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TAX REFORM ACT OF 1969

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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 4 OF 7 PARTS

SEPTEMBER 22, 23, 24, AND 25, 1969

GENERAL OUTLINE OF ORAL AND WRITTEN TESTIMONY IN PART 4:

- Cooperatives
- Farm Losses
- General
- Income Averaging
- Limit on Tax Preferences; Allocation of Deductions
- State and Local Bond Interest

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TAX REFORM ACT OF 1969

MONDAY, SEPTEMBER 22, 1969

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

The committee met, pursuant to recess, at 10 a.m., in room 2221, New Senate Office Building, Senator Herman E. Talmadge presiding.

Present: Senators Long (chairman), Anderson, Gore, Talmadge, Hartke, Harris, Byrd Jr. of Virginia, Williams of Delware, Curtis, Miller, Jordan of Idaho, and Fannin.

Senator TALMADGE. The committee will come to order.

This morning the subject before the committee is the tax treatment of farm losses and hobby farmers. We will also take testimony on the revisions proposed by the House tax reform bill in the taxation of cooperative enterprises and their patrons.

Because we have an unusually long list of witnesses to hear today, I am going to urge that each witness make a special effort to avoid duplicating testimony that has already been given to the committee. I urge that witnesses summarize their statements as expeditiously as possible so that the work of the committee might move forward.

Our first witness this morning is Mr. George Meany, president of the AFL-CIO.

I might say for the record that Mr. Meany's testimony does not deal with farm losses. Indeed, his statement barely touches on the subject.

Mr. Meany, we are happy to see you with us this morning. You may proceed as you see fit.

STATEMENT OF GEORGE MEANY, PRESIDENT OF THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS; ACCOMPANIED BY ANDREW J. BIEMILLER, DIRECTOR OF THE DEPARTMENT OF LEGISLATION, AFL-CIO; AND NATHANIEL GOLDFINGER, DIRECTOR OF THE DEPARTMENT OF RESEARCH, AFL-CIO

Mr. MEANY. Thank you.

My name is George Meany and I am president of the American Federation of Labor and Congress of Industrial Organizations.

The 13.5 million members of the unions of the AFL-CIO are, almost without exception, taxpayers. They pay their taxes regularly, payday after payday, through the payroll withholding program. They are loyal Americans; they appreciate the value of government, the services of government, the need for paying for government.

They are willing to pay their fair share.

But they are tired of having to pay the share of other Americans. Specifically, they are tired of paying the share of those Americans whose incomes are greater and whose taxes are lower—the "loophole set" in today's society.

So it is on behalf of the largest organized group of taxpayers in America that the AFL-CIO appears here today as advocates of tax justice. We do not have tax justice today and we will not achieve it under the House bill. And the administration's proposals bear no resemblance at all to tax justice.

The Federal tax system is rigged against those whose livelihood comes from the work they do. It is rigged in favor of those whose income results from investments.

This unfair rigging results from the fact that a triple standard is applied to income taxed by the Federal Government.

One standard applies to wages, salaries, and other forms of so-called ordinary income. This income is taxed in full and, for workers, the tax is regularly deducted from their paychecks.

A second standard applies to income from stocks, real estate, and other so-called capital assets sold at a profit. Only half of such income is taxed. And under present law the tax can never be more than 25 percent—even for those in the very top tax brackets.

A third standard is applied to certain forms of income which never even appear on the tax form, such as the interest on State and local bonds, or the income that is washed out by phantom, nonexistent costs as oil depletion, fast depreciation writeoffs, and bookkeeping farm losses. This type of income completely escapes taxation.

The wealthier you are, the greater are the opportunities to take advantage of these preferentially taxed or untaxed forms of income.

This triple standard will not be ended through reforms that eliminate or curb some relatively obscure tax dodges affecting a handful of people. Nor will it be ended merely by ensuring that those of extreme wealth and ability-to-pay are called upon to make some contribution to the Federal Treasury.

The now infamous 21 persons, for example, who paid no taxes at all on their incomes of $1 million and over, have become a symbol. And, I fear, too many have addressed themselves only to this symbol. Tax measures to insure that those with astronomically high incomes merely pay some taxes to the Federal Government falls far short of justice.

Justice can only come when:

The completely impoverished are removed from the tax rolls.

There is a meaningful reduction in the relative tax burdens of low- and middle-income families.

The loopholes of special tax privilege for wealthy families and businesses are eliminated.

The single most costly loophole and the one that is the prime culprit of unfairness is the capital gains loophole.

This is not a loophole which applies only to a handful. It is not a loophole which reduces anyone's taxes to zero. And its effect on the tax structure does not give rise to tax evasion horror stories that can be dramatically illustrated through the media.

Yet, because of the half tax on capital gains and the zero tax on such gains passed on at death, some $30-40 billion escapes the tax base, resulting in an annual Treasury revenue loss of over $10 billion.

And it is a tax preference that says, in effect, the more wealth and income you have, the more opportunities you should be allowed to avoid a fair share of taxes.

The AFL–CIO has continually pointed to this loophole as the major flaw in the tax system. The Treasury study published last February confirms this, saying that the special treatment accorded capital gains is the "most important factor in reducing the tax rates of those with high incomes."

We see no justice to a tax provision which says that a married taxpayer with $8,000 in capital gains income should pay a tax of $354 while a married taxpayer, with the same amount of wage income, should pay $1,000.

We also recommend taxation of the $15 billion in capital gains that is passed on annually to heirs without even being mentioned on the income-tax form.

Under the House action, some of the capital gains loopholes would be trimmed. The House would eliminate the 25 percent maximum and would extend the holding period for long-term capital gains from 6 months to 1 year.

Even with these improvements, capital gains would still remain as the prime factor in eroding the fairness of the tax structure, for unearned income would still be preferentially taxed. And, what is worse the administration has proposed to weaken even these modest reforms.

If the tax structure is to meet America's standards of fair play, loophole closing must be broad-gaged and substantial. On April 1, 1969, before the House Ways and Means Committee, the AFL–CIO presented a program which we believe would achieve tax justice—a program which would generate some $15 to 17 billion in federal revenues from substantial loophole closing, provide relief to those of low and moderate and middle incomes, and allow some $8 to $10 billion to fully fund existing Federal programs geared to meeting domestic needs.

Against that background, we think the House bill merits commendation, for:

1. The working poor are relieved of any Federal tax obligation.
2. The hard-working, tax-paying low- and middle-income Americans, who have been forced to bear far more than their just share of the tax burden, have been given a modicum of relief.
3. The single most inflationary pressure in the economy, the 7 percent investment credit to business, has been eliminated.
4. Some of the loopholes and gimmicks in the tax structure, designed to provide special, unfair tax bonanzas for the very wealthy, have been trimmed, although not eliminated.

We urge the Senate to improve upon the House action and to reject all proposals, including those of the administration, which would move the tax structure still further away from America's standards of fair play.

Specifically, we urge the Senate to:

1. Close the capital gains loophole, ending the major tax preference for unearned income.

There cannot be tax justice as long as unearned income is half-taxed while earned income is taxed in full.

The modest changes recommended by the House are welcome but not enough and the administration would largely undo the positive action taken by the House.

2. Put an end to the tax abuses of the oil, gas, and other mineral industries.

Again the measures taken by the House are welcome ones. They would reduce the depletion allowance, eliminate depletion on foreign oil and gas wells, place a limit on the amount of exploration expenses that can be immediately written off, and end some other abuses such as the carved-out production payment.

Nevertheless, of the total revenue that escapes taxation due to the activities of these industries, only one-third would be recorded by the House action.

We recommend the complete elimination of these abuses.

3. Eliminate the maximum-tax provision.

Under the maximum-tax provision contained in the House bill the top tax rate on earned income would be 50 percent.

This proposal would benefit only those with incomes above $50,000. It would serve to provide an uncalled-for tax bonanza of $100 million to top corporate executives, doctors, lawyers, and others whose income comes from astronomically high fees and salaries.

The administration has strongly endorsed this proposal. It reflects a cynical philosophy that if taxes on the wealthy are cut, they will not try so hard to find loopholes. Such a philosophy makes a mockery of tax-reform efforts. We cannot subscribe to it and we strongly condemn it.

4. Strengthen the minimum-tax provisions of the House bill.

The so-called limit on tax preferences—LTP—proposed by the House and the weaker version offered by the administration are prime examples of reforms addressed solely to symbols.

Both the House and the administration versions would limit the amount of certain types of income that can be completely tax exempt to no more than half of total income plus $10,000. Thus, the more the income you have, the more can be tax free.

What is more, if you fail to shelter all your income in 1 year, you can keep trying for another 5.

Under the House bill, though a wealthy individual affected by the LTP would by no means pay his fair share of taxes, he would pay some.

Under the administration proposals, since State and local bond interest would not be recognized as income under the LTP, some wealthy individuals would still escape scot free and pay no taxes at all.

The AFL-CIO has proposed a 25 percent tax on exempt income in excess of $10,000 for individuals and $25,000 for corporations—regardless of the amount of the taxpayer's ordinary income.

5. Strengthen and improve other measures contained in the House bill.

For example:

Interest on State and local bonds should be taxed in full with the Federal Government guaranteeing the bonds and providing an interest subsidy to insure that the fiscal powers of the State and local governments are not damaged.

Instead of the hobby farm loophole-closing proposals suggested by the House and the administration, the loss-limit approach contained in S. 500 should be adopted. This procedure was recommended by Senator Metcalf and endorsed by a bipartisan group of 26 Senators. This approach is specifically tailored to the tax-loss farmer and insures that legitimate farm operators will not be penalized.

The income-averaging formula should not be liberalized to include capital gains unless the preferential treatment accorded such gains is eliminated.

Interest deductions on bonds used to finance corporate mergers and acquisitions should be completely disallowed.

All rapid depreciation on real estate should be disallowed, except for low- and moderate-income housing.

Accelerated depreciation on regulated utilities should not be allowed unless the tax benefits flow through to the consumer.

Finally, the Senate should provide more substantive relief to those whose incomes are moderate and whose tax burdens are unnecessarily severe.

Tax relief and tax justice do not necessarily go hand-in-hand. The equity in the tax structure can be as badly damaged by tax cuts as it can by tax increases or the addition of new loopholes and gimmicks.

Under the House-passed bill this concept was partially recognized. Though all groups would receive relief, a significant proportion of the relief would flow to low- and middle-income taxpayers.

Under the changes proposed by the administration needed relief for those just above the Government-defined poverty threshold and those in the middle-income brackets would be cut back, the State gasoline-tax deduction would be disallowed, and a tax cut would be given to corporations.

Under the House proposals, $4 billion in tax relief is provided through the low income allowance and standard deduction increases. These primarily benefit low- and middle-income taxpayers. Another $4.5 billion is granted through across-the-board rate cuts. Over half of this relief goes to taxpayers with incomes of $15,000 or over.

The administration agrees with the House on cutting the taxes of the wealthy, but says it goes too far when it would cut taxes for those of low and modest incomes. In addition, claims the Treasury, corporate taxes should be cut $1.6 billion.

We endorse the House proposals to increase the low-income allowance to a flat $1,100. In addition, we endorse the House proposals to increase the standard deduction to 15 percent and $2,000.

We do not agree with the general rate reductions recommended by the House and the administration; and certainly there is no justification for a reduction in corporate taxes.

Instead we recommend a reduction in the tax rates that apply to the first $8,000 of everyone's taxable income for married individuals and the first $4,000 for single individuals.

The rate changes we propose and their effect are shown on tables that we will present to the committee along with this statement.

Our relief proposals would result in the same revenue loss as that proposed by the House. They would cost roughly $600 million more than proposed by the administration—an amount that could easily be made up by, for example, eliminating the maximum-tax provision, effectively closing the hobby-farm gimmick, and adopting a meaningful minimum tax.

Mr. Chairman, we urge that this committee bring the Federal income tax into line with what it is supposed to do—tax income in accordance with ability to pay. That is tax justice.

(The charts accompanying Mr. Meany's statement follow:)

TABLE I.—*AFL–CIO proposed changes in income tax rates*

The rate changes would be as follows:
The 14% rate should be cut to 9%.
The 15% rate should be cut to 13%.
The 16% rate should be cut to 15%.
The 17% rate should be cut to 16%.
The 19% rate should be cut to 18%.
All other rates would remain the same.

Under this procedure, every taxpayer would receive a tax reduction. But, the individual with a taxable income of $100,000 would get the same tax break as the $8,000 man. With the rate structure recommended by the House, a married individual whose taxable income is $100,000 would receive a $3,600 cut while the $8,000 married individual would have his taxes reduced by only $80. Under the AFL–CIO proposal both would receive a cut of $130.

TABLE II.—FEDERAL INCOME TAX BURDEN

PRESENT LAW COMPARED WITH HOUSE REFORM BILL, TREASURY PROPOSALS, AND AFL-CIO PROPOSALS—MARRIED COUPLE, 2 DEPENDENTS

	Total tax				Tax reduction		
Wage or salary income	Present law	House reform bill	Treasury proposals	AFL-CIO proposals	House	Treasury	AFL-CIO
$3,000	0	0	0	0			
$4,000	$140	$65	$81	$45	$75	$59	$95
$5,000	290	200	253	155	90	37	135
$7,500	687	576	616	526	111	71	161
$10,000	1,114	958	1,012	908	156	102	206
$12,500	1,567	1,347	1,447	1,300	220	120	267
$15,000	3,062	1,846	1,951	1,822	216	111	240
$20,000	3,160	2,968	2,968	3,030	192	192	130
$25,000	4,412	4,170	4,170	4,282	242	242	130
$50,000	13,388	12,604	12,604	13,258	784	784	130
$100,000	37,748	34,892	34,892	37,618	2,856	2,856	130

Note: Assumes deductions equal to 10 percent of income, minimum standard deduction (low-income allowance) or standard deduction—whichever is greater. Table takes into account the rate cutting, standard deduction changes, and low-income allowance proposed by the House, the Treasury and the AFL-CIO. Surtax excluded.

Source: AFL-CIO Research Department, September 1969.

The CHAIRMAN. Thank you, Mr. Meany. We are always pleased to have you here with our committee.

Senator Williams?

Senator WILLIAMS. No questions.

The CHAIRMAN. Senator Gore?

Senator GORE. Mr. Meany, I agree with many of the recommendations you have made, because of the progress that labor has made in organization, technical skill and productivity. Labor is now, I am pleased to say, middle income. It seems to me that the middle-income group, with annual earnings of from $7,000 to $15,000, constitute the group for whom the bill provides the least amount of equity.

Instead of the rate changes which the bill contains and which you suggest (I would prefer those you suggest to those contained in the bill) I have thought the fairest tax reduction would be to provide an increase in the personal exemption for each taxpayer and each of his dependents, because this would provide tax relief to those needing it most; those with the largest number of children to feed and educate.

I would like your reaction to this.

Mr. MEANY. We could go along with your proposal. However, we would prefer the approach suggested in our prepared statement.

Senator GORE. I would like to ask your view with respect to one other item.

When you were testifying about the capital gains tax rate, you said, "While earned income remains fully taxed." However, you later referred to the 50 percent ceiling. Now if earned income is to be given a tax preference, do you think we should start at the top?

Mr. MEANY. You mean remove the ceiling?

Senator GORE. If we are to give a preference for earned income above $50,000, what is the justification for refusing a tax preference to earned income below $50,000?

Mr. MEANY. I do not think there is any justification.

Senator GORE. You said in your statement that "The wealthier the individual the more attractive the tax loophole." As a matter of fact one must have either large wealth or large income to take advantage of any tax preference; is that not true?

Mr. MEANY. That is basically true. If you do not have the income you do not have to worry about taxes, but what we say is that the wealthier the person the more opportunities there are to escape taxation through these different devices.

Senator GORE. What opportunity do you see for a tax loophole for a man earning $100 a week, and having the taxes withheld out of each check?

Mr. MEANY. I don't see any.

Senator GORE. Where is there any loophole?

Mr. MEANY. None at all.

Senator GORE. Whereas a man with a $50,000 income can look about and find some preferential tax treatment areas.

Mr. MEANY. Tax exempts, real estate with fast depreciation writeoff. The ordinary wage earning taxpayer does not have any of those opportunities. He just pays his taxes through the withholding and that is that, and this, of course, is really the gist of our whole position.

There are many angles to this, but the basis of our whole position is the lack of what we call tax justice.

Senator GORE. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. Mr. Meany, I agree with the position on some of these matters. We are running a $6 billion deficit this year, and I do not feel that at this time we can adopt the 50 percent ceiling, nor do I feel that we can reduce the corporate levy, but I want to ask you about a couple of others. Do you favor the provisions of the House bill which tax the investment income of fraternities?

Mr. MEANY. The investment income of fraternities?

Senator CURTIS. Yes, sir.

Mr. MEANY. I think fraternities should pay their share the same as any other group.

Senator CURTIS. There are tax exempt organizations that——

Mr. Meany. On anything that is not related to their activities, and this would include fraternities and labor unions and any other group that is tax exempt, that income should be taxed.

Senator Curtis. I am talking about their tax-exempt income which would be interest dividends and the like.

Mr. Meany. That would be unrelated to their direct activities, and I think it should be taxed.

Senator Curtis. I am not sure that it is unrelated. I am quite intimately acquainted with one fraternity that has built up a fund. They use it all or 90 percent of it for loans for houses on college campuses thereby releiving the taxpayers of that much. Those loans earn interest. Under this bill—they have 10 percent otherwise——

Mr. Meany. If it is related to their normal activities in whatever field they are in it should not be taxed. If it is unrelated we say it should.

Senator Curtis. The House taxes their investment income. Do you support that or not?

Mr. Meany. If it is on unrelated business income, we say yes. I have not read the House bill. Do you mind letting Mr. Goldfinger reply?

Senator Curtis. No; I will be happy.

Mr. Goldfinger. Senator, our view, as President Meany indicated, is that the unrelated investment income of fraternal organizations and all other kinds of organizations including trade unions should be taxable, should be subject to taxes.

Senator Curtis. That is not my question. We understand that if a labor union buys a bank, the bank pays taxes as do other banks. That is the unrelated income. I am talking about the investment income that the organization itself has. The House bill imposes a tax on the investment income of fraternities. Do you have a position on that?

Mr. Meany. Without regard to what the income is used for, my position would be it should be taxed, unless it is used for the specific fraternal purposes of that organization. You say it is used——

Senator Curtis. It is not taxed as unrelated business. It is the investment income in their central treasury.

Mr. Meany. I would like to give that a little study, that specific question.

Senator Curtis. Now tax-exempt beneficial societies. According to the House bill are taxed on exempt income. Do you favor that?

Mr. Meany. No.

Senator Curtis. Investment income, according to the House bill, is tax that accrues to tax-exempt social clubs. Do you favor that?

Mr. Meany. No.

Senator Curtis. Take, for instance, Shrine, which operates some 12 or 14 hospitals for crippled children.

Mr. Meany. That is different than what you have just previously asked.

Senator Curtis. They have some investment income. Under the House bill it is taxable. Do you favor that?

Mr. Meany. No.

Senator Curtis. Do you favor—I gather from your answer—you are not in accord with the House bill taxing this investment income. Do you favor taxing labor unions on their investment income?

Mr. Meany. Yes; not related to their regular activities.

Senator CURTIS. No, no; that was not my question. I understand that if a labor union buys a bank, that the bank pays taxes. If the labor union has some money in the till, and it is either drawing interest from a bank, a savings and loan, or it is in securities. Should it be taxed?

Mr. MEANY. No.

Senator CURTIS. Are you at liberty to tell me how much investment income the labor unions have?

Mr. MEANY. I haven't any idea. I have no way of knowing, and I would not have any way of finding out.

Senator CURTIS. Now let me ask you something else. What percent of the compensation to labor, which enjoys the benefit of organized labor, collective bargaining, what percent of that compensation is fringe benefits?

Mr. MEANY. I do not know.

Senator CURTIS. Can your staff supply that?

Mr. MEANY. We might give you an approximate figure.

Mr. GOLDFINGER. It is somewhere in the area of 20–25 percent, sir.

Senator CURTIS. About 20 or 25 percent?

Mr. GOLDFINGER. Yes.

Senator CURTIS. What percent of fringe benefits are taxable under our revenue laws and what percent are not?

Mr. GOLDFINGER. To my knowledge, sir, they are all taxed when they are received. Some of these forms of fringe benefits are deferred payments, such as pension plans and pension money, and are subject to taxation when received. They are not ——

Senator CURTIS. Now the individual who operates a cobbler's shop for himself repairing shoes, unless he can qualify for an elaborate pension plan to set up and get some lawyers and tax accountants to set it up, if he makes some money and puts it in the savings and loan for a rainy day for his old age, he is taxed on that as he earns, is he not?

Mr. GOLDFINGER. Yes.

Mr. MEANY. He has another alternative.

Senator CURTIS. He is taxed on it as he earns it, is he not?

Mr. MEANY. If he puts it in a savings and loan, yes.

Senator CURTIS. Regardless of what he does. Isn't the earnings of an individual such as a shoe repair man operating on his own, his earnings are taxed as he earns them, is that right?

Mr. MEANY. I do not think he understands the question. You had better try again.

The CHAIRMAN. I must remind the audience that they are here as spectators and they are not here as a gallery to indicate approval or disapproval of any answer of the witnesses.

Senator CURTIS. Can your staff answer that?

Mr. MEANY. If he sets it aside separately, it is not taxed until he gets it. If he does not, he puts it in a savings and loan, it is taxed as of the time it is paid.

Senator CURTIS. I understand that he can go through a rather difficult and complex procedure and qualify for H.R. 10 benefits, but it is quite difficult for the individual of modest income to do that.

Now assuming that he has not, he pays taxes on it, as he earns it, if his few dollars in the savings and loan draw some interest, that is taxable, is it not?

Mr. MEANY. That is right.

Senator CURTIS. I am not suggesting that our pension plan tax laws be changed. But tax equality as the term implies, it is treating everyone alike who faces a similar circumstance. In reference to my question whether or not fringe benefits were taxed, your reply was they were taxed when they were received. Now that means this. That as a result of negotiations or otherwise, if employees are granted a retirement fund, the company or the employer pays into that fund and of course that is the tax deduction to the company and not taxed, is that correct?

Mr. GOLDFINGER. Yes.

Senator CURTIS. And the pension fund, if it earns interest, dividends or other capital gains, they are not taxed, isn't that right? But the recipient receives the taxes or pays taxes when he draws that retirement money some years later?

Mr. MEANY. Yes.

Senator CURTIS. I think it is a good system. What makes up to the 20 or 25 percent fringe benefits that are not taxed at the time besides retirement?

Mr. GOLDFINGER. That is about the only form that I can think of. There are probably medical insurance contributions and other things of that sort, but vacation pay is something that is taxed at the time that it is received. That would be during the year. Shift differentials are taxed when they are received.

Senator CURTIS. If as a result of negotiations the employer provides hospital and medical insurance as a fringe benefit, that is not taxed to the worker currently, is it?

Mr. MEANY. No.

Senator CURTIS. And it is your position that investment income not by an unrelated business but held by the unions should not be taxed?

Mr. MEANY. That is right.

Senator CURTIS. I cannot quarrel with your position. I do hope that we will not get involved in one group against another group, and these principles that you have come out for in reference to this group will not be applied to other groups.

That is all, Mr. Chairman.

The CHAIRMAN. Gentlemen, I am going to ask the committee to agree to a limitation on interrogating this witness. George Meany speaks for many millions of workers and I can understand why everyone would like to interrogate him on matters that interest them. But we started a procedure a while back which will make it impossible to hear other witnesses and some of them also represent a great number of the people. I am going to urge members that we limit ourselves. Let us say to about 7 minutes each on the first interrogation of this witness. Then, if anyone wants to ask any further questions I will arrange for one of our secretaries to meet with them in our conference room here, and they can interrogate Mr. Meany at length, and I am sure he would be glad to respond.

Senator Talmadge?

Senator TALMADGE. Mr. Meany, as I understood your testimony, you suggested a substitute or alternative plan from the minimum income tax proposal of the House bill?

Mr. MEANY. Yes.

Senator TALMADGE. What was that, please?

Mr. MEANY. We suggested that this provision of the House bill be strengthened by imposing a 25 percent minimum tax on exempt income in excess of $10,000 for individuals, and in excess of $25,000 for corporations regardless of the amount of the taxpayer's ordinary income.

Senator TALMADGE. In other words, your proposal is that, if an individual has more than $10,000 in income, regardless of its source, you would tax it at 25 percent.

Mr. MEANY. No, no, no. Outside of his regular, ordinary income.

Senator TALMADGE. Exclusive of his ordinary income. What would that be? His wages, salary?

Mr. MEANY. We say that we want 25 percent tax on the exempt income in excess of $10,000 for an individual, regardless of how much ordinary income he has, and the same thing for corporations, only it is in excess of $25,000.

Senator TALMADGE. In other words, above the normal deductions?

Mr. MEANY. That is right.

Senator TALMADGE. Do you know how much revenue that would bring in?

Mr. MEANY. We have some figures on all of these items, Senator. Mr. Goldfinger I think can give them to you.

Senator TALMADGE. How does that compare with the House bill?

Mr. GOLDFINGER. This would be substantially greater than the House bill. We can submit our estimates.

Mr. MEANY. We have estimates on all of these. We do not have them here.

Senator TALMADGE. You will submit that for the record, Mr. Meany?

Mr. MEANY. Yes.

Senator TALMADGE. Thank you very much.

(The information to be furnished for inclusion in the record follows:)

The revenue gains from AFL-CIO proposed 25% tax on *exempt* income in excess of $10,000 for individual or $25,000 for corporations would be $1.5 billion.

Exempt income is defined as:

(1) The excluded one-half of capital gains.

(2) State and local bond interest.

(3) Depletion taken after the cost of the property has been written off.

(4) The difference between the cost and the market value of property donated to charity.

(5) Depreciation on real estate taken in excess of straightline, except for low and moderate income housing.

The CHAIRMAN. Senator Miller?

Senator MILLER. Good morning, Mr. Meany.

Mr. MEANY. Good Morning.

Senator MILLER. May I ask what the position of the AFL-CIO was on the investment tax credit when it was originally proposed?

Mr. MEANY. The original granting. We were opposed to it.

Senator MILLER. What is your position now with respect to its repeal?

Mr. MEANY. We feel it should be repealed.

Senator MILLER. You have indicated that you wish to do away with capital gains?

Mr. MEANY. That is right.

Senator MILLER. I have almost come to think that the capital gains provisions were calculated to encourage people to invest capital, and that unless we have an investment of capital, our capitalistic system will go by the board, and that the capital is necessary in order to provide plant and equipment, in order to have job opportunities.

Mr. MEANY. Senator, you are not going to argue with me on that.

Senator MILLER. I want to ask you the question how would the capital formation occur in your thinking if the capital gains provision of the tax law were done away with?

Mr. MEANY. I think the investment would still be attractive. I am all for investment, because this is one of the things that makes our system work, but I do not think that if you took away this tax preference you would substantially discourage investment.

Senator MILLER. Do you think it would encourage investments to go overseas, over to England, for example, where they do not even have a tax on capital gains?

Mr. MEANY. Well, I do not know whether it would go overseas or not. I cannot answer that.

Senator MILLER. If you were persuaded that this is what would happen, and if you were persuaded that there would be a slowdown on construction if this were done——

Mr. MEANY. We undoubtedly would take another look at it.

Senator MILLER. Yes. I must tell you that while I have some reservations about some of the capital gains provisions that are proposed, I am deeply concerned that if we should just automatically repeal them, without more that we could have a drying up of capital which we deeply need in order to get into construction, in order to preserve our balance of payments, in order to encourage overseas investors to come into the United States, instead of having investors in the United States go over to Europe and other countries.

Let me ask you another question. I am not trying to get political, but I want to raise a point. It is my understanding that you supported Vice President Humphrey for the Presidency, is that correct? I think that is public record. Were you familiar with the fact that Vice President Humphrey, during the Presidental campaign, advocated that the percentage depletion provisions of the Internal Revenue Code be left alone?

Mr. MEANY. No; I am not aware of that, no. I listened to a lot of his statements, his speeches, but I do not recall that.

Senator MILLER. As I recall, it was in Business Week or one of the business publications where the positions of the two candidates were set forth, and they both were opposed to the repeal of the 27½ percent or a reduction of the 27½-percent depletion for oil and gas.

My recollection is that Vice President Humphrey premised his position on the theory that if this were done it would increase consumer prices. Do you think that this percentage depletion reduction is not going to affect consumer prices?

Mr. MEANY. I do not know, Senator, whether it is or not, but I know that the depletion allowance is very, very unfair, at least from my point of view, it is unfair, and I certainly will not change my idea just because Vice President Humphrey thinks differently.

Senator MILLER. I understand that. I would not expect you to. But I call your attention to his position, because I do think that it should carry some weight with you. There is a great fear on the part of many knowledgeable people that a change in this is going to result in an increase in consumer prices, and I know you are very much opposed to that too, and if you came to the conclusion that an arbitrary attack upon percentage depletion would in fact result in an increase in consumer prices, would that cause you to think this thing over a little more?

Mr. MEANY. I doubt it. I doubt it because I would have to have that demonstrated quite forcefully before I would change my mind. I think it is a tax gimmick that is unfair, and I think it should be done away with.

Senator MILLER. Let me ask you this. Let us take two corporations both oil corporations. One corporation, A, has $1 million in percentage depletion. Corporation B also has $1 million in percentage depletion. Corporation A takes that $1 million and plows it back into exploration and development of petroleum resources which redound to the benefit of the people of the country. Corporation B does not do that. Corporation B pays that out as dividends to stockholders. Do you think both corporations should be treated exactly alike?

Mr. MEANY. No, no; I do not. I think there should be some provision for the corporation that plows it back in for development.

Senator MILLER. Thank you very much.

The CHAIRMAN. Senator Jordan?

Senator JORDAN. Mr. Meany, under your AFL-CIO proposed changes in income tax rates, where you suggest that the 14-percent rate should be cut to 9 percent, the 15-percent rate cut to 13 percent, the 16-percent rate to 15 percent, the 17-percent rate to 16 percent, the 19-percent rate to 18 percent, how much revenue do you calculate would be lost under this proposal as compared to the present law, first, and secondly as compared to the House bill?

Mr. MEANY. The same as the House bill. I do not have the figures, Senator. We have put a price tag on all of these things but unfortunately I do not have it here. Mr. Goldfinger says it would be the same as the House bill.

Senator JORDAN. The proposed rate changes that you suggest would result in the same revenue income?

Mr. MEANY. As the House bill.

Senator JORDAN. As the House bill?

Mr. MEANY. Yes.

Senator JORDAN. No change. If you do find there is a change, will you supply that for the record?

Mr. MEANY. Yes.

Senator JORDAN. Thank you.

The CHAIRMAN. Senator Byrd?

Senator BYRD. Thank you, Mr. Chairman.

Mr. Meany, like you I feel it is very important that in a democracy that there be tax justice. I do not like the idea of persons in this country earning more than $200,000 paying no tax. I think all individuals who earn significant income should pay a tax. The problem as I see it that faces the Congress is how to tighten the so-called loopholes without penalizing a large segment of our population. I speak now of the colleges, hospitals and churches, and State and local governments.

I think that your testimony brings out interesting points. Some of your proposals I am sympathetic to. Some I am not too sympathetic toward. I have made no commitment, however, on any part of the tax bill.

There is one aspect that I find particularly interesting. I agree with you thoroughly that industrial development bonds should not be tax exempt. In regard to State and municipal bonds, this presents, as I see it, a real dilemma, because if we change the tax status of State and municipal bonds, and I do not say at this point whether it should or should not be changed, but if we do, that inevitably will increase the cost of local and State government, which means that every taxpayer in every country and every city and every State in the Union will feel the effect of it.

Now I notice in your testimony that you make a proposal which I do not recall ever seeing proposed before, and that is that the Federal Government should guarantee, should guarantee the State and local bonds.

Mr. MEANY. Guarantee the principal of the bonds.

Senator BYRD. Guarantee the principal of the bonds and pay——

Mr. MEANY. An interest subsidy.

Senator BYRD (continuing). One-third of the interest on these bonds. May I ask you this. How extensive is this? What is the total of State and local bonds now outstanding?

Mr. MEANY. The total amount? I do not know.

Mr. GOLDFINGER. We have worked this out, Senator, and we have come to the conclusion that there would be a gain of revenue.

Senator BYRD. My question is this. What is the total amount of State and local bonds outstanding?

Mr. GOLDFINGER. Offhand I do not know. We probably have it in the lengthy statement.

Senator BYRD. I can give you the answer. The answer is that at the end of 1969 it is estimated that there will be $140 billion in State and local bonds outstanding. As I understand your proposal, you would have the Federal Government guarantee all of these State and local bonds, am I correct in that assumption?

Mr. MEANY. That is right.

Senator BYRD. Aren't you asking that the Federal Government undertake a very severe task when it begins to guarantee State and local bonds?

Mr. MEANY. Yes; I think that is quite a job for them, but I think it should be done. After all, Senator, I think there is a factor here that you are perhaps disregarding, and that is that even though there may be some sound reasons from the point of view of State and local problems to have these bonds tax exempt, the average citizen of this country resents very much the fact that certain people get the benefit of this unearned income and pay no taxes on it. This has a tendency really to break down the morale of the people, and that certainly is a factor to be considered.

Senator BYRD. I concur in that statement. I do not defend that. I concur in what you say in that regard about morale. But these same people, including myself who feel that way, may not want the Federal Government guarantee the State and local bonds, and pay one-third of the interest on the State and local bonds. Where does the Federal

Government get the money to do that? It gets the money out of the taxpayer's pocket. That is the only place it can get it——

Mr. MEANY. That is right.

Senator BYRD (continuing.) From your members and every wage earner.

Mr. MEANY. And it would get some of that money from people who are not now paying taxes.

Senator BYRD. I just feel that this one proposal of yours that I have never seen advocated before. It is one of the most far-reaching proposals I think that has been presented to the Congress in a long time. I am glad to get your——

Mr. MEANY. I think the President has come up with a proposal for sharing the taxes with the State and local governments.

Senator BYRD. That is entirely different from taking over and assuming the $140 billion in bonds. My time has expired and I thank you, Mr. Meany.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Meany, we share your concern over the equitable treatment of earned income, and we are concerned about loopholes, but we are also concerned about jobs. Have you considered how many jobs would be eliminated if all your recommendations were enacted?

Mr. MEANY. We feel that there would not be any elimination of jobs.

Senator FANNIN. Don't you think that is a little farfetched to say that they would not be eliminated, when we are going to take investment capital away?

Mr. MEANY. I have heard this argument about proposals that we make eliminating jobs for many years. We have been told for 30 years now every time we discuss wage and hour legislation that it is going to eliminate jobs but it never has eliminated jobs.

