operating costs of $120,000, and depreciation of $80,000, and if the income from the farm is $30,000, the taxpayer should be entitled to deduct the full $100,000 amount of interest and taxes plus $12,000 of operating costs and $8,000 of depreciation

Sec. 231--Moving Expenses

Under present law certain expenses of moving a taxpayer's family and belongings from one place of employment to another are deductible. In general, the deduction applies only if the taxpayer's new place of employment is at least 20 miles farther from his former residence than was his former place of employment. The bill increases the required distance before any deduction is allowed from 20 miles to 50 miles. Treasury recommends that the 20-mile test contained in existing law be retained.

Sec. 301, 302--Limit on Tax Preferences and Allocation of Deductions

The House bill treats the following items as preferences for the purpose of the Limit on Tax Preferences: (a) the excess of tax-exempt interest on state and local bonds over expenses related thereto which are not allowed as deductions;* (b) the amount (50 percent) of net long-term capital gains which is excluded from income; (c) the untaxed appreciation in value of property contributed to charity; (d) the excess of accelerated depreciation over straight-line depreciation of real property; and (e) the excess of any farm loss over the amount that would be deductible under normal accrual accounting rules. For purposes of the Allocation of Deductions rule, the items of tax preference are the same except that: (a) interest on state and local bonds is included only with respect to bonds issued after July 12, 1969 (subject to the same 10-year transition rule); and (b) the preferences for this purpose also include the excess of the deductions for intangible drilling expenses and percentage depletion over

*Under a special transition rule, only 10 percent of such excess is taken into account in 1970, 20 percent in 1971, and, similarly, 10 percent more in each succeeding year so that the full amount is not taken into account until 1979 and thereafter.

the amount that would be deductible had these expenses been capitalized and recovered through straight-line depreciation and cost depletion.

1. Tax Preferences

Treasury recommends that the following modifications be made to the group of items treated as tax preferences:

(a) Appreciation in value of property contributed to charity should not be treated as a tax preference for the purpose of either the Limit on Tax Preference or the Allocation of Deductions.

(b) Interest on state and local bonds (without distinction as to when the bonds were issued) should be treated as a tax preference for the purpose of the Allocation of Deductions but not for the purpose of the Limit on Tax Preferences. The 10-year transitional rule should be eliminated.

(c) Intangible drilling expenses and percentage depletion in excess of cost should be treated as tax preferences for both the Limit on Tax Preferences and the Allocation of Deductions, except that a taxpayer 60 percent or more of whose gross income is from oil and gas properties should not treat the intangible drilling expense deduction

as an item of tax preference for purposes of the Limit on Tax Preferences.

(d) In the case of percentage depletion, the amount of the preference should be computed by first allowing full recovery of the tax basis of the property (increased as described below); that is, percentage depletion would first become a preference only after full recovery of basis. This will avoid the necessity of calculating cost depletion for each taxable year. In those instances in which the intangible drilling cost deduction is treated as a preference under the proposal, the full amount of the deduction would be treated as a preference, but the amount would be added to basis for purposes of the Limit on Tax Preferences to be recovered in full before any amount of percentage depletion with respect to such property would be treated as a preference. In the case of a taxpayer 60 percent or more of whose gross income is from oil and gas operations, since the intangible drilling cost deduction would not be treated as a preference for LTP purposes, it would not be added to basis for purposes of the Limit on Tax Preferences, and thus percentage depletion

taken by such a taxpayer in excess of actual basis (without inclusion of intangible drilling costs which have been expensed) would be the taxpayer's LTP preference.

(e) In addition to including the excess of accelerated depreciation over straight-line depreciation with respect to section 1250 property as a preference, the list of preferences should include such excess with respect to section 1245 property if such section 1245 property is leased on a net lease basis. Such excess should constitute a preference for purposes of both the Limit on Tax Preferences and the Allocation of Deductions.

(f) The amount of the deduction for interest, taxes, and ground rents with respect to real property during the period of construction of substantial improvements (other than housing construction) should be treated as a tax preference for both the Limit on Tax Preferences and the Allocation of Deductions.

(g) The excess of the deduction for amortization of rehabilitation expenditures for low-cost housing (provided in section 521 of the House bill) over the amount that would be deductible as straight-line depreciation should be treated as a tax preference for purposes of both the Limit on Tax Preferences and the Allocation of Deductions.

33-865 O—69—pt. 1——52

In connection with the Allocation of Deductions, allocable expenses which are disallowed because the taxpayer had items of tax preference which relate solely to the year in which a deduction is allowed (e.g., the excess of accelerated depreciation over straight-line depreciation) should be allowed to reduce the amount of ordinary income when the asset is later sold.

Also, as a complement to the rule that the intangible drilling cost deduction would not be treated as an LTP preference item for taxpayers 60 percent or more of whose income is from the operation of oil and gas properties, a provision should be added requiring such a taxpayer to recapture as ordinary income any gain on the sale of an oil or gas property (or a portion thereof), including a transfer to a controlled corporation, to the extent of intangible drilling costs previously deducted with respect to such property.

2. Intangible Drilling Expenses and Percentage Depletion

For purposes of determining the amount of tax preferences from percentage depletion and intangible drilling expenses, taxpayers would be divided into two broad categories: those whose income from oil and gas properties is less than 60 percent of gross income; and those whose income from oil and gas properties is 60 percent or more of gross income.

Taxpayers with less than 60 percent of their gross income from oil and gas properties would treat as preferences both percentage depletion and the intangible drilling cost deduction for both the Limit on Tax Preferences and for Allocation of Deductions. The amount of their preferences would be the full amount of the intangible drilling cost deduction taken during the year (not reduced by any amount which would have been allowable for the year as cost depletion or straight-line depreciation) plus, with regard to each oil and gas property, percentage depletion to the extent it exceeds the basis of the property and the amount of intangible drilling costs which were incurred with respect to such property and were expensed. Thus, percentage depletion would not begin to be treated as a preference until the cumulative amount

thereof exceeded the basis of the property plus the intangibles expensed with respect to that property.

Taxpayers whose gross income is 60 percent or more from oil and gas properties would include both intangible drilling expenses and percentage depletion as preferences to the extent set forth above only for purposes of the Allocation of Deductions. The Limit of Tax Preferences for this group would be determined without inclusion of intangible drilling expenses deducted during the taxable year. Percentage depletion deducted during the year would be considered a preference to the extent it exceeded the adjusted basis of the mineral property to which it related as of the end of the taxable year (determined without regard to any depletion deduction for the current year). In addition, such group of taxpayers would be required to recapture as ordinary income any gain on the sale, exchange, transfer or other disposition (including transfers to a controlled corporation under section 351 of the Code) of an oil and gas property, to the extent of intangible drilling costs previously deducted with regard to such property. The recapture rule would extend only to this

group of individual taxpayers who are not required to include intangible drilling costs as a preference for purposes of the Limit of Tax Preferences.

These special rules regarding percentage of income from oil and gas properties would not affect the treatment of persons whose preferences consist of percentage depletion for other minerals. Taxpayers with percentage depletion from a mineral property other than oil and gas properties would treat percentage depletion in excess of the basis of the property as a preference for both the Limit on Tax Preferences and the Allocation of Deductions, and would have no other preference with respect to the mineral activities concerning such property, irrespective of the percentage of their total income represented by income from such properties.

3. Net Leases of Personal Property

The excess of accelerated depreciation with respect to a particular item of section 1245 property over straight-line depreciation would be treated as a tax preference if that property is the subject of a net lease. For this purpose, a lease would be treated as a net lease only if: (i) the deductions allowable to the lessor for operating expenses with respect to

the property are less than 15 percent of the rental income from the property; or (ii) the lessor is either guaranteed a specified net return or is guaranteed in whole or in part against loss. The excess described in the first sentence is to be computed separately for each item of section 1245 property.

The inclusion of this preference in the Limit on Tax Preferences should not be taken as creating any inference that a transaction is to be treated as a lease if it would otherwise be treated as a sale, loan, or other business transaction.

4. Interest, Taxes, and Ground Rents

The amount allowable as a deduction for interest, taxes, and ground rents with respect to real property during the period of construction of substantial improvements or additions to, or other reconstruction of, existing substantial improvements (other than housing construction) would be treated as a tax preference to the extent such amount exceeded any gross income from the property for that year. Such rule would apply only

to real property used in the trade or business of the taxpayer, or held by the taxpayer for the production of income. Each separate acquisition of real property would be treated separately, irrespective of the eventual combined use with other parcels of real property. The rule would apply only if the improvements were "substantial," which would be defined as improvements having a value at least equal to the value of the land without improvaments. The period of construction would be deemed to end when the improvement is placed in service for purposes of taking depreciation thereon. The amounts would not be treated as a preference if the construction consisted of residential rental housing as defined in proposed section 167(j)(2) as added by section 521 of the House bill. Nor would the amounts constitute a preference in any case in which the property was held primarily for sale to customers in the ordinary course of business or was inventory in the hands of the taxpayer.

5. Amortization of Rehabilitation Expenditures for Low-Cost Housing

The excess of the deduction allowable under section 167(k) of the Code (added by section 521(a) of the House bill) for amortization of rehabilitation expenditures for low-cost housing over straight-line depreciation would be treated as a preference. Straight-line depreciation for this purpose would be computed on the basis of the actual useful life of the property (or the addition or improvement to the property) acquired or constructed with the rehabilitation expenditures. For this purpose, the excess would be computed separately for each item of property.

6. Adjustment of Recapture for Disallowed Allocable Expenses

Allocable expenses which are disallowed because the taxpayer has an item of tax preference which results in a deferral, rather than an exclusion of income, should be applied as an offset against any ordinary income on later sale of the asset giving rise to the preference. The tax preferences which result in a deferral rather than an exclusion of income are:

(a) accelerated depreciation on section 1250 property;

(b) accelerated depreciation on section 1245 property which is the subject of a net lease;

(c) farm losses;

(d) interest, taxes, and ground rents during period of construction;

(e) amortization of rehabilitation expenditures for low-cost housing; and

(f) the deduction for disallowed tax preferences allowable under section 218 of the Code (added by section 301(a)(2) of the House bill) to the extent attributable to the foregoing items of tax preference.