Senator FANNIN. I certainly question that.

Mr. MEANY. I think you are selling the American economy—the whole system—short if you think that by setting up a system of tax justice, where everyone would be paying his fair share, that this would eliminate jobs.

Senator FANNIN. Don't you think it has eliminated jobs that we have exported? Let us take the automotive industry.

Mr. MEANY. I think this is a problem and it is a problem for Congress about the export of jobs. I do not think anything we do on the tax situation is going to change that. The American corporations are exporting jobs quite rapidly right now.

Senator FANNIN. But only to become competitive in many of the foreign countries. That is why this is done.

Mr. MEANY. Well, be that as it may. Do you mean competitive in bringing down the standard of life?

Senator FANNIN. No, I certainly do not, but the consideration given by other countries. For example, there is no capital gains tax, in Canada, nor as brought out by Senator Miller, in the European countries.

Mr. MEANY. Isn't there anything Congress can do about that?

Senator FANNIN. Certainly Congress can do something about it. They can give greater incentive to hold industries in this country and to make us more competitive. Look at what has happened in the automotive industry and the electronic industry as a result of Japanese competition. I am vitally concerned about that, and I think you should be. I hope you consider that matter. It is I think of vital importance to us all.

Mr. MEANY. Mr. Senator, I do not think you are going to get the Americans and the average American trade unionist to consider competing with Hong Kong wages or wages that a lot of corporations are paying down on the Mexican border.

Senator FANNIN. I am talking about making it more enticing to our American industry to work with the labor unions, and to have a better competitive position with which to face the other nations of the world.

Now you know as far as world markets are concerned, we have lost out tremendously percentagewise in the last few years.

Mr. MEANY. Well, the best customer of the American corporations over the years, and I think statistics will prove this, is the American worker, the American citizen here at home, and I do not think, no matter what way you approach this, that the American worker is going to compete with 20 and 25 cents an hour wages in South America or in Africa or in the Far East.

Senator FANNIN. He can better compete if we have modernized equipment, if we have the capital investments that will make that possible. But to go on to another subject which Senator Curtis discussed with you, it is my understanding that all labor unions are now exempt from taxation under 501(c) of the Internal Revenue Code. I think you agree that that is right. What sort of union income would be included within the exemption? Would this include dues collected, interest on bonds, stock dividends and other investments of the unions? Are these all included?

Mr. MEANY. Yes.

Senator FANNIN. So we do have a situation where the unions are being given I think special treatment. H.R. 13270 in its present form would penalize foundations from engaging in political activities, including the sponsorship of voter registration drives.

I have introduced an amendment to this bill which would deny tax-exempt status to labor unions which engage in political activities. Do you see any objection to this measure?

Mr. MEANY. You mean political activities in Federal elections? We are barred from that now.

Senator FANNIN. Well, it would include activities in all elections.

Mr. MEANY. But we are not barred from using our money for voter registration drives, and we thought that was something everybody wanted. We want higher voter participation on the part of the people, and this is really a bipartisan, nonpartisan activity.

Senator FANNIN. Well, that is questionable but nevertheless——

Mr. MEANY. You would try to stop that?

Senator FANNIN. I am asking you a question. This bill, H.R. 13270, which you strongly support, and even want to go further than it does in this area would penalize foundations for engaging in political activities, including the sponsorship of voter registration drives. Do you agree with this provision? In other words, turnabout is fair play?

Mr. MEANY. I want to look at that bill again. I do not think there is a complete bar.

Senator FANNIN. Sir?

Mr. MEANY. I do not think there is a complete bar in that bill. I would have to look that up.

Senator FANNIN. I think you had better read it then and have your people look into it.

Mr. MEANY. All right.

Senator FANNIN. Further pursuing Senator Byrd's line of questioning about subsidizing and guaranteeing municipal bonds, how would this be controlled? Just to give you an illustration, some bonds now are not salable, but of course would be with the guarantee of the Federal Government. In many instances perhaps these bonds should not be issued, but what control would you have over this? Isn't that leaving your financing just wide open?

Mr. MEANY. Surely the Federal Government would set up some standards by which it would guarantee municipal bonds. It would not guarantee them indiscriminately no matter what the features of them were.

Senator FANNIN. How about the outstanding?

Mr. MEANY. How about what?

Senator FANNIN. The outstanding bonds? What would be your point as far as the outstanding bonds?

Mr. MEANY. We are talking about bonds from now on. We are not talking about the outstanding bonds.

Senator FANNIN. But I think in your testimony you considered that all issues would be approved whether or not needed.

Mr. MEANY. All future issues, yes.

Senator FANNIN. Whether or not needed?

Mr. MEANY. Whether what?

Senator FANNIN. Whether or not needed. In other words, I am questioning you as to how this could ever be controlled.

Mr. MEANY. I think it can be controlled by the Federal Government setting up standards.

Senator FANNIN. Then you would have them subsidized and then controlled?

Mr. MEANY. Yes.

Senator FANNIN. As to what is done in the local communities?

Mr. MEANY. That is right.

Senator FANNIN. And the States and all. Then is there any need for——

Mr. MEANY. I do not know that it would necessarily mean that they would control everything done by the local governments. I think setting up standards is one thing and controlling is another.

Senator FANNIN. How would you handle the interest on outstanding bonds? You are going to subsidize the interest on the bonds that are going to be issued now. What about the bonds on outstanding issues?

Mr. MEANY. We would not touch them at all.

Senator FANNIN. You would not, but they are touched by this bill.

Mr. MEANY. They are?

Senator FANNIN. Oh, yes. They are tax exempt, and so they are affected by the bill.

Mr. MEANY. You mean the outstanding bonds?

Senator FANNIN. Yes, the outstanding bonds.

Mr. MEANY. That is not our proposal.

Senator FANNIN. They are included in some of the stipulations, sir; as far as taxes are concerned, tax preferences and all, they are affected.

My time is up, Mr. Meany, but I wish you would look into some of these problems.

Mr. MEANY. I certainly will look at that one.

Senator FANNIN. I hope you will take a look at the effect that this would have on jobs and our competitive position with other countries also, the number of people that would be eliminated if all your recommendations were enacted. I think it would be disastrous.

Mr. MEANY. Well, we do not agree with that.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. Thank you, Mr. Chairman.

Mr. Meany, did I understand you to say it was your feeling that the proposals you have made would be prespective in nature, that they should apply to bond issues that are yet to be made?

Mr. MEANY. Yes.

Senator HANSEN. And it should not refer to those which are already on the books? I think Senator Byrd spoke about there being some $140 billion worth of bonds now outstanding. As I understand your proposal it would exempt that $140 billion worth of bonds?

Mr. MEANY. Well, the people who bought them bought them under the conditions which now prevail and we think that should prevail as far as those bonds are concerned.

Senator HANSEN. Would it be your feeling generally that this legislation should be prospective in nature rather than retroactive?

Mr. MEANY. I do not think the legislation should be retroactive if that is what you mean.

Senator HANSEN. That is what I mean.

I have no further questions, Mr. Chairman.

The CHAIRMAN. Mr. Meany, I would like to just ask one or two questions of you. I personally have always had some doubts about the wisdom of this investment tax credit, and I think that your organization probably did, too. At first I was willing to go along with part of it and then later on part of the rest of it. It occurred to me later on that the credit may have been providing too big an incentive at a time when money was tight, and I advocated that it be repealed well before the administration—at that time of President Johnson—agreed it ought to be repealed. I wanted to relieve the tight money situation as I do now. The repeal of the investment tax credit involves about $3 billion.

The one thing you have to give it credit for is that it really did stimulate a lot of investments.

From the point of view of a lot of business people at that time it had the effect of cutting the effective tax rate from 50 percent down to 36 percent if they could fully utilize the investment tax credit of 7 percent.

Of course, you are well aware of the fact that a tax credit of 7 percent is just like a deduction of 14 percent if the tax rate is 50 percent.

Now this accelerated depreciation thing started out under President Eisenhower, and it was made more liberal under the succeeding administrations. Capital gains had always been one of the things that business people looked for. I understand on Manhattan most rich people are not much interested in investing their money in something unless they can find some way to make a capital gain out of it, either in whole or in part. And I see that you would like to eliminate percentage depletion entirely.

Would it not seem to you that if we strike at all those items, I think they would total about $4.5 billion right there, and you take the other so-called incentive items that are justified on the basis that they would be incentive to invest money to do something constructive, it would add up to about $3.5 billion of tax incentive provisions that would be removed from law.

Would it not seem to you that that would discourage a lot of people from investing money in things that give labor good jobs?

Mr. MEANY. Well, I answered that before, Senator. I do not think so. I think the investments would still be attractive, despite these so-called sweetners.

The CHAIRMAN. I am just familiar with one phase of it. I know you feel strongly about it. In a small way I am in the oil business. My family owned a piece of property. We were willing to put up our money if we could find somebody else. Just the talk of change in this matter has made it so that nobody else was interested in going in. The impression that I gained is that independents were getting out of the business in droves the way it was, and that this change would accelerate that trend.

Now, of course, if we drill a well, we are going to pay the regular wages, and those are good wages, whether we find oil or not. We do not mind paying the union scale of wages. We hope to finish ahead, and if we have to pay a lot of wages that is all right with us. But we would like some hope of making our money back and winding up with a profit by the time the thing is all over with.

Now if you have literally hundreds of people getting out of that business the way it is now, and frankly I regard myself as one of those people——

Mr. MEANY. Getting out of the oil business?

The CHAIRMAN. Yes, sir, they are not drilling any more wells at all. There are a lot of people who have already quit. Now, why would not the elimination of the oil depletion allowance, and also taking away or compromising their intangible drilling cost provisions make a lot of people having doubt about it decide that that was the straw that broke the camel's back to say "Well, we just will not drill any more. Let us just get out of this business"?

Mr. MEANY. Well, that means we would have to put our cars up. There would not be any gasoline for our cars.

The CHAIRMAN. Well, it would put a lot of people out of work, I would think.

Mr. MEANY. I do not think so. I think the incentive for profit is still there, and I do not know who you mean is going out of business.

The CHAIRMAN. Now, Mr. Meany, I——

Mr. MEANY. Humble has not got out of the business, Standard Oil of New Jersey has not gone out of the business.

The CHAIRMAN. Mr. Meany, you are the first person I have heard advocating cutting the depletion allowance who did not couple that with the proposition that you ought to bring all your oil in from overseas, which means that you would hire Arabs, you would hire Spicks, you would hire various and sundry people to produce that oil but you would not be producing it here. You would be hauling it in from overseas.

Mr. MEANY. Irrespective of the depletion allowance, if oil companies can make more money by bringing it from overseas I suppose they would bring it from overseas, without regard to whether depletion allowance is there or not.

The CHAIRMAN. I am one of those fellows who has been trying to fix it up so they produce it here rather than bring it in from there. Over a period of time I suspect that has been part of the problem.

Mr. MEANY. As Senator Miller said, shouldn't there be some line drawn between those who put this money back into new ventures to try to provide new jobs, and others who just pay it out in dividends?

The CHAIRMAN. Well, I would ask you a question. We tell a man, "If you will go out and find some oil, or any other fuel, we will give you a liberal depletion allowance." That is h's incentive to do it.

Now, after he fulfills his end of the bargain why should we take it away from him? Why would you want to change it in the middle of the game after a fellow has gone out, relying upon that incentive, and performed on it?

Mr. MEANY. Well, I would be quite happy to set 27½ phased out over the years, little by little.

Senator GORE. Good, that is a deal.

The CHAIRMAN. May I say that is a generous concession.

Senator Anderson?

Senator ANDERSON. In this morning's mail there is a letter from a customer who wants to talk about bonds. He suggests that there are bonds he can dispose of which have three different charges: 8 percent note April 15; 7¼ percent note due in November, and 7½ during the coming year. Don't you think that is a pretty high rate of interest?

Mr. MEANY. I did not get the question.

Senator ANDERSON. The interest rate on bonds. Eight percent note, 7¼ percent note, and 7½ percent note. I think that interest is outrageous, don't you?

Mr. MEANY. I think interest rates generally are outrageous today. Certainly they are outrageous from the point of view of the ordinary home buyer. I would be happy to hear more about that because we have people who would like to buy their own homes, but the interest cost on the purchase of a new home is getting up near 9½ or 10 percent, when you figure the rate of interest at 7½, and then they add on points for this and that.

Senator ANDERSON. It is frightening. It has stopped home ownership to a great degree. I just hope that there will be lower interest rates in the future.

Mr. MEANY. We would like to see the interest rates come down.

The CHAIRMAN. Senator Williams?

I am going to let each Senator have one round. Senator Williams did not ask any questions, and so I am going to give him the opportunity now.

Senator Harris has shown up meanwhile and he will be covered by those same rules.

Senator WILLIAMS. I just want to clarify one point. As I understand it in your testimony and from questions, you have recommended that capital gains be taxed on the same basis as earned income, is that correct?

Mr. MEANY. Yes.

Senator WILLIAMS. Now one of the arguments that I have heard made, and I am wondering if you subscribe to it, is suppose Mr. X buys 100 shares of a bank stock. The dividends are taxed at regular income. Is it your theory that the appreciation in the bank stock is largely the result of undistributed income, the accumulation of it, which when he sells the stock he gets that as an appreciation? Is that the basis of suggesting that it be taxed as regular income?

Mr. MEANY. That is one of the bases. The general basis is as I stated in my testimony, that the fellow who works with his hands and draws a salary, he has got to pay on his income. Why shouldn't the others pay on their income?

Senator WILLIAMS. Now if a labor union owns a bank, the bank is taxed the same corporate rates as any other industry. Now if the labor union is buying that bank, and the bank distributes about half of its earnings, the other half builds up equity. If that union sells that stock later should they be taxed at capital gains—since it is a delayed payment of accumulated earnings—the same as you are proposing for individuals?

Mr. MEANY. If everybody else would have to pay it, why not the labor union.

Senator WILLIAMS. That is what I was asking.

Mr. MEANY. Yes.

Senator WILLIAMS. That answers the question. Thank you. You would have no objections to the bill being so amended?

Mr. MEANY. No.

Senator WILLIAMS. Thank you.

The CHAIRMAN. Senator Harris?

Senator HARRIS. I do not have any questions, Mr. Chairman, except to say that I have studied your testimony, Mr. Meany, and I appreciate the thrust of it and the influence that you have been generally on the side of tax reform and tax relief.

The CHAIRMAN. Senator Metcalf, a former member of this committee, has been sitting here with us. If you want to ask a question or two go ahead.

Senator METCALF. I am delighted that he is supporting the bill that I am going to testify to next.

The CHAIRMAN. Senator Cooper, do you have any questions?

Well, let me say if there are other members who want to interrogate Mr. Meany further I think he might make himself available to you to ask a few questions in our conference room. If someone wants to request that privilege, I would ask the witness to cooperate. Otherwise, we are going to excuse Mr. Meany. We have had him here for an hour and 15 minutes and we have many other important witnesses here.

Thank you very much, Mr. Meany, Mr. Biemiller and your able associate. We appreciate very much your being here to explain your views on behalf of your great organization.

Next we would like to hear from the Honorable Lee Metcalf, former member of this committee, and Senator from the State of Montana.

(George Meany's prepared statement follows:)

STATEMENT OF GEORGE MEANY, PRESIDENT, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

SUMMARY

My name is George Meany and I am president of the American Federation of Labor and Congress of Industrial Organizations.

The 13.5 million members of the unions of the AFL-CIO are, almost without exception, taxpayers. They pay their taxes regularly, payday after payday, through the payroll withholding program. They are loyal Americans; they appreciate the value of government, the services of government, the need for paying for government.

They are willing to pay their fair share.

But they are tired of having to pay the share of other Americans. Specifically, they are tired of paying the share of those Americans whose incomes are greater and whose taxes are lower—the "loophole set" in today's society.

So it is on behalf of the largest organized group of taxpayers in America that the AFL-CIO appears here today as advocates of tax justice. We don't have tax justice today and will not achieve it under the House bill. And the Administration's proposals bear no resemblance at all to tax justice.

The federal tax system is rigged against those whose livelihood comes from the work they do. It is rigged in favor of those whose income results from investments.

This unfair rigging results from the fact that a triple standard is applied to income taxed by the federal government.

One standard applies to wages, salaries, and other forms of so-called ordinary income. This income is taxed in full and, for workers, the tax is regularly deducted from their paychecks,

A second standard applies to income from stocks, real estate, and other so-called capital assets sold at a profit. Only half of such income is taxed. And under present law the tax can never be more than 25%—even for those in the very top tax brackets.

A third standard is applied to certain forms of income which never even appear on the tax form, such as the interest on state and local bonds, or the income that is washed out by phantom, nonexistent costs as oil depletion, fast depreciation writeoffs, and bookkeeping farm losses. This type of income completely escapes taxation.

The wealthier you are, the greater are the opportunities to take advantage of these preferentially taxed or untaxed forms of income.

This triple standard will not be ended through reforms that eliminate or curb some relatively obscure tax dodges affecting a handful of people. Nor will it be ended merely by ensuring that those of extreme wealth and ability-to-pay are called upon to make *some* contribution to the federal Treasury.

The now infamous 21 persons, for example, who paid no taxes at all on their incomes of $1 million and over, have become a symbol. And, I fear, too many have addressed themselves only to this symbol. Tax measures to ensure that those with astronomically high incomes merely pay *some* taxes to the federal government fall far short of tax justice.

Justice can only come when:

- The completely impoverished are removed from the tax rolls.
- There is a meaningful reduction in the relative tax burdens of low and middle-income families.
- The loopholes of special tax privilege for wealthy families and businesses are eliminated.

The single most costly loophole and the one that is the prime culprit of unfairness is the capital-gains loophole.

This is not a loophole which applies only to a handful. It is not a loophole which reduces anyone's taxes to zero. And its effect on the tax structure does not give rise to tax-evasion horror stories that can be dramatically illustrated through the media.

Yet, because of the half tax on capital gains and the zero tax on such gains passed on at death some $30-$40 billion escapes the tax base, resulting in an annual Treasury revenue loss of over $10 billion.

And it is a tax preference that says, in effect, the more wealth and income you have, the more opportunities you should be allowed to avoid a fair share of taxes.

The AFL-CIO has continually pointed to this loophole as the major flaw in the tax system. The Treasury study published last February confirms this, saying that the special treatment accorded capital gains is the "most important factor in reducing the tax rates of those with high incomes."

We see no justice to a tax provision which says that a married taxpayer with $8,000 in capital-gains income should pay a tax of $354 while a married taxpayer, with the same amount of wage income, should pay $1,000.

We also recommend taxation of the $15 billion in capital gains that is passed on annually to heirs without even being mentioned on the income tax form.

Under the House action, some of the capital-gains loopholes would be trimmed. The House would eliminate the 25% maximum and would extend the holding period for long-term capital gains from six months to one year.

Even with these improvements, capital gains would still remain as the prime factor in eroding the fairness of the tax structure, for unearned income would still be preferentially taxed. And, what is worse the Administration has proposed to weaken even these modest reforms.

If the tax structure is to meet America's standards of fair play, loophole closing must be broad-gauged and substantial. On April 1, 1969, before the House Ways and Means Committee. The AFL-CIO presented a program which we believe would achieve tax justice—a program which would generate some $15–17 billion in federal revenues from substantial loophole-closing, provide relief to those of low and moderate and middle incomes, and allow some $8–10 billion to fully fund existing federal programs geared to meeting domestic needs.

Against that background, we think the House bill merits commendation, for:

1. The working poor are relieved of any federal tax obligation.

2. The hard-working, tax-paying low- and middle-income Americans, who have been forced to bear far more than their just share of the tax burden, have been given a modicum of relief.

3. The single most inflationary pressure in the economy, the 7% investment credit to business, has been eliminated.

4. Some of the loopholes and gimmicks in the tax structure, designed to provide special, unfair tax bonanzas for the very wealthy, have been trimmed, although not eliminated.

We urge the Senate to improve upon the House action and to reject all proposals, including those of the Administration, which would move the tax structure still further away from America's standards of fair play.

Specifically, we urge the Senate to:

1. *Close the capital-gains loophole, ending the major tax preference for unearned income.*—There cannot be tax justice as long as unearned income is half-taxed while earned income is taxed in full.

The modest changes recommended by the House are welcome but not enough and the Administration would largely undo the positive action taken by the House.

2. *Put an end to the tax abuses of the oil, gas and other mineral industries.*—Again the measures taken by the House are welcome ones. They would reduce the depletion allowance, eliminate depletion on foreign oil and gas wells, place a limit on the amount of exploration expenses that can be immediately written off, and end some other abuses such as the carved-out production payment.

Nevertheless, of the total revenue that escapes taxation due to the activities of these industries, only one-third would be recovered by the House action.

We recommend the complete elimination of these abuses.

3. *Eliminate the maximum-tax provisions.*—Under the maximum-tax provision contained in the House bill the top tax rate on earned income would be 50%.

This proposal would benefit only those with incomes above $50,000.

It would serve to provide an uncalled-for tax bananza of $100 million to top corporate executives, doctors, lawyers and others whose income comes from astronomically high fees and salaries.

The Administration has strongly endorsed this proposal. It reflects a cynical philosophy that if taxes on the wealthy are cut, they won't try so hard to find loopholes. Such a philosophy makes a mockery of tax-reform efforts. We cannot subscribe to it and we strongly condemn it.

4. *Strengthen the minimum-tax provisions of the House bill.*—The so-called Limit on Tax Preferences (L.T.P.) proposed by the House and the weaker version offered by the Administration are prime examples of reforms addressed solely to symbols.

Both the House and the Administration versions would limit the amount of certain types of income that can be completely tax-exempt to no more than half of total income plus $10,000. Thus, the more the income you have, the more can be tax-free.

What's more, if you fail to shelter all your income in one year, you can keep trying for another five.

Under the House bill, though a wealthy individual affected by the L.T.P. would by no means pay his fair share of taxes, he would pay some.

Under the Administration proposals, since State and local bond interest would not be recognized as income under the L.T.P., some wealthy individuals would still escape scot-free and pay no taxes at all.

The AFL-CIO has proposed a 25% minimum tax on exempt income in excess of $10,000 for individuals and $25,000 for corporations—regardless of the amount of the taxpayer's ordinary income.

5. *Strengthen and improve other measures contained in the House bill.*—For example:

—Interest on State and local bonds should be taxed in full with the Federal Government guaranteeing the bonds and providing an interest subsidy to ensure that the fiscal powers of the State and local governments are not damaged.

—Instead of the Hobby Farm loophole-closing proposals suggested by the House and the Administration, the lost-limit approach contained in S. 500 should be adopted. This procedure was recommended by Senator Metcalf and endorsed by a bipartisan group of 26 Senators. This approach is specifically tailored to the tax-loss farmer and ensures that legitimate farm operators will not be penalized.

—The income-averaging formula should *not* be liberalized to include capital gains unless the preferential treatment accorded such gains is eliminated.

—Interest deductions on bonds used to finance corporate mergers and acquisitions should be completely disallowed.

—All rapid depreciation on real estate should be disallowed, except for low- and moderate-income housing.

—Accelerated depreciation on regulated utilities should not be allowed unless the tax benefits flow through to the consumer.

Finally, the Senate should provide more substantive relief to those whose incomes are moderate and whose tax burdens are unnecessarily severe.

Tax relief and tax justice do not necessarily go hand-in-hand. The equity in the tax structure can be badly damaged by tax cuts as it can by tax increases or the addition of new loopholes and gimmicks.

Under the House-passed bill this concept was partially recognized. Though all groups would receive relief, a significant proportion of the relief would flow to low- and middle-income taxpayers.

Under the changes proposed by the Administration needed relief for those just above the government-defined poverty threshold and those in the middle-income brackets would be cut back, the state-gasoline-tax deduction would be disallowed, and a tax cut would be given to corporations.

Under the House proposals, $4 billion in tax relief is provided through the low income allowance and standard deduction increases. These primarily benefit low- and middle-income taxpayers. Another $4.5 billion is granted through across-the-board rate cuts. Over half of this relief goes to taxpayers with incomes of $15,000 or over.

The Administration agrees with the House on cutting the taxes of the wealthy, but says it goes too far when it would cut taxes for those of low and modest incomes. In addition, claims the Treasury, corporate taxes should be cut $1.6 billion.

We endorse the House proposals to increase the low-income allowance to a flat $1,100. In addition, we endorse the House proposals to increase the standard deduction to 15% and $2,000.

We do not agree with the general rate reductions recommended by the House and the Administration; and certainly there is no justification for a reduction in corporate taxes.

Instead we recommend a reduction in the tax rates that apply to the first $8,000 of everyone's taxable income for married individuals and the first $4,000 for single individuals.

The rate changes we propose and their effect are shown on the attached tables.

Our relief proposals would result in the same revenue loss as that proposed by the House. They would cost roughly $600 million more than proposed by the Administration—an amount that could easily be made up by, for example, eliminating the maximum-tax provision, effectively closing the hobby-farm gimmick, and adopting a meaningful minimum tax.

Mr. Chairman, we urge that this committee bring the federal income tax into line with what it's supposed to do—tax income in accordance with ability-to-pay. That's tax justice.

TABLE I.—*AFL–CIO proposed changes in income tax rates*

The rate changes would be as follows:

The 14% rate should be cut to 9%.
The 15% rate should be cut to 13%.
The 16% rate should be cut to 15%.
The 17% rate should be cut to 16%.
The 19% rate should be cut to 18%.
All other rates would remain the same.

Under this procedure, every taxpayer would receive a tax reduction. But, the individual with a taxable income of $100,000 would get the same tax break as the $8,000 man. With the rate structure recommended by the House, a married individual whose taxable income is $100,000 would receive a $3,600 cut while the $8,000 married individual would have his taxes reduced by only $80. Under the AFL–CIO proposal both would receive a cut of $130.

TABLE II.—FEDERAL INCOME TAX BURDEN

PRESENT LAW COMPARED WITH HOUSE REFORM BILL, TREASURY PROPOSALS, AND AFL-CIO PROPOSALS—MARRIED COUPLE, 2 DEPENDENTS

	Total tax				Tax reduction		
Wage or salary income	Present law	House reform bill	Treasury proposals	AFL-CIO proposals	House	Treasury	AFL-CIO
$3,000	0	0	0	0			
$4,000	$140	$65	$81	$45	$75	$59	$95
$5,000	290	200	253	155	90	37	135
$7,500	687	576	616	526	111	71	161
$10,000	1,114	958	1,012	908	156	102	206
$12,500	1,567	1,347	1,447	1,300	220	120	267
$15,000	2,062	1,846	1,951	1,822	216	111	240
$20,000	3,160	2,968	2,968	3,030	192	192	130
$25,000	4,412	4,170	4,170	4,282	242	242	130
$50,000	13,388	12,604	12,604	13,258	784	784	130
$100,000	37,748	34,892	34,892	37,618	2,856	2,856	130

Note: Assumes deductions equal to 10 percent of income, minimum standard deduction (low-income allowance) or standard deduction—whichever is greater. Table takes into account the rate cutting, standard deduction changes, and low-income allowance proposed by the House, the Treasury and the AFL–CIO. Surtax excluded.

Source: AFL–CIO Research Department, September 1969.

STATEMENT

The federal income tax structure is unjust. Events of recent months have made this fact increasingly clear to all reasonably informed citizens.

In 1967, the most recent date for available information, the taxes paid by millionaires averaged only 25% of their total income. Twenty-one of these millionaires and 134 other persons whose reported incomes exceeded $200,000 paid not one cent in federal income taxes.

In that same year, 2¼ million taxpayers whose incomes fell below the government's definition of poverty paid $100 million in income taxes. And the married wage earner, with an income of $8,000, paid $1,000 in income taxes—12½ percent.

The federal tax structure is rigged against wages and salaries—against income from work. It is rigged in favor of unearned income.

This unfair rigging results from the fact that a triple standard is applied to income taxed by the federal government.

One standard applies to wages, salaries and other forms of so-called ordinary income. This income is taxed in full, and for workers the tax is regularly deducted through payroll withholding.

A second standard applies to income from stocks, real estate and other so-called capital assets sold at a profit. Only half of such income is taxed. And under present law the tax can never be more than 25%—even for those in the very top tax brackets.

A third standard is applied to certain forms of income which never even appear on the tax form, such as the interest on state and local bonds or the income that is washed out by phantom, nonexistent costs as oil depletion, fast depreciation write-offs, and bookkeeping farm losses. This type of income completely escapes taxation.

Thus:

● Income gains from the sale of stock or other property, held for more than six months, are taxed at only half the regular tax rate—with a top maximum rate of 25%. Moreover, when stock or other property is passed on to heirs at death, the increased value of the property from the date of purchase is not subject even to this much-reduced capital gains tax.

● Income from interest payments on state and local bonds is completely exempt from federal taxation.

● Sizable portions of the income from oil and gas properties and a large number of minerals never enter the tax stream because nonexistent "depletion" expenses are written off.

● Much of the income from real estate escapes taxation since it is written off as depreciation. Such income is not only exempt from taxation but, since it is considered a write-off cost. it provides an additional tax shelter for the wealthy because it is deducted from other taxable income.

● Because of the little-known unlimited-charitable-contribution-deduction special privilege, many wealthy individuals and businesses use the disquise of philanthropy to avoid paying any tax at all.

● Tax-exempt family foundations can be set up so wealthy families can control their fortunes in perpetuity without paying taxes.

● Wealthy nonfarmers can invest in farm operations which yield imaginary losses that can be charged off against their high nonfarm incomes.

● Business deducts 7% of the cost of new equipment and machinery from its tax bill—as a special tax credit. And, they can deduct it again as part of depreciation.

As a result of these and other inequities, an unduly large part of the burden of running the Federal government is heaped upon the shoulders of those who can afford it least.

These facts are generally known. They are causing an alarming erosion of public confidence in the tax structure and in the fairness of the federal government as well. And since Americans expect so much from their tax structure—national defense, public facilities and services, grants-in-aid to the States and local governments—these inequities in the tax structure undermine public support for much-needed expansion of government services—Federal, State and local—for a growing, urban population.

It is for these reasons ,the AFL–CIO is seeking tax justice. To us, there is a critical distinction between tax reform and tax justice, and recent events have made it imperative that this distinction be clearly set forth.

The now infamous 21 persons, for example, who paid no taxes at all on their incomes of $1 million and over have become a symbol. And too many have addressed themselves only to this symbol. Tax measures that eliminate or curb some obscure tax dodges or that ensure that those with astronomically high incomes merely pay *some* taxes to the Federal Government, fall far short of a just and equitable Federal income tax structure.

Justice can only come about if each taxpayer bears his rightful share of the burden of operating our government.

This will only happen when:

1. The impoverished are completely removed from the tax rolls.
2. There is a meaningful reduction in the relative tax burdens of low- and middle-income families.
3. The loopholes of special tax privilege for wealthy families and businesses are eliminated.

This is not now the case. Although the situation would improve if the House-passed Tax Reform Act becomes law, justice would still not be achieved. Moreover, the Administration would undo much of the good proposed by the House and would add additional inequities to the tax structure.

A major point here is that there are loopholes and there are loopholes.

There are some, like the unlimited-charitable-contribution gimmick, which enable a handful of multimillionaires to pay little or no taxes even though they make more in a year than the average worker makes in a lifetime.

This type of gimmick is an unconscionable flaw in our tax laws and it lends itself to horror stories of tax avoidance.

It should be ended. Both the House bill and the Administration recommend its termination. Ending it would add a measure of justice to the tax structure. But closing this loophole will do little in the way of eliminating the basic structural flaws in the system that cost billions upon billions in Federal revenues and serve to pull the entire structure away from principles of progressive taxation of income based on ability-to-pay.

In contrast, the single most costly loophole and the prime culprit in the unfair way in which our tax system is rigged is the capital-gains loophole.

This is not a loophole which applies only to a handful. It is not a loophole which reduces anyone's taxes to zero. And its effect on the tax structure does not give rise to tax-evasion horror stories that can be dramatically illustrated through the media.

Yet, because of the half tax on capital gains and the zero tax on such gains passed on at death, some $30–40 billion escapes the tax base, resulting in an annual Treasury revenue loss of over $10 billion.

And it is a tax preference that says, in effect, the more wealth and income you have, the more opportunities you should be allowed to avoid a fair share of taxes. Such gains come about through buying stocks, real estate, and other assets cheap and selling them dear. It is therefore a game for those who have wealth.

The effect of the half tax on capital gains on the entire tax structure was made alarmingly clear in the Treasury study presented to the Ways and Means Committee last February. The study showed, for example, that the capital-gains provisions alone compressed the tax-rate schedule down to a point where those with $1 million-and-over annual incomes paid an average tax rate of less than 33%. (See Table 4)

The AFL-CIO has continually pointed to this loophole as the major flaw in our tax system. The Treasury confirms this and claims that the special treatment accorded capital gains is the "most important factor in reducing the tax rates of those with high incomes."

We have proposed the elimination of this loophole. We see no justice to a tax provision which says that a married taxpayer with $8,000 in capital-gains income should pay a tax of $354 while a married taxpayer with the same amount of wage income would be taxed at $1,000.

We have also recommended taxation of the $15 billion in capital gains that is passed on annually to heirs without even being mentioned on the income-tax form.

As a result of the House-passed bill, some of the capital-gains abuses would be trimmed. The House would eliminate the 25% maximum and extend the holding period for long-term capital gains from six months to one year.

Even with these improvements, capital gains would still remain as the prime factor in eroding the fairness of the tax structure, for unearned income would still be preferentially taxed. Moreover, the Administration has proposed to undo even these modest improvements.

Thus, if the tax structure is to meet America's standards of fair play, loophole closing must be broad-gauged and substantial. The gimmicks that give rise to the evasion horror stories must be eliminated, but loophole closing also must be addressed to the costly and disruptive preferences that cause the burden of the Federal income tax to fall on those least able to bear it.

On April 1, 1969, before the House Ways and Means Committee the AFL-CIO presented a program which would achieve tax justice—a program which would generate some $15–17 billion in Federal revenues from substantial loophole-closing, provide relief to those of low and moderate and middle incomes, and allow some $8–10 billion to fully fund existing Federal programs geared to meeting domestic needs.

The House of Representatives has taken a major step in this direction. Unfortunately it has not gone far enough and the Administration's recommendations, if adooted, would undo many of the forward measures proposed by the House and aud additional inequities.

The House tax-reform measure merits commendation, for:

1. The working poor would be relieved of any Federal tax obligation—a measure long sought by the AFL-CIO.

2. The hard-working, tax-paying low- and middle-income Americans, who have been forced to bear far more than their just share of the tax burden, would be given a modicum of relief. This is a move toward a long-time goal of the AFL-CIO.

3. The single most inflationary pressure in the economy—the 7% investment credit to business—would be eliminated. The AFL-CIO has always opposed this device.

4. Some of the loopholes and gimmicks in the tax structure, designed to provide special, unfair tax bonanzas for the very wealthy in the nation, would be trimmed, although not eliminated. It has long been the AFL-CIO position that special tax privileges to the few best able to pay their fair share of taxes are completely unfair and must be eliminated. That remains our position.

We urge the Senate to improve upon the House action and to reject all proposals, including those of the Administration, which would move our tax structure still further away from America's standards of fair play.

Specifically, our recommendations are:

1. *The Senate should close the capital-gains loophole, ending the major tax preference for unearned income.*—The preferential half-tax rate which applies to capital gains and the zero tax that applies to such gains when passed on at death are the most disruptive elements in our tax structure. Indeed, there cannot be tax justice as long as unearned income is half-taxed while earned income is taxed in full.

The modest changes recommended by the House are welcome. Extending the holding period to one year and eliminating the 25% maximum are steps toward justice. Nevertheless the preferential one-half tax would not be changed and the Administration proposals, if adopted, would largely undo the positive action taken by the House.

2. *The Senate should put an end to the tax abuses of the oil, gas and other mineral industries.*—Again the measures taken by the House are welcome ones. They would reduce the depletion allowance, eliminate depletion on foreign oil and gas wells, place a limit on the amount of exporation expenses that can be immediately written off, and end some other abuses such as the carved-out production payment.

Nevertheless, of the total revenue that escapes taxation due to the activities of these industries, only one-third would be recovered by the House action.

The AFL-CIO recommends the complete elimination of these abuses.

3. *The Senate should eliminate the maximum-tax provision.*—Under the maximum-tax provision, the top tax rate on ordinary income would be 50%.

This proposal would benefit only those with incomes above $50,000. It would serve to provide an uncalled-for tax bonanza to top corporate executives, doctors, lawyers and others whose income comes from astronomically high fees and salaries.

The Administration has strongly endorsed this proposal. It is a proposal which reflects the cynical philosophy that if you cut the taxes on the wealthy, they won't try so hard to find loopholes. Such a philosophy makes a mockery of tax-reform efforts. We cannot subscribe to it, and we condemn it.

4. *The Senate should strengthen the minimum-tax provisions of the House bill.*—The so-called Limit on Tax Preferences (L.T.P.) proposed by the House and the weaker version offered by the Administration are prime examples of reforms addressed solely to symbols.

Both the House and the Administration versions would limit the amount of certain types of income that can be completely tax-exempt to no more than half of total income plus $10,000. Thus, the more the income you have, the more can be tax-free.

What's more, the amounts of tax-exempt income disallowed under the L.T.P. formula can be carried forward for five years. In other words, if you fail to shelter all your income in one year, you can keep trying for another five.

Under the House bill, though a wealthy individual taxed under the L.T.P. would by no means pay his fair share of taxes, he would pay some.

Under the Administration proposals, since state and local bond interest would not be recognized as income under the L.T.P., some wealthy individuals would still escape scot-free and pay no taxes at all.

The AFL-CIO proposed a 25% minimum tax on exempt income in excess of $10,000 for individuals and $25,000 for corporations—regardless of the amount of the taxpayer's ordinary income.

As part of the minimum-tax approach, both the House and the Administration have recommended what is called an Allocation of Deductions provision. Individuals with substantial amounts of tax-free income would be required to allocate itemized personal deductions between tax-free income and taxable income. This is a desirable provision, but various phase-in periods and exceptions recommended by the House and the Administration would blunt its effectiveness. Moreover, neither the House nor the Administration would extend this provision to corporations.

Under present law, those who receive tax-exempt income derive a double benefit. The income never appears on the tax return; hence no tax is paid. Secondly, personal or non-operating business deductions can be deducted in full from taxable income.

The AFL–CIO recommends that before such deductions are permitted, since they are designed to define ability-to-pay, total income (taxable and exempt income) should be taken into account: Thus, individuals with excluded income, as defined below, in excess of $10,000, should be required to allocate certain personal deductions in line with the ratio their adjusted gross income bears to adjusted gross income *plus* exempt income. The deductions that should be allocated are: interest and tax payments, casualty losses, charitable contributions, medical expenses, and cooperative housing expenses. Allocation formula should be as follows:

$$\text{Deductions} \times \frac{\text{Adjusted Gross Income}}{\substack{\text{AGI Plus Exempt Income}\\ \text{Minus \$10,000}}} = \text{Allowable Deductions}$$

Excluded income which would cause deduction to be allocated should include the following:

1. One-half of capital gains.
2. State and local bond interest.
3. Depletion taken after the cost of the property has been written off.
4. The difference between the cost and the market value of property donated to charity.
5. Depreciation on real estate taken in excess of straight-line, except for low- and moderate-housing.

Corporations with excluded income, as defined above, in excess of $25,000 should be required to allocate non-operating expense deductions between net profit from operations and excluded income.

The allocation formula should be as follows:

$$\substack{\text{Non-operating}\\ \text{Deductions}} \times \frac{\text{Net Operating Profit}}{\substack{\text{Net Operating Profit}\\ \text{Plus Exempt Income}\\ \text{Minus \$25,000}}} = \substack{\text{Allowable Non-operating}\\ \text{Deductions}}$$

The AFL-CIO further recommends that deductions disallowed under the allocation formula should be taken into account under the AFL-CIO proposed minimum tax. The disallowed deductions should be added to the $10,000 ($25,000 for corporations) of exempt income that would not be affected by the minimum tax.

5. *The Senate should strengthen and improve other measures contained in the House bill.*

For example:

—Interest on state and local bonds should be taxed in full with the federal government guaranteeing the bonds and providing an interest subsidy to assure that the fiscal powers of the state and local governments are not damaged.

—Instead of the Hobby Farm loophole-closing proposals suggested by the House and the Administration, the loss-limit approach contained in S. 500 should be adopted. This procedure was recommended by Senator Metcalf and endorsed by a bipartisan group of 26 Senators. This approach is specifically tailored to the tax-loss farmer and ensures that legitimate farm operators will not be penalized.

—The income-averaging formula should *not* be liberalized to include capital gains unless the preferential treatment accorded such gains is eliminated.

—Interest deductions on bonds used to finance corporate mergers and acquisitions should be completely disallowed.

—All rapid depreciation on real estate should be disallowed, except for low- and moderate-income housing.

—Accelerated depreciation on regulated utilities should not be allowed unless the tax benefits flow through to the consumer.

Of equal importance, the Senate should provide more substantive relief to those whose incomes are moderate and whose tax burdens are unnecessarily severe.

Tax relief and tax justice do not necessarily go hand-in-hand. The equity in the tax structure can be as badly damaged by tax cuts as it can by tax increases or the addition of new loopholes and gimmicks.

Under the House-passed bill this concept was partially recognized. Though all groups would receive some relief through the combination of changes in the low-income allowance, the standard deduction and the rate reductions, a significant proportion of the relief recommended by the House would flow to low- and middle-income taxpayers.

Under the changes proposed by the Administration, needed relief for those just above the government-defined poverty threshold and those in the middle-income brackets would be cut back; the state-gasoline-tax deduction would be disallowed, and a tax cut would be given to corporations.

Under the House proposals, $4 billion in tax relief is provided through the low-income allowance and the standard-deduction increases. Another $4.5 billion is granted through rate cuts.

The first two relief proposals—the low-income allowance and standard-deduction provisions—provide 90% of the tax relief or $3.6 billion to those with incomes of $15,000 or less. The Administration would cut back on both of these forms of tax relief.

But the House rate cuts which in the main benefit higher income groups would remain intact. Specifically, of the $4.5 billion relief recommended through rate cutting, over half flows to the 10% of taxpayers with incomes of $15,000 or over. On top of this the Administration would provide a $1.6 billion tax cut to corporations.

In basic terms, the Administration agrees with the House when the House wishes to cut the taxes of the wealthy. But the Administration says the House goes too far when it suggests cutting taxes for those of low and modest incomes—instead, claims the Treasury, corporate taxes should be cut.

We endorse the House proposals to increase the low-income allowance to a flat $1,100. In addition, we endorse the House proposals to increase the standard deduction to 15% and $2,000.

We do not agree with the general rate reductions recommended by the House and the Administration; nor do we feel there is any justification for a reduction in corporate taxes.

Instead of the general rate reductions proposed by the House and the $1.6 billion corporate rate cut, we recommend a reduction in the tax rates that apply to the first $8,000 of everyone's taxable income for married individuals and the first $4,000 for single individuals.

The rate changes would be as follows:

The 14% rate should be cut to 9%.
The 15% rate should be cut to 13%.
The 16% rate should be cut to 15%.
The 17% rate should be cut to 16%.
The 19% rate should be cut to 18%.
All other rates would remain the same.

Under this procedure, every taxpayer would receive a tax reduction. But, the individual with a taxable income of $100,000 would get the same tax break as the $8,000 man. Under the rate structure recommended by the House, a married individual whose taxable income is $100,000 would receive a $3,600 cut while the $8,000 married individual would have his taxes reduced by only $80. The AFL-CIO proposal would grant both a cut of $130 (see Table 2).

Under the AFL-CIO proposals, the net revenue loss would be approximately the same as that proposed by the House. It would be roughly $600 million more than proposed by the Administration—an amount that could easily be made up, for example, by eliminating the maximum-tax provision, effectively closing the hobby-farm gimmick, and adopting a meaningful minimum tax.

We want to reemphasize that the complete loophole-closing programs we have urged would leave many billions of dollars which could be used for funding the social and economic programs which the Congress has enacted in recent years.

The objective of tax justice is an ambitious one. But it is long overdue and critically urgent. There is no longer time for pause, delay, gestures or tokens.

Only twice since its inception in 1913 has the federal tax structure been revised. And these two revisions—in 1939 and 1954—were, according to a former Commissioner of Internal Revenue, only "faceliftings."

The tax system must now provide for the interests and needs of a nation of over 200 million people who are demanding more and better public facilities. Yet many of the flaws that have existed since the federal government first began to tax incomes still exist and many new ones have been added.

The costs of government are not being shared fairly. An unwarranted limitation is placed on the effectiveness of tax policy in promoting broad goals of balanced economic growth and full employment and public confidence is decaying.

When tax revenues are to be spent, the legislative and executive branches appropriately study and evaluate every outlay of public funds to assure that national interests will be forwarded and priorities balanced. Yet, on the revenue-raising side, tax policy is all too frequently considered only in terms of need for more dollars or fewer dollars.

The temporary surtax, adopted in 1968, is a prime example. A flat percentage tax on top of the existing tax is a fair way to divide the burden of an increase in taxes—but only if the original burden is fair.

Since a tax on a tax cannot be collected if no taxes are paid, those who are rich enough to avoid their fair share of taxes through capital gains, depletion, accelerated depreciation, tax-exempt interest and other tax-escape routes, pay no surtax on such exempt income. Because of this, others pay more and the basic inequities are compounded.

What is more, many of the inequities cause the taxation system to run in direct opposition to the objectives sought through public tax-spending programs.

For example:

● While the nation is being burdened with inflationary pressures and high interest rates, the task of easing these burdens is made more difficult by the tax system. Privileges such as the 7% investment credit and accelerated depreciation on real estate fuel the fires of the only source of inflationary demand in the national economy—business investment in plants, machines and equipment.

● $935 million in federal funds are being spent on low- and moderate-income housing; yet $800 million worth of tax loopholes go to real-estate operators constructing motels, office buildings, plants and high-rise, high-rent apartment complexes.

● $4.5 billion is spent to "stabilize farm incomes"; yet wealthy nonfarmers are encouraged, through the tax system, to disrupt and distort the farm economy.

● The large and growing concentrations of wealth and economic power are a source of growing national concern; yet the income-tax system allows $15 billion in appreciated assets to accumulate and be transferred to heirs without ever entering the tax base. At the same time, tax-exempt status is given to certain types of family foundations set up for avoiding taxes and perpetuating control of family and industrial financial dynasties. Eight million dollars are spent enforcing antitrust laws; yet the tax system provides incentives for those who would merge and "conglomerate."

● Oil, gas and other depletion allowances are justified largely on the basis of encouraging development of domestic productive capacity; yet similar tax benefits flow to those bolstering the productive capability of foreign nations.

● Some $25 billion in federal categorical grant-in-aid funds will go to the states and localities in 1969; yet the amount of federal money available to hard-pressed state and local governments is diluted by allowing interest on state and local bonds to go tax-free, since this exemption costs the Treasury more than the states and municipalities gain.

● The nation is committed to alleviating the plight of its 25 million poor; yet many of these families today pay federal income taxes while many of the wealthiest legally ignore the federal tax collector.

Though the case for reform is compelling and perhaps conclusively demonstrated by these incongruities and paradoxes, there is another too frequently overlooked aspect.

Federal income taxes are not the only taxes Americans must pay. In fact, though federal income-tax revenues have grown and still loom largest among the taxes paid by most individuals, state and local taxes have grown at a far faster pace. What's more, the increases in state and local taxes have in the main resulted from levies on property and sales to consumers which take their toll from those whose ability to pay taxes is the least.

The 1969 *Economic Report of the President* showed that the combined federal, state and local tax systems converge in such a manner as to redistribute income "away from the poor." At the same time, those of modest and middle incomes are bearing a disproportionately high share of the tax burden while those with wealth and ability-to-pay escape their fair share.

Thoroughgoing federal income-tax loophole closing and reform would make a substantial contribution toward compensating for the unfair manner in which the burden of other taxes fall.

Furthermore, it is the federal income-tax system that most states look upon as the standard for a good and fair way to allocate the costs of public services. A number of states that do use income taxes use the federal definitions and standards as models for their own systems, and three states now "piggyback" their taxes directly upon the federal taxes that their residents must pay.

Yet, as the inequities in the federal system grow and become more and more notorious, the basic principles of taxation based on income and ability-to-pay become suspect and fair-minded state and local legislators find it increasingly difficult to convince those they represent of the advantages of fair taxation methods.

CLOSING THE LOOPHOLES

Capital gains

The capital-gains route is, according to the Treasury, the most important factor in reducing the tax rates of those with high incomes.

In examining the tax returns of all those with incomes of over $100,000, the Treasury shows that this group shelters $3.8 billion from the tax base through this loophole—nine times the amount this group shelters through tax-exempt interest, 36 times the amount this group shelters through the unlimited-charitable-contribution loophole, 54 times the amount this group shelters through tax-loss farming.

Under present law, when certain so-called "capital" assets are sold, the profit is taxed at only one-half the rates that apply to ordinary income. And, the tax rate cannot exceed 25% regardless of the amount of the seller's total income. Capital assets under the Internal Revenue Code consist of property such as corporate stocks, vacant land, and other assets not held for use in the taxpayer's trade or business.

In addition, profits from the sale of many other assets—although not defined by the Code as capital assets—can also receive this same privileged preferential tax treatment. Profits from the sale of livestock used for draft, dairy or breeding; real estate used in a trade or business; royalties from sales of timber, iron ore, and coal deposits can all qualify for the preferential treatment as capital gains as can gains on sales of business machinery and equipment.

What's more, the capital-gains-tax escape route combines neatly with many other avoidance schemes, stimulating their use and compounding the tax benefits. Accelerated depreciation on real estate—a loophole which permits postponement of taxes and creates opportunities for tax-loss gimmickry—also paves the way for converting what would be ordinary rental income into capital gains. The depletion allowances for mineral industries, in themselves an unconscionable gimmick for deducting nonexistent expenses, also serve as the vehicle whereby ordinary income is unjustifiably converted to capital gains.

Another major leak in the tax system, according to the Treasury Department, results from the fact that large amounts of capital gains "fall completely outside the income system," since capital gains on assets transferred at death or by charitable donation go tax-free. The Treasury estimates that $15 billion of capital gains in 1967 were not taxed at all, through this escape route. If an individual holds an appreciated asset till he dies, the appreciation is not subject to the income tax. If an individual or corporation donates appreciated property to a charitable organization, the appreciation is never taxed—and the full appreciated value can be deducted from other income.

For example, if a taxpayer donates $1,000 work of stock which cost him $100, he pays no tax on the $900 of appreciated value and is permitted to deduct the full value ($1,000) from his income. If he were in the 50% bracket, this gift of an asset which cost him $100 would save him $500 in taxes. If he sold the assets, included half the capital gain in his income, and then contributed the $1,000 in cash, his net tax saving would have been only $275. If the $900 appreciation were taxed at ordinary rates rather than the 25% maximum capital-gains rate, the donation of this asset that cost $100 would have only yielded a net tax saving of $50.

Moreover, under certain circumstances it is possible for an individual to actually improve his after-tax position by giving away rather than selling an asset.

In testifying before the House Ways and Means Committee, Professors Martin David and Roger Miller of the University of Wisconsin said:

"The American public has every right to ask what positive justification exists for the failure to collect $15–20 billion of revenue, for the 'tax expenditure' created by the capital gains provisions. No concrete research indicates that this tax expenditure has contributed to our economic growth; no one has defended this system who does not himself have a vested interest in its preservation; any tax lawyer or tax economist will confess that these provisions are the ulcer that is primarily responsible for rotting out the taxing power of our nominal tax rates. The dishonesty sanctioned by the capital gains provisions is the first step to a taxing system, such as Italy's, where it is known that open collusion exists between taxpayers and tax accountants to defraud the government."

The modest reforms recommended by the House are welcome. Extending the holding period to one year and eliminating the 25% maximum are steps toward justice. Nevertheless the preferential one-half tax would not be changed nor would gains passed on to heirs be subject to income tax. The Administration proposals, if adopted, would largely undo the positive action taken by the House.

To close this loophole, the AFL–CIO urges adoption of the following proposals:

1. Elimination of preferential tax treatment of capital gains for both individuals and corporations. Such gains should be taxed at regular tax rates. At the same time, the present income-averaging provisions should be broadened to include capital gains.

The approximate revenue gain from the AFL–CIO proposal would be $6–7 billion. The House bill would raise $810 million and the Administration, $600 million.

2. Capital gains on property transferred at death.

All appreciation (difference between original cost and market value) should be taxed in full on transfer at death. The tax rate should apply to all appreciation occurring after date of enactment; one-half the tax rate should apply to all gains occurring between an appropriate date such as January 1, 1950, and the date of enactment.

The tax should be allowed as a deduction for estate-tax purposes. It should not apply on transfers between the decedent and spouse nor to estates valued at less than $60,000.

To prevent "forced" sales of assets, appropriate installment-payment procedures should be adopted.

The approximate revenue gain under the AFL–CIO proposals would be $3–4 billion. Neither the House nor the Administration made proposals in this area.

Depletion

Oil, gas and other mineral-extraction industries are allowed to take deductions for depletion. In principle, depletion for extractive firms is akin to the depreciation allowance taken by other industries and is geared to permit the gradual write-off of capital cost over the life of the investment.

However, the percentage-depletion deduction formula is based on income; it has no relationship to the amount of investment. Moreover, unlike depreciation the annual deduction from income never stops—it continues *even after the cost of the investment has been fully written off.*

On top of this, certain exploration and development expenditures are immediately tax-deductible (for other industries such expenditures would have to be amortized over a period of years) which means a major part of the investment of many companies has already been written off—yet the depletion allowance is not changed.

As a result, according to Treasury estimates, oil, gas and other depletion deductions average twelve times the deduction that would be allowed if the deductions were based on actual costs. In the petroleum industry, for example, 90% of the depletion deductions taken are "excessive." In other words, these firms are legally deducting nonexistent costs.

The percentage-depletion formula allows mineral operators to deduct amounts ranging from 5% (gravel, sand and clay) up to 27.5% (in the case of oil) of the gross income from the property—regardless of the amount of investment. The amount that can be deducted is limited to 50% of net income which means, in many cases, that only half the net income generated from the property is subject to tax.

In addition, there are other gimmicks used by mineral industries to circumvent the modest limitations that do exist on the depletion deduction. The carved-out production payment, for example, is in actuality a loan. The proceeds, however, are treated as income in the year received, thereby boosting the depletion deduction that can be taken. When paid off, the loan is considered an expense. These transactions are timed to generate tax advantages which the Treasury estimates cost $200 million in lost revenues.

And again, these abuses become magnified and compounded by providing opportunities for individuals, corporations and their stockholders to defer taxes, convert ordinarily taxable income to preferentially taxed capital gains, and traffic in tax-loss gimmickry by writing off imaginary losses against other income.

According to the Treasury, the 1968 revenue loss due to excess percentage depletion and the immediate write-off of development costs was as follows:

	Millions
Excess depletion:	
To corporations	$1,100
To individuals	200
Expensing capital costs:	
To corporations	240
To individuals	60
Total	1,600

The two most frequently offered justifications for the tax incentives granted these industries are: (1) special incentives are needed because these businesses are risky, and (2) these resources must be developed domestically for strategic considerations. Yet, risk is certainly not unique to mineral development and many other industries are as strategic or more so. What's more, the fact that percentage depletion is also allowed to companies developing the mineral capabilities of foreign nations hardly squares with the notion of developing a domestic productive base.

The most dramatic testimonial to the fallacy of these arguments, however, was contained in a study done under contract with the Treasury by the Consad Research Corporation of Pittsburgh. This study viewed the $1.6 billion tax incentive appropriately in terms of a federal subsidy, since this is the amount of tax revenue the nation loses as a result of the special privileges. The study showed that this $1.6 billion subsidy led to additional national mineral resources valued in the market at only $150 million. Every dollar in federal tax forgiveness yielded 9c worth of additional reserves.

And, according to the Treasury's analysis of the Consad study, the depletion allowance encourages excessive drilling and inefficient production methods and discourages research into other potential fuel sources.

The House reform measures would reduce the depletion allowance, eliminate depletion on foreign oil and gas wells, place a limit on the amount of exploration expenses that can be immediately written off, and end some other abuses such as the carved-out production payment.

Nevertheless, of the total revenue that escapes taxation due to the activities of these industries, only one-third would be recovered by the House action.

The AFL–CIO recommends that deductions for depletion should not be permitted to be taken after the cost of the property has been fully written off.

The approximate revenue gain under our proposals would be $1.5 billion. The House action and the Administration proposals would raise $600 million.

Interest on State and local bonds

The interest paid to holders of state and local bonds is completely tax-exempt and never even appears on the income-tax form.

The Treasury estimates that state and local governments save $1.2 billion in interest expense, since the tax-exempt privilege enabled them to sell these bonds at less than market rates of interest. And the Treasury loses $1.8 billion in revenue. The balance—$600 million—goes as tax benefits to the wealthy individuals and commercial banks holding most of the bonds.

Since the Treasury loses more than the state and local governments gain, the tax-exempt privilege is a wasteful, as well as back-door, method of providing aid to state and local governments. Moreover, this tax-free interest erodes the equity of the income-tax system since the tax advantages benefit only the wealthy. The Treasury notes that tax-free income from state and local bonds is the second most important factor (capital gains is first) in reducing the taxes of those individuals with incomes of over $100,000 per year.

In 1968, for example, the average yield on high-grade municipal bonds was 4.51% and top-rate (Aaa) corporate bonds was 6.18%. The tax-exempt status compensates for the lower rate only for those in tax brackets of 27% and higher—the rates which apply to married persons with taxable incomes in excess of $16,000 per year.

To illustrate, if a married person with taxable income of about $8,000 (22% bracket) bought a high-rated tax-exempt municipal rather than a corporate bond, he would lose $1.67 in interest on every $100 invested and save $1.36 in taxes, suffering a net loss of 31c for each $100 invested. On the other hand, for someone in the $100,000-or-over bracket the $1.67 in interest lost saves him $3.83 in taxes—thus, a net gain of $2.16 on each $100 invested in tax-exempt bonds.

Also the benefits of the tax forgiveness to state and local governments often run counter to the needs and objectives of most subsidies. Since the amount of debt most state and local governments can issue is tied to property values, it is the richer areas of the nation that rely heaviest on debt financing. Thus, the wealthier areas get the largest tax-forgiveness subsidies. Similarly, the bonds issued by the smaller, less affluent governments generally are low-"rated" or not "rated" at all by the investment analysts. Consequently, these bonds are considered riskier and, if they are to compete in the bond market, the poorer governments must bear higher interest costs.

On top of this, there has been a rapid growth in the proportion of municipal bonds held by commercial banks. In 1961 these banks purchased 56% of the state and local debt, and in 1967 roughly 90% of the net purchases were attributed to commercial banks. This has resulted in an erratic market for municipal securities, since these banks switch their investment portfolios back and forth in response to demand for business loans.

In time of tight money and rising business loans, commercial banks reduce purchases of municipals and may, in fact, sell them, thereby limiting the market and driving up the interest rates that municipalities must pay. Such developments require states and localities to pay higher and higher interest rates, in order to market their bonds.

A June 1968 study by the Federal Reserve Bank of Philadelphia notes: many bankers have ". . . begun to view municipals as a secondary reserve subject to liquidation when funds are needed for other purposes." A year later *Business Week* magazine stated: "Indeed, municipal bond rates have been streaking up for weeks as commercial banks turned from major buyers of tax-exempt issues into substantial sellers."

Hence, in many ways the interest rates a municipality must pay on its debt (and the amounts of taxes its citizens must pay as a result) are at the mercy of the commercial banks and the bond raters.

What's more, many state and local governments have abused the tax-exempt privilege by issuing so-called industrial development bonds. These tax-exempt bonds have been used to build factories for private industry—sometimes to the corporations' exact specifications. In this manner, a number of states have pirated firms from other areas, using their federal subsidy for the private benefit of wealthy corporations.

Under the Tax Reform Act passed by the House, state and local governments would be given a choice between floating taxable or tax-exempt bonds. If they choose the former, they will receive a federal subsidy.

The Administration is against this proposal.

The AFL–CIO recommends that all interest on state and local debt securities issued after the date of enactment (following an appropriate transition period) should be subject to the income tax. The federal government should guarantee the bonds and pay the issuing state or local government an amount equal to one-third of the interest cost on such taxable issues. No federal guarantee or interest-rate subsidy should be permitted for industrial development bonds, regardless of the amount of the issue.

There would be a net revenue gain, after taking into account the cost of the subsidy and the guarantee, of approximately $100 million under our proposal. The net revenue gain under the House proposal would be small. The Administration would keep the present system.

Real estate

A host of special tax-forgiveness provisions apply to real estate. Taken by themselves, these privileges are hardly justifiable but, when manipulated and combined, they result in unconscionable tax-avoidance opportunities for wealthy real-estate operators, investors, and speculators.

The major tax-escape route is the special accelerated-depreciation deduction. Under these fast write-off formulas, the cost of new buildings can be deducted from income at twice normal or "straight-line rates" and the cost of used buildings can be charged off at 1½ times normal depreciation rates. In the case of a new building with a 40-year estimated life, the result is that about 23% of its cost can be deducted from income during the first five years of the property's life. For a used building, 17% of the investment can be written off in the first five years.

The following table shows the effects of the special depreciation formulas compared to the "straight-line" method which apportions the depreciation deduction equally over the useful life of the asset:

[In percent]

	Building with a 40-year life			
Cumulative total	Straight-line	200-percent-declining-balance	Sum-of-the-years-digits	150-percent-declining-balance
1 year	2.5	5.0	4.8	3.7
2 years	5.0	9.8	9.6	7.4
3 years	7.5	14.3	14.3	10.8
4 years	10.0	18.5	18.8	14.2
5 years	12.5	22.6	23.2	17.4
10 years	25.0	40.1	43.3	31.7
20 years	50.0	64.0	74.4	53.4

Since depreciation write-offs are considered a cost, these fast write-offs and other costs are subtracted from rental income and the income tax, if any, is paid on the remainder. Often there is no income at all, or even a reported loss in the early years of ownership, as a result of accelerated depreciation.

Technically, the fast write-off provisions mean that tax liabilities are deferred—in principle, the lower taxes in the early life, due to excess deductions, will be made up later, as smaller deductions are permitted. To this extent, the excess depreciation results in an interest-free, no-strings federal loan to the real-estate operator.

But the accelerated-depreciation special privilege also paves the way for other tax gimmickry. First, a good part of the excessive depreciation deductions are never returned to the tax base, because the property is sold long before the depreciation deduction runs out. And a good part of that which is eventually taxed is taxed at only half the usual rate, and never more than 25%, since it is considered a capital gain.

Combining these advantages with "leverage"—much debt, little equity—the infamous real-estate tax shelter is created. The excessive depreciation plus interest charges on the debt result in large bookkeeping tax losses. These phantom losses are in turn washed out against an individual's other income, sheltering it from the federal tax. To take full advantage of this, many high-income individuals join together into syndicates. These syndicates buy or develop high-depreciation property that will show a loss which can be applied to the wealthy investors' other income. What's more, when the properties approach a point when a profit might be shown (depreciation and interest become less than rental income), the property is then sold or refinanced, starting the cycle all over again.

A Treasury study of 19 investors, exploiting the real-estate shelter, showed that the group had a combined income of $2.7 million from their major economic activities. But, since they made investments in real estate, they were able to "shelter" (remove from their otherwise taxable income) $1.5 million and cut their tax bill by more than half.

The average investor in this group, according to the Treasury, had an income of $141,000 from his other interests. He sheltered $77,500 of this from the Internal Revenue Service by his real-estate investments, and his paper real-estate "losses" saved him $45,000 in taxes.

The Treasury also traced the activities of one real-estate investor over a seven-year period. This operator had a seven-year income of over $7.5 million. Yet, because of real-estate depreciation deductions, he paid the same effective tax rate on his total income as a married wage earner with two children and an annual income of $10,000.

Moreover, real-estate operators can unfairly lighten their share of taxes through reporting capital gains in installments, exchanging appreciated property tax-free, and through complicated mortgage-refinancing arrangements. Again, these are all games open only to those with wealth. And, this real-estate gimmickry:

1. Costs hundreds of millions of dollars in terms of federal revenues foregone—expenditures or subsidies granted through the tax system. Nonhousing, fast depreciation, alone, accounts for a revenue loss of $960 million.

2. Runs in direct opposition to meeting one of our most serious national needs. These privileges serve to channel resources into luxury housing and away from the much-needed improvements and additions to the housing available for those with low and moderate incomes. The Treasury estimates that, of the total tax benefits flowing to real-estate operators, only $50 million went to those investing in low- and moderate-income facilities.

The House bill would limit double depreciation to residential property. Depreciation write-offs for commercial and industrial real estate would be limited to 150% of normal. The House bill provides a five-year write-off for expenditures for the rehabilitation of buildings for low-cost rental housing. The Administration supports the House proposals.

The AFL–CIO recommends that all depreciation in excess of straight-line should be disallowed on all real estate except low- and moderate-housing.

Approximate revenue gain, under the AFL–CIO proposal would be approximately $1.5 billion. The House and Administration proposals would raise about $1 billion.

Tax havens for wealthy farm investors

Under the Internal Revenue Code there are special tax-accounting privileges for farmers—privileges which were developed to ease the bookkeeping chores of ordinary farmers.

However, these accounting privileges are being manipulated to provide windfall tax benefits to wealthy individuals and corporations who operate or invest in farms in order to get tax losses. These losses are not true losses; nevertheless they can be deducted from the wealthy investor's nonfarm income, sheltering it from the federal income tax.

Though most businesses use the "accrual" method of accounting, since it is the most accurate way to reflect the true income of the business, farmers are permitted to choose between use of the accrual method or the "cash" method. Using the cash method, inventories are ignored. The growth in inventories is not balanced off against other costs. Put another way, costs that reflect the building up of an asset (inventories) are deducted from otherwise taxable income, but there is no corresponding adjustments made for increase in the value of the asset (inventory). As a result, certain farm operators abuse this privilege by carefully mismatching costs and the income generated by these costs, to their tax advantage.

Losses, which under normal (accrual) accounting procedures would result in gains, are created which, in turn, are used to "shelter" the wealthy investor's nonfarm income from his taxable income.

What's more, since many of these "paper" losses actually reflect increases in investment, income taxes that should be paid annually at ordinary rates are postponed until the sale of the inventory at which time the tax is cut in half because capital-gains rates apply. Under these circumstances it is possible for the tax-deductible costs of raising an animal to *exceed* the taxable gain even though the animal is sold at a profit.

For example, a cash-basis farmer spends $200 over a three-year period in raising a cow and charges the $200 off over the period as an expense. He then sells the cow for $250. His real profit on the transaction was $50; yet, since the entire $250 is considered as capital gains, only half of the $250 ($125) must be reported as taxable income. As a result, he reports $125 in income and deducts $200 in expenses over the three-year period—his tax returns show a $75 loss on a transaction which in actuality yielded a profit of $50.

Under normal accounting techniques, the $200 spent in raising the cow would have been treated as an increase in inventory and would not have resulted in a deductible expense. Upon the sale of the cow, the capital gain would have been $50 and one-half of it, or $25, would enter his taxable income. Hence the "accrual" farmer would have reported $25 in income (although it was really $50) and no deducrions. The "cash" farmer reported income of $125 and expenses of $200.

Moreover, the definition of what are capital assets (and therefore subject to capital-gains tax rates) is stretched considerably, to the advantage of certain farmers. The Internal Revenue Code, for example, treats livestock used for draft dairy or breeding purposes as depreciable capital assets.

Through the use of "leveraging" (much borrowing—little cash investment), the advantages of these special privileges are compounded. The combined effects of interest charges on the money borrowed for the farm investment and the operating losses, that are so easily shown through cash accounting, result in phenomenal phantom tax losses, which are washed out against the other income of wealthy farm investors, sheltering it from taxation.

Some insight into how these special privileges are utilized by the wealthy can be found in the annual income-tax return data published by the Internal Revenue Service.

In 1967, for example, there were over 1 million tax returns filed showing net farm losses, and almost 2 million reporting a net gain. For those taxpayers with adjusted gross income *under* $50,000, the number of returns showing profits from farm operations exceeded the number showing losses, by rather substantial amounts. The overwhelming majority of actual, operating farmers were in this group.

However, where adjusted gross incomes were over $50,000, *more* returns showed losses than gains. In the $1,000,000-and-over income group, only 12 returns showed profits—totaling $74,000—compared to 101 returns claiming losses—totaling $7.6 million. (See Table 5.)

Obviously, "nonfarmers" are investing in farms solely for tax purposes. As a consequence, these nonfarmers compete unfairly with legitimate farmers. They distort the farm economy by bidding up the price of farmland and forcing ordinary farmers to compete in the market with those who are totally indifferent to whether they receive a fair price for the product or not.

The Treasury estimates an annual tax loss of some $800 million due to the farm loopholes. By placing a $15,000 limit, just on the amount of phantom tax loss that can be applied against other income, some $145,000,000 in revenue could be recouped.