A separate account would be established for the allocable expenses disallowed by reason of each of the taxpayer's assets (or in the case of a farm loss, the group of assets) giving rise to a tax preference listed above. Thus, if a taxpayer were claiming accelerated depreciation on two section 1250 assets, two accounts would be established. The disallowed expenses added to such account would not retain their character as interest, taxes, medical expenses, or the like but would simply be carried as a

dollar amount available to offset ordinary income if any, on a later sale of the asset which gave rise to the disallowance.

7. Publication of Statistics of Excludable Income

Section 6108 of the Internal Revenue Code should be amended to provide that the statistics the Secretary is required to publish annually shall include tax-exempt income in addition to taxable income, deductions, and credits.

Sec. 311--Income Averaging

Relationship to Accumulation Trust Rules

The House bill provides that if a taxpayer elects the benefits of income averaging, he will not also be entitled to the benefits of certain provisions of section 668 of the Code which limit the tax imposed by the throw-back rules on a beneficiary of an accumulation trust. The limitations of section 668 have the effect of spreading distributions of accumulated income over the taxable years during which the income was earned by the trust, which is a form of averaging.

If both income averaging and the limitations of section 668 were available, the taxpayer would obtain an unintended benefit in the event of a large accumulation distribution where the taxpayer qualified for averaging by reason of receiving such accumulation distribution. On the other hand, however, it is unfair and unnecessary to require a taxpayer who would qualify for the benefits of income averaging even in the absence of an accumulation distribution to

choose between the benefits of income averaging with respect to all his income and the limitation on tax on accumulation distributions of section 668. Treasury recommends that the limitations of section 668 apply with respect to all accumulation distributions but that accumulation distributions be excluded from averagable income.

Sec. 321--Restricted Property

1. Transferable Interests in Restricted Property

Under the House bill an individual receiving restricted property in connection with his performance of services is subject to tax when his interest in that property becomes transferable even though it is still forfeitable. The intent of this provision was to impose tax when an individual received property which he could transfer to a bona fide purchaser for value whose rights would not be subject to the forfeiture provision. In such a case, the bill imposes a tax on the theory that such individual has unrestricted use of the property even though he might be required to respond in damages to the original transferor in the event of breach by him of the forfeiture condition.

This rule merely says that the property is not truly forfeitable if it is within the recipient's power to realize its full value, avoiding forfeiture, by transferring the property by sale. The House bill, however, would result in

income to the employee merely because the property is transferable by gift or upon death though it remains subject to forfeiture. It would appear that the employee should not be treated as realizing income merely because a donative transfer could be made. The employee has not realized the value of the property and the circumstances depriving it of determinable value continue to exist.

Treasury recommends that the provision in the House bill be simplified by providing that an interest in property is not forfeitable unless the original transferor could compel a subsequent transferee to return the identical property upon the happening of events causing forfeiture. Where the property is forfeitable, the original recipient will be treated as realizing income on a transfer of the property for value if this occurs prior to the time the property ceases to be forfeitable. The original recipient would realize income equal to the amount received in the sale (assuming the sale is an arm's length transaction).

Under this rule, tax would not be imposed merely because the original recipient can transfer his forfeitable interest to another person in a donative transaction if such other person will also be subject to the forfeitability condition. Such a donative transfer will not, however, change the tax consequences to the original recipient at the time his transferee's rights become nonforfeitable; he will realize income at that time just as if there had been no donative transfer.

2. Transfers Under Qualified Annuity Plans

Under proposed new Code section 85(d)(2), transfers by an employer to an employees' trust which satisfy the qualification requirements of section 401(a) are not subject to the restricted property rules of section 85. Similar treatment should be provided with respect to premiums paid by an employer under nontrusteed annuity plans for an employee which meets these requirements.

3. Transition Rules

Under proposed new Code section 85(f), the restricted property rules of section 85 do not apply to property transferred before July 1, 1969, or to certain property transferred on or after that date if certain conditions are satisfied. This section should be amended to provide that where corporate securities to which section 85 does not apply because of these effective date provisions are exchanged for other securities in a tax-free transaction and the new securities are subject to restrictions identical to those applicable to the old securities, section 85 will not apply to the new securities.

4. Nonexempt Trusts and Nonqualified Annuities

Section 321(b) of the bill amends sections 402(b) and 403(c) of the Internal Revenue Code to provide essentially the same tax treatment for pension, profit-sharing, stock bonus, and annuity plans which do not satisfy the qualification requirements of section 401(a) as would be provided under the bill for restricted stock plans. This section should be amended to make it clear that the amount subject

to tax when the employee's interest becomes nonforfeitable is the value of his interest in the trust at that time or the value of the annuity contract at that time. The value of amounts subsequently contributed to the trust, or premiums subsequently paid, by the employer on behalf of the employee should be includible in the income of the employee in the subsequent years in which contributed or paid to the trust or insurer.

In addition, section 403(c) should be amended to make it clear that the restricted property rules of section 85 do not apply to any amount excluded from gross income under section 403(b) dealing with annuities purchased for an employee by a section 501(c)(3) organization.

33-865 O—69—pt. 1——53

## Sec. 341--Accumulation Trusts

### 1. Transitional Problem

Under present law, if a trust makes an "accumulation distribution"--that is, a distribution in excess of distributable net income for the current year--there is a five-year "throwback." This results in a recomputation of the beneficiary's income tax for each of such years to determine the increase in tax which would have resulted had the trust income been distributed to him currently rather than accumulated. This amount is then added to his tax liability in the year of distribution. Under existing law, however, the only accumulated income which is subjected to this additional tax is that which was accumulated in the five years preceding the year of the distribution. All earlier accumulations are distributed tax free. Moreover, there are several exceptions under the existing throwback rule so that even part of the accumulation during the preceding five years may be distributed free of additional tax.

The House bill removes the five-year limitation on the throwback rule as well as all of the exceptions. All accumulation distributions by trusts would be thrown back and the amount of tax at the time of distribution would be calculated as though they had been distributed to the beneficiary in the year earned by the trust. The bill provides, however, that this unlimited throwback rule will not operate to tax accumulations made in a taxable year of the trust ending before April 23, 1964. This limitation would prevent a throwback to years prior to the five years which are subject to the rule under existing law.

As indicated, however, the exceptions to the throwback rule contained in existing law are removed by the bill. Thus, even though a distribution would have qualified under one of these exceptions in present law, the distribution of such income accumulated by a trust prior to the effective date of this provision would be subject to additional tax when distributed.

Treasury recommends that present law be continued for all income accumulated in taxable years of trusts beginning on or before April 22, 1969, and that the unlimited throwback provided by the bill be made applicable only to accumulations made in taxable years beginning after that date. Any amounts accumulated in taxable years of a trust beginning before April 22, 1969, should, when paid out in an accumulation distribution in a taxable year beginning after that date, be subject to the law in existence on the date when the income was accumulated. Consistent with present law and the House bill, an accumulation distribution should be deemed to have been made from the most recently accumulated income of the trust. Thus, distributions made during taxable years beginning after April 22, 1969, would be subject to the new unlimited throwback rules to the extent the trust had undistributed net income accumulated during a taxable year beginning after such date.

For example, if a trust using the calendar year as its taxable year had undistributed net income of $500 accumulated in each of the years 1968 through 1972 and on December 31, 1973, made a distribution of $2,500 in excess of the trust's 1973 distributable net income, $1,500 would be taxed pursuant to the new unlimited throwback rules and $1,000 would be subjected to additional tax only if it did not fall within one of the exceptions to the definition of an accumulation distribution presently contained in section 665(b) of the Code. Thus, for example, if any portion of the $1,000 accumulated in 1968 and 1969 were distributed to meet the "emergency needs" of the beneficiary, or had been accumulated prior to the beneficiary's 21st birthday, such sum would be distributed tax free. There should, however, be no $2,000 de minimis exception for distributions made in taxable years beginning after April 22, 1969.

The five-year limitation of present law should continue to apply to income accumulated during taxable years beginning before April 23, 1969. Accordingly, if income accumulated in 1968 were distributed in 1975, it would be subject to no additional tax.

2. "Short-Cut" Method of Limiting Tax

The House bill provides that one method of limiting the beneficiary's tax attributable to an accumulation distribution is to compute the average increase in the beneficiary's tax caused by adding the average annual income of the trust for the period over which the amount distributed was earned to the beneficiary's income for the current year and each of the two preceding years. This averaging device would be more accurate if it utilized the three preceding years and excluded the current year.

The current year's income will necessarily include the trust income for that year even though it is not part of the accumulation distribution and therefore should not enter into the computation. Treasury recommends that this so-called "short-cut" limitation be altered to eliminate a recomputation of the beneficiary's tax for the current year and include in its place a recomputation of the tax for the third year preceding the year in which the accumulation distribution occurs.

Treasury also recommends that the short-cut method should not be available to the taxpayer if prior accumulation distributions made to him by two or more other trusts overlap the accumulation distribution in question. This is necessary to prevent the creation of multiple trusts with staggered accumulation distributions to take advantage of the short-cut rule. Thus, the short-cut method would not be available to limit the tax attributable to an accumulation distribution made to a beneficiary if during any preceding taxable year in which such accumulation distribution was deemed to have been distributed to such beneficiary under section 666(a) of the Code, prior accumulation distributions made by two or more other trusts were deemed, under section 666(a), to have been distributed to such beneficiary.

Sec. 401--Multiple Corporations

1. Transition Period

The House bill provides for an eight-year transition period beginning on January 1, 1969, during which the amount of each additional $25,000 surtax exemption, $100,000 accumulated earnings credit, and $25,000 limitation on the small business deduction of life insurance companies, otherwise allowable to the controlled group, would be phased-out. At the end of this period, the group would be limited to only one of each of these tax benefits.