Both the House and the Administration recommend trimming this abuse.

Though the Administration would go further than the House, the basic approach is the same and little would be done to curb the tax-loss farm abuses. What's more, under the House and Administration recommendations there is a possibility that some legitimate farmers would be penalized.

The AFL–CIO recommends enactment of the loss-limit approach contained in S. 500. This procedure was recommended by Senator Metcalf and endorsed by a bipartisan group of 26 Senators. This approach is specifically tailored to the tax-loss farmer and ensures that legitimate farm operators will not be penalized.

Under this approach, each dollar of nonfarm income over $15,000 would reduce the amount of farm loss that can be deducted from nonfarm income by $1. This provision would not apply to farm losses resulting from taxes, interest, casualty, drought, and sale of farm property. This provision would not apply to farmers using the accrual method of accounting.

The approximate revenue gain under our proposal would be $145 million. The House would raise $20 million; the administration $50 million.

Tax-exempt foundations

The tax-exempt status granted to certain foundations represents one of the most glaring examples of how a well-intentioned, seemingly desirable, tax privilege can become twisted.

As a nation, we recognize that philanthropy is desirable and it should be encouraged. In line with this reasoning, individuals are permitted, within certain limits, to deduct from their taxable income, contributions to organizations established for religious, charitable, scientific, educational and similar purposes. Likewise, the federal government grants tax-exempt status to the organizations receiving the contributions.

Granting special tax privileges for such contributions or to such institutions raises the same fundamental question as in all tax-forgiveness schemes. The government is relinquishing funds it would otherwise be entitled to, and therefore others must pay a higher share of the costs of government. Thus, where there is tax foregiveness, there must also be an assurance that the nation's interests are being served.

Recent investigations into certain tax-exempt foundations—non-profit organizations set up and supported by wealthy families or individuals—have raised some serious doubts as to whether appropriate purposes are in fact being fulfilled and the nation's interest is being served.

Tax-exempt foundations have grown phenomenally—new ones are cropping up at the rate of some 2,000 per year. The assets of the larger foundations have recently been estimated at some $20 billion, and each of the 27 largest foundations has assets worth $100 million or more.

The philosophy underlying the private foundations, according to a foundation spokesman is "the systematic use of private funds for public purposes." Unfortunately, the studies of the activities of tax-exempt foundations done by the House Committee on Small Business have shown that in many cases the opposite situation prevails. That is, public funds are being systematically used for private purposes.

Family foundations frequently are used as a means whereby the wealthy can avoid income, gift and inheritance taxes, yet maintain control over wealth. When families donate company stock to private family-run foundations, family control over the business can be assured from generation to generation, while inheritance taxes are avoided. The donor can control the management of the foundation—appointing relatives, rewarding friends and employees. The foundation provides the conduit for donations which reduce the taxes on his business income.

Furthermore, this control can be parlayed to a point where the foundation is used to promote the foundation owner's other business interests. Practices have been uncovered which can be questioned on the basis of unfair competition, conflict of interest, self-dealing, "insider" arrangements to affect stock prices, and so forth.

Foundations, for example, can lend money to the founder, his family, or the family business at preferential interest rates, thus supplying venture capital for the donor's other interests. The Subcommittee's studies noted situations, where suppliers and buyers have made sizeable contributions to foundations, controlled by customers, indicating underhanded pricing deals. What's more, these organizations can enter into deals, whereby through intricate tax maneuvering, they can buy a business, invest none of their own money and pay the seller more than the market value of the business. On top of this, the deal can be set up as an installment purchase, permitting the seller to convert what should have been ordinary income into preferentially taxed capital gains.

A Prentice-Hall Executive Tax Report, for example, offers this advice:

> Have You Put a Price on Your Business? You may be able to double it—by selling to a Charity.
>
> Say you're planning to sell your business, and you think a fair price would be five times earnings. If the company earns, say, $101,500 after taxes ($200,000 before), you're probably figuring on selling for about $500,000. If that's the case, Stop Right There—you may be shortchanging yourself:
>
> That business could be worth $1,000,000 to a tax-exempt organization: An ordinary buyer is only interested in earnings after taxes—that's all he gets to see. But a tax-exempt buyer keeps a hundred cents on the dollar. So a fair price to a charity would be five times $200,000, or $1,000,000—twice what you figured!

Finally, the Report notes some "frosting on the cake" and cites a case where the seller maintained 48% ownership of the corporation "was active in management and drew a good salary."

Commenting on the abuses uncovered, a *New York Times* editorial added another dimension—that of the increased role of foundations in shaping national policy:

"Since almost everyone pays income taxes, the burden of exempting the income of the foundations is borne by the public at large. Yet the public is virtually powerless to influence the ways in which the foundations spend their tax-free dollars."

Generous tax treatment is appropriate for charitable organizations since private philanthropy is an important adjunct to public programs serving the goals of the nation. However, this special treatment is justifiable only if these organizations are in fact using the foundations, and their tax-exempt privilege, for the public good and not merely for the private advantage of a select well-heeled few.

The House-passed bill would substantially narrow the permissible activities of private foundations desiring to preserve their tax-exempt status. Limits would be placed on self-dealing between foundations and contributors, and provisions are recommended which would require distribution of their income over a period of time, limit their private business holdings, and make sure that investments of these organizations are not jeopardized by financial speculation. The House would also levy a 7.5% tax on the investment income of private foundations.

The Administration has, in the main, endorsed the House action. However, the Administration recommends a 2% levy on investment income rather than the 7½% rate recommended by the House.

The AFL–CIO recommends that:

(1) Financial transactions between a foundation and its founders, contributors, officers, directors or trustees should be prohibited.

(2) Foundations should be required to spend their incomes within one year of receipt.

(3) Foundations should not be permitted to own 20% or more of any business unrelated to their charitable function—a reasonable time should be allowed for presently organized foundations to comply with this provision.

(4) If a donor maintains control of a business or property after it is contributed, no donation deduction from taxes should be allowed until the foundation disposes of the property or the donor's control over the property ends.

(5) Foundation borrowing to buy investment properties should be prohibited. Foundation lending should be limited to appropriate charitable functions.

(6) A limitation, such as 40 years, should be placed on the life of foundations.

(7) Congress should carefully examine the problems posed by the actual operations of foundations and the need for some degree of federal regulation of the use of the tax-exempt funds of foundations.

Unlimited charitable-contribution deduction

The ordinary taxpayer cannot deduct charitable contributions that exceed 30% of his income. However, through use of a little-known loophole—the unlimited charitable-contribution deduction—about 100 of the nation's wealthiest families escape paying $25 million in taxes. Many of these families pay no federal income taxes at all.

Though the loophole alone yields tax benefits to some of the nation's wealthiest, the major part of the tax bonanza comes about through combining the unlimited-deduction gimmick with another loophole—that which permits the contribution deduction to be based on the appreciated value of assets (typically stocks) donated, not the cost. Hence, no tax—not even at privileged capital-gain rates—is ever paid on the appreciated value; yet the full amount is allowed as a deduction from income.

The unlimited-deduction privilege seems stringent in that it's only allowed if total contributions plus income taxes paid in eight out of the ten preceding years exceeds 90% of *taxable income*. However, these criteria are easily met by many wealthy individuals whose income comes from nontaxable sources. Thus many who rely upon state and local bond interest, or capital gains, or whose taxable income is "sheltered" by means of excessive depletion or depreciation deductions can easily give away large percentages of taxable income—since so little of their income is subject to tax.

The Treasury studied the 1964 tax returns of four wealthy "non-taxpayers" and found that each had a total income of between six and ten million dollars and a taxable income of zero. Their incomes came almost entirely from dividends and/or capital gains. Each gave away property close to, or in excess of, the *reported* adjusted gross income—property which was for the most part appreciated stocks, upon which no capital-gains tax was ever paid—and in each case, taxable income and income tax were $0.

As a result, a seemingly innocent and appropriate tax-forgiveness provision geared to encouraging philanthropy serves in the main to divert public revenues to private use. The public revenue cost is far out of proportion to the philanthropic goals forwarded, and the difference flows to a privileged few individuals of extreme wealth.

What is more, studies have shown that the charities supported by the contributions of the wealthy are generally quite different from those that receive the bulk of their contributions from the majority of the nation's taxpayers. And this evidence suggests that Congressional intent and the national interest in supporting charitable organizations is thwarted.

For example, a 1965 Treasury Department report showed that in the income classes under $20,000, over 80% of the contributions went to religious organizations and charities concerned with social welfare, such as the Community Chest and the Red Cross. In contrast, those in the over-$1,000,000 income class gave over two-thirds of their contributions to so-called "other organizations"—principally foundations. Religious and social-welfare organizations like the Community Chest received less than 10% of the wealthier group's philanthropy.

The House tax-reform bill would phase out the unlimited-charitable-contribution loophole over a five-year period. However, the House would also increase the general-charitable-contribution deduction from its current level of 20% or 30% (depending on type of organizations contributed to) to 50%. In the main, the Administration has endorsed these proposals.

The AFL–CIO recommends immediate repeal of the unlimited-charitable-contribution deduction. The approximate revenue gain under our proposal would be $50 million. Under the House and Administration proposals $20 million would be gained.

The 7% investment credit

The investment-credit tax privilege was added to the Internal Revenue Code in 1962 and liberalized in 1964. The privilege was enacted as an effort to spur the economy by encouraging business to invest in new machinery and equipment.

Under this provision, business firms are permitted to deduct from the federal income taxes owed an amount equal to 7% of the cost of new machinery and equipment. The full 7% can be deducted for firms with tax liabilities up to $25,000. If the tax liabilities are more than $25,000 the amount of credit that can be deducted is limited to one-fourth of their taxable income. In other words, the only limit on the credit is that it cannot reduce the firm's tax bill by more than 25%.

In effect then, the nation's taxpayers are picking up the tab so that a private firm can get a discount on the costs of its equipment.

What's more, prior to 1964, businesses had to deduct the credit from the cost of the investment before they were allowed to write off depreciation. This was changed in 1964 and currently the credit can be taken, *and* the full purchase price can be written off. Thus, more than 100% of the cost can be written off and, like the oil-depletion deduction, imaginary expenses are used to reduce taxable income.

The revenue cost of the credit, according to the Treasury, amounts to $3.3 billion at current levels of business profits and investment. This $3.3 billion tax forgiveness subsidy induces increased business investment and feeds the only major source of inflationary-demand pressure in 1969—while the entire national economy is burdened with tight money, unprecedented interest rates and other generally restrictive measures.

Both the House and the Administration recommend repeal of the credit. This is also the position of the AFL–CIO.

The approximate revenue gain would be $3.3 billion.

Multiple surtax exemptions

The corporate income tax is a two-step affair. The first $25,000 of profit is taxed at a rate of 22% and the remainder is taxed at 48% (excluding the temporary 10% surtax).

The exemption of the first $25,000 from the full corporate tax rate was made part of the Internal Revenue Code in order to help small corporations.

However, the intent of this provision has been thwarted by many large corporations, which have intentionally organized themselves into chains, to shelter much of their income from the full corporate rate.

Thus, by spinning off into subsidiaries, a corporation can reduce its taxes annually by $6,500 per subsidiary. A single corporation, for example, with a net profit of $1 million would pay a tax of $473,500. If the same corporation operated through 40 subsidiaries, each showing a profit of $25,000, the tax would be cut by more than half.

The Treasury estimates that the exemption results in a reduction of the tax rate on corporations generally from 48% to 45.8% and a revenue loss of approximately $1.8 billion. The combined effect of both the 7% investment credit and the $25,000 exemption brings the effective rate down to only 43.4% and the revenue loss to some $4–5 billion.

Moreover, this special privilege amounts to a tax incentive that encourages unsound corporate arrangements. It also adds an element of discrimination between those types of corporations that can easily be split up to take advantage of the special privilege and those that cannot.

As a result, a benefit intended to help small business also provides tax-windfall opportunities to large, highly profitable operations.

Both the House and the Administration recommend repeal of the multiple surtax exemption. This is also the position of the AFL–CIO.

Approximate revenue gain: $235 million.

Conglomcrates

The greatest wave of corporate mergers in American history is now rolling through the economy. This movement towards the concentration of economic power has been building up over the last 20 years. It obscures the peaks of the two previous corporate merger waves in 1899 and 1929. The number of mergers of mining and manufacturing companies zoomed from 219 in 1950 to 844 in 1960 to nearly 1,000 in 1966 and over 2,400 in 1968, according to the Federal Trade Commission.

Not only are the "bigs" taking over the "smalls", but the minows are swallowing whales, and the "bigs" are merging with other "bigs." Conglomerates marriages, with increasing frequency, involve partners with assets over $10 million. In 1966, there were 101 mergers involving an acquired company with assets in excess of $10 million. The Federal Trade Commission reported 192 such mergers in 1968, with assets of the acquired companies totaling $12.6 billion. The 200 largest companies acquired 70 firms in mergers in 1968, the FTC reported

As a result, one of every six firms that made Fortune Magazine's 1962 top-500 list has completely disappeared.

These conglomerate corporations grow in all directions, by acquiring companies in any industry or product-line, no matter how unrelated. They operate in all kinds of different industries and markets.

The great merger movement of recent years has brought an alarming increase in the concentration of economic power in the hands of the major corporations. In 1967, the 200 largest manufacturing corporations held nearly 59% of the total assets of all manufacturing corporations—up from about 48% in 1948. The 78 giant manufacturing corporations, with assets of $1 billion or more, held 43% of the assets of manufacturing corporations in 1968 and received 49% of the profits of all manufacturing corporations.

The concern is not with large conglomerate corporations merely because they are large. It is the effects which must be examined. The immediate questions concern plant closedowns and impacts on collective bargaining and the local community. Beyond this, what does the concentration of economic power do to the political system and economic system in terms of prices, competition, efficiency and inventiveness?

These questions go beyond those that can be answered through the tax structure. They involve the anti-trust laws and the operations of the Justice Department, as well as such other government agencies as the Federal Trade Commission and the Securities and Exchange Commission. Yet it is clear that there are tax inducements to those who would merge and the tax structure adds thrust tc the corporate take-over movement.

- By "swapping debt for equity" (offering bonds in exchange for stock) the acquiring firm has to pay bond interest rather than stock dividends. Interest is tax-deductible; dividends are not. Because of this tax advantage, the purchaser can offer a bond (debenture) supposedly valued at more than the stock, creating what has been labeled "funny money."

The seller also has a tax advantage since he pays no taxes on the transaction until the bond is paid off. Hence, it is the nation's taxpayers who are helping to finance the take-over.

- If the seller receives stock in the acquiring firm in exchange for his old stock, the transaction, under most circumstances, is tax-free. Of the 352 major acquisitions that took place in 1967 and 1968, some 90% were tax-free. The "new" firms were valued in the stock market at $3 billion higher than the pre-merged firms; yet no taxes were paid.
- The tax-loss "carry-over" provisions in the Internal Revenue Code lead to anomalous situations, where a firm showing a loss becomes a more desirable partner for a merger than a profitable one. And again the nation's taxpayers are the losers. If a firm has losses, it pays no taxes. If the firm merges with a profitable firm, its losses can be washed out against the acquiring firm's otherwise taxable income. And, of course, other tax loopholes can be called into play to create phantom losses and situations similar to the tax havens built by wealthy real-estate speculators and tax-loss farmers.

Moreover, other business tax privileges—as the 7% investment credit, for example, and accelerated depreciation—help to provide many corporations with unreasonably large amounts of cash (depreciation allowances plus retained profits) after payment of taxes and dividends to stockholders. The cash is thus available for such ventures as those involved in the sharp rise of foreign investment and buying out other firms.

The House bill would curtail some of the financial manipulations that encourage the rise of corporate mergers and the spread of conglomerates. The AFL-CIO agrees with these proposals. Most important, under the House action (supported by the Administration), limitations would be placed on the amount of interest deductions allowed on debt used to finance corporate mergers and acquisitions.

The AFL-CIO recommends that such interest deductions be completely disallowed. Furthermore, the AFL-CIO recommends a thorough investigation be conducted to determine the extent to which the federal tax structure contributes to the alarming trend of corporate mergers and acquisitions.

Among the tax provisions that should be examined are those which permit:

1. Capital-gains taxes to be paid in installments when stock is exchanged for debt securities.
2. Tax-free exchanges on corporate stock transfers made for purposes of mergers and acquisitions.
3. Corporations to "carry over" the operating and capital losses of an acquired firm.

In addition, the penalty tax provisions applying to excessive amounts of retained profits should be made workable in the light of recent experience.

OTHER HOUSE PROPOSALS

The House bill includes other improvements which we consider steps toward tax justice and which we support. Among these are:

1. Liberalization of moving expense deductions.
2. Tightening of the deferred-compensation loophole.
3. Limiting the tax advantages of foreign investment income.
4. Requiring financial institutions to shoulder more of the tax burden.
5. Eliminating special tax breaks for stock dividends.

TABLE 1.—FEDERAL INCOME TAX BURDEN

PRESENT LAW COMPARED WITH HOUSE REFORM BILL, TREASURY PROPOSALS, AND AFL-CIO PROPOSALS—MARRIED COUPLE, 2 DEPENDENTS

Wage or salary income	Total tax				Tax reduction		
	Present law	House reform bill	Treasury proposals	AFL-CIO proposals	House	Treasury	AFL-CIO
$3,000	0	0	0	0			
$4,000	$140	$65	$81	$45	$75	$59	$95
$5,000	290	200	253	155	90	37	135
$7,500	687	576	616	526	111	71	161
$10,000	1,114	958	1,012	908	156	102	206
$12,500	1,567	1,347	1,447	1,300	220	120	267
$15,000	2,062	1,846	1,951	1,822	216	111	240
$20,000	3,160	2,968	2,968	3,030	192	192	130
$25,000	4,412	4,170	4,170	4,282	242	242	130
$50,000	13,388	12,604	12,604	13,258	784	784	130
$100,000	37,748	34,892	34,892	37,618	2,856	2,856	130

Note: Assumes deductions equal to 10 percent of income, minimum standard deduction (low-income allowance) or standard deduction—whichever is greater. Table takes into account the rate cutting, standard-deduction changes, and low-income allowance proposed by the House, the Treasury, and the AFL-CIO. Surtax excluded.

TABLE 2.—EFFECT OF AFL-CIO-PROPOSED REDUCTION IN 1ST 5 TAX BRACKET RATES TO 9 PERCENT, 13 PERCENT, 15 PERCENT, 16 PERCENT, AND 18 PERCENT ON MARRIED TAXPAYER FILING JOINT RETURN

Taxable income[1]	Present Federal income tax	Tax under AFL-CIO proposal	Tax reduction	Tax reduction as a percentage of present tax (percent)
$1,000	$140	$90	$50	35.7
$2,000	290	220	70	24.1
$3,000	450	370	80	17.8
$5,000	810	710	100	12.3
$7,500	1,285	1,160	125	9.7
$10,000	1,820	1,690	130	7.1
$12,500	2,385	2,255	130	5.5
$15,000	3,010	2,880	130	4.3
$20,000	4,380	4,250	130	3.0
$35,000	9,920	9,790	130	1.3
$50,000	17,060	16,930	130	.8

[1] Wage and salary income less personal exemptions and deductions.

Note: Figures exclude 1968 surtax and do not take into account additional relief measures which would increase the standard deduction and provide a low-income allowance.

TABLE 3.—IMPACT OF FEDERAL, STATE, AND LOCAL TAXES, FAMILY OF 4, 1963-68

				Change in net income after taxes (in percent)		
Wage or salary income	Decrease in Federal income tax	Increase in OASDHI	Increase in State and local taxes	Federal income taxes only	Federal income and OASDHI	Federal income, OASDHI, State, and local
$1,000		$7.75	$89		−0.9	−14.2
$2,000		15.50	110		−.8	−7.9
$3,000	$60.00	23.25	132	+2.0	+1.3	−3.9
$5,000	130.00	46.00	168	+2.8	+1.9	−2.2
$7,500	139.50	156.00	182	+2.1	−.3	−3.4
$10,000	174.45	169.20	245	+2.0	0	−3.1
$12,500	216.50	169.20	290	+2.0	+.5	−2.6
$15,000	270,35	169.20	317	+2.1	−.8	−1.9
$20,000	403.00	169.20	368	+2.5	+1.5	−.9
$35,000	943.40	169.20	567	+3.6	+3.0	+.9

Note: State and local taxes were estimated by the AFL-CIO Research Department. These estimates were based upon Council of Economic Advisers studies for 1965 and Bureau of Census State and local tax data for 1963, 1965, and 1968. Federal income taxes based on family of 4, using the minimum standard deduction where applicable and assuming deductions equal to 10 percent of income for all other groups.

TABLE 4.—RETURNS WITH TAXABLE INCOME 1966 EFFECTIVE TAX RATES

	Percent of effective tax rate—	
Adjusted gross income (thousands)	On present law taxable income	On taxable income including excluded half of capital gains[1]
$0 to $5	15.3	15.0
$5 to $10	16.4	16.2
$10 to $20	18.1	17.8
$20 to $50	24.0	22.8
$50 to $100	35.8	32.6
$100 to $200	45.6	37.8
$200 to $500	52.3	37.9
$500 to $1,000	55.3	35.8
$1,000 and over	55.5	32.7

[1] These effective rates are actually overstated—particularly in the upper brackets—because other forms of exempt income, such as interest from State and local bonds are not taken into account in this table. For example, the Treasury Department estimates that the effective tax rate on total income for nearly ⅗ of those with adjusted gross incomes of $1,000,000 and over is 30 percent or less—4 percent of this group pay an effective tax rate of 5 percent or less.

Source: U.S. Treasury Department "Tax Reform Studies and Proposals" Feb. 5 1969 p. 81.

TABLE 5.—SELECTED DATA FROM INCOME TAX RETURNS REPORTING FARM PROFITS AND LOSSES

[Dollar amounts in thousands]

	Farm returns			
	Net profit		Net loss	
Adjusted gross income	Number of returns	Amount	Number of returns	Amount
Under $5,000	415,346	$728,615	180,557	$183,588
$5,000 to $10,000	502,044	1,580,178	371,917	410,518
$10,000 to $20,000	240,493	1,386,520	161,340	254,104
$20,000 to $50,000	50,608	605,232	41,441	161,673
$50,000 to $100,000	6,059	100,476	10,023	83,326
$100,000 to $1,000,000	1,292	25,537	4,262	85,827
$1,000,000 or more	12	74	101	7,577

Source: U.S. Treasury Department, Internal Revenue Service, Preliminary Statistics of Income, Individual Income Tax Returns, 1967.

TABLE 6.—ILLUSTRATION OF AFL-CIO 25 PERCENT TAX ON EXEMPT INCOME AND ALLOCATION OF DEDUCTIONS PROPOSALS ON A TAXPAYER (ACTUAL CASE) WITH OVER $1,000,000 OF INCOME AND AN EFFECTIVE TAX RATE OF 0.03 PERCENT (ACTUAL CASE CITED BY TREASURY DEPARTMENT)

	Actual	Proposed
A. Application of allocation of deductions proposal:		
Reported adjusted gross income	$679,405	$679,405
Less personal exemption	−600	−600
Less itemized deductions	−676,419	−357,352
Taxable income	2,386	321,453
Income tax	383	210,507
B. Application of 25-percent tax on exempt income:		
Total excluded income:		
Excluded capital gains		605,313
Excess depreciation on real estate		11,141
Total		616,454
Less $10,000		−10,000
Less disallowed deductions ($676,419−$357,352)		−319,067
Exempt income subject to 25-percent tax		287,387
25-percent tax on exempt income		71,847
Add tax on taxable income after deductions allocated		210,507
Income tax	383	282,354
Income tax as percent of total income	0.03	21.8

[1] Computed as follows:

Adjusted gross income	$679,405
Add excluded capital gains	605,313
Add excess depreciation on real estate [a]	11,141
Total income	1,295,859

Deductions $\times\frac{\$679,405}{\$1,295,859-\$10,000}$=$357,352 allowable deductions.

[a] Actual loss reported was $22,283—analysis assumes only ½ of this loss due to excessive depreciation.

Note: 1968 surtax excluded.

TABLE 7.—ESTIMATED FEDERAL REVENUE GAINS RESULTING FROM MAJOR AFL-CIO LOOPHOLE-CLOSING PROPOSALS

Loophole-closing proposals	Approximate revenue gain (in millions of dollars)
1. Elimination of preferential tax treatment of capital gains	6,000-7,000
2. Taxation of gains on property transferred at death	[1] 3,100–[2] 4,200
3. Disallowance of depletion after investment fully written off	1,500
4. Elimination of tax-exempt State and local bond interest and inclusion of Federal subsidy and loan guarantee	100
5. Elimination of 7-percent investment credit	3,300
6. Elimination of accelerated depreciation on real estate except for low- and moderate-income housing	1,500
7. Limitation of farm-loss deductions	145
8. Elimination of unlimited charitable-contribution deduction	50
9. Elimination of corporate multiple surtax exemption	235
Total	15,930-18,030
10. Allocation of deductions [3]	250
11. 25-percent minimum tax on exempt income [3]	1,500
Total	1,750

[1] If taxed at current capital-gains rates.
[2] If taxed at full rates.
[3] Proposal would not apply if loopholes eliminated.

STATEMENT OF HON. LEE METCALF, A U.S. SENATOR FROM THE STATE OF MONTANA; ACCOMPANIED BY STEVE KOPLAN

Senator METCALF. I have with me Mr. Steve Koplan who has been helpful with me working on this and on other tax legislation. I am very grateful to return to this committee and I appreciate this opportunity to testify for legislation that would remove inequities between those who depend on farming and ranching for their livelihood and the comparative few who now distort the farm economy by taking unfair advantage of farm accounting rules.

Rules originally intended to ease the bookkeeping chores of legitimate farmers and ranchers are being used by both corporations and individuals to create artificial farm losses that are then used to reduce the amount of taxes they would otherwise have to pay on substantial amounts of nonfarm income.

My bill, S. 500, would eliminate that problem by limiting to $15,000 or to the amount of special deductions listed in my bill, whichever is higher, the amount by which a farm loss may be used to offset nonfarm income. Special deductions are those that would be allowed to someone whether or not he was in farming or because it is the type of deduction clearly beyond the taxpayer's control. I am referring to such things as taxes, interest, abandonment or theft of farm property, fire, storm or other casualty, losses and expenses from drought, and recognized losses from sales, exchanges, and involuntary conversions of farm property.

Neither the House-passed bill nor the administration's proposal contain a comparable provision to protect the legitimate farmer and rancher from being penalized for having incurred an economic agricultural farm loss in a given year.

My bill also provides safeguards to protect those just starting out in farming as well as those who might find themselves in a loss situation in a given year, not by design for tax purposes but rather by chance.

This is accomplished by the provision that allows any disallowed loss to be carried back 3 years and forward 5 years against past or future farm income.

The problem with the approach recommended by the administration and now contained in the House-passed bill except for different dollar exclusions is that it allows the tax-dodge farmer to defer any recognized capital gains while at the same time he is allowed to continue using the full amount of his artificial losses as an offset against nonfarm income year after year. This is what the National Livestock Tax Committee had to say about the excess deductions account approach when its representatives testified before the House Ways and Means Committee in 1963, and I quote:

> We cannot say whether it would work or would not, but it is the most modest approach that has come to our attention.

With proper tax planning, the balance in an excess deduction account, EDA, can be substantially reduced before the taxpayer decides he is ready to recognize long-term capital gains. Such a proposal will not remove any of the incentive from existing clients of cattle management firms such as Oppenheimer Industries.

While I am on the subject of that particular firm, I should mention that last week my office requested an opportunity to examine a representative sample of that firm's advertising brochures. At first the request was granted. However, before the material could be sent to me, I was informed that on direct orders from the Bonaparte of Beef himself, Gen. Harold L. Oppenheimer, no material would be forthcoming.

I suggest that this committee make a similar request of General Oppenheimer before concluding consideration of the farm tax problem.

(Subsequent to the above discussion regarding Oppenheimer Industries, Senator Metcalf submitted the following information:)

U.S. SENATE,
Washington, D.C., October 3, 1969.

HON. RUSSELL LONG,
Chairman,
Senate Finance Committee,
U.S. Senate,
Washington, D.C.

DEAR CHAIRMAN LONG: When I testified before your Committee on the problem of tax-dodge farming, I mentioned that my office had requested an opportunity to examine a representative sample of the advertising brochures of Oppenheimer Industries. I further informed the Committee that I was advised that on direct orders from General Harold L. Oppenheimer, my request was denied. I then suggested that your Committee make a similar request of General Oppenheimer before consideration of the farm tax problem.

Apparently representatives of Oppenheimer Industries were present when I testified because the next day General Oppenheimer's Washington representative circulated to members of your Committee the very materials I had been denied.

Because of the relevance of certain of those materials to any consideration of this problem and to avoid any criticism that there has been biased analysis on my part, I request that this letter together with the document entitled, "An Introduction To Cattle Ownership And Its Benefits," and General Oppenheimer's message contained in his corporation's Annual Report for fiscal year ended January 31, 1969, be printed in their entirety as a part of the hearing record.

Very truly yours,

LEE METCALF.

Enclosure.

OPPENHEIMER INDUSTRIES, INC.—AN INTRODUCTION TO CATTLE OWNERSHIP AND ITS BENEFITS

Federal tax laws favor cattle *if* you pick the right kind and stick to the rules. Herds of beef cows top the list. When you buy them, you become a farmer and can keep your books on the cash basis. You put in dollars that depreciate or are deductible. You take out capital gains.

As in oil exploration, you are better off if you are presently paying high income taxes, say, 60% or better. This makes every ingoing $1.00 cost you 40¢. Unlike oil, you never get a dry hole. Your returning dollars are taxed at only 25% making them worth 75¢.

To take advantage of this favorable atmosphere you might raise your own cattle herds. This creates management headaches, however, and could require lots of your time for supervision. Your best bet is to hire qualified executive managers to run your cattle business for you.

Let's see how this works:

1. *Buying the Cattle.*—Your managers select grade cows and yearlings. "Grade" means they are the normal commercial stock you see around the West and not expensive "registered" show animals. Your cattle may be on two or more ranches, to give you dispersion. These are regular Western cattle ranches and *do not belong to the managers.* You get a bill of sale on the cattle, backed up by a registered brand.

2. *Terms of the Purchase.*—Cash *can* be paid, and it generally earns you a 10% discount. Most buy for a low downpayment (10%), and give their 90% non-recourse note for the balance. If you do this, you are required to prepay your feed bill and the breeding fee one year, as well as the interest on your note.

3. *Manager's Fee.*—Setting up your business and acquiring your cattle is complicated if done properly. An initial fee ranging from 8½% to 5¾% (depending on the number of head purchased) times the gross cost of the cattle is charged. This also entitles you to the ultimate sale of your business without further charge. Year-to-year as you continue to own the business, you also pay a mangement charge again ranging from 8½% to 5¾%, this time computed against the annual operating expense (roughly equal to a real estate agent's fee for managing a building).

4. *An Example (Starting November 15):*

(a) Cost of 400 cows at $225	$90,000
(b) Downpayment (percent)	10
(c) Equity	9,000
(d) Interest on $81,000 note at 7 percent	5,700
(e) Year's feed bill paid at start of contract at $50	20,000
(f) Year's breeding fee paid at start of contract at $8	3,200
(g) Manager's initial fee plus regular management fee at 7½ percent ($6,750 plus $2,170)	8,900
(h) Cash due Nov. 15 to carry for 1 year	46,800

5. *Initial Tax Situation.*—Your herd is an asset and depreciates. Like other personal property, you are entitled (if you file a joint return) to a special 20% depreciation on the first $20,000 of initial purchase. You also get 150% declining balance depreciation. All expenses are deductible when paid. Here's how the above example would work out still assuming November 15th purchase date):

(a) Cash requirement (from above)		$46,800
(b) Expenses paid at start	$37,800	
(c) Depreciation	5,300	
(d) Deductions		43,100
(e) Percent deductible		90

Now, when all this is complete, you will be in the cattle business for as long as you wish to stay. Your managers take care of all the records and physical operation, sending you a steady stream of recommendations and reports including your year end income tax results (Schedule F, Form 1040). When the next November rolls around, your herds on the different ranches are rounded up, counted, and culls (unfit animals) sent to market. Calves are weaned, with steers being sold and heifers retained to grow into cows and build up the herd size. Before sale calves are weighed and the rancher is paid a bonus (usually $10 to $15 per head) if good results were obtained. But, if the operation is below average, he pays *you* a penalty. In other words, you pay only for what you get.

At this point, you have completed one annual cycle running from November to November. *Most* of your expenses (approximately 80%) were paid the previous year at the start of the cattle maintenance contracts. The rest (approximately 20%) are paid as the cattle are rounded up. Now, a second annual cycle begins. Again you (a) pay for feed and breeding fees for the second contract year, (b) pay interest in advance on your note, and (c) pay the management fee. For the second *calendar* year, it would look something like this:

(a) Interest	$4,100
(b) All expenses paid to:	
(1) Settle expiring maintenance contracts	6,400
(2) Prepay new (2d-year) contracts	30,700
(c) Cash outlay for expense	41,200
(d) Proceeds from steer calf sales	19,200
(e) Cash due second Nov. 15 to carry for another year	22,000

Your tax situation for the second calendar year would show net expenses of $22,000 and depreciation of $21,000, for a total of $43,000. However, it is normal to make an amortization payment the second year equal in size to the depreciation. You would actually contribute the principal ($21,000) and money to pay the expenses ($22,000) for a total of $43,000. Against this you would have a matching $43,000 of deductions.

How long do you keep the herd? *As long as it serves a purpose for you.* It is an excellent estate planning device, and some herds are retained indefinitely for that purpose. If you have an unexpected change of heart or circumstances, you can sell at any time with reasonable notice. The minimum holding period to qualify for capital gain is 12 months, but you might have to pay an ordinary tax anyway unless you can convince your IRS agent that you really intended to keep them longer.

Let's say you decided at the end of five years sell your cattle business. You did, but only broke even. What have you accomplished? Something like this:

(a) You sold your herd for $225,000, paid your taxes (capital gain on herd, ordinary on calf crop), came out with			$150,000
(b) You had contributed, *in increments*		$225,000	
(c) Your deductions were	$228,000		
(d) Your tax bracket was (percent)	70		
(e) You had tax savings of		$160,000	
(f) Giving and after-tax cost of			$65,000
(g) For a profit of 130 percent			$85,000

Here are some other things that could have happened:

1. *High market prices.*—You might have had an economic profit as high as 25 percent, making the after-tax profit 200 percent or better.

2. *Low market prices.*—Economically, you might lose up to half of your cash, reducing your after-tax profit to a nominal amount.

3. *Reduced tax bracket.*—Your personal income circumstances may change, making tax shelter less attractive and creating after-tax losses should the cattle market go down.

4. *Changes in field operation.*—Calf production and operating expenses can be higher or lower, affecting the outcome. Over a period of time, however, the averages are reliable.

When you decide to sell your herd, you may do so for cash. You may also sell on installments over a two-year period. You get a 10% premium from the buyer when you accept installments. Herds are generally sold in the Fall. Sales could require up to 90 days to accomplish in full. Purchasers are other individuals and partnerships such as yourself, ranchers, cattle order buyers, etc. Parts of your herd can be sold outright at central markets such as Omaha or Kansas City.

Our company has been handling these cattle businesses as agents and managers for nearly 15 years. We operate on a nationwide basis, and our reputation can be verified by bank inquiry or Dun & Bradstreet reports. You can have a specific program for your examination by calling or writing our Sales Manager at 1808 Main Street in Kansas City, Missouri (A.C. 816; VI 2-6925).

Please Note.—All information furnished above is approximate and has been over-simplified for the purpose of clarity and understanding. While considered reliable, it is subject to change. Interpretation may also be different. Those intending to start a cattle business should first confer with their attorney or accountant.

MESSAGE FROM THE CHAIRMAN OF THE BOARD

In our fiscal year ending 31 January 1969 earnings before income taxes were $683,966 as compared to $269,253 the previous year. After taxes they were $339,227 as compared to $159,180. On the shares outstanding on 31 January the earnings per share were $2.13 before taxes and $1.06 after taxes as compared to $.85 and $.50 the preceding year. Subsequent to the close of the fiscal year but before the printing of this report a 10% stock dividend was issued. In addition, differing from previous years, we diluted our per share earnings with the number of shares set aside for employee options even though such options were neither exercised nor assigned. Adding the 10% dividend shares and 52,470 shares from the unissued stock options we arrive at a figure of $1.78 per share before taxes and $.88 per share after taxes. The comparisons are shown later in this report.

In addition to doubling its after tax earnings despite the new surtax, your Company significantly reoriented its business during fiscal 1969. Increased emphasis is being put on rural land brokerage and development, agricultural consulting, and on feeder cattle transactions over the running of breeding herds on contract. Income derived from rural land brokerage and management increased from $86,000 in 1968 to $551,000 in 1969. As a percentage of total gross revenue the change was from 2% to 20%. Feeder income increased from $94,000 to $286,000 and its percentage of gross from 6% to 11%.

Over the past six months a substantial portion of the time of the executive staff of your Company has been tied up in working with the livestock industry to fight hostile legislation aimed at removing the tax incentives encouraging urban risk capital to invest in American agriculture. The current Treasury proposal on farm taxation, which we think has little chance of passing, would only hurt the breeding herd end of our business, not affecting the deductibility of expenses but increasing the portion of eventual herd sales that would be ordinary income instead of capital gain.

While the breeding herd portion of the business provides a decreasing but still substantial percentage of our total gross revenue, it should be noted that it creates a disproportionately large portion of our gross expenses. Should the unlikely event occur that the present Treasury proposal be passed intact, the adverse effect on our net income might be of modest proportions.

Other major developments during the year: (1) Approximately 150,000 square feet of additional land was acquired in the downtown Kansas City area, much of it adjacent to our existing holdings in the proposed urban renewal area, south of the new Crosstown Freeway, which is nearing completion. (2) An office was opened in Calgary, Canada to line up local feedlots to service our customers. It is believed that relatively lower grain prices in Canada will enable us to provide very competitive contracts. Numerous inquiries have been received from European and Latin American corporations for Canadian cattle. (3) The Oppenheimer-Janss Realty Corporation was set up in Sun Valley, Idaho with your Company having a 45% interest, to specialize in ranch brokerage and agricultural land development in the Idaho, Nevada, and Montana areas. The other principal stockholder is Mr. William Janss, the Chairman of the Board of the Janss Corporation of Los Angeles, California. (4) At the end of the year we obtained the management of a substantial portion of the land and cattle holdings formerly owned by the Kern County Land Company of California.

At the moment discussions are being conducted by various of our clients and several major ranch ownerships on the merger of their holdings into a very large public corporation that will be one of the principal land owning entities in the United States. In the event this should occur, it is believed that your Company will be employed to handle its agricultural and land development affairs.

Senator METCALF. Yesterday in the Sunday Post appeared another ad from the Chateau Briand Ranches, Inc., offering managed breeding herds of purebred Charolais cattle as tax sheltered investment programs exclusively for the high-tax bracket investor. It might be well to have a copy of their current prospectus before the committee to find out what they are doing. Apparently they are not very much afraid of what this committee is going to do as a result of this hearing, because they took quite an ad in yesterday's paper.

Instead of catching the tax-dodge farmer with his hand in the cookie jar by limiting premature deductions each year, the EDA approach lets him put us, that is Uncle Sam, in the position of having to refill an empty cookie jar. Revenue figures provide some insight into the comparative effectiveness of the House bill, the administration proposal and S. 500. My bill would affect about 14,000 individual tax returns, and would raise about an additional $205 million a year from these individuals.

The House bill would affect about 3,000 returns and when fully operative raise an additional $25 million annually. These revenue estimates do not include comparative figures for corporations. I can only imagine the amount by which the gap between the two bills would widen even further. The administration has estimated its fourth of September proposal would apply to 9,300 individuals, and raise $50 million annually. I am puzzled by that revenue estimate, since that was the same estimate used when Treasury officials testified before the House Ways and Means Committee last April.

The April proposal contained a much lower dollar exclusion in its EDA provision. I suggest that this committee ask Secretary Kennedy to explain how he was able to come up with the same revenue estimate earlier this month on substantially higher exclusion figures.

I do not quarrel with the administration's comment on the House bill. On the fourth of September Treasury officials termed the dollar exclusions contained in the tax reform bill so high as to render it ineffective.

Mr. Chairman, I was going to conclude my testimony at this time, but after I read some of the statements that have been or are about to be presented, very graciously given to me by the committee, I have a couple of comments because some of those people are going to testify a little later today.

I do not mind losing a fair fight, but it is inexcusable to find inaccurate descriptions of my bill being presented to this committee at this late date. I refer first to the fifth of September when Assistant Secretary of the Treasury Edwin Cohen appeared before this committee and he was specifically asked by Senator Hartke what was wrong with S. 500.

> Well, suppose, as Senator Gore said a short while ago, there were an actual economic loss of $50,000. Suppose there is an economic loss from tornados, floods, low prices, drought, any number of factors. Why should we disallow a true economic loss to the farmer or should we disallow it in any event at strictly $15,000 a year?

Now that answer completely ignores the specific safeguards in my bill to protect economic agricultural losses. I have already described these in more detail in my full statement. But I find Mr. Cohen's answer somewhat ironic, since it is the Treasury's proposal that fails to distinguish between true economic losses and artificially created ones. The EDA approach looks only to dollar figures, not to the nature of the deduction that generates the loss.

Turning next to today's prepared testimony of the National Livestock Tax Committee, I found at page 47 that under my bill, and I quote:

> Farm loss deductions would be restricted or totally denied to farmers or ranchers who are not on a proper accrual method of accounting and who had nonfarm income in excess of $15,000.
>
> Legitimate farmers or ranchers who earned $30,000 of nonfarm income would have all farm losses disallowed.

Again the fact that my bill applies only to artificial losses is completely ignored. No mention is made of the fact that my bill, and it is the only bill, takes into account a taxpayer's economic agricultural losses.

Next there is the following statement contained on page 10 of the statement of the American Horse Council, and I quote:

> The Metcalf Bill (S. 500) applies to any farmer who does not adopt the accrual method and capitalize all costs which can now be expensed or capitalized at the taxpayer's option. Farmers who do not comply with these conditions would lose their right to offset farm losses against nonfarm income on a dollar-for-dollar basis to the extent that nonfarm income exceeded $15,000. Thus, a farmer having a $30,000 nonfarm income, could deduct no farm losses against his nonfarm income.

Now that statement completely ignores the fact that my bill contains a provision to carry back 3 years and forward 5 years against past or future farm income, the disallowed portion of a farm loss in a given year. So in addition to safeguarding against economic losses, my bill contains safeguards for those just getting into farming by providing them ample time to get their feet on the ground and turn an economic profit.

This provision also safeguards the taxpayer who finds himself in a loss situation in a given year by chance rather than by design, as I have already remarked. The bill does not require anyone to change his method of accounting. Ever since this bill was introduced 2 years ago, the main charge has been it would force the farmer to go into accrual accounting, and even in the statements today there are still charges to that effect.

Mr. Davenport, in the statement he submitted to the committee, points this out very clearly, that the real way to get at this is to remove the cash basis accounting system that has been to the benefit of the ordinary legitimate farmer.

I do not want to do that. I want only to correct abuses that have grown up, and at the same time, continue the cash basis system for the benefit of legitimate farmers and ranchers.

My bill merely provides the tax dodge farmer wit h the option to report his income the way he would in any other kind of business, or be covered by the bill. And by tax dodge farmers, I mean people who do not depend on farming for their livelihood, but depend on it rather as a primary device to reduce taxes on their nonfarm income.

I intend to comment further, of course, on today's statements when I have an opportunity to review the hearing record before this bill is reported.

For example, one witness testifies or implies that if you favor my bill you are opposed to rural electrification, soil conservation, and motherhood. However, to conserve this committee's time, I will discuss the opposition's testimony in further comments on the Senate floor.

As this committee knows, I am concerned with many tax problems, some of which have been discussed today; co-op, capital gains, tax exempt securities, depletion allowance, Mr. Chairman, and others; and I hope that I will have an opportunity to discuss those matters, but this is a matter that I have worked on specially, and I feel that I should present my views to the committee.

Here is a unique opportunity to combine substantial revenue increases with substantial equity and tax justice by restoring healthy and fair competition to our farm economy. The House-passed bill can be amended and reshaped to serve as a meaningful vehicle for equitable and effective reform in this area.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Anderson?

Senator ANDERSON. Some of the objections are from ranch owners who have been involved in this for 50 to 100 years. You are not opposed to them; are you?

Senator METCALF. This bill protects the ranch owner who has been there for 50 to 100 years. The ranch owner who has been in my part of the country since it was settled more than 100 years ago, and his children when they inherit a ranch, have to pay an inheritance tax, for example, on this inflated tax value that has been created by eastern industrialists, Texas oilmen, local bankers, who buy farmland for hobby farming and tax shelter programs.

A legitimate rancher in the State of Montana or the State of New Mexico or anywhere in the West will not be affected by this bill. He will be helped because the price of land will be restored to its productive capacity and he will not have to compete with these tax dodgers who create an artificial loss on their beef or their orange groves or something of that sort, in order to reduce the taxes they would otherwise have to pay on their nonfarm income.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. Would you continue the present capital gains treatment for livestock, or would you repeal that?

Senator METCALF. Now that is a different proposition. With this section I am trying to continue the present capital gains treatment for livestock. When we come to livestock, when we come to the capital gains provision, I feel that maybe when we have a complete reform of it, capital gains would be affected to the regular farmer just the same as everything else, but what I am trying to do here is to say that when we do give the farmer a capital gains treatment, and we allow him a cash basis rather than accrual system of tax accounting, so that when he sells his crop off, whether it is calves or mature steers or something from an orange or citrus grove, he can take his capital gains. What I am trying to do is to keep nonfarmers from abusing that by creating artificial farm losses year after year.

Senator WILLIAMS. Livestock is the only type of farming operation which is subject to capital gains then?

Senator METCALF. No, orchards are.

Senator WILLIAMS. I am speaking of the Montana farming or Delaware farming. I do not think orchards would come in as real estate. They can charge off citrus groves for the land, sure. I was just asking for——

Senator METCALF. The question is without any change in our present structure, such as I have suggested here, should we remove the exception for livestock from recapture of capital gains. I say no. Someone else said in a statement that is filed today, that the way to correct this abuse is to go back to the accrual system for all farming.

I do not want to do that. I feel that the farmer needs this special benefit. The legitimate farmer needs cash basis accounting, but people who abuse these accounting rules by creating artificial farm losses to offset substantial amounts of nonfarm income, do not.

The CHAIRMAN. Senator Gore?

Senator GORE. Are you satisfied with the House bill?

Senator METCALF. No. I have submitted an amendment to the House bill that would replace the EDA provision, so that artificial farm losses over $15,000 could not be used to offset more than that amount of nonfarm income in a given year. That is to take care of the man who is working on a farm and has a part-time job in a town.

Above $15,000 nonfarm income you begin to phase out the otherwise allowable portion of an artificial farm loss on a dollar-for-dollar basis, so that someone with over $30,000 of nonfarm income could not use an artificial farm loss to offset nonfarm income in that year. I am not referring to farm losses that occur as a result of flood or drought or natural occurrences—they are not artificially created farm losses.

Senator GORE. As I listened to your statement, you seemed to place emphasis on economic loss. Would you mind explaining just what you mean by that?

Senator METCALF. Yes. I feel that when a farmer goes in, a livestock operator or any other farmer goes into a business and it costs him so much to grow a crop, raise some 2-year-olds or something of that sort and then sells them at a loss that is an economic loss and that is a legitimate farm loss, and you can take that loss against any other income. If a man had a $100,000 economic loss, he could take the whole amount. But he could not charge an artificial farm loss above $15,000 off against outside income in a given year.

Senator GORE. You confuse me a little about what kind of loss he could charge against income from other sources.

Senator METCALF. He could take the whole amount.

Senator GORE. He could take the whole amount?

Senator METCALF. If he were a broker and had an income let us say of $100,000 a year, if he were an oilman and had depletion allowance income of $100,000, he could charge the loss against the whole income.

Senator GORE. What kind of ——

Senator METCALF. And my bill is unique in that.

Senator GORE. What kind of losses would you deny him?

Senator METCALF. The prospectus of Black Watch Farms provides a splendid example.

I would like to make the prospectus of Black Watch Farms a part of the hearing record, Mr. Chairman, if there is no objection.

(The document referred to follows:)

STATEMENT OF TAX SHELTER

The tax advantages inherent in the cattle industry are unusual when compared with most other industries. For instance, although the life expectancy of purebred cattle is generally well over 10 years, particularly since such animals enjoy the benefits of unusual care, feeding and treatment, the Federal Internal Revenue Service permits depreciation that is based on an 8-year period. Under these circumstances, the entire sum paid for an Angus which is, for instance, 2 years old, may be depreciated for tax purposes in the remaining 6 years, and the sum paid for an Angus at age four may be depreciated in the remaining 4 years. Furthermore, since breeding cattle themselves are considered a capital asset, under certain interpretations, profit realized on their sale is considered long term capital gain.

There is still another tax advantage which is unique to this industry. Based on the cash method of accounting, which Black Watch Farms will adopt, when a calf is born, no capital asset is required to be recorded on the books and only at the time of sale is the required entry made. Therefore the only capital addition to the herd that can be made is through purchase of additional cattle or interests in other cattle and hence no tax is paid until time of sale.

It is the opinion of counsel, for the general partner, that the operations of Black Watch Farms will be taxed as a partnership.

TABLE OF TAX STATUS OF ANTICIPATED PARTNERSHIP DISTRIBUTIONS

Year	Anticipated cash distribution per $10,000 unit	Portion representing ordinary income	Portion representing return of capital	Portion representing term capital gain
1	$450	0	$450	0
2	900	0	0	$900
3	1,375	0	124	1,251
4	1,500	$13	0	1,487
5	1,500	13	0	1,487
6	1,500	13	0	1,487
7	1,500	13	0	1,487
8	1,500	13	0	1,487
9	1,500	13	0	1,487
10	1,500	13	0	1,487

This treatment of distributions for income tax purposes does not change the proportionate interest of each limited partner in the partnership property or in any future cash distributions to the partners. The tax shelter as estimated is subject to review by the Internal Revenue Service and applies only if the presently existing applicable sections of the U.S. Internal Revenue Code and Regulations are not repealed or materially amended.

ADDITIONAL POSSIBLE DISTRIBUTIONS

All income from Black Watch Farms which exceeds the amount necessary to pay distributions to limited partners at the rate of 15 percent per annum return on their investment capital, will be distributed in the ratio of 50 percent to the limited partners and 50 percent to the general partners.

Senator Metcalf. The kind of loss is where Oppenheimer Industries, and I guess this outfit that advertises in the Washington Post, gets someone to invest in a farm, and he pays an advance fee and converts taxes at ordinary income rates into eventual capital-gain rates. He does not sell his yearlings the first year; he sells them the second year, and he takes a loss, and he charges that off against his outside income, and charges fencing. Mr. Stevens charged an airstrip out in Montana and took a farm loss. Things of that sort have distorted the price of the——

Senator Gore. As I understand it then, you are suggesting that——

Senator Metcalf. In my prepared statement I have said that these artificial losses arise from deductions taken because of capital costs or inventory costs and represent an investment in farm assets rather than an amount actually lost. Usually the investment is ultimately sold as cattle are sold later, and taxed only at capital gains rates. Both the administration, the House, and I recognize the same problem. They approach it from the EDA account, but I approach it on an annual basis by limiting the amount of artificial losses that can be used to offset nonfarm income.

Senator GORE. Thank you, Senator.

I note you have given a great deal of study to this problem, and you have been a member of this committee, also a member of the House Ways and Means Committee, so you have had a great deal of experience. I am trying to discover the precise problem covered by your amendment.

As I understand the example you have given, you would deny to a man who purchases a horse or a cow or a sheep dog or any other four-footed animal the privilege of depreciating his investment. Is this correct?

Senator METCALF. No; that is not correct. Farm accounting grew up before we even had capital gains.

Senator GORE. I was asking you first about depreciation.

Senator METCALF. Let me tell you. So we said to the farmer, "Look, we are going to allow you to use the cash basis, and when you sell a flock of sheep or a herd of steers or something, you report your income, and we are not going to make you say I grew some here and I had a certain inventory this year and then I have to carry that over to next year," and so forth.

Then along came capital gains.

Senator GORE. Let me understand your problem. You say that the Congress provided that a farmer (to put it in farmers' language if I may) does not have income until he sells his pig or his calf or his horse; is that correct?

Senator METCALF. Yes. They said he did not have to keep an inventory from year to year like a man in a store, an industrialist.

Senator GORE. Do you wish to change that?

Senator METCALF. No, sir. I wish to keep that. That is just exactly what I wish to keep.

Senator GORE. Then you would apply that to all farmers?

Senator METCALF. All farmers. Everybody has the same privilege. I do not change that provision of the law. I think it grew up and it grew up well, and I am in favor of it.

Senator GORE. Then I do not quite get your point that——

Senator METCALF. If he takes a loss in 1 year or 2 years or 4 years, and takes a consistent loss——

Senator GORE. What kind of a loss?

Senator METCALF. He says, "Well, I did not sell my cattle," or he only sells part of them, or he lets them stay in. He continues to feed them.

Senator GORE. You would say to one farmer that he does not have an income until he sells it, but you say to the other that he does?

Senator METCALF. They all have an income when they sell it; but when they have outside income, and they take artificial losses, they cannot charge that artificial loss against their outside income. Now here are two farmers. One makes $50,000 a year from outside activities, and one has to live on the productive capacity of his farm. One has a tremendous competitive——

Senator GORE. That outside income does not necessarily have to be earned income; does it?

Senator METCALF. No.

Senator GORE. He could draw that from oil.

Senator METCALF. Dividends, oil wells, but under my bill, he cannot charge artificial farm losses off against it.

Senator GORE. Thank you. My time is up.

The CHAIRMAN. Senator Curtis?

Senator CURTIS. Senator, you referred to economic losses and artificial losses? What is an artificial loss?

Senator METCALF. An artificial loss is a loss that arises from deductions taken because of capital costs or inventory costs and thus usually represent an investment in farm assets rather than amounts actually lost. Usually the investment is sold and taxed only at lower capital gains rates. This is the technique—because of this special bookkeeping privilege that we lend farmers, the technique of the tax-dodge farmer is to convert ordinary income rates into capital gains rates.

Senator CURTIS. Soil and water conservation practices can be treated as a business expense under existing law. Do they fall under your definition of an artificial loss?

Senator METCALF. Some of them would fall under my definition.

Senator CURTIS. Some of them?

Senator METCALF. Some of them would fall under my definition of an artificial loss, if year after year soil conservation practices such as fencing, fertilizing and so forth, amounted to a reported agricultural loss on the farm that is charged off against outside income, and then at the end of the year, or the end of the period, they come in here and sell, get all that money back, but they pay capital gains of 25 percent instead of ordinary income rates of let's say 60 percent on that same income.

Senator CURTIS. Would you apply this across the board to everybody or just single out farmers.

Senator METCALF. No, the farmer has been singled out.

Senator CURTIS. No, no, he has.

Senator METCALF. I beg to differ with you, Senator. My proposal does not attack the legitimate farmer.

Senator CURTIS. Well, now, here. Do you propose that if someone owns a newspaper and runs it year after year at a loss that that be denied offsetting that loss against other income?

Senator METCALF. The newspaperman does not have the special tax accounting benefits that the farmer gets.

Senator CURTIS. Do you propose that if a newspaper is operated with no intention of making a profit by someone who has other income that the loss be denied?

Senator METCALF. When someone elects the special farm accounting system of the cash basis, which is only given to farmers, then I say that the farmer, the legitimate farmer, should be the only one that should have that benefit.

Senator Curtis. Does your bill call for denying the loss to a restaurant or a tearoom in a department store that is run year after year at intended loss, denying that loss to the department store against its other income?

Senator METCALF. My bill does not touch that.

Senator CURTIS. That is what I say. Your bill is the only bill——

Senator METCALF. There isn't any analogy Senator.

Senator CURTIS. Oh, yes, there is. Across the board in our economic life losses in one activity are offset against income in another activity, and the Treasury or no one else has come up with a proposal that affects anybody in this respect.

That is all, Mr. Chairman.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. Mr. Chairman, Senator Metcalf, it is a pleasure indeed to welcome you back as a former member of this committee before us today. This morning a leading cattleman of my State came in the office. He is completely and utterly self-made. He started with nothing. He is one of the better Hereford breeders of the country. He happens to be incorporated at the present time. Last year I believe he had a three hundred thousand-odd dollar loss. How would your amendment affect that?

Senator METCALF. Is that loss to be charged off against outside income?

Senator TALMADGE. He is incorporated. He has no other income in the corporation except his farm operations.

Senator METCALF. It would not touch him.

Senator TALMADGE. Would not affect him at all?

Senator METCALF. Would not affect him at all.

Senator TALMADGE. Suppose he were not incorporated, would it affect him if he had no outside income?

Senator METCALF. No.

Senator TALMADGE. In other words, your amendment comes into play only if there is outside income involved?

Senator METCALF. Yes, sir. My amendment comes into play only if there is outside income of more than $15,000 offset by artificial agricultural losses.

Senator TALMADGE. And then what happens if he operates his farm at a loss for say 5 or 6 years? What happens to his farm situation at that time?

Senator METCALF. In which case, when he has outside income?

Senator TALMADGE. Yes. Say he has the $15,000 outside income, and maybe the price of cattle is quite cheap. You know, it has gone down from something like 35 cents to about 28 cents for prime steers in the last 6 or 8 months, so if the price stays down, he could lose money on his farming operation for several years. Would his farm loss, would he utilize that in any way in the future, or would he have to just take it as a permanent loss?

Senator METCALF. I tried to draw the bill and I think it does contain the provision that there is no penalty on a recognized loss, an unanticipated loss. Moreover, the disallowed portion of an artificial loss can be brought forward 5 years or back 3 years to offset past or future farm income.

Now if he has nonfarm income of between $15,000 to $30,000, he can offset artificial farm losses at a decreasing rate, because it is phased out. But if he has income, outside income of over $30,000 a year, we just say he is not in the legitimate farming business so he cannot charge any portion of an artificial loss off. A loss that occurs from drought or something of that sort, can be charged off against any amount of nonfarm income because something of that sort is not an artificial loss.

Senator TALMADGE. I think I know what you are trying to do, Senator Metcalf, and I applaud your efforts to eliminate these farm gimmicks. For instance there is the ad that you read in your testimony-in-chief, "Buy some cattle and lose some money and save yourself some taxes." I think everyone wants to eliminate that. But wouldn't you accomplish the same result by the depreciation features that are in the House bill, and its recapture provisions?

Senator METCALF. No.

Senator TALMADGE. Why wouldn't you?

Senator METCALF. I feel that the House bill features, regarding depreciation recapture and the holding period of livestock, in the first place will not remove the incentive from the very people that you are talking about, that we are trying to prevent from abusing a legitimate farm activity.

Senator TALMADGE. Let me see if I follow you. In the first place, they cannot depreciate the cattle unless they have held them one year from the time they should have been brought into service. Now normal breeding time of a heifer is certainly not earlier than 15 months, sometimes 18 months, and occasionally 2 years, so if they bought a heifer, say, that was 2 years old, they would have to hold that heifer for a year before they could sell her and take depreciation. When they took depreciation and sold the heifer, as I understand it, there would be a recapture provision in the House bill where they would make no profit whatever on the depreciation. Is that not correct?

Senator METCALF. Well, of course several other things enter into it. There is a tax-free loan as far as that amount of tax forgone is concerned. May I have your permission to read out of my full statement what Mr. Oppenheimer, who is the known expert on this, says about that very situation?

Senator TALMADGE. Certainly.

Senator METCALF. Elimination of the exception for livestock from the depreciation recapture rules was analyzed in detail several years ago by the president of Oppenheimer Industries, Gen. Harold L. Oppenheimer. He has authored three books for the cattle industry, "Cowboy Arithmetic," "Cowboy Economics," and "Cowboy Litigation." He said that:

> Members of Congress and officials of both the old and the new administrations have suggested that where accelerated depreciation is taken on any subsequent sale, the portion of the capital gain which represents the recovery of previously taken depreciation should be treated as ordinary income. This is essentially the system now used in Canada.
>
> This piece of legislation is undoubtedly going to get passed within the next year or so, although it was deleted by the House Ways and Means Committee from the 1964 tax bill. However, as far as breeding herds are concerned, this is a matter of relatively little significance.
>
> During the first two years of a purchased breeding herd the culls sold from the herd on a capital gains basis are very unlikely to exceed the depreciated value by more than a few hundred dollars. During the third and fourth years, this could be a matter of some importance in the sale of culls, but without an appreciable percentage effect on the overall picture. During the fifth year, most of the animals with an original capital base will have been sold and the herd will consist almost entirely of animals born to it at no cost basis, so the effect this legislation would achieve would then be zero.

Senator Talmadge. It seems to me though if you recapture depreciation, you would take the gimmick out of the tax dodge and thereby solve the problem.

Senator Metcalf. It still gives the tax-dodge farmers, this big operator that you and I are talking about, and that I am trying to eliminate, it still leaves him with the opportunity to determine when his artificial losses are going to be, and when he is going to use artificial losses against nonfarm income.

Senator Talmadge. Thank you, Senator. My time has expired. I appreciate very much your comments on this.

Senator Anderson. Senator Miller?

Senator Miller. Senator, you and I share a common objective in this area. As a background I would guess that what motivated both of us was the realization that the farm economy is at the bottom end of the economy. If the farm economy was sharing, the farm industry was sharing—fairly with segments of other industries I do not imagine we would be as concerned as we are, isn't that so?

Senator Metcalf. That is right. We need every bit of incentive to help the farmer.

Senator Miller. That is right, and there are two thrusts of your comments. One is that this so-called artificial farm loss deal results in increased real estate prices which aggravate farmers from the standpoint of property taxes and the like, and the other is that they have unfair competition when a farm loss writeoff taxpayer does not have to worry so much about the prices he receives because after all Uncle Sam is going to pick up 70 percent of the loss, or 70 percent of the reduced price, whereas the farmer who has to make it on his own is going to have to keep on fighting for the price, isn't that so?

Senator Metcalf. That is right. That is the most important impact of the legislation.

Senator Miller. That is what you are talking about, that this constitutes unfair competition. Now you did state, I believe, that the provision in your bill to recognize losses if they consist of losses attributable to drought and hardship and things of that nature is a unique feature of your bill, or that your bill is unique on that point?

Senator Metcalf. I did not compare it to your bill. I compared it to the administration bill and the House bill.

Senator Miller. Because as you know both——

Senator Metcalf. Because your bill does, yes.

Senator Miller. Do I understand that this 3-year carryback and 5-year carryover disallowed losses, that is, those that exceed $15,000, is to be applied against farm income only?

Senator Metcalf. Yes.

Senator Miller. Because, as I understand it, that was available against ordinary income. Suppose a farmer had $100,000 of wages or salary, and he had a farm loss of $25,000. He would be allowed to take $15,000 off that, against the $100,000, but the $10,000 that was not allowed could be carried over to apply against another year's $100,000 of outside income, is that correct?

Senator Metcalf. I do not think so. I am not quite sure. In the first place, if he had $100,000 outside income, the phaseout——

Senator Miller. And a loss of $25,000.

Senator METCALF. The phaseout provision would come into operation.

Senator MILLER. Well, let us just take 1968. He had $100,000 of outside income and $25,000 loss?

Senator METCALF. Yes.

Senator MILLER. He would be allowed to take off $15,000 against the $100,000?

Mr. KOPLAN. That would depend on the nature of the deduction that gave rise to the farm loss.

Senator MILLER. I am talking about the deductions that are not recognized in this case. I am not talking about drought losses or anything. I am just talking about ordinary farm loss. He does not sell off his inventory. He just went into the whole $15,000 expenses over income, I mean $25,000 of expenses over income. Now as I understand it, you will say to him $15,000 is OK but the other $10,000 is not OK, but you can carry it over, or carry it back?

Senator METCALF. There is carryback carryforward.

Senator MILLER. Now, my question is what do you do with it when you carry it back?

Senator METCALF. You use it against past and future farm income only.

Senator MILLER. And not against the $100,000 of salary. Let us just take the carryover to 1969 to keep it simple. In 1969 he had $100,000 of outside income, and his farm income was zero. He just broke even. what happens to that $10,000 that was carried over?

Senator METCALF. Nothing.

Mr. KOPLAN. It would still be carried forward again.

Senator MILLER. Until he had——

Mr. KOPLAN. But that is because the type of deduction or loss that is carried back or carried forward is only the artificial deduction or the artificial loss that we are talking about.

In other words, your casualty and your drought, your taxes and interest or your recognized losses on the sale or exchange of farm property, they do not get thrown into the carry-back, carry-forward provision. You are allowed to use them to the full extent against nonfarm income regardless of the amount of nonfarm income that you have.

Senator METCALF. But his question—if your question had $25,000 drought loss, he would take the whole $25,000.

Senator MILLER. I do not want to mix those side things in.

Senator METCALF. Then the answer is on next year it is no.

Senator MILLER. Where he has $25,000, you say we recognize $15,000 of that. There is an example, $15,000. So he can write the $15,000 off against his $100,000 salary, right? What is the $15,000 limit that you are talking about?

Senator METCALF. Then, of course, the phaseout provision from $15,000 to $30,000 would also come into effect in the example that you have given.

Senator MILLER. Let us just take one year, and he has got $25,000 of farm losses, his wages and his seed and all that, property taxes and interest?

Senator METCALF. He can only carry it forward or carry it back against farm income.

Senator MILLER. All right, but in that one year in which it was incurred, as I understand it, you say he can take $15,000 against nonfarm income?

Mr. KOPLAN. That is right, unless his nonfarm income is in excess of $30,000. When his nonfarm income is between $15,000 and $30,000, the Senator's bill has, as he has already described, a phaseout provision, so for every dollar of nonfarm income above $15,000 you subtract a dollar of what would otherwise be the allowable $15,000 artificial loss, so a fellow with nonfarm income above $30,000 with $15,000 of artificial losses in a given year would not be able to take any of those artificial losses in that year.

He would have to carry them back first and then forward against past and future farm income.

Senator MILLER. But up to $30,000 he could offset against nonfarm income?

Senator METCALF. But it would be phased out again, you know, the first dollar above $15,000 of nonfarm income.

Senator MILLER. But on the carryover there is no capability of offsetting this carryover loss again nonfarm income?

Senator METCALF. That is right.

Senator MILLER. You mentioned this. Do I understand that your bill exempts accrual basis farmers from its impact?

Senator METCALF. Yes, sir.

Senator MILLER. I have two questions on that. The first is wouldn't this have a tendency to encourage farmers to switch from the cash basis to the accrual basis to protect themselves against disallowance of farm losses?

Senator METCALF. A farmer that had no outside income would never have to be forced to change from one basis to another. It is only the tax-dodge farmer who has outside income of over $30,000 that might choose to go into the accrual basis or to the accrual reporting system in which case, of course, he could take all his losses and take his deductions just as in the example given by the Senator from Nebraska.

Senator MILLER. All right. Now, the second question is this. If you are going to exempt the accrual basis farmer, are you going to or don't you recognize that you have different methods of evaluating your inventory in the accrual basis of accounting, and if you are trying to put a stop to the conversion of ordinary losses into capital gain, you are not going to plug up the loophole very much with respect to the inventory valuation on a unit livestock basis. Now if you are going to have the farmer value his livestock on a fair market value basis, then you do not have a problem, but if he values it on the unit livestock price basis, all he has to do is to set unit values at an arbitrary, very low figure, and to that extent he will incur losses, and to that extent he is going to convert ordinary losses into capital gain. Now do you have any idea of how we can handle that problem, or could we cover it by exempting the accrual basis farmer who does not use the unit livestock price basis? Would that be your thought?

Senator METCALF. I did not have any thought. You just brought up a new subject. My problem is as you have outlined it, the problem that you and I are trying to reach is the fact that the farmer has been allowed a special accounting system, that system is being abused by tax-dodge farmers who create artificial farm losses to reduce the taxes they would otherwise have to pay on their nonfarm income.

Senator MILLER. We have the same objectives.

Senator METCALF. And you brought up a question that perhaps is not covered in here.

Senator MILLER. I do not want to belabor the question.

My time is up. But would you be good enough to give us a suggestion for the record on how to cover that problem?

Senator METCALF. I certainly shall. I will look at it.

Senator MILLER. Thank you very much for your testimony. I might say that you and I share a very common objective on this, and I applaud your position.

Senator METCALF. Thank you very much.

(Pursuant to the above discussion the following information was received by the committee:)

U.S. SENATE,
Washington, D.C. October 2, 1969.

Hon. RUSSELL B. LONG
Chairman, Senate Finance, Committee
Senate Office Building,
Washington, D.C.

DEAR CHAIRMAN LONG: When I testified before your Committee on September 22 in behalf of my tax-dodge farming amendment to H.R. 13270, I was asked by Senator Miller whether an accrual basis farmer using the unit livestock method could still create artificial farm losses by setting his unit values "at an arbitrary, very low figure . . ."