Treasury does not oppose the eight-year phase-out period. However, the transition period originally recommended by Treasury on April 22, 1969, would also be equitable and would reduce the administrative complexity of the longer eight-year period. Under the earlier proposal, the maximum number of $25,000 surtax exemptions and other benefits listed above of a controlled group for taxable years including a December 31 after 1968 and before 1974 would be reduced over a five-year transition period in accordance with the following schedule:

| Taxable years including -- | Maximum number |
|---|---|
| December 31, 1969 | 100 |
| December 31, 1970 | 50 |
| December 31, 1971 | 25 |
| December 31, 1972 | 10 |
| December 31, 1973 | 5 |

2. Special Transition Rules

Treasury recommends that the two special transition rules, not included in its April 22, 1969, proposal, be eliminated from the bill. The first rule, in general, provides for a gradual increase of the dividends received deduction for certain transition period dividends from 85 to 100 percent over an eight-year transition period. The second rule applies only to a controlled group filing a consolidated return and, in general, provides for the deductibility of a gradually increasing portion of certain pre-consolidation net operating losses arising in the transition period. These rules involve extraordinary complexity and are not necessary in addition to the extended transition period to provide equity.

3. Mutual Insurance Companies

The House bill limits a controlled group of mutual insurance companies subject to taxation under section 821 of the Code to only one of each of the stated dollar amounts in subsections (a)(1) and (c) of section 821 (relating to the imposition of the income tax upon mutual insurance companies) and subsection (c) of section 823 (relating to the special deduction for a small company having a gross amount of less than $1,100,000). Treasury recommends that this provision be deleted as unnecessary.

After study of this provision, Treasury has found that there is no known controlled group of mutual insurance companies in existence, and because of the 80-percent stock ownership requirement of section 1563(a), it is very doubtful that such a group would come into existence in the future. Since it is extremely remote that the provision could ever apply, it can safely be deleted from the bill.

## Sec. 411, 412--Debt-Financed Corporate Acquisitions and Related Problems

1. <u>Disallowance of Interest Deduction</u>

The House bill contains a provision denying corporations a deduction for interest paid on an obligation issued as consideration for the acquisition of stock or assets of another corporation under certain conditions. These conditions are designed to determine if the obligation has characteristics normally associated with equity rather than debt.

One of the conditions which must exist if the disallowance of interest on corporate acquisition indebtedness is to apply is that the obligation be "subordinated to the claims of trade creditors of the issuing corporation generally." Some recent acquisitions would not be covered because the indebtedness, though subordinated to pre-existing indebtedness, including, for example, substantial outstanding unsecured bank credit, is not subordinated to all "trade creditors generally." Treasury recommends that the scope of the definition of corporate acquisition indebtedness be broadened to include an obligation which by its terms (other than solely

by operation of law) is subordinated in right of payment to the payment of any substantial amount of indebtedness of the corporation. For this purpose, indebtedness will not be deemed subordinated merely because the corporation has secured indebtedness; there must be a legal subordination of the debt.

Another condition which must exist for the interest on corporate acquisition indebtedness to be disallowed is that the issuing corporation have either (i) a debt-to-equity ratio in excess of two to one, or (ii) projected earnings which do not exceed three times its annual interest expense. Treasury recommends that in applying the debt-equity or projected earnings test in the case of a taxpayer engaged in the business of making loans, the amount of the taxpayer's indebtedness be reduced by amounts owed to the taxpayer and that the annual interest expense of the taxpayer be reduced by the taxpayer's annual interest income. Treasury believes that this was the intention of the House bill and that the failure to provide special rules for the application of these tests to such taxpayers was inadvertent.

The House bill provides for the disallowance of interest paid during the taxable year with respect to corporate acquisition indebtedness only to the extent that such interest exceeds $5 million, reduced, however, by the amount of interest paid during the taxable year on obligations which have the general character of "acquisition indebtedness" as defined in the bill. Obligations would have that character if they were issued for the acquisition of stock or at least two-thirds of the assets of another corporation, but do not fall within all of three specific tests as to subordination, convertibility, and debt-equity ratio. Although the Committee report states that the annual interest cost incurred or paid on such obligations issued before the effective date of this provision of the House bill would reduce the $5 million exemption, the bill itself is unclear on this point. Further, the Committee report places no limit on the number of past years which must be considered. Treasury recommends that the statutory language make it clear that the $5 million amount is so reduced, but only with respect to such obligations issued after January 1, 1964.

As pointed out above, one of the characteristics of "corporate acquisition indebtedness" as defined in the bill is that it is issued for the acquisition of stock or assets of another corporation. The bill specifies that in an asset acquisition, obligations do not fall in this category unless "at least two-thirds of the total value of all the assets" are acquired. Since the focus of asset acquisition transactions is on the operating assets, the two-thirds test might be avoided in those instances where the acquired corporation has more than one-third of its total assets in cash and non-operating properties. Accordingly, Treasury recommends that the two-thirds test be applied only to operating assets (excluding cash).

2. Installment Method

Under present law, a taxpayer may elect the installment method of reporting gain on a sale of real property, or a casual sale of personal property where the price is in excess of $1,000, if the payments received by the seller in the year of sale (not counting evidences of indebtedness of the purchaser) do not exceed 30 percent of the sales price. The

House bill would deny installment reporting where the obligations consist of bonds, debentures, notes, or other evidences of indebtedness with interest coupons attached, in registered form, or in a form designed to be readily traded on an established securities market. The House bill also provides that installment reporting is available only where payment of the principal, and interest (if any), of the obligation is required to be made periodically and in such amounts during the calendar year as shall be prescribed under regulations.

The latter provision requiring periodic payments throughout the term of the obligation is a significant departure from existing law and could disrupt the pattern of legitimate commercial transactions where payment is deferred because of lack of ability to make immediate payment. This is precisely the situation that the installment sales provisions were designed to ameliorate. The installment method is consistent with the cash method in not requiring the taxpayer to report income until the income has been assured by receipt of payment by the seller and thus until he has received cash to pay his tax.

Treasury recommends that this periodic payment provision be deleted except that installment reporting should not be available where the obligation is payable on demand. In all events, the periodic payment provision should not be made effective until January 1, 1970, so as to give taxpayers an opportunity to adjust to the new rule. The installment reporting rule had widespread application to many common sales transactions in small as well as large amounts, and many taxpayers may not be aware of this change at the present time. There was no advance warning of this change, and an adjustment period seems warranted.

Sec. 431, 432--Foreign Tax Credit

1. Foreign Tax Credit Reduction in Case of Foreign Losses

The House bill provides for the carryover of previously deducted foreign losses in computing the foreign tax credit limitation in the case of taxpayers who have chosen the per-country limitation (section 904(a)(1) of the Code) for the year in which the loss was incurred. Treasury recommends that this section also apply to taxpayers who have elected the over-all limitation (section 904(a)(2) of the Code) and who have sustained an over-all loss on their foreign operations in a prior year.

Treasury has concluded that the operation of the provision can be improved, and be made more equitable, by some technical changes which we believe consistent with the purpose of the House bill. These technical changes would make the provision inapplicable where loss carryover provisions in the foreign law achieve the same result as recapture; would provide a recapture rule where the taxpayer elects to deduct foreign income taxes; and would make it clear that capital losses, as well as other losses, are intended to be covered.

33-865 O—69—pt. 1——54

**The changes would also limit the number of years to which losses must be carried (but at the same time eliminate the annual 50 percent limit on recapture). With respect to the provision providing for an addition to gross income in certain cases where property in the loss country is disposed of, the amount of the addition should be limited to the amount of gain on disposition and it should be made clear that the foreign tax credit limitation is to be computed without regard to such addition.**

2. Foreign Mineral Income

The bill provides for the separate computation of the foreign tax credit limitation with respect to foreign mineral income in cases in which it is presumed that the amount of foreign tax in excess of the U.S. tax on the same income constitutes a hidden royalty payment. An examination of the tax and royalty structure in the international minerals industry does not justify such a presumption. Treasury believes that the defect to be remedied in present law is the ability of taxpayers to offset U.S. tax on other foreign income by the use of excess foreign tax credits generated as a result of the fact that the United States grants a percentage depletion allowance and the foreign country

does not grant such an allowance or otherwise imposes a tax at a higher rate than the effective U.S. rate. Treasury believes that the "spill-over" of excess credits attributable to the percentage depletion allowance should not be permitted.

Accordingly, Treasury recommends that in lieu of the approach in section 432 of the bill, the amount of foreign taxes otherwise creditable under section 901 of the Code be reduced on a country-by-country basis by the amount by which the U.S. tax on the foreign mineral income, defined along the lines set forth in the House bill, is exceeded by either: (1) the foreign tax on the foreign mineral income; or (2) the simulated U.S. tax on such income calculated as though percentage depletion were not allowed for U.S. tax purposes (but as if cost depletion were allowed), whichever figure is lower.

The provision permitting a taxpayer to change from the over-all to the per-country limitation, set forth in the House bill, should be retained.

Any additional problems which may exist in this area, including the disguised royalty problem, require further long-range study and will be dealt with in the Treasury's planned restudy of the entire tax treatment of foreign income.

3. Continental Shelf Areas

Treasury recommends that the definition of the term "United States" in section 7701(a)(9) be amended by expressly including the continental shelf areas of the United States with respect to the exploration for, or exploitation of, mineral resources, consistent with principles of international law. This means, for example, that income earned with respect to mineral exploration and development on the continental shelf (whether or not there is a physical connection with the shelf) is income earned within the United States for tax purposes. Conforming amendments should also be adopted to delete reference to the Outer Continental Shelf where that term appears elsewhere in the Internal Revenue Code in conjunction with the term "United States." See for example, sections 48(a)(2)(B)(vi) and 617(a) of the Code.

The amended definition should also specify that continental shelf areas are not taken into account in determining whether a foreign country is contiguous to the United States for purposes of the Internal Revenue Code. This would make it clear that certain provisions dealing with contiguous countries are only applicable with respect to countries having a common land border with the United States.

Treasury similarly recommends that the term "foreign country" be defined in section 7701 of the Code to include the continental shelf areas of foreign countries with respect to exploration for, or exploitation of, mineral resources, to the extent tax jurisdiction is exercised by such countries over such areas under principles of international law. This change is desirable because international law does not recognize that coastal states have "sovereignty" over their continental shelves, but rather have limited "sovereign rights." Section 904(a) and 911 of the Code are examples of provisions which would be affected by this change.

Continental shelf areas should also be taken into account for tax treaty purposes in such cases where the other country indicates its concurrence.

## Sec. 441-443--Financial Institutions

1. <u>Bad Debt Reserves</u>

Under present administrative rulings, commercial banks are allowed to establish a reserve equivalent to 2.4 percent of noninsured loans, even though their recent actual experience would appear to entitle them to a reserve of less than 0.2 percent of such loans. The bill would require these institutions for the future (after the transition period) to compute additions to reserves on the basis of actual loss experience.