The unit-livestock-price method was incorporated in December 1944 into the regulations in order to obviate some of the difficulties encountered by livestock raisers in determining the price of their livestock. It is applicable only to livestock raised and to livestock purchased before maturity and raised to maturity. (Livestock purchased after maturity is to be included in inventory at cost when the unit-livestock method is used. However, draft, breeding or dairy animals purchased after maturity can, at the election of the livestock raiser, be either included in inventory or treated as depreciable capital assets.)

Under this method, the livestock is to be grouped by the raiser according to class and age. Thus, a cattle raiser might have separate classes of calves, steers, heifers and cows, and might have further classification into those for resale, those for breeding, and those kept for dairy purposes. He must divide these into age groups for calves, yearling steers, two-year-old steers, yearling heifers, two-year-old heifers, and mature animals. The selected unit livestock price figure for each class should represent the estimated average cost of raising the animal during the first year. At the close of the following year, the estimated cost of raising the animal for that year is added to the original unit livestock price. At the end of the next year, a further addition is made, until after three years, a flat sum for livestock of a particular class is arrived at and this price remains constant.

The fact that once established, the unit prices and classifications selected by the taxpayer cannot be changed without the approval of the Commissioner, could possibly result in a premature deduction of costs when costs are rising. In order to assure proper recognition of price increases, I would suggest that a provision be added to my bill that would enable the Secretary of the Treasury or his delegate in conjunction with the Department of Agriculture and local officials, to conduct an annual review of the propriety of existing estimated average costs.

I request that this letter appear in the hearing record at the conclusion of my testimony.

Very truly yours,

LEE METCALF.

Senator ANDERSON. Senator Harris?

Senator HARRIS. Senator, I, you know, share your desire to get at these people who arrange purposely for a farm loss in order to charge it against nonfarm income. Do you have any way to know what percentage of farm and ranch land is under their control or what percentage of the cattle market say these kind of people represent?

Senator METCALF. I do not know. I do not have that information. I have been informed by the staff of the Joint Committee on Internal Revenue Taxation that my bill would affect less than 2 percent of the taxable individual income tax returns reporting a net loss from farming. I base it on the available statistics of returns of individuals with nonfarm income rather than the amount of land that each person has.

Senator HARRIS. I know that you also are worried as I am that in the process we not hurt the legitimate farmer and rancher, and it has been said that with that amount involved, you are not talking about very much recaptured revenue, but perhaps a lot of extra accounting and other problems, tax problems for those who are legitimately in this business. How would you respond to that?

Senator METCALF. We are not touching those who are legitimately in this business. In fact, as the Senator from Iowa has indicated, the people that are legitimately in this business are suffering from higher taxes and greater adjacent land values as a result of distorted land prices, and are suffering from the unfair competition of people who can turn outside income coupled with artificial farm losses year after year into a tax profit, and so the other 98 percent of the farm returns that we are talking about are going to be benefited by this bill.

I said I think that my bill would affect 14,000 individual tax returns and bring in $205 million. I would hope that eventually my bill, Senator Miller's approach or something of that sort would result in having no tax revenue, because we would remove this distortion, and this kind of competition, from our farmers, and our livestock men.

Senator HARRIS. That is all I have.

The CHAIRMAN. Senator Jordan?

Senator JORDAN. Senator, I just have a very simple question, and I will relate an exact circumstance I am familiar with. A cattle rancher, you and I know can grow a catch crop every year, and it takes possibly 80 years to grow a crop of trees, but suppose that this cattle rancher once in 80 years sells the stumpage on his ranch for a capital gain. Can he offset the losses of his cattle operation against that capital gain?

Senator METCALF. I think both Senator Miller and I have exempted that type of income, timber and such sold off the land.

Senator JORDAN. All right. Now assume that the $100,000 of timber income is from a tract of land adjacent to the cattle operation but not used in connection with it?

Senator METCALF. No. If it is not used in connection with a farming operation, for instance, if the adjacent land had an oil well on it, and the income from the oil well, that would be nonfarm income.

Senator JORDAN. So in the one instance if the timber is cut, harvested on the land, it is used with the cattle operation, it is——

Senator METCALF. We specifically have taken care of that.

Senator JORDAN. But if it is adjacent to it, if it is over the fence, timberland upon which no cattle graze, you would not grant that exemption?

Senator METCALF. A lumber yard or, something of that sort, we do not grant it. That would be nonfarm income.

Senator JORDAN. Thank you.

The CHAIRMAN. Senator Fannin?

Senator FANNIN. Mr. Chairman, I have just two questions.

Senator Metcalf, I agree with your objective of protecting legitimate farmers, but I am just wondering how you determine who are legitimate farmers. According to your testimony this morning, I would think that when a farmer becomes successful and wants to diversify his investments, then he becomes illegitimate.

Senator METCALF. Golly, in Arizona and Montana you call a farmer illegitimate and you get into a shooting match.

Senator FANNIN. I don't know how else to say it. You say legitimate, but I am concerned because I am thinking of Arizona. I don't know about Montana, but we have farmers that over a period of years, their family and all, become successful and they certainly are entitled to diversify their investments.

Senator METCALF. But those successful farmers are the farmers that make a profit on their farm, year in and year out. They are not these men who take big artificial farm losses and try to offset them with outside income.

Senator FANNIN. I disagree with you on that. I think that we can prove that you are wrong in that respect as far as the risk involved in our State. I know you are covering drought and things of that nature, but you are not covering farming prices, you are not covering many of the problems that occur.

You, for instance, say that an airstrip is wrong; to have an airstrip.

Senator METCALF. I say that it is wrong to take some outside income from a Texas oil firm and build an industrial type fence and put "no trespassing" and "no hunting" every 200 yards around a 200,000 acre farm——

Senator FANNIN. But that isn't what you said. You were referring to an airstrip.

Senator METCALF. I referred to an airstrip that J. P. Stevens, the former Secretary of the Army, built on a farm in Montana, and he uses it for weekend recreation for people from his area, and he charges off artificial farm deductions, and I doubt if he has enough herefords on that farm to have a barbecue.

Senator FANNIN. Isn't that an exception? Senator, you are talking about covering all of the livestock people or the ranchers just because of one exception. There are exceptions.

Senator METCALF. No; 14,000 individual tax returns are what I am going to cover. Comparable statistics for corporations are not available.

Senator FANNIN. Wait a minute, you are talking about an airstrip. It is highly essential in my State to have an airstrip on a farm or to have it in a livestock operation.

Senator METCALF. I know wheat farmers, I know livestock operators, I know sheep farmers in my State that have built airstrips, but they don't build them because they are bankers or brokers who have outside income and went in and bought that farm so that they could have tax losses that they could use to reduce taxes they would otherwise have to pay at ordinary income rates.

Senator FANNIN. What I am concerned about, do you know of any other businesses that are being legislated against on the basis of your bill except these?

Senator METCALF. I don't know any other business, and this is what I told Senator Curtis, that has this special accounting advantage, and the only reason that I am trying to put this legislation in is because this accounting advantage that farmers have had, and I want them to keep, and they deserve, is being abused by people who are not legitimate farmers.

Senator FANNIN. But the thing about it, you are saying that as soon as a man becomes successful, then he is in trouble.

Senator METCALF. That is not right. What I am saying is when a man goes out and gets himself an oil well or makes himself $100,000 income, or is a downtown banker, and then goes out and pays twice as much as the productivity of the farm concerned, and takes artificial farm tax losses in order to offset his nonfarm income and by doing that changes his income tax bracket from 60 percent a year to at the most 25 percent, we should keep him out of the farming business.

Senator FANNIN. I am not arguing with you about your objectives. I am arguing with you about what you achieve and the effect it has on our livestock and farm economy.

Senator METCALF. The effect it will have on the livestock and the farm economy will be to restore the livestock and farm economy to the legitimate livestock operator.

Senator FANNIN. I can't understand your analogy there. It just doesn't apply to successful livestock, people who are successful farmers, because you would penalize them the same as you would somebody where you give an isolated example.

Senator METCALF. Successful livestock operators and successful farmers don't suffer tax losses year after year after year.

Senator FANNIN. When you say year after year, they don't have to before your bill would apply, it doesn't have to year after year after year after year.

Senator METCALF. They do. My bill doesn't affect an economic farm loss no matter what the income off the farm is. One of the men on the Ways and Means Committee asked me the same question. He said:

"This bill won't apply to my farm because I make a profit on my farm."

And as Stanley Surrey said when he testified a couple of years ago, he said it is a strange situation that the best businessmen in America, the highest paid lawyers in America, the best brokers in America, the minute they go into farming they lose more money than anybody else, and these are the kinds of men that it would apply to.

Senator FANNIN. I think that you are taking some examples that are, I don't say completely isolated, but I would just compare it in my own State as to what is actually happening. I think that is what we have to do. We have to consider what is happening. What exists in our States. And I don't know about Montana, but I certainly do know about Arizona, and I think this bill would be disastrous to my State, because you would be taking one group and legislating against them.

Senator METCALF. We have one group, and that is the farmer, and we have given him a preferred accounting system. We have already done that. And I want to continue to do that, but as a result of that preferred accounting system, Senator, we have abuses by other people coming in and using that to reduce taxes at ordinary income rates, and that is what I want to stop, and I think my bill, next Senator Miller's bill, next the administration bill, and last the House bill will help accomplish that.

Senator FANNIN. Of course, when you say what you are trying to accomplish, it is what is actually happening that I am concerned about.

Senator METCALF. I am telling you what is actually happening.

Senator FANNIN. If your bill is approved, I am thinking about the consequences.

My time is up but I certainly cannot follow your conclusions.

The Chairman. Senator Byrd.

Senator BYRD. Senator Metcalf—thank you, Mr. Chairman—a Virginia citizen came to my office and brought me his income tax returns, and asked me to take off some figures and then to put a question to you. I think he would qualify under your definition of being a legitimate farmer in that in 19 of the past 22 years he has made a profit. He lost money 3 years. Now as he did well in the farming business, he made investments, and he now has an outside income, and the outside income, while it varies from year to year, to simplify the matter I will just put it at $50,000.

Now in 1961 he had a net income from his farming operations of $30,000, and he added that to his 50 and paid a tax on $80,000. In 1962 he had an income from his farming operations of $12,000. In 1963 he had a net income from his farming operations of $15,000. In 1964 he had an income from his farming operations of $9,000.

In 1965 conditions were excellent and he had an income from his farming operations of $41,000. In each case, of course, he added that to his $50,000 of nonfarm income and paid a tax on the total.

Now we come to 1966, and this is the point that particularly interested him. As a result of a combination of factors, general marketing conditions, general weather conditions, the weather was too cold when it should have been cool and was too hot when it should have been warm, and a combination of factors, as a result of that he lost $60,000 in 1966.

Now, under your proposal, what would happen to that $60,000?

Senator METCALF. I think under $60,000, he could go back 3 years, and take it off. In 1963, 1964, and 1965 he had farm income in total of $65,000. He could charge it off against his farm profits and take it off, or if he didn't have enough 3 years back, and the next year he made say $15,000, he could go forward.

Senator BYRD. How would he pay a tax in 1966. He had outside income of $50,000 but lost $60,000 on his farming operation. What could he do then?

Mr. KOPLAN. Senator, from the way you described the deductions that generated that loss in 1966, they would seem to fall into the category of special deductions in the Senator's bill, and if that is so, then he could take the higher figure, either the $60,000 against his nonfarm income in that same year, because the way I understood you describe those deductions, they appear to be actual economic agricultural losses in 1966.

Senator BYRD. With marketing conditions being the number one.

Mr. KOPLAN. Well, if these are recognized losses on the sale or exchange of farm property and what have you, he could take all of it in that year and he won't even have to carry-back or carry forward.

Senator BYRD. In other words, your bill takes into consideration the general marketing conditions?

Mr. KOPLAN. Assuming that he has a recognized loss on the sale of his farm property. I mean like a piece of stock, nothing happens until you sell the stock.

Senator BYRD. This has nothing to do with capital gains at all. It is a general income.

Mr. KOPLAN. Right.

Senator BYRD. From general farming operations.

Mr. KOPLAN. Right.

Senator BYRD. There is no change of equity.

Mr. KOPLAN. Under the facts as you have described, I believe that he would be able to take it all off in 1966 against his—if it is not in the special deduction category, and the breakdown of that category is specifically listed in the bill, taxes, interest and what have you, when you add it all up if it is not in that category then he has the opportunity to carry-back and forward, but you raise a point. There is a provision in the bill that says that if you are reporting your income the way you would in any other kind of business, then the bill doesn't apply to you. That particular provision is in there as a relief measure, for the fellow who isn't satisfied with all of the safeguards that are in the bill, for example, he is not satisfied with the fact that there is a category for special deductions and if they add up to a higher figure he could take it all off, he is not satisfied with the fact that there is a carry back-carry forward provision in the bill, he is the one that Senator Metcalf describes as the tax dodge farmer, and that fellow is given this relief measure in the bill to either report his income the way he would in any other kind of business, rather than have the bill apply to him because he creates premature deductions at a time when there is no offsetting income.

Senator BYRD. Did I understand you to say though that your bill takes into consideration the general marketing conditions? If the price of hogs is 35 cents in one year and it drops to 21 cents the next year, then that is a special exemption is it?

Mr. KOPLAN. If he sells at 21 cents in that year, yes, because if those hogs cost him more than 21 cents that is a recognized loss on the sale of those hogs.

Senator METCALF. But when I first responded to your question, Senator, I am not sure when you say well, he saved his money and so he had an $80,000 income, $30,000 of which was from farming, and then he had $12,000, and you didn't tell me how much it was——

Senator BYRD. Just assume the outside to be 50.

Senator METCALF. Yes.

Senator BYRD. For the purposes of simplicity.

Senator METCALF. Well, just as again with the store with the teahouse that takes a loss, if he is on the accrual system and he pays taxes on the whole unit, he is in a different situation than if he is on the cash basis that we have especially allowed the farmer. So if he just lumps his whole income, outside income and farm income together, and uses inventories and so forth, he takes his losses every year. He is not affected by this legislation. That is what Senator Miller was pointing out, that we have excepted the accrual farm.

Senator BYRD. Assuming he is a legitimate farmer under the definition of a legitimate farmer, he makes money 19 years out of 22, he is a fairly good farmer if he can do that, not many I guess can do that, then he operates his farm the same as any other farmer operates his farm.

He calculates his earnings or his losses the same as any other farmer does, and then when he determines how much he earns on that farm operation, he adds that to his outside income. That doesn't put him on an accrual basis.

Senator METCALF. It does not. Then the response that we gave you, both Mr. Koplan and I, would be correct.

Senator BYRD. Thank you very much, Senator. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Hansen.

Senator HANSEN. Thank you, Mr. Chairman.

I am very pleased to welcome my colleague from Montana here this morning. I served with him on a few other occasions, and I have great respect for him.

I want to clarify, if I can, Senator Metcalf, the concerns that have prompted your introducing the amendment that you have proposed. I understand that there are roughly around 3 million taxpayers in the farming business who report annually, and this figure has remained fairly constant. Does this check with the figures you get? And I understand from your testimony, your bill would affect about 14,000 individual tax returns and would raise an additional $205 million a year in tax revenue. Is that right?

Senator METCALF. According to the estimate that the staff of the Joint Committee on Internal Revenue Taxation have given me.

Senator HANSEN. Oh, I see.

Senator METCALF. It is from the Joint Committee.

Senator HANSEN. Do you agree with that?

Senator METCALF. I don't have any reason to disagree with it.

Senator HANSEN. What is the major purpose that you seek in proposing your amendment? Are you thinking about tax reform and tax relief?

Senator METCALF. I am thinking about tax equity.

Senator HANSEN. Tax equity.

Senator METCALF. And removal of unfair competition from the livestock and the farming industry, and removal of a serious distortion of farm prices which causes increased taxes and so forth of legitimate farmers above and beyond the productive capacity of those farms and ranches.

Senator HANSEN. You say a serious distortion of farm prices. Are you implying that the presence of this unfair competition has driven farm prices down?

Senator METCALF. No. It has driven the price of land in and around productive farms above the productive capacity of such a farm, so that if a young farmer, for example, wants to expand his farm, he has to pay sometimes twice as much for the land as it can produce, and so he can't go to a bank or an insurance company and say "Look, I would like to get a couple sections of land over here." He says, "Well, that land sold the other day to so and so from Texas, and how much am I going to have to pay for it?"

The banker says "Well, you will have to pay about the same amount per acre."

The young farmer says "I can't produce that. I can't make a profit on that basis on that land." And then it is completely distorted. Then the tax assessor comes through and says "Look, this land sold here, this land sold there, we will have to double your tax." And so a serious distortion of land values results.

Senator HANSEN. When you speak of a serious distortion of land values, I guess you are aware, if my arithmetic is correct, that if this bill would affect some 14,000 individuals, out of around 3 million, this would be about one out of every 214 persons.

Senator METCALF. Your arithmetic I know is better than mine, so if you have made the computation, that is right.

Senator HANSEN. Wouldn't guarantee it, but as I figure it, it comes to about one out of every 214. Now I can share your concern over the young man who would like to get into the ranching business. Obviously he would like to get into a profitable business just as cheaply as he could having in mind the least amount of necessary capital outlay. What would be the attitude of the other 213 persons in the business? Do you think they would like to see their land increase or decrease in value?

Senator METCALF. Legitimate farmers trying to keep their farming business productive want to keep this distortion of land value out of the farm economy.

Senator HANSEN. How did you find that out?

Senator METCALF. Well, I am just guessing just as you are. May I finish?

Senator HANSEN. Yes.

Senator METCALF. Maybe 14 or 15 who have their land for sale immediately are anxious to sell to these industries that are going into the area for the tax benefits they can have. Some of the people who are immediately inheriting the land, and want to get out of their father's farming business are anxious to sell.

But the one who inherits the land and has to pay an inheritance tax on the basis of a distorted value next door doesn't like it. The one who is going out and trying to expand his farm doesn't like it. The man who has to pay taxes on this distorted value doesn't like it. It is only the man who is trying to liquidate his ranch that thinks that that is a pretty good idea.

Senaor HANSEN. I would question that the typical rancher, who has had to go to a bank and ask for credit would like to see the price of real estate lowered materially. I know I have talked with a good friend of mine who makes appraisals for one of the major life insurance companies, and he cites me a considerable instance of people in the Nebraska, Colorado and Wyoming area near Cheyenne, who have asked for appraisals on their land, and invariably have made an application for increased loan backed up by the appreciated land values.

Now, would you suspect that any of those people would like to see a depreciation in land values?

Senator METCALF. They don't like to see a depreciation in land values if it is a depreciation in the productive capacity of their land, but those farmers, at least it has been my experience from insurance companies and lending agencies in Montana, those farmers can't get an appraisal on the basis of the productive capacity. They have to compete with substantial outside income so that they can convince others that they can pay off this extra amount of money that they are paying for others to enjoy a tax shelter.

Senator HANSEN. It has been proposed that for estate taxation purposes, evaluations be made on the basis of productive capacity rather than on real value. What is your feeling in this instance?

Senator METCALF. I think that it should be based on productive capacity; yes, sir.

Senator HANSEN. And not on actual value.

Senator METCALF. Not on a distorted value as a result of sales to tax-dodge farmers.

Senator HANSEN. May not a distorted value become actual value?

Senator METCALF. If it is on a productive capacity. Of course if it is in subdivisions or something like that, that is another matter. That is not a matter that enters into the proposition of this bill. This bill applies only to those people who are taking advantage of the special tax situation that the farmer has, and abuses it by covering substantial high nonfarm income, as this ad I have for high income people suggests, with a tax shelter.

Senator HANSEN. Thank you, Senator Metcalf.

My time is up.

Senator GORE. Since Senator Byrd responded to a request, I had a young man from a neighboring State the other day ask me to submit to you his problem and ask your reaction.

He has a farm which he obtained from his father. He made quite an investment, in brood mares, and some cows. He expects to lose money for the next 3 or 4 years. Hopefully eventually it will be profitable. He has fallen in love with a young lady who had inherited a building from her father that provides considerable rent; also she teaches. Her income is something in excess of $15,000, and he wants to know of you whether they should go ahead and get married or live in sin.

Senator METCALF. I would say that that young man, who is a very smart young man, will nail down that proposition right now and get married.

Senator GORE. Will you provide an amendment in your bill for him?

Senator METCALF. He will have the income anyway.

Senator GORE. I will not argue with you, Senator. There is a problem of tax shelter here with which the Congress must deal, but I think your contribution this morning and the questions indicate that we haven't found the proper and full answer yet. I thank you very much.

Senator METCALF. I do want to say, that every single farm organization is in favor of my bill. I hope, Mr. Chairman, that my other colleagues that follow me in support of other types of legislation will be treated better by the audience than I have been treated just in the last response.

(Senator Lee Metcalf's prepared statement and the text of his amendment follow:)

STATEMENT OF HON. LEE METCALF, A U.S. SENATOR FROM THE STATE OF MONTANA ON BEHALF OF HIS PROPOSAL TO ELIMINATE "TAX-DODGE" FARMING

SUMMARY

My bill, S. 500, would eliminate existing distortions in the farm economy by limiting to $15,000 or to the amount of "special deductions" listed in my bill, whichever is higher, the amount by which a "farm loss" may offset nonfarm income. Special deductions are those that would be allowed to someone whether or not he was in farming or because it is the type of deduction clearly beyond a taxpayer's control. I am referring to such things as taxes, interest, abandonment or theft of farm property, fire, storm, or other casualty, losses and expenses from drought, and recognized losses from sales, exchanges, and involuntary conversions of farm property. Neither the House-passed bill nor the Administration's proposal contain a comparable provision to protect the legitimate farmer and rancher from being penalized for having incurred an economic agricultural farm loss in a given year. My bill also provides safeguards to protect those just starting out in farming as well as those who might find themselves in a loss situation in a given year, not by design for tax purposes but rather by chance. This is accomplished by a provision that allows any disallowed loss to be carried back three years and forward five years against past or future farm income.

The problem with the approach recommended by the Administration and now contained in the House-passed bill except for different dollar exclusions is that it allows the tax-dodge farmer to defer any recognized capital gains while at the same time he is allowed to continue using the full amount of his artificial losses as an offset against nonfarm income year after year. By attempting to convert capital gains into ordinary income rather than nip the losses in the bud before the tax-dodge farmer can use them, both the House bill and the Administration allow offenders an easy out with just the proper amount of tax planning.

Revenue figures provide some insight into the comparative effectiveness of the House bill, the Administration's proposal, and S. 500. My bill would affect about 14,000 individual tax returns and would raise an additional $205 million a year from these individuals. The House bill would affect about 3,000 returns and when fully operative raise an additional $25 million annually. These revenue estimates do not include comparative figures for corporations. I can only imagine the amount by which the gap between the two bills would widen even further.

The Administration estimated its 4 September proposal would apply to 9,300 individuals and raise $50 million annually. The Administration has already admitted that although the House bill adopts the same approach, the dollar exclusions contained in the House bill are so high as to render it ineffective.

Here is a unique opportunity to combine substantial revenue increases with substantial equity by restoring healthy competition to our farm economy. The House-passed bill can be reshaped to serve as a meaningful vehicle for equitable and effective reform in this area.

STATEMENT

I appreciate the opportunity to testify for legislation that would remove inequities between legitimate farm operators and tax dodge farmers—people who engage in farming for the purpose of creating artificial losses which can be used to offset substantial amounts of their nonfarm income.

In the first session of the 90th Congress, I introduced S. 2613, to amend the Internal Revenue Code of 1954 to provide that farming losses incurred by persons who are not bona fide farmers may not be used to offset nonfarm income. When I ultimately decided upon the loss limitation approach as the best way to get at this problem, one of the sources of information I considered was an article written by Hendrik S. Houthakker, now a member of the Council of Economic Advisors. At the time that he wrote the article, Mr. Houthakker was engaged as a professor of Economics at Harvard. He concluded his article, which appeared in the January-February 1967 issue of Challenge, with the observation that "if this sacred cow is to be finally eliminated, the Internal Revenue Service may need some help from the Congress."

I found Mr. Houthakker's discussion of possible methods to get at this problem particularly stimulating. He stated as follows:

"If the tax laws are to be effective in this area, a more sophisticated definition of farmers is needed, or, alternatively, the offsetting of farm losses against other income should be restricted. But this restriction has to be introduced with due regard to the interests of genuine farmers.

"The best possibility would be to limit the farm loss deduction to, say, $10,000 in any one year, with provisions to carry larger losses backward or forward to be offset against earlier or later farm profits, but not against nonfarm income. In 1962 the taxpayers who claimed over $10,000 in farm losses had an average nonfarm income of about $50,000.

"Another possibility would be to treat as farmers only those who have derived a specified fraction of their income from farming during the past five years.

"Still another (similar to the Treasury proposal of 1963 which was rejected by Congress) would be to allow capital gains treatment only for the amount by which sales exceed deductions for farm losses in prior years. This proposal, however, would not deter those who do not take capital gains at all."

The 1963 Treasury proposal referred to by Mr. Houthakker is basically the same proposal as that suggested by Administration officials in their testimony before the House Ways and Means Committee on 22 April of this year and restated again but with higher dollar figures before this Committee on 4 September. This proposal which has come to be known as the Excess Deductions Account approach is now contained in the tax reform bill under review by this Committee.

In July of last year, both the Departments of Treasury and Agriculture issued highly favorable reports on S. 2613, the predecessor to my bill, S. 500, which I reintroduced with substantial bipartisan support in January of this year. Both of those reports endorsed the principle of my original bill but at the same time suggested constructive modifications which I incorporated in the bill which was introduced last Fall for discussion purposes and then reintroduced early this session.

In order for the record to be complete on this matter here are the constructive suggestions made by the Treasury Department in its report of 11 July 1968:

"As an alternative, we suggest placing a ceiling on the amount of nonfarm income which could be offset by farm losses in any one year. If there were excess farm losses, they could be carried backward and forward to offset farm income, but no other income, of other years. If part of a taxpayer's income for a year consists of capital gains, his carryover of excess farm deductions arising from the special farm accounting rules would not be permitted to offset it. On the other hand, the ordinary farmer incurring a loss would be protected under this approach in two ways: First, by allowing a limited deduction for farm losses, an ordinary farmer who must take part-time or seasonal employment to supplement his income in a poor year in his farm operations would not be deprived of his farm loss deductions. Second, the carryover and carryback provisions would be available to absorb large one-time losses. In other words, the provision would, in operation, only affect taxpayers with relatively large amounts of nonfarm income, that is, individuals who do not have to depend on their farm income for their livelihood.

"It is suggested that . . . corporations could be covered in the same manner as individual farmers and farms run by a partnership."

The Treasury Department concluded by suggesting that some kinds of farm expenses should be excepted from the disallowance provisions. Here is the reason for that suggestion:

"One category of farm expenses would include taxes and interest which are generally deductible whether or not they are attributable to an income producing activity. A second category would include casualty and abandonment losses and expenses and losses arising from drought. These events are generally not in the taxpayer's control and disallowance of the loss or expense could create an undue hardship to the taxpayer since they may be catastrophic. These same expenses and losses are now excluded from the operation of section 270 which excludes losses in connection with a hobby operation."

One additional suggestion made in the report was to provide "for an adjustment that would limit the measure of allowable farm deductions to the taxable one-half of capital gains." The reason for this suggestion was to prevent the taxpayer from receiving a double deduction against his capital gain farm income.

The suggestions contained in last year's Treasury and Agriculture reports together with those contained in Mr. Houthakker's article made a great deal of sense. For example, it was clear that all concerned agreed the most equitable and effective way to get at this problem is to limit the amount of farm losses that can be used as an offset against nonfarm income in any one year.

The problem which now exists is that liberal tax accounting rules designed for the benefit of the ordinary farmer are being manipulated by nonfarmers. These nonfarmers engage in farming for the purpose of creating artificial losses that they can use to reduce the taxes they would otherwise have to pay on high-bracket nonfarm income. The tax losses which these tax-dodge farmers show are not true economic losses. These so-called "tax losses" arise from deductions taken because of capital costs or inventory costs and thus usually represent an investment in farm assets rather than amounts actually lost. Usually, the investment is ultimately sold and taxed only at lower capital gains rates.

The deductions are set off against ordinary income, while the sale price of the resulting assets represents capital gain. The gain is then usually the entire sales price since the full cost of creating the asset has previously been deducted against ordinary income. In reporting on my original bill S. 2613, in July of 1968, the Treasury reviewed the two principal methods of accounting used in reporting business income for tax purposes. Generally speaking, those businesses which do not involve the production or sale of merchandise may use the cash method. Under that method, income is reported when received in cash or its equivalent, and expenses are deducted when paid in cash or its equivalent.

However, in businesses where the production or sale of merchandise is a significant factor, income can be properly reflected only by deducting the costs of merchandise in the accounting period in which the income from its sale is realized. This means that costs are recorded when incurred and sales when made, and costs attributable to unsold goods on hand at year's end are included in inventory. Under this method of accounting, the deduction of costs included in inventory must be deferred until the goods to which they relate are sold rather than being deducted wuen the costs are incurred. Thus, under this second method of accounting, income from sales of inventory and the costs of producing or purchasing such inventory are matched in the same accounting period. The end result in this type of business is a proper reflection of income.

The Treasury Department has historically permitted farmers to deviate from general accounting practices to spare the ordinary farmer the bookkeeping chores associated with inventories and accrual accounting. In addition the Treasury has in the case of some capital outlays permitted farmers to write them off as if they were current expenses.

On 5 February of this year, the House Ways and Means Committee published a study of needed areas for tax reform conducted by the Treasury Department during the last two years of the Johnson Administration. In discussing the effect that tax-dodge farmers have on the farm economy the study points out that "when a taxpayer purchases and operates a farm for its tax benefits, the transaction leads to a distortion of the farm economy. The tax benefits allow an individual to operate a farm at an economic breakeven or even a loss and still realize an overall profit. For example, for a top-bracket taxpayer, where a deduction is associated with eventual capital gains income, each dollar of deduction means an immediate tax savings of seventy cents"—or seventy-seven cents with the surtax—"to be offset in the future by only twenty-five cents of tax. This cannot help but result in a distortion of the farm economy, and it is harmful to the ordinary farmer who depends on his farm to produce the income needed to support him and his family.

"This distortion may be evidenced in a variety of ways: For one, the attractive tax benefits available to wealthy persons have caused them to bid up the price of farmland beyond the price which would prevail in a normal farm economy, and is harmful to the ordinary farmer who must compete in the marketplace with these wealthy farm owners who may consider a farm profit—in the economic sense—unnecessary for their purposes."

My bill would eliminate these distortions by limiting to $15,000 or to the amount of the "special deductions" listed in the bill, whichever is higher, the amount by which a "farm loss" may offset a taxpayer's nonfarm income. The $15,000 figure is reinforced by the following observation contained in Treasury's two-year study, and I quote: "If a taxpayer has more than $15,000 of nonfarm income, his primary source of livelihood is not likely to be his farming efforts, and, thus, he is not the type of farmer for whom the special accounting rules were devised." Generally, a farm loss would be the amount by which farm deductions exceeded farm income in any given year. For this purpose, as the 1968 Treasury report suggested, the untaxed one-half of long-term capital gains attributable to farm property would not be included in farm income. Farm deductions include all deductions that are attributable to the business of farming. If the taxpayer's nonfarm income is in excess of $15,000 in any given year, the limit on his deductible loss in that year would be reduced by one dollar for each dollar of such excess. However, economic losses are protected by providing that the $15,000 loss limitation will be raised to the amount of the taxpayer's special deductions if that amount is higher than $15,000.

When Assistant Secretary of the Treasury Edwin S. Cohen testified before this Committee on 5 September he referred to the fact my bill is now pending before this Committee. He was then asked by Senator Hartke and I quote: "What is wrong with that bill?" Answer by Mr. Cohen, "Well, suppose as Senator Gore said, a short while ago, there were an actual economic loss of $50,000, suppose there is an actual economic loss from tornado, floods, low prices, drought, any number of factors, why should we disallow a true economic loss to the farmer or where should we disallow it in any event at strictly $15,000 a year."

There are two observations I must make with respect to that answer. First, if there were an actual economic loss of $50,000 from tornado, floods, low prices, drought or any other factor beyond the control of the taxpayer under the provisions of my bill the entire amount of that economic loss could be used to offset nonfarm income. Assistant Secretary Cohen's answer simply demonstrated that he had never read my bill. My bill specifically takes into account the nature of the deductions that generate a loss in a given year. It provides that if the sum total of deductions paid or incurred in the business of farming and which are attributable to taxes, interest, the abandonment or theft of farm property, or losses of farm property arising from fire, storm, or other casualty, losses and expenses directly attributable to drought, and recognized losses from sales, exchanges and involuntary conversions of farm property—if any one or all of those deductions adds up to a figure that is higher than $15,000 then the taxpayer is allowed to use the higher figure as an offset against nonfarm income. An exception is made in my bill for such deductions since they are in general deductions which would be allowed to anyone holding farm property without regard to whether it was being used in farming or because it is the type of deduction that is clearly beyond the control of the taxpayer.

My second observation is that assuming an actual economic loss of $50,000 caused by any of the economic factors listed by Assistant Secretary Cohen, and assume one additional fact . . . that the taxpayer has an adjusted gross nonfarm income in excess of $25,000 in that same year, it is the Administration's proposal that would penalize the taxpayer for an economic loss. Although the loss could be used as an offset against nonfarm income the entire amount of that loss would have to be included in the Administration's excess deductions account. To the extent of the balance in that account, what would otherwise be a long-term capital gain from farming in a subsequent year would be converted into ordinary income. The House-passed bill would also attempt to recapture an economic loss by the same method but to a lesser degree because it only applies to that portion of a farm loss above $25,000 and then only if nonfarm adjusted gross income is above $50,000. When Assistant Secretary Cohen testified he observed that the dollar exclusions contained in the House-passed bill render the bill ineffective.

Getting back to the loss limitation approach, my bill adopts a suggestion made in both the 1968 Agriculture and Treasury reports as well as in Mr. Houthakker's article. If the farm loss in any given year is greater than the allowable amount, it would be carried backward three years and forward five years to offset farm income of those years. This safeguard is in the bill to protect new farmers who are sincerely interested in farming but who understandably might be unable to turn an economic profit in those years.