Mutual savings banks and savings and loan institutions, on the other hand, are allowed by provisions in the Internal Revenue Code to compute additions to their bad debt reserves using the greater of: (a) their actual experience; (b) 60 percent of taxable income; or (c) 3 percent of qualifying real property loans. In addition, savings and loan institutions, but not mutual savings banks, are required to meet comprehensive investment standards.

The House bill would repeal the 3 percent method of computing reserves. In addition, the allowance based on 60 percent of taxable income would be reduced to 30 percent over a 10-year period. Since favorable bad debt treatment is allowed mutual thrift institutions only because they provide a major source of residential mortgages, the bill would tie the bad debt reserve to a sliding scale which permits the full 30 percent of taxable income deduction only if a savings and loan institution has 82 percent of its assets invested in residential real estate loans and certain other qualifying items and only if a mutual savings bank has 72 percent of its assets in those categories. The 30 percent would be reduced a proportionate amount as qualified investment falls below the 82 percent or 72 percent mark, and the 30 percent method would be altogether denied if investment in residential and other qualifying property drops below 60 percent of total assets. Existing categories of qualifying property would be liberalized under the bill to include loans made for the improvement of commercial real property located within an urban renewal area or a model cities area, loans secured by an interest in educational, health or welfare institutions,

loans secured by mobile homes not used on a transient basis and student loans.

Treasury recommends that in lieu of the provisions of present law and the House bill, all financial institutions (commercial banks, small business investment companies, business development corporations, savings and loan associations, cooperative banks and mutual savings banks) be required to compute their bad debt reserves using an actual experience method. Thus, mutual savings banks and savings and loan associations should be allowed the same bad debt deduction provided for other financial institutions under the House bill, including the use of a six-year moving average of actual bad debt experience and the use of industry bad debt experience in the case of new financial institutions. Moreover, under a transition rule, financial institutions would be allowed to maintain the balance in their existing reserve through an annual deduction equal to actual bad debt losses in excess of recoveries until an addition to the reserve is permitted under the actual experience method.

Section 441 of the House bill, which provides for the computation of bad debt reserves on the basis of actual experience, does not set forth any definition of the term "loan" or "loans outstanding." Section 441 should be clarified so that government insured or guaranteed loans, which were intended to be included in the loan base under the House bill, would definitely be included as "loans outstanding" under proposed amended section 585(b)(1)(B)(ii).

2. Special Housing Deduction

In order to provide an incentive for investment in residential real property mortgages (permanent financing) and certain other preferred loans, Treasury also recommends a separate special deduction related to investment by financial institutions in such mortgages and loans. The special housing deduction would be equal to a specified percentage of the gross income realized from residential real property mortgage loans and certain other qualifying loans. Treasury suggests that the special deduction be 5 percent of gross income from

such loans. Gross income for this purpose would include discount, points, and any other amounts which in substance are interest income.

Qualifying loans would include not only residential real property loans but also certain other loans which further national policy objectives. Residential real property loans for this purpose should include long-term loans, including typical home improvement loans, but not construction financing, and would include the same categories proposed in the House bill--single or multifamily dwellings, facilities in residential developments dedicated to public use or property used on a nonprofit basis by residents, mobile homes not used on a transient basis, and property used primarily for church purposes. Other categories of qualifying loans should include loans guaranteed by the Small Business Administration and the additional categories proposed in the House bill of student loans, loans made for the improvement of real property located within an urban renewal area or a model cities area, and loans secured by an interest in educational, health or welfare institutions.

To prevent the incentive from enabling financial institutions to avoid paying a reasonable tax on their income, a limit would be placed on the use of the deduction so that it could not reduce taxable income to less than 60 percent of their economic income. Economic income for this purpose only would be computed by adding tax-exempt interest to taxable income, and by determining such income without allowing the 85 percent dividends received deduction. Thus, if the financial institution's gross income consisted of $100,000 of interest income from residential real estate mortgages, and if its operating expenses (including interest paid to depositors) amounted to $80,000, its taxable income and its economic income would both be $20,000. The special deduction would be $5,000 (5 percent of $100,000 interest income), and it would pay tax on only $15,000. If the institution had instead received $5,000 of tax-exempt interest and only $95,000 of interest from residential real estate mortgages, economic income would remain at $20,000, but taxable income before allowance of the special housing deduction would only be $15,000. The special housing deduction ($4,750 before

applying the limitation) would be limited to $3,000 since it could not reduce taxable income below $12,000 (60 percent of $20,000).

3. Transition Rule

The foregoing proposal is intended to provide for a substantial increase in the effective rate of tax to be paid by mutual thrift institutions as compared to present law. To prevent undue hardship on mutual thrift institutions and to minimize the possible adverse effect on the housing market, a transition rule should be provided to phase-in gradually the increased tax burden on these institutions.

Treasury recommends a five-year transition period during which mutual thrift institutions would be allowed a deduction equal to the greater of: (a) the special 5 percent deduction (subject to the 60 percent of income limitation); or (b) an amount equal to the following percentages of taxable income:

| Taxable Year Beginning In | Applicable Percentage |
|---|---|
| 1969 | 60 |
| 1970 | 56 |
| 1971 | 52 |
| 1972 | 48 |
| 1973 | 44 |
| 1974 | 40 |

The deduction would be allowable in full only if such institutions had at least 82 percent of their assets invested in residential real property loans and other qualifying loans and assets as defined in the House bill (72 percent for mutual savings banks). The amount of deduction otherwise allowable in any such year would be reduced 2 percent (4 percent for mutual savings banks) for each percentage point by which their percentage of assets invested in qualifying assets was less than 82 percent of total assets (72 percent for mutual savings banks). No deduction would be allowed if the percentage of qualifying assets were below 60 percent of total assets. These investment standards would remain in the law only until the end of the transition period (the end of the taxpayer's taxable year ending in 1974). Further, at that time the deduction based on a percentage of taxable income (40 percent for taxable years ending in 1974 as set forth above) would terminate, and the taxpayer would use only the special 5 percent deduction (subject to the 60 percent of income limitation).

Sec. 444--Foreign Deposits in United States Banks

The House bill extends from December 31, 1972, to December 31, 1975, the expiration date of the rule of existing law exempting from Federal income tax certain interest paid to nonresident aliens and foreign corporations on deposits in U.S. banks. This rule applies where the interest constitutes income not effectively connected with a trade or business of the foreign person in the United States. The extension of the expiration date would also apply to the existing exemption from Federal estate tax for such deposits held by nonresident aliens.

Under current law, interest paid by U.S. branches of foreign banks to nonresident aliens or foreign corporations ordinarily is not subject to U.S. income tax whether or not the interest is effectively connected with the depositor's U.S. trade or business. While the Foreign Investors Tax Act of 1966 recognized that U.S. business-connected deposits in U.S. branches of foreign banks should be subject to U.S. tax to the same extent as if the deposits were made in a U.S. bank, that Act provided that such deposits in U.S. branches

of foreign banks would not become taxable until January 1, 1973. Treasury believes that there is no further reason to postpone this parallel treatment. Therefore, we recommend that interest paid by U.S. branches of foreign banks become subject to the same treatment as interest paid by U.S. banks effective with respect to taxable years beginning after December 31, 1969. We also recommend that parallel treatment be similarly provided for estate tax purposes for deposits by nonresident aliens in U.S. branches of foreign banks.

## Sec. 451--Regulated Utilities

1. <u>Normalization</u>

The House bill requires a regulated utility under certain circumstances to use the normalization method of accounting in order to qualify to use accelerated methods of depreciation for tax purposes. The Ways and Means Committee report makes it clear that a utility is required to use the normalization method of accounting both in computing cost of service for ratemaking purposes and for the purposes of reflecting operating results on its regulated books of account. However, the bill as drafted creates a possible implication that a utility may satisfy the requirement of this section merely by using the normalization method of accounting for purposes of reflecting operating results on its regulated books of account. Any such implication should be eliminated.

The normalization method of accounting is defined in proposed new section 167(1)(5)(B) of the Code. This section provides that a taxpayer uses the normalization method of accounting only if he computes his tax expense for purposes of establishing his cost of service and of reflecting operating

results in his regulated books of account by using a method of depreciation other than the method he used for purposes of computing his allowance for depreciation for tax purposes; he must also make adjustments to a reserve for deferred taxes to reflect the tax deferral resulting from the use of such different methods of depreciation. This provision of the bill should be clarified to indicate that such a taxpayer must compute both his tax expense (including any deferred tax expense) and his depreciation expense, for the purposes of establishing his cost of service and for reflecting operating results in his regulated books of account, based upon the same method of depreciation. This will prevent a taxpayer from computing his tax expense by a method only nominally different from the method used for tax purposes so that in effect he flows through most of the saving. To qualify for accelerated depreciation, the normalizing taxpayer must normalize to the full extent of the difference between the tax which would be payable under the method of depreciation for book purposes and that which is paid under the method used for tax purposes.

33-865 O—69—pt. 1——55

The normalization reserve required by the House bill is described as a "reserve for deferred taxes." In some jurisdictions the same purpose is accomplished by making adjustments to a depreciation reserve. The bill should not restrict the latter method of reflecting the tax deferral where it achieves the same result.

2. Public Utility Property

The bill defines public utility property to include property used predominantly in the trade or business of furnishing or sale of electrical energy, water, sewage disposal services, gas through a local distribution system, telephone services (other than those provided by the Communications Satellite Corporation), or transportation of gas, oil (including shale oil) or petroleum products by pipeline, if the rates are regulated by a utilities commission or similar agency. Oil pipelines, unlike gas pipelines, are nonmonopolistic common carriers, subject to the regulation of the Interstate Commerce Commission. Like other common carriers such as railroads, motor carriers and air carriers, rates for oil pipelines are not fixed so as to provide a guaranteed return

and the problem which has arisen with respect to the other regulated public utilities described in the bill does not pertain to carriers of oil and other petroleum products. Therefore, references in the definition of section 451 of the bill to "oil," "shale oil," and "petroleum products" should be deleted. On the other hand, the bill should make clear that property of regulated steam producers is within the definition of public utility property.

3. Effective Date

The bill provides that a taxpayer may not use an accelerated method of depreciation with respect to property acquired or constructed before December 31, 1969, unless he used an accelerated method in a tax return filed before July 22, 1969. The proper cutoff date is not July 22, 1969, since there was no public announcement of a change from the Administration's recommendation of April 22, 1969, until the press release dated July 25, 1969, and even then the announcement did not describe the provision as actually adopted in the bill. The date of July 22, 1969, should be changed to August 1, 1969, wherever it appears in section 451 of the bill. The August 1 date is the date the bill was introduced,

the first date on which the terms of this provision became available to the public.

Under the bill, this provision is effective only with respect to taxable years ending after July 22, 1969; thus a taxpayer who has not yet filed his return for a taxable year ending before such date could apparently elect accelerated depreciation for such year even if he has not previously used such a method. This is not in accord with the intent of the bill and it should be changed to be effective for all taxable years for which a return has not been filed before July 22, 1969 (or August 1, 1969, as recommended above, hereinafter referred to as the "proper cutoff date").

It appears that certain utilities were collecting rates based upon flow-through, or had filed rate schedules with a regulatory agency based upon flow-through and were thus in effect committed to flow-through, and had reflected accelerated depreciation with flow-through in establishing cost of service and for reflecting operating results in their regulated books of account even though they had not yet filed a tax return using an accelerated method of depreciation. Utilities which

have made such a change in computing their tax expense in their regulated books of account for the latest monthly accounting period ending on or before the proper cutoff date should be permitted to elect an accelerated method of depreciation with flow-through for such property and for future acquisitions.

Additionally, certain utilities had, prior to the proper cutoff date, filed with the Internal Revenue Service Form 3115, Application for Change in Accounting Method, which would have had the effect of permitting these companies to elect an accelerated method of depreciation for existing property. Although these companies had not reflected their decision to adopt accelerated depreciation for tax purposes in a return filed by that date, the Form 3115 evidences their decision to do so as much as the actual filing of a return. Treasury recommends that utilities which filed a Form 3115 prior to the proper cutoff date be permitted to elect an accelerated method of depreciation for property which is the subject of such Form 3115. In addition, since they had thereby evidenced their intention to elect accelerated depreciation for existing property, they should be allowed to

elect accelerated depreciation for any year for which a return has not yet been filed (which would not be covered by the Form 3115). Further, if in addition to filing Form 3115, the taxpayer prior to the proper cutoff date used flow-through with respect to such property, he should be permitted to use flow-through with respect to future property.

Utilities which have not elected an accelerated method of depreciation in a tax return filed prior to the proper cutoff date, nor used accelerated depreciation in computing their tax expense in their regulated books of account for a monthly accounting period ending prior to the proper cutoff date, nor filed Form 3115 prior to the proper cutoff date would not be permitted to elect an accelerated method of depreciation for existing property.

### Sec. 452--Effect on Earnings and Profits of Accelerated Depreciation

The House bill provides, as recommended by Treasury, that accelerated depreciation in excess of straight-line depreciation shall not be taken into account for purposes of computing the earnings and profits of a corporation. In this respect, the bill would treat the excess depreciation in the same way as the excess of percentage over cost depletion is treated in determining earnings and profits under existing law. The stated purpose of this provision is to prevent the payment of dividends which are not treated as ordinary income because accelerated depreciation in the case of some companies exhausts earnings and profits. Questions have been raised as to the application of this provision in the determination of the foreign tax credit under section 902 of the Code.

Section 902 allows a "deemed paid" foreign tax credit to a domestic corporation, owning 10 percent or more of the voting stock of a foreign corporation, with respect to foreign income taxes paid by such foreign corporation to the extent the taxes are allocable to a dividend paid by the foreign corporation to the domestic corporation. In general, the allocation of foreign taxes to the dividend is made on the basis of the ratio of the dividend to "accumulated profits," and any increase in "accumulated profits" will result in an allocation of less of the foreign taxes to the dividend. Since "accumulated profits" are determined in accordance with criteria applied under United States income tax law for determining earnings and profits (see Rev. Rul. 63-6, 1963-1 C.B. 126),* the increase in earnings and profits accomplished by the House bill (representing the excess of accelerated depreciation over straight-line depreciation) will increase "accumulated profits" and thereby decrease the foreign income taxes allocated to the dividend.

*While the taxpayer can elect to determine accumulated profits under one of two methods, both methods depend upon the U.S. concept of earnings and profits.

The net effect of this provision is to deny the benefits of accelerated depreciation to operations conducted through foreign subsidiaries by allowing a credit for the foreign taxes on the income as if only straight-line depreciation had been taken. The same result occurs under existing law with respect to percentage depletion. While not previously stated as an intended purpose of the provision, Treasury considers that this result is proper and that the provision should be retained in the form contained in the House bill.

Section 452 of the bill will effect a similar reduction in the foreign tax credit for foreign income taxes paid by a 50 percent or more owned foreign subsidiary of a 10 percent owned foreign subsidiary.

In addition, this provision would affect the U.S. taxation of subpart F income (section 951-964 of the Code) including minimum distributions under section 963 and the special foreign tax credit provisions, the increase in earnings of controlled foreign corporations invested in United States property (section 956 of the Code), gain on sale or exchange of stock in a foreign investment company (section 1246 of the Code) and gain on sale or exchange of stock of a controlled foreign corporation (section 1248 of the Code).

## Sec. 461, 511-516--Capital Gains and Losses

1. <u>Alternative Capital Gains Rate for Corporations (Sec. 461)</u>

Under existing law, corporations which have an excess of net long-term capital gains over net short-term capital losses may exclude such excess from taxable income and pay an alternative tax of 25 percent of such excess. The bill increases the alternative capital gains tax rate to 30 percent for sales or other dispositions made after July 31, 1969.

Treasury recommends that the increase in the capital gain rate be made applicable only to the extent that in any year net long-term capital gains exceed net short-term capital losses plus $50,000.

2. <u>Alternative Capital Gains Tax for Individuals (Sec. 511)</u>

Under existing law, 50 percent of an individual's net long-term capital gain in excess of his net short-term capital loss is included in adjusted gross income. Existing law establishes a limit on the tax of a person other than a corporation by providing that the tax rate on the excess of long-term capital gains over short-term capital losses may not exceed 25 percent.

The effect of this limitation on the rate of tax is to increase above 50 percent the amount of long-term capital gains that are not subject to tax. In other words, the same tax burden would result if, instead of taxing the included 50 percent of these gains at a maximum rate of 50 percent, the portion of the total gains subject to tax were reduced below 50 percent and that portion were subject to the regular graduated rates of tax. The following example will illustrate the interchangeability of these approaches:

Assume that a single individual has $500,000 of long-term capital gains and no other income for the taxable year. Disregarding personal exemptions and itemized deductions, his tax is $125,000, i.e., 50 percent of the $250,000 of long-term capital gains which are included in his adjusted gross income. The same tax would result, however, if instead of taxing $250,000 at a 50 percent rate, $199,300 (39.86 percent) of his gains were subject to tax at the regular graduated rates of tax now in effect.

Thus, under the particular facts of the preceding example, the effect of the alternative capital gains tax is the same as permitting him to exclude $300,700 ($500,000 - $199,300), or slightly more than 60 percent of the $500,000 long-term capital gains. Under the tax rate schedule provided in existing law, this percentage can be as high as 64.3 percent, and under the tax rate schedule in the House bill, it can be as high as 61.5 percent.

Viewed as an exclusion of income from the tax base, the alternative tax is an item of tax preference which should be subject to the Limit on Tax Preferences. However, while it is known that under the proposed tax rate schedule the additional exclusion produced by the alternative tax will never exceed 11.5 percent of the total capital gain (61.5 percent maximum exclusion minus 50 percent exclusion available in all cases), the exact amount cannot be determined until the taxpayer computes his tax and his effective rate is known. For this reason, this tax preference cannot readily be integrated into the Limit on Tax Preferences, which is determined at an earlier stage in the tax computation.

The intent of the Limit on Tax Preference proposal is to make certain that a taxpayer will not be able to use the preferences beyond 50 percent of his income calculated without allowance of such preferences--an amount that might be referred to as his economic income. Thus, if a taxpayer has other preferences equal to or in excess of his taxable income, he will not pay tax on 50 percent of his economic income if he is allowed the benefit of the alternative tax under which he includes in adjusted gross income, in effect, less than one-half of his capital gains. On the other hand, if a taxpayer's taxable income exceeds his tax preferences, he would be paying tax on more than 50 percent of his economic income other than capital gains, and therefore he could be allowed in this circumstance the benefit of the alternative tax computation to a proper degree without violating the principle of the LTP proposal.

Treasury recommends that for taxable years beginning after December 31, 1969, in lieu of repealing the alternative tax, a limit be placed upon the amount of long-term capital gains to which it can be applied. The excess of the long-term capital gains over the limit should, after applying the 50 percent exclusion, be taxed at the ordinary rates (but at a rate not less than 50 percent applied to the 50 percent included portion). Thus, the amount by which the excess of the net long-term capital gain over the net short-term capital loss exceeds the limit would be taxed, after applying the 50 percent exclusion, at the graduated rates by including the full 50 percent includible portion in the taxpayer's adjusted gross income without the benefit of the alternative tax computation (except that the lowest graduated rates so applied would be not less than 50 percent).

The limit on the availability of the alternative tax would be four times taxable income adjusted in the following manner:

(a) Increased by the itemized deductions disallowed under the Allocation of Deductions,

(b) Reduced by the sum of:

(i) Allowable tax preferences (as defined for purposes of the Limit on Tax Preferences) in excess of $10,000 (the 50 percent capital gain exclusion would not be considered a tax preference for this purpose), and

(ii) Included capital gains (i.e., 50 percent of the excess of the net long-term capital gains over the short-term capital losses).

If a taxpayer's allowable tax preferences (other than the 50 percent capital gain exclusion) do not exceed $10,000, the limit on the amount subject to the alternative tax would be deemed to be not less than $140,000 if married and $85,000 if single (under the Treasury's proposed rate schedule). A taxpayer would be permitted to carry over to the next succeeding five years the unused portion of his limit on the alternative tax for any taxable year.