My bill also provides that a taxpayer may treat a nonfarm business as a part of his farming operation if it is related to and on an integrated basis with the farm business. Some recent inquiries about this provision indicate that there are those who would attempt to use it to offset some artificial farm losses arising from the farm tax accounting rules against income earned in another business. This provision is not intended to allow a business to be considered as related and conducted on an integrated basis with the farming operation unless it consists of the processing of a product raised in the farming operation. Furthermore, it is only equitable that to qualify to elect this provision, the sale of such processed product should produce a substantial portion of the total receipts of the over-all operation. Moreover, this provision is intended only for purposes of measuring the size of the "farm loss" to ascertain whether certain deductions are allowable. This provision is not meant to allow the nonfarm business to be treated as a farm operation for the purpose of adopting accounting methods, the filing of estimated tax returns, or the filing of final returns, aud the like.

The House-passed bill and the Administration's proposal both adopt the proposal contained in S. 500 which would exclude from the application of any limitation, the taxpayer who is willing to follow with respect to his farming income, accounting rules which apply generally to other taxpayers; that is if he uses inventories in determining taxable income and treats as capital items—but subject to depreciation in cases where other taxpayers would take depreciation—all expenditures which are properly treated as capital items rather than treating them as expenses fully deductible in the current year.

My bill has gained substantial bipartisan support in both the House and the Senate. Twenty-six other Senators, including three members of this Committee

(Senators Hartke, McCarthy, and Harris) are cosponsors of S. 500. At last count, the loss limitation approach contained in the bill had been specifically endorsed by members of at least thirty different Congressional delegations.

Aside from Congressional support the method of approach taken in S. 500 has the full support of all those who are sincerely interested in the working farmers of our Nation. For example, the National Farmers Union, the American Farm Bureau Federation, the National Grange, the National Farmers Organization, the National Council of Farmer Cooperatives, the National Association of Wheat Growers, the Cooperative League of the U.S.A., the National Association of Farmer Elected Committeemen, the Farmland Industries Cooperative, the Mid-Continent Farmers Association—formerly known as the Missouri Farmers Association, the Farmers Grain Dealers Association, the AFL–CIO, the Industrial Union Department of the AFL–CIO, the United Steelworkers, the South Texas Cotton and Grain Association, Inc., and the Amalgamated Meat Cutters and Butcher Workmen, have all called for a limit to be placed on the amount of artificial farm losses that can be used as an offset against nonfarm income.

Contrast this type of support with the testimony of the National Livestock Tax Committee before the House Ways and Means Committee some six years ago. This is what the National Livestock Tax Committee had to say about the excess deductions account approach in 1963 and I quote: "We cannot say whether it would work or would not, but it is the most modest approach that has come to our attention."

Well, that sort of grudging praise coming from an organization that has been fighting tax reform in this area every step of the way made be take a hard look at the EDA approach when I first considered ways to get at this problem without hurting the legitimate farmer.

The basic problem with the EDA approach is that it allows the tax-dodge farmer to defer any recognized capital gains until he chooses to sell and at the same time, allows him to continue along his merry way each year using artificial farm losses as an offset against nonfarm income. With proper tax planning the balance in the excess deductions account can be milked dry by the time the taxpayer decides he is ready to recognize long-term capital gains. Such a proposal will not remove any of the incentive from existing clients of cattle management firms such as Oppenheimer Industries. Instead of catching the tax-dodge farmer with his hand in the cookie jar by limiting premature deductions each year, the EDA approach lets the tax-dodge farmer put us in the position of having to refill an empty jar.

Farm operations carried on by corporations usually are not separately reported on the corporation tax return. Consequently, data concerning the number of corporations and revenue effect with respect to corporations could not be be determined with respect to either the EDA approach or the loss limitation approach.

However, I do have revenue figures that provide some insight into the comparative effectiveness of the House bill, the Administration's proposal, and S. 500. At my request the Chief of Staff of the Joint Committee on Internal Revenue Taxation, Laurence N. Woodworth, has provided me with the following statistics.

My bill would affect in the neighborhood of 14,000 individual tax returns. It is estimated that it would raise an additional $205 million a year from these individuals. The number of returns affected by the "Excess Deductions Account" provision of H.R. 13270 is estimated to be in the neighborhood of 3,000. By 1979 the estimated increase in tax liability under the farm provisions of the House bill are as follows: excess deductions account, $10 million; depreciation recapture, $5 million; holding period of livestock, $5 million; hobby losses, negligible; for a total of $20 million by 1979. It is estimated that sometime after 1979 the increase in tax liability ascribed to the excess deductions account provision would increase an additional $5 million. So we are talking in terms of increased revenue under the House-passed bill of $25 million a year as opposed to $205 million under S. 500. These revenue estimates do not include comparative figures for corporations. We can only leave to the imagination the amount by which the gap between the two bills would widen even further.

The Administration estimated on 4 September that its modified EDA rule "would apply to only 9,300 individuals" and that the long-range revenue effect of its farm loss provisions would be $50 million, still a far cry from the amount of revenue that could be raised by equitably and effectively dealing with this problem.

Elimination of the exception for livestock from the depreciation recapture rules was analyzed in detail several years ago by the President of Oppenheimer Industries, General Harold L. Oppenheimer. General Oppenheimer has been described by Time magazine as the "Bonaparte of Beef." He has authored three books for the cattle industry, Cowboy Arithmetic, Cowboy Economics and Cowboy Litigation. I have been informed by his Washington representative that a fourth book, Cowboy Politics is now in preparation. Here is what the General had to say in 1966 in his book, Cowboy Economics, about the depreciation recapture provision that has since been adopted in the House-passed bill:

"Members of Congress and officials of both the old and the new administrations have suggested that where accelerated depreciation is taken, on any subsequent sale, the portion of the capital gain which represents the recovery of previously taken depreciation should be treated as ordinary income. This is essentially the system now used in Canada.

"Evaluation. This piece of legislation is undoubtedly going to get passed within the next year or so, although it was deleted by the House Ways and Means Committee from the 1964 Tax Bill. However, as far as breeding herds are concerned, this is a matter of relatively little significance. During the first two years of a purchased breeding herd, the culls sold from the herd on a capital gain basis are very unlikely to exceed the depreciated value by more than a few dollars. During the third and fourth years, this could be a matter of some importance in the sale of culls but without an appreciable percentage effect on the overall picture. During the fifth year, most of the animals with an original capital base will have been sold and the herd will consist almost entirely of animals born to it at no cost basis, so the effect this legislation would achieve would then be zero."

General Oppenheimer's book, Cowboy Litigation, contains an interesting chapter, "Tax Play in Race Horses." Here are some of the observations contained in that chapter.

"The tax aspects of the horse business are unique, but in most instances, parallel the cattle business . . .

"Stud fees paid by the owner of a mare are currently deductible or they can be capitalized and depreciated over the life of the foal. Unless the breeder is in a loss position and concerned about a so-called hobby loss, it would be better to expense the fee . . .

"Depreciation can produce considerable tax benefits as with cattle . . .

"Animals held for breeding are treated the same as other livestock such as cattle . . .

"Continued losses are a problem and always subject to scrutiny. . . . Breeding, racing, and the showing of horses have always been suspect, particularly when conducted by a high-bracket taxpayer that endeavors to write the losses off against other income . . . As with cattle, the decision turns on the subjective motives and profit potential of the owner . . . Country estates and small operations are in the face suspect. The more attention paid to the business and the professional manner in which the business is operated are all plus factors."

I shall turn now to some of the more common allegations made by those who oppose my bill. For example, there are some who say that the bill would force farmers to use the accrual system of accounting; that the bill would prevent the successful farmer or rancher from engaging in nonfarm operations with outside income for fear of losing his right to deduct farm losses; that the bill would discourage the flow of outside money into ranching and farming operations and so on.

I have repeatedly denied these allegations. Statistics reveal that there are a comparatively few taxpayers who enter into farming as a tax-dodge device. The 32-page report, "Statistics of Income—1967, Preliminary, Individual Income Tax Returns," published on January 14 of this year reveals that for 1967 there were approximately 770 thousand taxable individual income tax returns filed that reported a net loss from farming. My bill would affect in the neighborhood of 14 thousand or slightly less than 2 percent of those returns. This is statistical evidence that my bill will only affect the tax-dodge farmers who are currently distorting the farm economy.

In discussing statistical evidence of this problem, the Treasury's two-year study, published on 5 February of this year, points out that a growing body of investment advisors is currently advertising that they will arrange farm investments for high-bracket taxpayers to enjoy deductions on dollars that are really spent to acquire capital assets. It is because of that kind of advertising that people are being drawn to farm "tax-loss" situations.

Just last year I saw an ad in a magazine called the Airline Pilot that read in part—"Own a citrus grove using tax dollars as your total investment, . . ." The ad was headed "Tax Shelters for 1968." You can pick up the Wall Street Journal on any given day and find ads of this type. For example, the other day I came across one that read in part: "Pistachio Nuts, The Green Nut with the Golden Future . . . Outstanding opportunity for land investment and Pistachio nut tree planting program . . . Most of growing costs deductible."

As I evaluated each of the proposals pending before this Committee, I must admit that I have become even more convinced that the fairest and most effective way to get at this problem is to adopt the loss limitation approach contained in S. 500. Here is a unique opportunity to scale down the long run revenue loss that results from the sum total of all the provisions of the 368-page House bill while at the same time we increase substantially the equity of our tax laws through a healthier farm economy.

[H.R. 13270, 91st Cong., first sess.]

[Amdt. No. 139]

IN THE SENATE OF THE UNITED STATES

August 13, 1969

Referred to the Committee on Finance and ordered to be printed

AMENDMENT

Intended to be proposed by Mr. Metcalf to H.R. 13270, an Act to reform the income tax laws, viz: Page 139, beginning with line 10, strike out all through line 6, page 152 (section 211 of the bill), and insert the following:

SEC. 211. FARM LOSSES.

(a) In General.—Part IX of subchapter B of chapter 1 (relating to items not deductible) is amended by adding after section 279 (added by section 411(a) of this Act) the following new section:

"SEC. 280. LIMITATION ON DEDUCTIONS ATTRIBUTABLE TO FARMING.

"(a) General Rule.—In the case of a taxpayer engaged in the business of farming, the deductions attributable to such business which, but for this section, would be allowable under this chapter for the taxable year shall not exceed the sum of—

"(1) the adjusted farm gross income for the taxable year, and

"(2) the higher of—

"(A) the amount of the special deductions (as defined in subsection (d) (3)) allowable for the taxable year, or

"(B) $15,000 ($7,500 in the case of a married individual filing a separate return), reduced by the amount by which the taxpayer's adjusted gross income (taxable income in the case of a corporation) for the taxable year attributable to all sources other than the business of farming (determined before the application of this section) exceeds $15,000 ($7,500 in the case of a married individual filing a separate return).

"(b) Exception for Taxpayers Using Certain Accounting Rules.—

"(1) In General.—Subsection (a) shall not apply to a taxpayer who has filed a statement, which is effective for the taxable year, that—

"(A) he is using, and will use, a method of accounting in computing taxable income from the business of farming which uses inventories in determining income and deductions for the taxable year, and

"(B) he is charging, and will charge, to capital account all expenditures paid or incurred in the business of farming which are properly chargeable to capital account (including such expenditures which the taxpayer may, under this chapter or regulations prescribed thereunder, otherwise treat or elect to treat as expenditures which are not chargeable to capital account).

"(2) TIME, MANNER, AND EFFECT OF STATEMENT.—A statement under paragraph (1) for any taxable year shall be filed within the time prescribed by law (including extensions thereof) for filing the return for such taxable year, and shall be made and filed in such manner as the Secretary or his delegate shall prescribe by regulations. Such statement shall be binding on the taxpayer, and be effective, for such taxable year and for all subsequent taxable years and may not be revoked except with the consent of the Secretary or his delegate.

"(3) CHANGE OF METHOD OF ACCOUNTING, ETC.—If, in connection with a statement under paragraph (1), a taxpayer changes his method of accounting in computing taxable income or changes a method of treating expenditures chargeable to capital account, such change shall be treated as having been made with the consent of the Secretary or his delegate and, in the case of a change in method of accounting, shall be treated as a change not initiated by the taxpayer.

"(c) CARRYBACK AND CARRYOVER OF DISALLOWED FARM OPERATING LOSSES.—

"(1) IN GENERAL.—The disallowed farm operating loss for any taxable year (hereinafter referred to as the 'loss year') shall be—

"(A) a disallowed farm operating loss carryback to each of the 3 taxable years preceding the loss year, and

"(B) a disallowed farm operating loss carryover to each of the 5 taxable years following the loss year,

and (subject to the limitations contained in paragraph (2)) shall be allowed as a deduction for such years, under regulations prescribed by the Secretary or his delegate, in a manner consistent with the allowance of the net operating loss deduction under section 172.

"(2) LIMITATIONS.—

"(A) IN GENERAL.—The deduction under paragraph (1) for any taxable year for disallowed farm operating loss carrybacks and carryovers to such taxable year shall not exceed the taxpayers' net farm income for such taxable year.

"(B) CARRYBACKS.—The deduction under paragraph (1) for any taxable year for disallowed farm operating loss carrybacks to such taxable year shall not be allowable to the extent it would increase or produce a net operating loss (as defined in section 172(c)) for such taxable year.

"(3) TREATMENT AS NET OPERATING LOSS CARRYBACK.—Except as provided in regulations prescribed by the Secretary or his delegate, a disallowed farm operating loss carryback shall, for purposes of this title, be treated in the same manner as a net operating loss carryback.

"(d) DEINITIONS.—For purposes of this section—

"(1) ADJUSTED FARM GROSS INCOME.—The term 'adjusted farm gross income' means, with respect to any taxable year, the gross income derived from the business of farming for such taxable year (including recognized gains derived from sales, exchanges, or involuntary conversions of farm property), reduced, in the case of a taxpayer other than a corporation, by an amount equal to 50 percent of the lower of—

"(A) the amount (if any) by which the recognized gains on sales, exchanges, or involuntary conversions of farm property which, under section 1231(a), are treated as gains from sales or exchanges of capital assets held for more than 12 months exceed the recognized losses on sales, exchanges, or involuntary conversions of farm property which under section 1231(a) are treated as losses from sales or exchanges of capital assets held for more than 12 months, or

"(B) the amount (if any) by which the recognized gains described in section 1231(a) exceed the recognized losses described in such section.

"(2) NET FARM INCOME.—The term 'net farm income' means, with respect to any taxable year, the gross income derived from the business of farming for such taxable year (including recognized gains derived from sales, exchanges, or involuntary conversions of farm property), reduced by the sum of—

"(A) the deductions allowable under this chapter (other than by subsection (c) of this section) for such taxable year which are attributable to such business, and

"(B) in the case of a taxpayer other than a corporation, an amount equal to 50 percent of the amount described in subparagraph (A) or (B) of paragraph (1), whichever is lower.

"(3) SPECIAL DEDUCTIONS.—The term 'special deductions' means the deductions allowable under this chapter which are paid or incurred in the business of farming and which are attributable to—

"(A) taxes,

"(B) interest,

"(C) the abandonment or theft of farm property, or losses of farm property arising from fire, storm, or other casualty,

"(D) losses and expenses directly attributable to drought, and

"(E) recognized losses from sales, exchanges, and involuntary conversions of farm property.

(4) FARM PROPERTY.—The term 'farm property' means property which is used in the business of farming and which is property used in the trade or business within the meaning of paragraph (1), (3), or (4) of section 1231(b) (determined without regard to the period for which held).

"(5) DISALLOWED FARM OPERATING LOSS.—The term 'disallowed farm operating loss' means, with respect to any taxable year, the amount disallowed as deductions under subsection (a) for such taxable year, reduced, in the case of a taxpayer other than a corporation, by an amount equal to 50 percent of the amount described in subparagraph (A) or (B) of paragraph (1), whichever is lower.

"(e) SPECIAL RULES.—For purposes of this section—

"(1) BUSINESS OF FARMING.—A taxpayer shall be treated as engaged in the business of farming for any taxable year if—

"(A) any deduction is allowable under section 162 or 167 for any expense paid or incurred by the taxpayer with respect to farming, or with respect to any farm property held by the taxpayer, or

"(B) any deduction would (but for this paragraph) otherwise be allowable to the taxpayer under section 212 or 167 for any expense paid or incurred with respect to farming, or with respect to property held for the production of income which is used in farming.

For purposes of this paragraph, farming does not include the raising of timber. In the case of a taxpayer who is engaged in the business of farming for any taxable year by reason of subparagraph (B), property held for the production of income which is used in farming shall, for purposes of this chapter, be treated as property used in such business.

"(2) INCOME AND DEDUCTIONS.—The determination of whether any item of income is derived from the business of farming and whether any deduction is attributable to the business of farming shall be made under regulations prescribed by the Secretary or his delegate, but no deduction allowable under section 1202 (relating to deduction for capital gains) shall be attributable to such business.

"(3) CONTROLLED GROUP OF CORPORATIONS.—If two or more corporations which—

"(A) are component members of a controlled group of corporations (as defined in section 1563) on a December 31, and

"(B) have not filed a statement under subsection (b) which is effective for the taxable year which includes such December 31,

each have deductions attributable to the business of farming (before the application of subsection (a)) in excess of its gross income derived from such business for its taxable year which includes such December 31, then, in applying subsection (a) for such taxable year, the $15,000 amount specified in paragraph (2)(B) of such subsection shall be reduced for each such corporation to an amount which bears the same ratio to $15,000 as the excess of such deductions over such gross income of such corporation bears to the aggregate excess of such deductions over such gross income of all such corporations.

"(4) PARTNERSHIPS.—A business of farming carried on by a partnership shall be treated as carried on by the members of such partnership in proportion to their interest in such partnership. To the extent that income and deductions attributable to a business of farming are treated under the preceding senence as income and deductions of members of a partnership, such income and deductions shall, for purposes of this chapter, not be taken into account by the partnership.

"(5) TWO OR MORE BUSINESSES.—If a taxpayer is engaged in two or more businesses of farming, such businesses shall be treated as a single business.

"(6) RELATED INTEGRATED BUSINESSES.—If a taxpayer is engaged in the business of farming and is also engaged in one or more businesses which are directly related to his business of farming and are conducted on an integrated basis with his business of farming, the taxpayer may elect to treat all such businesses as a single business engaged in the business of farming. An election under this paragraph shall be made in such manner, at such time, and subject to such conditions as the Secretary or his delegate may prescribe by regulations.

"(7) SUBCHAPTER S CORPORATIONS AND THEIR SHAREHOLDERS.—

"For a special treatment of electing small business corporations which do not file statements under subsection (b) and of the shareholders of such corporations, see section 1380.

"(f) REGULATIONS.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section."

(b) SUBCHAPTER S CORPORATIONS.—Subchapter S (relating to election of certain small business corporations as to taxable status) is amended by adding after section 1379 (as added by section 541(a) of this Act) the following new section:

"SEC. 1380. ELECTING SMALL BUSINESS CORPORATIONS ENGAGED IN BUSINESS OF FARMING.

"(a) SEPARATE APPLICATION TO FARMING INCOME AND DEDUCTIONS.—Under regulations prescribed by the Secretary or his delegate, an electing small business corporation which is engaged in the business of farming during its taxable year (other than a corporation which has filed a statement under section 280(b) which is effective for such taxable year), and the shareholders of such corporation, shall apply the provisions of sections 1373 through 1378, separately with respect to—

"(1) income derived from the business of farming by such corporation and deductions attributable to such business, and

"(2) all other income and deductions of such corporation.

In computing the taxable income and undistributed taxable income, or net operating loss, of such corporation with respect to the business of farming, no deduction otherwise allowable under this chapter shall be disallowed to such corporation under secton 280.

"(b) SHAREHOLLERS TREATED AS ENGAGED IN BUSINESS OF FARMING, ETC.—For purposes of section 280—

"(1) each shareholder of an electing small business corporation to which subsection (a) applies shall be treated as engaged in the business of farming,

"(2) the undistributed taxable income of such corporation which is included in the gross income of such shareholder under section 1373 and is attributable to income and deductions referred to in subsection (a)(1), and dividends received which are attributable to such income and deductions and are distributed out of earnings and profits of the taxable year as specified in section 316(a)(2), shall be trerted as income derived from the business of farming by such shareholder, and

"(3) the deduction allowable (before the application of section 280) to such shareholder under section 1374 as his portion of such corporation's net operating loss attributable to income and deductions referred to in subsection (a)(1) shall be treated as a deduction attributable to the business of farming.

"(c) SPECIAL RULES OF SECTION 280(e) APPLICABLE.—For purposes of this section, the special rules set forth in section 280(e) shall apply."

(c) CLERICAL AND CONFORMING AMENDMENTS.—(1) The table of section for part IX of subchapter B of chapter 1 is amended by adding at the end thereof the following new item:

"Sec. 280. Limitation on deductions attributable to farming."

(2) Section 172(l) is amended by adding at the end thereof the following new paragraph:

"(3) For limitations on deductions attributable to farming and special treatment of disallowed farm operating losses, see section 280."

(3) Section 381(c) is amended by adding at the end thereof the following new paragraph:

"(24) FARM OPERATING LOSS CARRYOVERS.—The acquiring corporation shall take into account, under regulations prescribed by the Secretary or his delegate, the disallowed farm operating loss carryovers under section 280 of the distributor or transferor corporation."

(4) The table of sections for subchapter S is amended by adding at the end thereof the following new item:

"Sec. 1380. Electing small business corporations engaged in business of farming."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1969, except that for purposes of applying section 280(c) of the Internal Revenue Code of 1954 (as added by subsection (a)) with respect to disallowed farm operating losses of any taxpayer for taxable years beginning after such date—

(1) such amendments shall also apply to the 3 taxable years of such taxpayer preceding the first taxable year beginning after such date, and

(2) in the case of a taxpayer to whom section 1380(b) of such Code (as added by subsection (b)) applies for any of his first 3 taxable years beginning after such date, section 1580 of such Code shall apply with respect to the electing small business corporation of which such taxpayer is a shareholder for the 3 taxable years preceding each such taxable year of such taxpayer, but only with respect to any such preceding taxable year for which the corporation was an electing small business corporation.

Senator ANDERSON. Senator Cooper.

STATEMENT OF HON. JOHN SHERMAN COOPER, A U.S. SENATOR FROM THE STATE OF KENTUCKY

Senator COOPER. Yes.

Mr. Chairman and members of the committee, it is my honor today to introduce to the committee the Governor of the Commonwealth of Kentucky, the Honorable Louie B. Nunn, now serving the second year of his 4-year term. We appreciate your waiting here. He will testify on a subject which is of concern to our State.

STATEMENT OF HON. LOUIE B. NUNN, GOVERNOR OF THE STATE OF KENTUCKY; ACCOMPANIED BY GEORGE A. SMATHERS, GENERAL COUNSEL, AMERICAN HORSE COUNCIL

Mr. SMATHERS. Mr. Chairman, may I say preliminarily that we had an agreement with the chairman and the staff that the American Horse Council* would have four witnesses, each one of which would testify not to exceed 10 minutes, and that we are, of course, very proud and happy to have as our first witness the distinguished Governor of Kentucky, Mr. Nunn.

Governor NUNN. Thank you Senator Cooper, Mr. Smathers, members of the committee. I appreciate this opportunity to appear before the committee, but more than that, the opportunity to listen to the various witnesses and the discussion this morning, particularly as it relates to the farm economy. As I listened, I was reminded of Mr. Butler, a farmer down in Kentucky and I think he would fall in the category of a "legitimate farmer." He had been farming for several years, when the county agent, under a State and Federal program, went out to advise him on how he could enhance his income. The agent suggested that he buy a herd of cattle and feed them out, which the farmer did.

*The prepared statement of the American Horse Council submitted by former Senator Thruston Morton and George Smathers appears at p. 2792.

Later, at a meeting that the county agent was conducting down at the local schoolhouse, he was explaining the programs and what they had meant to the farmers. He called on Mr. Butler to explain what his herd of cattle had meant to him.

The old farmer said that when he took into consideration the feed that he had raised, the feed that he bought, and the time that it took to care for them, that he figures he broke about even.

The county agent said "that is the trouble with you farmers—you didn't take into consideration, Mr. Butler, the fact that if you hadn't had that herd of cattle, you would have had to buy fertilizer for that east 40 acres. Since you used the manure, that saved you from spending money on fertilizer, and you should consider that as profit."

Mr. Butler said that he thought the farm situation had come to a sorry plight when you had to take your profit out in manure. [Laughter.]

My purpose in appearing before this committee is to present to you facts and statistics on this proposed legislation which would materially and adversely affect the economy of my own State and that of 26 other States that are involved in horse raising and breeding.

In addition to the 27 States to which I refer, I am sure that there will be other presentations that will be made to this committee on the effect that the legislation would have on them.

Realizing the importance and the significance of the proposed legislation, and the limited time resulting from the tremendous workload of this committee, my remarks shall be very brief and pointed.

Kentucky, as you know, has achieved the position of worldwide preeminence in thoroughbred, standard bred, and saddle bred, breeding and racing horses. While these endeavors are most drastically affected by the legislation that you now must consider, they are not the only areas about which we have the greatest concern. I would only point out in passing that my State ranks 10th in the production of cattle and dairy products, and certainly we all know that in every phase of the farm economy, it is suffering. Therefore my interest is not directed toward a single purpose.

Indeed, even though I may make frequent references to my own State, this legislation is of such wide geographical and economic concern that I am sure any number of Governors could and would appear before you if time permitted.

Let me make it abundantly clear that I am not here today to ask for special favors for Kentucky or for special treatment for the Kentucky horse industry. My purpose is to outline the importance of the horse industry of the United States and to help the members of this committee to weigh carefully the consequences of the various tax changes that have been proposed.

My statement is not mere conjecture or verbiage. It is based on statistics—statistics developed by the Spindletop Research, Inc., a not-for-profit independent research institute established to stimulate the economy and the industrial development of Kentucky and its regions.

I would point out that the Federal Government and many private enterprises have used Spindletop for research purposes.

The study is entitled "Economic Importance of the Horse Industry in the United States." The study was performed as a special public service in hopes of clarifying some of the questions and some of the misconceptions surrounding the horse industry. Attached to this statement and to be filed herewith is the complete text of the Spindletop Research report. (See p. 2755.)

When viewing the horse industry from the national standpoint, it is necessary to consider not only its economic importance but also its recreational and educational significance. Directly affected are those who engage in the commercial activity of the horse industry. This includes breeding, training, racing and showing, since people in these activities make their living directly from working on or with horses. In other words, horses are the tools of their trade.

Indirect commercial activities are conducted by the manufacturers and suppliers who furnish products and the professional people who furnish service for either commercial or recreational horses. Therefore the total horse population can be considered applicable to indirect commercial activity.

I would like to discuss briefly tourism. In some areas of the country, and especially in Kentucky, the tourist industry is considerably strengthened by the substantial number of visitors to our famous horse farms. Last year alone the tourist industry resulted in $43 million in direct taxes being paid into our State's economy. The horse industry was responsible either directly or indirectly for attracting more than 50 percent of this amount, and I want to pause here to say that there are other areas for tax consideration other than the Federal Government alone, because the States must have a source of revenue likewise.

The most difficult factor to measure in terms of the recreational aspect of the horse industry as it affects tourism is the potential number of people who come to the horsefarms, who go to horseshows, to racing and to rodeos. There are certainly many secondary factors that merit consideration, such as the extra time that the families spend in the State, the distance that they travel, to view participate in these activities, and the promotional value of the image created by the horse recreation activity More directly, the matter of commerce. In 1968 the horse population of the United States was estimated to be in excess of 6 million. Of this, 1.2 million horses were known to be registered. Of the registered horses, 832,000 were listed as recreational, and over 428,000 were listed for commercial purposes.

The labor utilized for commercial horses alone in the category of breeding, training, and showing amounts to more than 125,000 full-time jobs. In addition, there are between 25,000 and 33,000 full-time jobs in supportive services and supply industries for all horses, bringing a total of 150,000 full-time jobs with many more people employed throughout the year on a part-time basis, and much of this employment is in the agricultural sector.

The known total annual wages for this labor amounts to more than $727 million. Wages paid by service vendors and suppliers were approximately $250 million. Thus the proposed legislation would adversely affect total annual wages of $1 billion.

As to capital investment, total capital investment in breeding facilities and equipment is $543 million. An additional $79 million is invested in training, and $602 million in racetracks. The value of the commercial horse is $1.12 billion. This adds up to a total capital investment of $2.34 billion. Although substantial, this figure must be considered only a very conservative estimate, because there are many items as to which we were not able to get exact figures. This would have to do with horse trailers and other related industries.

Now as to land use and values. Land devoted to commercial horses used in 1968 amounted to more than 1.9 million acres, having a total value of $1.26 million. I would remind you that these values apply only to those portions of farms that are devoted to commercial horses.

The statistics make it abundantly clear that this extensive industry employs a large number of workers in agricultural type jobs, and further that the capital investment in facilities, equipment, and land represents major generators of economic activities.

Gentlemen, these facts are particularly significant when those of us charged with public responsibility face the multitude of contemporary problems with which we are expected to deal.

The horse industry provides jobs at a time when we are seeking solutions to unemployment.

As to State revenue, the horse industry generates substantial revenue directly to the States at a time when you are being asked to provide Federal revenue to the States. Last week at the Southern Governors' Conference I said that the States must commence to solve their own problems rather than looking to the Congress. The States cannot solve their problems without revenue any more than the Federal Government can solve the problems for the States without revenue.

In 1968 the total parimutuel revenue to all States amounted to $26.9 million. This combined with the almost $19 million in other taxes paid by racetracks brings the total tax from tracks and parimutuel betting to over $44 million.

Proponents of this legislation might argue that you are indirectly subsidizing this sector of the farm economy. If that argument be true, I would only say in response that subsidizing employment, encouraging industry, and supporting a viable revenue producing source certainly is far more preferable than subsidizing unemployment and nonproductivity.

I would also add that migration from the rural to the urban areas is considered a major problem in this country. This proposed legislation conceivably compounds that problem.

RECREATION AND SOIL CONSERVATION

In this period of urban sprawl and urban blight, it is gratifying to note that a substantial amount of land, much of it within easy commuting distance of our cities, has been set aside for horse industry activities. Land use for horses is generally well cared for, with good cover and with a minimum of eroding. In some parts of the country such land represents the only open space in the greenbelts that would otherwise be an endless sea of houses.

It is clear to me, coming as I do from a State having an unparalleled richness in scenic attractions, that the conservation and esthetic aspects of the horse industry have great intangible value. It is my sincere hope that changes in the tax structure will not result in fragmenting these farms or in drastically altering existing land use patterns.

Many Federal dollars are being invested in recreation. I think it is therefore significant that the number of horses used in recreation has increased considerably in the last decade.

Furthermore, Future Farmers of America, 4–H Clubs and other farm-oriented youth organizations are becoming increasingly engaged in horse projects. Thus it is clear that the success of many of these projects depends strongly on the availability of horses at a reasonable price.

To further demonstrate the recreational aspects of the industry, in 1967 the attendance at horse-racing events alone exceeded the attendance of all other professional or amateur sports.

In summary, I urge you to carefully reflect on the dimensions of this important industry that I have outlined to you today. I respectfully ask that you also consider the other factors which either have not been measured or are of an intanigible nature. These factors also substantially increase the economic impact and the other contributions of the horse industry to America.

I certainly want to salute you and your diligent efforts to find equitable means for sharing the burden of taxation, but by the same token I would urge you to take care that you do not throw out the baby with the wash water.

Senator ANDERSON. Will you be available this afternoon?

Governor NUNN. I can be available. However, there are others here who I am sure will be glad to answer any questions that I may not be able to answer. I will make myself available to the committee if it is their desire. If any member desires that I appear I will be glad to do so.

Senator ANDERSON. I think we can excuse you and we will return at 2:30 this afternoon.

(Gov. Louie B. Nunn's prepared statement with attachment follows:)

STATEMENT BY LOUIE B. NUNN, GOVERNOR, COMMONWEALTH OF KENTUCKY

SUMMARY

Proposed legislation before the Congress would have a detrimental effect on the national horse industry and thus would materially and adversely affect the economy of Kentucky as well as several other states, Governor Louie B. Nunn told the Senate Finance Committee.

Armed with a report from Spindletop Research, Inc., of Lexington, Kentucky, the Governor strongly implied that the impact of the many contributions of the horse industry would be significantly lessened should proposed legislation be approved.

He cited the following supportive evidence:

More than half of Kentucky's tourist industry, which last year contributed $43 million in tax revenue to the State, results directly or indirectly from the horse industry.

Labor utilized for commercial horses alone in the categories of breeding, training, racing and showing amounts to more than 125,000 full-time jobs.

Between 25,000 and 33,000 full-time jobs are created among the supportive services and supply industries for horses.

Known total annual wages for horse industry labor and related service and supply vendors amount to $1 billion.

Total capital investment in the commercial horse industry is $2.34 billion.

1.9 million acres of land valued at $1.26 billion is devoted to commercial horse uses.

The horse industry in 1968 generated $426.9 million directly to the states in revenue from pari-mutuel wagering and $18.9 million in other taxes paid by race tracks.

Recreation, conservation of aesthetic values and education are other facets of the horse industry important to any consideration of detrimental legislation.

"The horse industry provides jobs at a time when we are seeking solutions to unemployment. It generates substantial revenue directly to the states at a time when you are being asked to provide federal revenue to the states," Governor Nunn said.

"Let me make it abundantly clear to you that I am not here today to ask for special favors for Kentucky or for special treatment for the Kentucky horse industry," he added.

"At the same time, however, I would urge you to take care that you do not 'throw out the baby with the washwater'," Governor Nunn said.

STATEMENT

Mr. Chairman and members of the committee; I am Louie B. Nunn, Governor of the Commonwealth of Kentucky. My purpose for appearing before this distinguished Committee is to present facts and statistics on proposed legislation which would materially and adversely affect the economy of my own state and that of twenty-six (26) additional states that are involved in horse racing or breeding.

In addition to the 27 states to which I refer, others who will make presentations to this Committee no doubt will give further information as to how this proposed legislation would affect them.

Realizing the importance and the significance of the proposed legislation and the limited time resulting from the tremendous workload of this Committee, my remarks shall be brief and to the point.

Kentucky has achieved a position of worldwide preeminence in Thoroughbred, Standardbred, saddlebred and quarter-horse breeding and racing.

While these endeavors are most drastically affected by the legislation that you must now consider, they are not the only areas about which we have the greatest concern.

Other testimony no doubt will dwell on the detrimental effect that H.R. 13270 will have on the cattle industry and other phases of the suffering farm economy, but in passing, I would only relate that my state ranks 10th in the nation in the production of cattle and dairy products.

Therefore, my interest is not directod toward a single purpose. Indeed, even though I shall make frequent reference to my own state, this legislation is of such wide geographical and economic concern that I am sure any number of Governors could appear before you and many of them stand ready to do so if your time permits.

Let me make it abundantly clear to you that I am not here today to ask for special favors for Kentucky or for special treatment for the Kentucky horse industry.