For the first five taxable years ending after December 31, 1969, the unused limit on the alternative tax computation, if any, would be computed on the basis of the taxpayer's taxable income for the preceding five years, even though this rule did not apply to all such years. However, the Limit on Tax Preferences would be taken into account to reduce taxable income for years beginning before December 31, 1969, as if it applied to such years. In effect, a simulated computation would be made with respect to years beginning before December 31, 1969, to determine the carryover as if these provisions had been in effect.

The application of this limit on the availability of the alternative tax may be illustrated (for taxpayers filing joint returns) by the following examples:

*Example 1:

| | | |
|---|---|---|
| Dividends | | $110,000 |
| Long-term capital gain | | 250,000 |
| Adjusted gross income ($110,000 + 1/2 of $250,000) | | 235,000 |
| Taxable income | | 235,000 |
| Limit on amount subject to the alternative rate | | |
| Limit on alternative rate taxable income | $235,000 | |
| Included capital gains | 125,000 | |
| | 4 x $110,000 | 440,000 |
| Tax computation | | |
| Alternative tax on capital gain (25% x $250,000) | | 62,500 |
| Tax on taxable income other than capital gain ($110,000 - married, filing joint return) | | 47,380 |
| Total tax | | $109,880 |

*Assume the taxpayer has no income other than that shown and has no tax preference amounts other than capital gains. Itemized personal deductions and exemptions are ignored. Assumes 1972 rate schedule under the House bill.

*Example 2:

| | | |
|---|---|---|
| Dividends | | $ 35,000 |
| Long-term capital gains | | 250,000 |
| Adjusted gross income ($35,000 + 1/2 of $250,000) | | 160,000 |
| Taxable income | | 160,000 |
| Limit on amount subject to the alternative rate | | |
| Limit on alternative rate (4 x $35,000) | | 140,000 |
| Capital gain subject to alternative tax | | 140,000 |
| Amount of capital gain included in adjusted gross income to which alternative tax will apply [one-half of $140,000] | | 70,000 |
| Amount of capital gain included in adjusted gross income--to which alternative tax will not apply [one-half of ($250,000 - $140,000)] | | 55,000 |
| Amount of taxable income to which alternative tax will not apply [$160,000 - $70,000] | | 90,000 |
| Tax computation | | |
| Alternative tax on capital gain (25% x $140,000) | | 35,000 |
| Tax (married, filing joint return) ordinary income ($35,000) | $ 9,380 | |
| **Capital gain of $55,000 (tax on $119,000 minus tax on $64,000) | 29,740 | 39,120 |
| Total tax | | $ 74,120 |

*Assume the taxpayer has no income other than that shown and has no tax preference amounts other than capital gains. Itemized personal deductions and exemptions are ignored. Assumes 1972 rate schedule under the House bill.

**Capital gain in excess of limit is taxed at progressive rates, the lowest of which is 25%. Since one-half of gain is included in income, the lowest rate for the computation must be 50%. Hence the computation must assume an ordinary income element of $64,000, which is the point at which a married taxpayer reaches the 50% bracket.

*<u>Example 3</u>:

| | |
|---|---|
| Dividends | $ 65,000 |
| Long-term capital gain | 300,000 |
| Adjusted gross income ($65,000 + 1/2 of $300,000) | 215,000 |
| Taxable income | 215,000 |
| <u>Limit on amount subject to the alternative rate</u> | |
| Limit on alternative rate (4 x $65,000) | 260,000 |
| Capital gain subject to alternative tax | 260,000 |
| Amount of capital gain included in adjusted gross income to which alternative tax will apply [one-half of $260,000] | 130,000 |
| Amount of capital gain included in adjusted gross income--to which alternative tax will not apply [one-half of ($300,000 - $260,000)] | 20,000 |
| Amount of taxable income to which alternative tax will not apply [$215,000 - $130,000] | 85,000 |
| <u>Tax computation</u> | |
| Alternative tax on capital gain (25% x $260,000) | 65,000 |
| **Tax (married, filing joint return) on $85,000 (dividend income of $65,000 plus capital gain of $20,000) | 33,540 |
| Total tax | $ 98,540 |

*Assume the taxpayer has no income other than that shown and has no tax preference amounts other than capital gains. Itemized personal deductions and exemptions are ignored. Assumes 1972 rate schedule under the House bill.

**Since the $20,000 of capital gain is taxed at the marginal rate of 50% or above, it is not necessary, as in example 2, to assume a hypothetical ordinary income in order to compute the tax on the portion of capital gain which is taxed at progressive rates of 50% and higher.

3. Holding Period of Capital Assets (Sec. 514)

Under existing law, capital gains on assets held for more than six months are considered long-term gains. The House bill lengthens the holding period to 12 months. Treasury recommends that the six months holding period be retained. In addition, we recommend that the provisions of the bill changing the holding period for timber under existing law be eliminated.

4. Casualty Losses Under Section 1231 (Sec. 516)

Under present law, uninsured losses from casualty or theft of property used in a trade or business, or property held for the production of income, are deductible from ordinary income. The bill provides that all casualty gains and losses, whether or not insured, are to be consolidated, and if losses exceed gains, the excess gives rise to an ordinary loss. If the gains exceed the losses, the excess is consolidated with other section 1231 gains and losses. However, the bill, apparently through a drafting error excludes from this treatment capital assets which are neither used in a trade or business nor held for the production of income (i.e., personal capital assets).

Treasury recommends that casualty gains and losses on personal capital assets be included in the consolidation of casualty gains and losses. Treasury believes this was the intention of the House bill and that the exclusion of such gains and losses was inadvertent.

5. <u>Transfer of Franchises (Sec. 516)</u>

Under present law, the tax treatment of the transfer of franchises has been uncertain. Some such transfers have been treated as sales, resulting in capital gains, and some have been treated as leases so that payments to the transferor are treated as ordinary income. The bill denies capital gain treatment to the transfer of a franchise if the transferor retains any significant power, right, or continuing interest with respect to the subject matter of the franchise.

Treasury recommends that the criteria for determining whether capital gain treatment will be denied the disposition of the franchise be broadened to include the method of payment. Thus, the term "significant power, right, or continuing interest" would include a right to continuing payments unless such payments are to be made only for a specified period which is substantially less than the useful life of the property and which in any event is less than 20 years.

Sec. 521--Real Estate

1. Recapture of Depreciation

The House bill provides that with respect to sales of depreciable real estate at a gain after July 24, 1969, accelerated depreciation taken after July 24, 1969, in excess of straight line depreciation will be recaptured as ordinary income to the extent of such gain. Thus, the percentage reduction under existing law in the amount recaptured, based on the period the asset has been held, would be eliminated.

Although more favorable depreciation is provided under the House bill for new residential housing than for other buildings, no difference is provided under the recapture rule. It appears that application of the same recapture rule tends to reduce materially the stimuli to new residential housing intended by the House bill.

Treasury recommends that there be a percentage reduction in the amount of excess depreciation recaptured with respect to sales of new residential housing in the hands of the original owner. The percentage reduction, however, should be stretched out over a substantially longer period than that provided in existing law. The full excess of accelerated

over straight line depreciation should be recaptured with respect to sales within the first ten years, at which time the percentage reduction would begin at the rate of one percent per month. A sale after the fourth month of the nineteenth year of the taxpayer's holding period would thus result in no recapture.

Treasury recommends further that the recapture rule of existing law be retained without change for certain Federally-assisted projects under the so-called FHA 221(d)(3) and FHA 236 programs. These programs provide a limited return to investors of 6 percent, this low rate of return having been based on the existing favorable tax treatment. It is inappropriate to change this treatment unless and until Congress acts to increase the allowable return.

The revised recapture rules of section 1250 would apply under the House bill to all depreciation attributable to periods after July 25, 1969. It is suggested that the effective date be changed to apply to depreciation taken after December 31, 1969. This would provide a simpler transition rule comparable to the effective date provision used when section 1250 was first enacted.

2. Foreign Housing

The House bill reduces accelerated depreciation allowances for certain real estate investments. New real estate other than housing would be limited to an amount not in excess of the amount allowable under the 150 percent declining balance depreciation method. Housing was excepted from the limitation in order to foster our national housing goals. As drafted, however, the House bill would allow the benefits of 200 percent accelerated depreciation in respect to housing constructed both in the United States and in foreign countries. Treasury recommends that the 200 percent depreciation allowance be available only for housing constructed in the United States or its possessions. The same transition rule for existing commitments as is contained in proposed section 167(j)(3)(B) (which would be added by section 521(a) of the bill) would be provided.

Sec. 531--Cooperatives

Additional 30 Percent Requirement

Under present law, cooperative organizations are permitted to reduce their taxable income by the amount of "qualified" patronage dividends distributed to members. This requirement is satisfied if a "qualified" written notice of allocation is distributed and if 20 percent or more of the amount of a patronage dividend is paid in money or by qualified check.

The House bill imposes an additional requirement in order for a written notice of allocation to be treated as "qualified." The bill provides that an additional 30 percent (phased-in over a 10-year period) must be paid to patrons either: (1) with respect to the current allocation; or (2) in redemption of prior allocations by the cooperative for any taxable year.

The additional payout requirement will result in complexity and administrative difficulty. The House bill provides that the requirement may be met either: (1) by an

additional cash payment on account of the patronage dividend for the current year; or (2) by redemption of any prior qualified written notice of allocation by the cooperative for any taxable year. The following problems illustrate the difficulty of this rule.

Since the cooperative is allowed a period of 8-1/2 months after the close of its taxable year within which to pay a patronage dividend, a payment could be made by a fiscal year cooperative after April 15 (the patron's calendar year filing date) of a given year which the cooperative might allocate to a written notice of allocation issued by the cooperative prior to the end of the previous calendar year. This would thereby qualify a previously issued notice which had not yet otherwise been qualified, and which would then be taxable to the patron for the prior calendar year even though his return had already been filed. This could not occur under existing law where the 20 percent cash payment requirement must be satisfied at the time the written notice is issued.

Similarly, the cooperative might satisfy the additional 30 percent payout requirement by redeeming prior written

notices of some patrons and not others. The bill contains no requirement that redemptions be made on a *pro rata* basis. As a result, written notices of allocation could become qualified, and become income to patrons, although some patrons receive more cash in relation to their allocations in a given year than others.

For example, a cooperative on a calendar year basis might pay patronage dividends of $1,000 each to Patrons A and B on March 15, 1970 ($200 in cash and $800 in written notices of allocation). The cooperative at that time might also pay $600 in cash in redemption of prior years' written notices of allocation held by A, thus qualifying the written notices issued to both A and B, though A received $800 in in cash and B only $200. In fact, the cooperative might instead pay only $300 in redemption of prior years' notices held by A but apply this to B's current written notice of allocation so that B would be taxed currently but A would not (since the additional 30 percent payout requirement would not be deemed satisfied with respect to A).

Treasury has considered whether better rules could be developed with respect to the additional 30 percent payout requirement but has concluded that the 15-year payout requirement, when fully effective, will be sufficient in and of itself to assure adequate annual payments to patrons. Thus, the complexities of the additional 30 percent payout requirement are unnecessary and the requirement should be deleted.

Sec. 601--State and Local Obligations

1. Subsidy for Taxable Issues

Treasury recommends that the provisions in the House bill providing an election to state and local governmental units to issue taxable bonds and for payment by the Federal Government of a percentage of the interest yield on such taxable issues be deleted. The Administration is developing an alternative provision which will be submitted to the Congress in due course.

2. Arbitrage Obligations.

Some states and localities have used funds received from the issuance by them of tax-exempt bonds to purchase higher yield taxable securities. Since municipal governments are not subject to Federal income taxes, the interest received is not taxed in their hands; the issuer thus profits in an amount equal to the spread between the tax-exempt interest paid and the higher interest received on the higher yield taxable securities. The House bill deals with this problem by providing that an "arbitrage obligation" shall not be entitled to tax-exempt status. The definition of an arbitrage obligation is left to regulations.

Treasury supports the objective of the bill to deny tax-exempt status to state and local bonds issued in a true arbitrage transaction. However, Treasury recommends that the bill be amended to provide a rule which may be easily understood and applied and which furnishes a clearer standard to be followed in the regulations. Treasury proposes that an obligation be considered an "arbitrage obligation" if, under regulations prescribed by the Secretary or his delegate the circumstances (including but not limited to the terms of the obligation, the specified purpose of the issue, the nature of the security provided for the obligation, and all other relevant facts) demonstrate that the result of the issuance is the realization of an arbitrage profit from reinvestment of the proceeds in higher yield securities other than governmental obligations to which section 103(a) of the Code applies.

The provision, however, should contain explicit authority for the regulations to treat temporary investment of the proceeds of an issue in higher yield securities as not constituting an arbitrage transaction where substantially all of the proceeds of the issue are used within a specified period for other purposes, such as construction of new government

facilities. Similarly, authority should be given to provide that obligations issued to refund obligations then outstanding which are not themselves arbitrage obligations will not be arbitrage obligations if the refunding is completed within a stated period.

Further, explicit authority should be given to exclude from the definition of an arbitrage obligation any obligation the proceeds of which are used to provide permanent financing (mortgage funds) for family housing, sports facilities, or other exempt activities specified in section 103(c) of the Code. No limit is placed in the Code on the issuance of tax-exempt bonds to construct governmental facilities which may in fact produce a profit from operation. The same considerations justifying the blanket exemptions from industrial revenue bond treatment apply with respect to funds used to provide mortgage financing for the construction of such facilities. The exception should only be available if the yield received on such mortgage obligations does not substantially exceed the interest yield on the obligations of the state or local government. Further, a limitation should

be included making the exception inapplicable with respect to such obligations of the state or local government for any period for which they are held by the mortgagor (see, for example, section 103(c)(7) of the Code).

## Sec. 704--Amortization of Pollution Control Facilities

1. Definition of a Certified Pollution Control Facility

The House bill provides for five-year amortization of the cost of a "new identifiable treatment facility" construction of which is completed after December 31, 1968, or which is acquired after that date. There is no differentiation between pollution control facilities which are added to existing plants and those which are incorporated into new plants constructed after that date. In general, the cost of modifying an existing installation for pollution control is greatly in excess of the cost of incorporating such facilities into new construction. The impact of pollution control laws will thus be more severe on existing plants where the need for such devices is the greatest. A special incentive for installation of pollution control facilities in new plants constructed in the future subject to pollution control laws seems unnecessary.

33-865 O—69—pt. 1——57

Treasury recommends that the benefits of this provision be limited to pollution control facilities added after December 31, 1968, to plants which were in actual operation on that date. In addition, the definition should be further limited so as to exclude any facility which serves any function other than pollution control.

The intent of this provision of the bill, as shown by the Committee report, is to assist those industries which add pollution control devices to correct or reduce pollution now being released directly in the course of manufacturing operations. It has been suggested that the bill could be construed to extend this rapid amortization privilege to primary fuel processors, such as an oil refinery, which add facilities to remove pollutants from fuels sold to customers. The bill should be clarified to limit the provision solely to installations which prevent or minimize the direct release of pollutants into the air or water in the course of manufacturing operations and to exclude any facilities which tend to remove from fuel certain elements which upon burning would cause pollutants to be released.

2. Amortization Basis

The five-year write-off provided by the House bill, when applied to property having a long useful life, is a considerably greater tax benefit than the 7 percent investment credit. For instance, for property with a 50-year life, the five-year amortization is approximately equal to a 20 percent investment credit. This provides too great a tax benefit and makes the benefit vary too greatly dependent on the normal life of the equipment.

Treasury recommends that the five-year amortization be limited to:

(i) the adjusted basis of property with a normal useful life of 15 years or less; and

(ii) in the case of property with a longer life, the proportionate part of the adjusted basis which is represented by the first 15 years of the normal useful life of such property.

In this latter circumstance, the taxpayer would commence depreciation of the remainder of the basis in the sixth year over a period of time equal to the remaining normal useful life. The taxpayer would use any method of depreciation otherwise allowable under section 167 of the Code, as though the remaining basis represented the cost of a separate item of new property acquired on the first day of the sixth year.

Sec. 801-805--Adjustment of Tax Burden

Treasury recommends several changes in the provisions of the bill relating to the adjustment of the taxes paid by individuals. Treasury also recommends certain changes concerning computation of tax by the Internal Revenue Service for persons electing this treatment, withholding provisions, and other related matters. Finally, Treasury recommends a tax reduction for corporations. No changes are recommended with respect to the 50 percent maximum rate on earned income (Sec. 802) or the new rate schedules for married persons (Sec. 804).

1. Low-Income Allowance

The bill adopts the Treasury proposal for a low-income allowance designed to eliminate from the tax rolls persons with income at or below the poverty levels, effective for 1970 and subsequent years. Under the Treasury proposal the allowance was to be reduced by 50 cents for each dollar of adjusted gross income over the maximum tax-free income. The bill eliminates this "phase-out" after 1970, thus in effect converting the low-income allowance (in combination with the existing minimum standard deduction) into a minimum standard deduction of $1,100 for each taxpayer for 1971 and later years.

Treasury recommends that the "phase-out" be retained but liberalized so as to provide that the reduction in the low-income allowance be 25 cents for each dollar of income above the maximum tax-free income. This would be effective for 1970 and subsequent years.

2. Standard Deduction

The bill increases the present 10-percent standard deduction and $1,000 ceiling to 15 percent with a $2,000 ceiling in three stages: 13 percent and a $1,400 ceiling in 1970; 14 percent and a $1,700 ceiling in 1971; and 15 percent and a $2,000 ceiling for 1972 and subsequent years.

Treasury recommends that in lieu of these increases, the percentage and dollar limitations of the standard deduction be increased to 12 percent and $1,400 effective for 1971 and subsequent years. There would be no increase for 1970.

3. Single Persons

The bill extends the "head-of-household" tax rates to all single persons 35 years and older and to widows and widowers, regardless of age. In addition, the bill extends for

an unlimited period the joint return privilege now granted for two years to a surviving spouse maintaining a home for a dependent child.

Treasury recommends that the extension of the joint return privilege for surviving spouses beyond two years be eliminated. In lieu of the extension of head-of-household rates to all widows and widowers and single persons age 35 and over, Treasury recommends that for 1971 and subsequent years the single persons rate schedule be reduced so that a single person (whether under or over age 35) will pay a tax that is no more than 20 percent greater than the tax paid by a married couple with the same taxable income. In addition, the head-of-household rates would be adjusted (for persons who qualify for that status under present law) so that they fall, as they do now, approximately halfway between the new single persons rate schedule and the married persons rate schedule. To accomplish the foregoing, the following rate schedules representing the rates when fully effective in 1972 and later years would apply (somewhat higher rates would apply for 1971 reflecting roughly the same tax differential from the married persons tax burdens applicable for 1971):

| Taxable Income Bracket | Regular Rate Schedule | Head-of-Household Rate Schedule | Intermediate Rate Schedule |
|---|---|---|---|
| $ 0 - 500 | 13% | 13% | 13% |
| 500 - 1,000 | 14 | 13 | 14 |
| 1,000 - 1,500 | 15 | 15 | 15 |
| 1,500 - 2,000 | 16 | 15 | 16 |
| 2,000 - 3,000 | 18 | 17 | 18 |
| 3,000 - 4,000 | 18 | 17 | 18 |
| 4,000 - 6,000 | 21 | 19 | 20 |
| 6,000 - 8,000 | 23 | 20 | 22 |
| 8,000 - 10,000 | 27 | 22 | 24 |
| 10,000 - 12,000 | 30 | 23 | 26 |
| 12,000 - 14,000 | 34 | 25 | 28 |
| 14,000 - 16,000 | 37 | 27 | 30 |
| 16,000 - 18,000 | 40 | 29 | 32 |
| 18,000 - 20,000 | 42 | 31 | 34 |
| 20,000 - 22,000 | 44 | 32 | 35 |
| 22,000 - 24,000 | 47 | 34 | 37 |
| 24,000 - 26,000 | 47 | 36 | 37 |
| 26,000 - 28,000 | 49 | 38 | 42 |
| 28,000 - 32,000 | 49 | 40 | 42 |
| 32,000 - 36,000 | 50 | 43 | 47 |
| 36,000 - 38,000 | 50 | 45 | 47 |
| 38,000 - 40,000 | 52 | 47 | 52 |
| 40,000 - 44,000 | 52 | 48 | 52 |
| 44,000 - 50,000 | 54 | 51 | 54 |
| 50,000 - 52,000 | 58 | 53 | 58 |
| 52,000 - 60,000 | 58 | 53 | 58 |
| 60,000 - 64,000 | 60 | 55 | 60 |
| 64,000 - 76,000 | 60 | 55 | 60 |
| 76,000 - 80,000 | 60 | 55 | 60 |
| 80,000 - 88,000 | 61 | 57 | 61 |
| 88,000 - 100,000 | 61 | 57 | 61 |
| 100,000 - 120,000 | 62 | 60 | 62 |
| 120,000 - 150,000 | 63 | 62 | 63 |
| 150,000 - 160,000 | 64 | 62 | 64 |
| 160,000 - 200,000 | 64 | 63 | 64 |
| 200,000 - 240,000 | 65 | 64 | 65 |
| 240,000 - 300,000 | 65 | 64 | 65 |
| 300,000 - 400,000 | 65 | 65 | 65 |
| Over - 400,000 | 65 | 65 | 65 |

Married persons would use the regular rate schedule by determining the tax on one-half the income in the joint return and then doubling the amount of tax so determined, as under existing law. Single persons would use the intermediate rate schedule. It is not appropriate to eliminate the regular rate schedule and construct a new rate schedule for joint returns because married persons filing separately are not to be eligible for the intermediate rate schedule. Married persons filing separately will be required to use the regular rate schedule. This treatment is necessary to prevent married persons from arranging their affairs so as to have amounts of income on which, if they could separately use the intermediate rate schedules, the combined tax would be less than the amount payable on a joint return.

4. Repeal of the State Gasoline Tax Deduction

Present law permits an income tax deduction for state and local taxes levied on the sale of gasoline or other motor fuels. Treasury recommends repeal of this provision, effective for 1971 and subsequent years. Gasoline tax payments paid or accrued in carrying on a trade or business or for the production of income would continue to be deductible.

5. Liberalization of Filing Requirements

Present law requires an individual to file a return if his gross income is $600 or more. An individual over 65 is required to file if his income is $1,200 or more. The House bill made no change in these requirements although the Low-Income Allowance adopted in the House bill substantially raises the levels under which individuals will not be subject to income tax. Treasury recommends that the filing requirements be raised to the new nontaxable levels created by the Low-Income Allowance as follows: $1,700 for single individuals; $2,300 if married or over 65 ($600 if married and either spouse files a separate return); $2,900 if married with one spouse over 65; and $3,500 if married and both spouses are over 65. This proposal should eliminate filing of returns by approximately 5 million individuals.

6. Tax Computed by Internal Revenue Service

The bill authorizes the Secretary or his delegate to extend by regulation the election granted by section 6014(a) to taxpayers to have their tax computed by the Internal Revenue Service. Treasury recommends that section 6014 be amended to permit the Secretary or his delegate under regulations to extend this election regardless of: (1) the amount or source of his adjusted gross income; (2) his marital filing status; (3) the nature of credits claimed; or (4) his electing the standard deduction. This greater degree of flexibility will permit the Internal Revenue Service to extend substantially its program of assistance to taxpayers.

7. Withholding Provisions

Treasury recommends the inclusion of provisions authorizing the Secretary to promulgate regulations giving employers more flexibility in devising withholding systems to fit their particular needs. Thus, the Code should provide for regulations which permit "annualizing" of wages for this purpose

and which authorize the Secretary or his delegate to approve other methods which would produce substantially the same amount of withholding as is required by sections 3402(a) or 3402(c) of the Code. The "annualizing" provision would permit the employer to: (a) multiply the amount of wages paid to an employee in the current payroll period by the number of such periods in the year, (b) determine the amount of withholding upon such annualized wages as if such wages constituted the actual wages for the entire year, and (c) determine the withholding for the current payroll period by dividing the amount in (b) by the number of payroll periods in the year.

Treasury also recommends that the existing problem of overwithholding with respect to nontaxable students who work only during the summer months (and any other nontaxable persons who work for only part of the year) be resolved in the bill. Such persons should be relieved of any withholding on certification by them to their employer that they: (a) estimate that they will have no Federal income tax liability for the current year; and (b) in fact had no Federal income tax liability for the preceding year. This could relieve as

many as 10 million persons from unnecessary withholding. A substantial administrative saving to the Internal Revenue Service would result from the elimination of the necessity for issuing refunds in these cases.

Also, the Treasury recommends the inclusion in the bill of provisions which would authorize the promulgation of regulations prescribing conditions for voluntary income tax withholding with respect to amounts paid for services which are not "wages" as defined in section 3401 of the Code. The authority to withhold would apply in those cases in which both the person paying and the individual receiving such remuneration agree voluntarily to such withholding. This would simplify income tax payment for retired persons (or their survivors) receiving annuities, farm and domestic workers, recipients of payments under supplemental unemployment benefit (SUB) plans, and other persons receiving payments for services not now subject to withholding where they choose to agree voluntarily to withholding.

In cases in which a voluntary withholding agreement is executed, the remuneration covered by the agreement would be deemed to be "wages" for purposes of the Code provisions which relate to withholding on wages. Accordingly, the person paying the remuneration would be liable for timely payment to the United States of the amounts withheld. Further, the amounts withheld would be credited to the recipient of the remuneration as a payment against his Federal income tax liability. The provisions of the Code requiring information documents regarding wages paid and amounts withheld, and providing for penalties for nonpayment of withheld amounts, would be applicable.

The amount to be withheld would normally be computed on the basis of the regular withholding rates or tables. However, as in the case of mandatory withholding, the recipient could request the withholding of additional amounts. Voluntary withholding agreements could be entered into whether the remuneration paid related to present, past, or future services.

8. Withholding Rate Schedules and Optional Tax Tables

Treasury recommends that the bill incorporate the annual withholding rate schedule into the Code. This will eliminate any question as to the proper amount of withholding which could be derived from various combinations of rates and wage brackets. These schedules will provide a clear basis for all other withholding rate schedules and wage bracket withholding tables.

Treasury also recommends that the optional tax tables be incorporated into the Code by the bill. This will also serve to set forth specifically the amount of tax imposed under any method of tax computation adopted by the taxpayer.

9. Reduction of Tax on Corporations

Under present law, the corporate tax rate is 48 percent on taxable income in excess of $25,000 (without regard to the income tax surcharge). The rate consists of a 22-percent normal tax rate imposed by section 11(b) of the Code (applying to all corporate income) and a 26-percent surtax rate imposed by section 11(c) (applying to corporate income in excess of $25,000). Thus, corporations are taxed at a 22-percent rate on their first $25,000 of taxable income and at a 48-percent rate on the taxable income above that amount.

Treasury recommends that section 11(b) of the Code be amended to provide that the normal tax rate in the case of a taxable year beginning after December 31, 1970, would be 21 percent and that section 11(c) of the Code be amended to provide that the surtax rate in the case of a taxable year beginning after December 31, 1971, would be 25 percent. The combined corporate tax rate for 1971 would thus be 47 percent, and for 1972 and subsequent years it would be 46 percent.

Section 963(b) of the Code (relating to receipt of minimum distributions by domestic corporations) should also be amended to provide for new minimum distribution tables to reflect the change in corporate tax rates for taxable years beginning after 1970. For taxable years beginning in 1971, the following table would apply:

| If the effective foreign tax rate is (percentage)-- | The required minimum distribution of earnings and profits is (percentage)-- |
|---|---|
| Under 9 | 82 |
| 9 or over but less than 17 | 78 |
| 17 or over but less than 25 | 75 |
| 25 or over but less than 31 | 68 |
| 31 or over but less than 35 | 62 |
| 35 or over but less than 38 | 50 |
| 38 or over but less than 40 | 36 |
| 40 or over but less than 41 | 24 |
| 41 or over but less than 42 | 13 |
| 42 or over | 0 |

For taxable years beginning after 1971, the following table would apply:

| If the effective foreign tax rate is (percentage)-- | The required minimum distribution of earnings and profits is (percentage)-- |
|---|---|
| Under 9 | 81 |
| 9 or over but less than 17 | 77 |
| 17 or over but less than 24 | 74 |
| 24 or over but less than 30 | 67 |
| 30 or over but less than 34 | 61 |
| 34 or over but less than 37 | 49 |
| 37 or over but less than 39 | 35 |
| 39 or over but less than 40 | 23 |
| 40 or over but less than 41 | 12 |
| 41 or over | 0 |

Comparison of House Bill and Treasury Proposal
by Principle Feature in Terms of Long Run Revenue Effect

| | House Bill | Treasury Proposal | Difference (-) is increased revenue loss or decreased gain |
|---|---|---|---|
| | (............ | $ millions........ | ....) |
| **Rate Reduction and Relief Provisions** | | | |
| Individual | | | |
| Rate reduction | -4,498 | -4,705 | -207 |
| Standard deduction | -4,025 | -1,690 | 2,335 |
| Single person | - 650 | - 445 | 205 |
| Other | - 500 | - 500 | - |
| Total | -9,673 | -7,340 | 2,333 |
| Corporation | | | |
| Normal tax reduction | | -870 | -870 |
| Surtax reduction | | -800 | -800 |
| Total | | -1,670 | -1,670 |
| Incentive Provisions | | | |
| Individual | - 70 | - 70 | - |
| Corporation | - 760 | - 380 | 380 |
| Total Rate Reduction and Incentive | -10,503 | -9,460 | 1,043 |
| **Reform Provisions** | | | |
| Individuals | | | |
| Investment credit repeal | 600 | 600 | - |
| Other | 1,815 | 1,970 | 155 |
| Total | 2,415 | 2,570 | 155 |
| Corporations | | | |
| Investment credit repeal | 2,700 | 2,700 | - |
| Other | 2,970 | 2,755 | -215 |
| Total | 5,670 | 5,455 | -215 |
| Combined Individuals and Corporations Reform | 8,085 | 8,025 | - 60 |
| Total | | | |
| Individuals | -7,328 | -4,840 | 2,488 |
| Corporations | 4,910 | 3,405 | -1,505 |
| Combined | -2,418 | -1,435 | 983 |

Office of the Secretary of the Treasury
Office of Tax Analysis

October 2, 1969

O