My purpose is to outline the importance of the horse industry in the United States and to help the members of this Committee to weigh carefully the consequence of the various tax changes that have been proposed.

My statement is not mere conjecture or verbage. It is based on statistics developed by Spindeltop Research, Incorporated, a not-for-profit, independent research institute established to stimulate the economic and industrial development of Kentucky and its region.

Spindletop has engaged in many projects that relate to Kentucky's most important industries, as well as having done work for the federal government and many private enterprises.

The study entitled "Economic Importance of the Horse Industry in the United States" was performed as a special public service in hope of clarifying some of the questions and misconceptions surrounding the horse industry. Attached to this statement and to be filed herewith is the complete text of the Spindletop Research report.

When viewing the horse industry from a national standpoint, it is necessary to consider not only its economic importance, but also its recreational and educational significance.

Directly affected are those who engage in the commercial activity of the horse industry. This includes breeding, training, racing, and showing, since people in these activities make their living directly from working on or with horses. In other words, horses are the tools of their trade.

Indirect commercial activities are conducted by the manufacturers and suppliers who furnish products and by professional people who furnish services for either commercial or recreational horses.

Therefore, the total horse population can be considered applicable to indirect commercial activity.

TOURISM

Furthermore, in some areas of the country, especially in Kentucky, the tourist industry is considerably strengthened by substantial numbers of visitors to our famous horse farms.

Last year alone, the tourist industry resulted in $43 million dollars in direct taxes being paid into our state's economy. The horse industry was responsible, either directly or indirectly, for attracting more than fifty (50) per cent of this amount.

The most difficult factor to measure in terms of the recreational aspects of horses is the tourist potential for horse farms, horse shows, racing and rodeos.

There are certainly many secondary factors that merit consideration, such as the extra time that families spend in an area because of these attractions, the extra distance traveled to view or participate in these activities, and the promotional value of the image created by the horse recreation activities.

COMMERCE

In 1968, the total horse population of the United States was estimated to be in excess of six (6) million. Of this total, 1.2 million horses were known to be registered. Of the registered horses, 832 thousand were listed as recreational and over 428 thousand were listed for commercial purposes.

The labor utilized for commercial horses alone in the category of breeding, training, racing and showing amounts to more than 125 thousand full-time jobs.

In addition, there are between 25 thousand and 33 thousand full-time jobs in the supportive services and supply industries for all horses, bringing the total employment to more than 150 thousand full-time jobs, with many more persons employed throughout the year on a part-time basis. Much of this employment is in the agricultural sector.

The known total annual wages for this labor amounted to more than $727 million dollars.

Wages paid by service vendors and suppliers were approximately $250 million dollars. Thus, this proposed legislation would adversely affect total annual wages of $1 billion dollars.

CAPITAL INVESTMENT

Total capital investment in breeding facilities and equipment is $543 million dollars. An additional $70 million is invested in training, $602 million is invested in race tracks. The value of the commercial horse is $1.12 billion dollars.

This adds up to a capital investment of $2.34 billion dollars. Although substantial, this figure must be considered only a very conservative estimate, in as much as there are many items of equipment such as horse trailers which could not be estimated with any degree of precision.

LAND USE AND VALUES

Land devoted to commercial horse uses in 1968 amounted to more than 1.9 million acres having a total value of $1.26 billion dollars. I would remind you that these values apply only to those portions of farms that are devoted to commercial horses.

The statistics make it abundantly clear that this extensive industry employs a large number of workers in agricultural type jobs and further, that the capital investment in facilities, equipment and land represents major generators of economic activities.

Gentlemen, these statistics are particularly significant when those of us charged with public responsibility face the multitude of contemporary problems with which we are expected to deal.

The horse ind'ıstry provides jobs at a time when we are seeking solutions to unemployment.

STATE REVENUE

The horse industry generates substantial revenue directly to the states at a time when you are being asked to provide federal revenue to the states.

Last week at the Southern Governors' Conference, I said that the states must commence to solve their own problems rather than look to the Congress. The states cannot solve their problems without revenue any more than the federal government can solve the problems for the states without revenue. In 1968, the total pari-mutuel revenue to all states amounted to $426.9 million. This combined with the $18.9 million in other taxes paid by race tracks brings the total tax from tracks and pari-mutuel betting to $445.8 million.

Proponents of this legislation might argue that you are indirectly subsidizing this sector of the farm economy. If that argument be true, I would only say in response that subsidizing employment, encouraging industry and supporting a viable revenue-producing source certainly is far more preferable than subsidizing unemployment and nonproductivity.

I would also add that migration from the rural to the urban areas is considered a major problem in this country. This proposed legislation conceivably compounds the problem.

RECREATION AND CONSERVATION OF AESTHETIC VALUES

In this period of urban sprawl and urban blight, it is gratifying to note that a substantial amount of land . . . much of it within easy commuting distance of our cities . . . has been set aside for horse industry activities.

Land used for horses is generally well cared for, with good cover and a minimum of erosion. In some parts of the country, such land represents the only open space and "green belts" in what would otherwise be an endless sea of houses.

It is clear to me, coming as I do from a state having an unparalleled richness in scenic attractions, that the conservation and aesthetic aspects of the horse industry have great intangible value.

It is my sincere hope that changes in the tax structure will not result in fragmenting these farms, or in drastically altering existing land-use patterns.

Many federal dollars are being invested in recreation. It is therefore highly significant that the number of horses used in recreation has increased considerably in the last decade.

Horseback riding is a major outdoor recreation activity and even without being federally subsidized has contributed to the health and vitality of our citizens.

Furthermore, Future Farmers of America, 4–H Clubs and other farm-oriented youth organizations are becoming increasingly engaged in horse projects. Thus, it is clear that the success of many of these projects depends strongly on the availability of horses at reasonable prices.

To further demonstrate the recreational aspects of this industry, in 1967 the attendance at horse racing events alone exceeded the attendance at all other professional or amateur spectator sports.

There were 63.4 million spectators at horse races in America while only 43.4 million attended professional and college football games and 24.2 million attended all major league baseball games.

In summary, I urge you to carefully reflect on the dimensions of this important industry that I have outlined briefly today. I respectfully ask that you also consider the many other factors which either have not been measured or are by nature intangible.

Still, these factors, too, substantially increase the economic impact and other contributions of the horse industry to America.

I salute each of you for your diligent efforts to find equitable means for sharing the burden of taxation.

At the same time, however, I would urge you to take care that you do not "throw out the baby with the washwater."

THE IMPACT OF HORSES ON THE ECONOMY OF THE UNITED STATES IN 1968

SUMMARY REPORT

SEPTEMBER 15, 1969

SPINDLETOP RESEARCH, INC.

(2755)

THE IMPACT OF HORSES ON THE ECONOMY OF THE UNITED STATES IN 1968

(Summary Report)

By

Jack Hopper, Ph.D.

September 15, 1969

SPINDLETOP RESEARCH CENTER • LEXINGTON, KENTUCKY

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I. INTRODUCTION

The public's interest in all forms of recreation in the United States has expanded during the last ten years, primarily as a result of the rapid growth of income. Overlooked has been the growth in recreational activities associated with horses. Especially impressive has been the growth of activities utilizing western horses, such as horse shows, trail riding, contests, and other participatory events. Interest in the different breeds and all horse activities is evident in the rapid increase in horse registrations, in numbers and frequency of horse sales, in the rapid growth in sales volume of supplies and equipment, and the proliferation of firms established to supply and service horses. One of the more obvious indicators of interest in horses is the increase in the number of horse magazines and their circulation. The study includes data obtained from a survey of 75 horse periodicals, most of which have been operating less than 15 years.

The size, scope, and growth of the horse "industry" has been largely unnoticed by much of the nation. The fragmented, heterogeneous nature of horse activities has prevented horsemen from joining in a common effort to publicize the renewed and changed size of the horse industry and its importance to the economy of the nation.

The Commonwealth of Kentucky is internationally known for the high quality of its horses. This reputation results from two factors: favorable geography, and expert horsemen. People in Kentucky have long recognized the importance of horses to the economy of the state, and are interested in the growth and vitality of the horse industry.

Spindletop Research, Inc., a not-for-profit research institution established by the Commonwealth in 1961, is active in research efforts directed toward the growth and development of Kentucky. As a public service effort, it has undertaken this study of the effect that horses have upon the economy of the nation, and indirectly upon the state. The results of the study may help show the importance of horses to Kentucky and to the nation as a whole.

SCOPE OF WORK

A nationwide study of an economic activity in the entire country can be made by two methods: a study of the activity in individual states can be made, and the state totals added to give national results; or, the study can be made on a broad aggregate basis, without specific attention paid to any individual states. Since there have been no comprehensive, state-wide studies of horse activities, only the second alternative was possible, and the results obtained in this study are aggregate national figures. It includes no figures for individual states.

The bulk of the published work on horses relates to pari-mutuel racing and the distribution of racing income to the various participants. Most of the money at tracks becomes transfers between segments of the racing industry. To the extent that money transactions in racing, or in other commercial horse activities, affect the economy of the nation, they have been included in the study. The basic aim of the study was to estimate the resources used on horses. The final results show the total amount of three traditional economic resources--land, labor, and capital--that were used in the horse industry in one year, 1968. Nothing can be or has been said about earlier years, and no projections are shown for future years. However, the rapid increase in activities related to horses is obvious, and this growth can be expected to continue for some years after 1968.

PLAN AND METHOD

Horses are no longer used in any number for either transportation or power. Their sole purpose now is to provide recreation, either as commercial spectator recreation, or as non-commercial participatory recreation. For purposes of data collection and analysis, the study was divided into three areas of impact:

- Direct commercial
- Indirect commercial
- Recreation

Direct commercial activities are those in which the horse is the instrument of commerce: breeding, training, racing, showing, and rodeoing. People in these activities make their living directly from working on or with horses. These horses are the tools of the trade. Only a small fraction of the total horse population can be considered part of direct commercial activities.

Indirect commercial activities are conducted by manufacturers and suppliers who furnish products and by professional people who furnish services. People who supply goods and services for either commercial or recreation horses depend upon horses for their livelihood, so that the total horse population can be considered applicable to indirect commercial activities.

Recreation as an economic activity has been given attention here only in its role as a generator of economic activities. The end product of the horse industry is recreation in the form of viewing races, shows, and rodeos; and in owning and riding pleasure horses.

The lack of economic data on horse activities required that the bulk of the information be gathered from each different group or activity in the direct commercial sector and for several in the indirect sector. Nearly 800 questionnaires were mailed, including distribution to 20 separate activity groups. None of these surveys was scientific enough to determine the statistical limits and accuracy of the results. However, the data received from questionnaires from 17 breed registries did allow the findings to be within the limits of reasonable accuracy. The final results are shown as high estimates and low estimates, based upon assumed upper and lower numbers of horses. The low total is the critical total in the study and is presented here as a conservative figure. It was not possible to gather economic data on hundreds of known and unknown firms in the many indirect commercial activities. No attempt was made to sum all of each resource used nationally, but instead, unit resources used for each horse was determined on a limited basis. Once the resource requirements for each horse in each breed and direct commercial activity were determined, then the requirements were applied to the number of commercial horses in that breed and activity.

The determination of thoroughbred trainers' employment and wages can be given as an example. Returns from thoroughbred trainers indicate that as a general average, two men can take care of three horses in training. There are 40,000 to 46,000 thoroughbred horses in training; hence, training requires a minimum of 27,000 employees each year. At an annual average wage of $5,050, the total wage bill is $135,000,000. Employment, wages, and capital in each commercial activity were determined by this method.

II. THE HORSE POPULATION

The total number of horses in the United States has never been accurately determined, but it is likely that the horse population increased along with the increase in human population. The Census of Agriculture has reported the number of horses and mules on farms through 1959. The peak year was 1915, when 26 million were reported; the number has steadily declined since then (reflecting the mechanization of farming), and in 1959, it was 3.2 million. The last count by the Department of Agriculture was 3.0 million in 1960. The series was discontinued and was not reported in the 1964 census.

A count of non-farm horses in the United States has never been made, but the number must have declined after 1900 when automobiles became widely used. The horse population probably reached its lowest point during the 1955 to 1960 period, when the use of horses for transportation and power had practically stopped. Stimulated by the growth of personal income, more leisure time, and suburban living, the use of the horse for recreation probably began to increase during that same decade. The increase in recreation horses, and the accompanying stimulus to commercial horse activities, has gone practically unnoticed except by the people directly involved with horses.

The only current data available on numbers of horses come from the horse breed registries. They registered 143,035 horses in 1968, compared to 72,898 in 1960, an increase of 96 percent (see Table 1). All kinds of horse recreation have been increasing rapidly. Local horse shows, contests, trail rides, and horse club activities have increased along with the increase in registration. The registries estimate that there were 1.26 million horses alive on their books in 1968.*

The number of unregistered (grade) horses used on farms or for recreation in the United States in 1968 is not known. The surveys of horse population made by individual states (see Table 2) have shown that the total number of horses exceeded that shown by the last national census. These studies indicate that the growth in non-registered recreational horses is greater than the decline in farm horses. A conservative estimate of the total number of horses in the country is the combined number of registered horses in 1968,

*The number of Shetland ponies was not available and has not been included.

Table 1
Horses Registered in the United States

Type Horse	Number Registered in 1960	Number Registered in 1968	Uses: Commercial	Uses: Recreation	Total Number Alive in 1968
American Albino	45	78	100	900	1,000
American Saddle	1,600	3,500	30,000	20,000	50,000
Appaloosa	4,052	12,389	10,000	90,000	100,000
Arabian	1,610	6,980	28,000	17,000	45,000
Half Arabian	2,200	9,800	5,500	49,500	55,000
Hackney	459	656	800	6,700	7,500
Morgan	1,069	2,134	1,700	15,300	17,000
Palomino	657	1,262	4,600	18,400	23,000
Pinto	230	2,258	2,000	8,000	10,000
Paint	-	2,390	2,000	8,000	10,000
Quarter	37,000	57,000	86,500	413,500	500,000
Standardbred	7,100	10,200	75,000	57,500	132,500
Tennessee Walker	2,623	8,492	60,000	15,000	75,000
Thoroughbred	12,901	22,700	119,500	87,500	207,000
Ponies:					
Pony of America	612	1,468	1,000	8,500	9,500
Connemara	-	303	200	1,800	2,000
Welsh	740	1,425	1,600	14,400	16,000
TOTALS	72,898	143,035	428,500	832,000	1,260,500

Source: Individual breed registries

Table 2

Comparison of Horse Censuses in Various States

Number of Horses (in 1000's)

	USDA* Count	LATEST COUNT			
State	1960	Farm	Recreation	Total	Year Made
California	79	N.A.	N.A.	267	1959 †
New Jersey	8	10	8	18	1961 ‡
Pennsylvania	58	12	73	85	1961 §
New York	48	N.A:	N.A.	125	1964 **
Virginia	90	23	85	108	1964 ††

* USDA, Agricultural Statistics 1961, pp. 370

† California State Horseman's Association, Horse Census, 1959

‡ New Jersey Crop Reporting Service, New Jersey Equine Survey, 1961

§ Pennsylvania Department of Commerce, Pennsylvania Horse and Pony Survey, 1964

** Harold A. Willman, New York Equine Survey, 1964

†† Virginia Commission of the Industry of Agriculture, The Horse Industry, 1964

and the 1960 farm census number, or 1.2 million plus 3.0 million. A minimum probable total for 1968 is therefore 4.2 million horses. A conservative upper limit to the total number of horses might be 6.2 million, somewhat less than the 7.5 million estimate that the United States Department of Agriculture. A conservative estimate for the horse population in 1968 thus would range from 4.2 million to 6.2 million. Estimates of resource use with horses are based upon these upper and lower limits. These estimates of the horse populations assumed for this study are shown in Table 3. These assumptions imply an incomplete knowledge of the actual numbers of horses in this country.

Table 3
Horses in the United States in 1968

	Number
Registered horses in 1968	1,260,500
Rate of increase 1960-68	96 percent
Number of Commercial registered horses in 1968	428,500
Minimum number of non-registered horses in 1968*	3,000,000
Total minimum number of horses	4,260,500
Maximum number of non-registered horses in 1968*	5,000,000
Total maximum number of horses	6,260,500

*Assumed for purpose of study

Source: Spindletop Research

III. COMMERCIAL HORSE ACTIVITIES

The major part of the resources used with horses in this country is in commercial activities; the remainder is associated with recreation activities and pleasure horses. The activities classified as commercial are breeding, training, showing, racing, and rodeoing, which comprise what could be called the horse industry. Firms and individuals who supply and serve horses do so for both the commercial horse industry and for recreation horses. The total resources directly engaged in the horse industry and in supplying and serving all horses represent the economic effort resulting from horses.

BREEDING HORSES

Commercial breeders hold the responsibility for continuing the blood lines for the horse and pony registries. Even the smallest breed registries have some horse breeders who depend upon commercial breeding for most of their livelihood. The number of these commercial breeders in each breed registry varies from the 40,000 in quarterhorse to the dozen or less in American Albinos.

Commercial breeding is characterized by a high investment in land, equipment, and bloodstock (horses). The total land and capital varies according to the breed of horse. A trade-off exists between the amount of land required and the total value of land; more expensive land will support more horses per acre, so that less total acreage is required.

The labor and equipment required will also vary, depending upon the breed and purpose of the horse, the geographical location of the land, and the size of the breeding operation. Information is not available, however, that would allow precise relationships to be established for these variables. The survey data on labor and equipment are good enough to furnish reasonable averages, but the quality of the data will not justify conclusions about whether or not economies of scale exist.

Source of Data

Data on land acreage, land and equipment values, employment, and wages were obtained from a mail survey of horse farms of the five largest breeds of horses. Both random and selected sampling were used, and more than 300 questionnaires were mailed to breeders in the United States. The response was close to 20 percent. This information was supplemented by a number of personal interviews with selected breeders.

Average horses/man and wages/man ratios were established from the returns for each breed, and the ratios applied to the reported number of commercial horses of that breed. The ratios, total employment, and total wage bill for breeding are shown in Table 4.

Part-time employees have been converted to full-time equivalents, and the employment shown is for 12 month employment, or man-years of work. Instead of being classified as number of employees, a better description might be the number of equivalent yearly jobs that were filled.

Average acres/horse ratios were determined and applied the same way to get the total land used and equipment required. Table 5 shows the factors used for land and equipment, the total land used, and the investment for land and equipment in breeding. The investment in commercial horses is shown in Table 6 (includes value of animals only).

TRAINING RACE HORSES

Training thoroughbred, standardbred, and quarterhorses for racing is carried on by a large number of individualistic, mobile, entrepreneurial types. Trainers employ nearly all of the vast "backstretch" labor at all 135 race tracks. The trainer and his entourage of stable hands and horses move from track to track with the changing racing schedule. Trainers tend to be either local or national, and the national trainers might be running horses at four or five tracks simultaneously.

The arrangement between trainers and owners is flexible, and two types prevail: the public trainers who takes horses from almost any owner, and the employee-trainer who trains the horses of one or two owners of large stables. Standardbred trainers most commonly drive in races in addition to training horses, so that the categories of trainer and trainer-driver have been determined.

Source of Data

Questionnaires were mailed to a selected sample of 120 small, medium, and large trainers in the United States. The response of nearly 10 percent was too small to furnish more than reasonable

Table 4
Employment and Wages Used in Breeding Horses in 1968

HORSE	RATIO HORSES/MAN	YEARLY WAGES/MAN	TOTAL EMPLOYMENT (1000 man-year)	TOTAL WAGES (Million Dollars)
Thoroughbred	6	$4000	13.2	$ 52.8
Standardbred	8	4000	5.0	20.0
Saddlehorse*	10	4500	3.0	13.5
Tennessee Walking Horse*	18	4700	3.3	15.5
Appaloosa	17.5	5400	0.6	3.2
Ponies: Pony of America, Welsh, Connemara	18	5000	0.2	1.0
Palomino, Pinto, Paint	18	5400	0.5	2.7
Arab	18	5000	1.6	8.0
Half Arab	18	5000	0.3	1.5
Morgan, Hackney, Albino	18	5000	0.1	0.5
Quarter	17.5	5400	4.9	26.5
TOTAL			32.7	$145.2

*Includes Training

Source: Spindletop Research

Table 5
Land, Structures, and Equipment Used in the Commercial Horse Breeding Industry in 1968

Horse	Acre Per Horse	Number Commercial Horses (1000's)	Number Acres Used (1000's)	Value Of Land Per Acre (Dollars)	Total Value Of Land (Million Dollars)	Structures & Equipment	
						Fixed Value of (Dollars)	Total Value of (Million Dollars)
Thoroughbred	5	119.5	597.5	$ 1,000	$ 597.5	$ 1,500	$ 179.3
Standardbred	3	75.0	225.0	700	157.5	1,500	112.5
Saddle and Tennessee Walking	3	90.0	270.0	500	135.0	1,500	135.0
Quarter	8	86.5	692.0	400	276.8	1,000	86.5
Other	3	29.5	88.5	500	44.3	1,000	29.5
Total			1,873.0		$1,211.1		$ 542.8

Source: Spindletop Research

Table 6
Investment in Commercial Horses in 1968*

Breed	Number (1000's)	Average Value (Dollars)	Total Value (Million Dollars)
Thoroughbred	119.5	$6,000	$717.0
Standardbred			
Racing	35.0	3,000	105.0
Breeding	40.0	2,500	100.0
Saddle			
Tennessee Walking	90.0	950	85.5
Quarter			
Racing	9.0	1,200	10.8
Other	77.5	700	54.3
Arab	28.0	1,000	28.0
Others	29.5	500	14.8
Total	428.5		$1,115.4

*Value of animals only

Source: Spindletop Research

averages for labor, wages, and investment in training. Knowledgeable racing people have known that training is highly labor intensive, and the survey confirms this general knowledge. Table 7 shows the ratios used and the total employment wages and investment for training.

Estimates for the number of trainers and their earnings were obtained from several sources. Although most trainers belong to trade groups, those organizations have very little information on the number or earnings of full-time trainers. The Horsemen's Benevolent Protective Association reports about 16,000 members who are trainers. The number of full-time trainers is estimated to be 10,000, and each earns an average of $10,0C0 a year. Trainer employment is also shown in Table 7.

RACING HORSES

There are 154 racing associations which conduct racing programs at 135 tracks in the United States. They vary in size from $6 million average daily bet at Aqueduct in New York, to $110,000 at the Fair, in Billings, Montana. Associations usually operate for two to six months and most tracks are closed the rest of the year. A number of tracks, such as Ak-Sar-Ben, in Omaha, remain open all year for racing and other uses.

Many track employees do not work full-time, although a sizeable number travel the track circuit and work much of the year. Employment at tracks varies with the day of the week, and peak employment is on Friday and Saturday.

Source of Data

Labor, wage, and investment information was obtained from a mail survey of 21 race tracks in the United States. A selected sample of three each of the small, medium, and large tracks, including harness, thoroughbred, and quarterhorse, provided detailed information on wages and employment. Replies were received from 19 of the tracks. Representative data on employment and wages by job classification allowed averages to be determined for "representative" tracks for each size on a race-day basis. The number of race days for each track size, multiplied by the representative track average, were grouped into three sizes according to average daily bet. Tables 8 and 9 show the number of tracks in each size, equivalent employment, and wages for thoroughbred and harness tracks.* Information on track investment, shown in Table 10, was much less complete, so that estimates of average track investment are not as accurate as track employment and wages.

*Thoroughbred tracks include quarterhorse data

Table 7
Resources Used for Training Horses

Horse	Ratio Horses/man	Yearly Employment (thousands)	Yearly Wages/man (dollars)	Total Wages (million dollars)	Horses in Training	Equipment Investment/ horse (dollars)	Total Equipment Investment (million dollars)
Thoroughbred Training Labor	1.5	26.7	5,050	135.0	40,000	1000	40
Trainers		10.0	10,000	100.0	-	-	-
Standardbred Training Labor	1.5	20.0	5,050	101.0	30,000	1000	30
Trainers		0.9	-	8.0	-	-	-
Quarterhorse Training Labor	3.5	2.5	6,250	15.7	9,000	1000	9
Total		60.1		359.7	79,000		79

Source: Spindletop Research

Table 8
Employment and Wages at Thoroughbred Race Tracks

Track Size	Number of Tracks	Yearly Employment (Man-Years)	Total Wages Paid (Million Dollars)
Small	47	3,998	21.8
Medium	30	5,153	32.6
Large	23	6,928	61.0
TOTALS	100	16,079	115.4

Source: Spindletop Research

Table 9
Employment and Wages at Harness Race Tracks

Track Size	Number of Tracks	Yearly Employment (Man-Years)	Total Wages Paid (Million Dollars)
Small	20	1,859	10.6
Medium	23	2,781	14.9
Large	10	903	7.0
TOTALS	53 (34)*	5,543	32.5

*Fifty-three harness racing associations hold meetings, but nineteen use thoroughbred tracks.

Source: Spindletop Research

Table 10
Investment in Race Tracks in 1968

	NUMBER OF TRACKS	VALUE EACH (Million Dollars)	TOTAL VALUE (Million Dollars)
Thoroughbred	100	5	500
Standardbred	34	3	102
TOTAL	134		602

Source: Spindletop Research

Associated racing activity is shown in Table 11. Most tracks contract out their food service, and could not furnish information. The estimates shown were based upon a limited amount of data supplied by one of the major concessionaires.

The numerous other services at tracks also are furnished by outsiders. Totalisator, film patrol, photo finish, Telautograph, and automatic timer services are provided by dozens of firms, from whom wage and employment data could not be obtained. Several thousand employees and millions of dollars in wages are not included.

Thirty four racing commissions operate in the 30 states that permit pari-mutuel betting. The employment and wage data were solicited from each, and these totals also are shown in Table 11.

The number of jockeys and driver-trainers and their earnings were estimated from data published in The American Racing Manual and by the United States Trotting Association. Earnings were based upon minimum charges plus winnings. Data on quarterhorse jockeys came from the American Quarterhorse Association.

SHOWING HORSES

The number of shows in the United States has been increasing along with the increase in registered horses. Much of the show activity is recreational, and most horse shows have low employment. Many of the larger shows contribute to charity, but the total amount is not available. The minimum employment at nearly any show will be one or two judges for the length of the show. The larger shows, such as Pin Oak, in Houston, and Devon, in Pennsylvania, employ sizeable numbers of people during the show and have a full-time staff during most of the year. Few shows are this large, however. Even fewer shows own their own quarters; most lease space and employees from stadiums or arenas.

Shows are listed by the American Horse Association, or the breed registry, or by both. Eastern shows are generally larger than western shows, but there are fewer of them.

Source of Data

Questionnaires were sent to a selected sample of 12 eastern and 40 western small, medium, and large horse shows. In addition, personal interviews were conducted with the operators of four medium and large eastern shows not included in the sample. The personal

Table 11
Employment and Wages Used in Associated Track Activities

	Yearly Employment (Man-Years)	Wages (Million Dollars)
Track Food Concessions	3,200	9.8
State Racing Commissions	1,000	9.1
Thoroughbred Jockeys*	1,100	23.0
Thoroughbred Jockeys' Valets†	247	1.3
Standardbred Driver-Trainers	1,900	11.4
Standardbred Trainers	884	8.8
Quarterhorse Jockeys‡	1,000	0.4
Total	9,331	63.8

*Represents jockeys who made most of their income from riding. Part of jockeys' earnings go to support agents.
†Valets are paid by both tracks and jockeys, but only the track payments are shown here.
‡Includes part-time jockeys.

Source: Spindletop Research

interviews and small questionnaire response provided the basis for the wage and employment estimates for representative size of shows. The number, employment, and wage data are given separately for eastern and western shows in Tables 12 and 13.

RODEOS

The increase in the number of rodeos has also been substantial, following the general trend of increased recreation activities. Rodeos are similar to horse shows in their great number and variety. The Rodeo Cowboys Association and the International Rodeo Association list the rodeos in which their cowboy members are allowed to participate.

Each rodeo requires a minimum number of non-stock people, such as announcers, judges, clowns, ushers, and parking attendants. The stock contractor provides the animals and the stockmen to handle them. Rodeos vary in size from the Houston Livestock Show and Rodeo, put on for six days in the Astrodome, to one day performances in small towns.

Source of Data

A mail survey was made of eight small and medium rodeos. Personal interviews with several rodeo operators and stock contractors supplemented the survey. Information from these sources provided the basis for averages to be developed for two sizes of representative rodeos. The total number of rodeo days was applied to average daily employment and wages for each of the two sizes of rodeos. Total employment and wages are shown in Table 14.

Table 12
Employment and Wages at Eastern Horse Shows

	Number of Shows	Yearly Employment (Man-Years)	Total Yearly Wage Bill (Thousand Dollars)
Large Shows	63	140	990
Small Shows	608	163	1,150
TOTALS	671	303	2,140

Source: Spindletop Research

Table 13
Employment and Wages at Western Horse Shows

	Number of Shows	Yearly Employment (Man-Years)	Total Yearly Wage Bill (Thousand Dollars)
Large Shows	1,958	376	2,643.3
Small Shows	450	6	48.6
TOTALS	2,408	382	2,691.9

Source: Spindletop Research

Table 14
Employment and Wages at Rodeos

	Number of Shows	Yearly Employment (Man-Years)	Total Yearly Wage Bill (Thousand Dollars)
Large Rodeos	108	855	7,117.0
Small	565	699	5,800.0
TOTALS	673	1,554	12,917.0

Source: Spindletop Research

IV. SUPPLIERS OF GOODS AND SERVICES TO HORSES

It is not practical nor necessary to separate the goods and services used by commercial horses from those used by recreation horses. Sales to recreation horses generate employment and wages, have an effect on the economy of the nation, and therefore should be included as part of the total impact from horses.

Suppliers of goods and services to horses are the most diverse of the horse related activities examined in this study. Little information could be obtained from the individual commercial service and supply firms, who often were unable or unwilling to furnish information.

SUPPLIES

Horses require a large variety of goods and materials for their upkeep, but the impact has been shown for only four categories of suppliers:

- Employment in retail feed sales
- Employment and wages in manufacturing saddles and harness
- Employment and wages in manufacturing drugs
- Employment and wages in manufacturing western horsemen's clothing

Estimates can be made for employment and wages in these categories, and they probably represent a large part of all supplies used. No estimates have been made for any other retail or wholesale acitivity, nor for feed manufacturing. The employment and wages for suppliers for these categories are shown in Table 15.

Data are not available on other horse products and services, such as horseshoes, sulkies, vans and trailers, feed supplements, and horse transportation.

Feed Retailing

The number of people employed and wages in retailing feed could not be determined directly; instead, an indirect method was used. It was assumed that commercial horses were fed a recommended diet

Table 15
Employment and Wages of Horse Suppliers in 1968

	Employment (full-time) (Thousands)		Wages (Million Dollars)	
	High*	Low†	High*	Low†
Suppliers				
Feed Retailing	12.3	8.5	91.3	62.8
Equipment Harness & Saddle	2.8	2.1	12.8	9.5
Horse Medicine and Drugs	0.6	0.5	5.5	4.8
Western Clothing	0.8	0.5	2.8	1.6
Total	16.5	11.6	112.4	78.7

*Based on 6.2 million horses
†Based on 4.2 million horses

Source: Spindletop Research

of corn, oats, and hay, and that non-commercial horses were fed a much lower volume of feed. The amount of feed going to non-commercial horses was based upon published survey data gathered from recreation horse owners. Sales/employee and wages/employee ratios from feed retailing were taken from the 1963 Census of Retailing, SIC 5962. Many feed stores handle a complete line of livestock feeds, but the assumption was made that the share of employees attributable to horses was directly related to the sales volume of horse feed. Figures shown are for the two assumed horse populations, 4.2 million and 6.2 million, and show upper and lower estimates of employment and wages.

Saddle and Harness Equipment

The only category horse products that is reported separately in the Census of Manufacturers is leather goods, saddles and harness, SIC 3109931. The employees and wages in manufacturing saddles and harness have been estimated using 1963 and 1967 census data. An upper and lower estimate were made and are shown in Table 15.

Horse Drugs and Medicine

The volume of medicine and drugs used on horses was determined directly from a questionnaire survey made of members of the American Association of Equine Practitioners. The value of sales was converted to manufacturing employees and wages using data taken from the 1967 Census of Manufacturers, SIC 2833. Figures have been shown for the two horse populations (see Table 15).

Western Clothing Manufacturing

The boom in western horse activities is reflected in the increased sales of western clothing. The employment and wages in manufacturing were determined indirectly. High and low estimates of sales were made from sales/advertising ratios in the clothing industry, using the value of 1968 advertising in the five main westerm magazines. Total sales figures were then converted to employment and wages using ratios taken from the 1967 Census of Manufacturers, SIC 232. High estimates were based on an assumed three cents per one dollar of sales, and low estimates on five cents per one dollar. Results are shown in Table 15.

SERVICES

Veterinary Medicine

The number of people working in equine practice was determined from the questionnaire survey of members of the American Association of Equine Practitioners. People who spend part of their time treating horses were converted to full time equivalents, or man-years. The employment and wages results are shown in Table 16.

Farriers

The number of farriers and their earnings were also determined indirectly. Owners of commercial horses shoe their horses more often, and pay more than do the owners of recreation horses. Estimates were made based upon the known average income and yearly shoeing capacity of farriers for each of the two classes of horses. The results shown are better described as average yearly farrier demand, instead of showing the actual supply of farriers. The upper and lower estimates shown in Table 16 are based upon the two estimates of horse population.

Publishing

Nearly 100 horse magazines were asked to furnish information on their employment, wages, and circulation. Their incomplete returns provided the basis for the estimates of total employment and wages for publications about the horse industry, shown in Table 16.

Horse Organizations

More than 100 horse organizations were asked to supply information on their employment and wages. The estimates shown in Table 16 are based upon the incomplete returns from these questionnaires.

Table 16
Employment and Wages in Horse Services in 1968

	Employment 1000's		Wages (Million Dollars)	
	High*	Low†	High*	Low†
SERVICES				
Veterinarians and Helpers	4.7	4.2	36.0	25.0
Farriers	11.5	8.8	137.0	111.1
Publishing	0.6	0.5	3.3	2.9
Horse Organizations	0.2	0.2	1.9	1.7
Total Service	17.0	13.7	178.2	140.7

*Based on 6.2 million horses
†Based on 4.2 million horses

Source: Spindletop Research

V. TAX CONTRIBUTION FROM HORSES

Horse activities generate tax revenues similar to other kinds of commercial and recreational activities in the nation, with one important exception: states which permit pari-mutuel betting share in the earnings from horse racing. These earnings are a sizeable contribution to most states; New York alone received more than $155 million in 1968.

Only two types of tax revenue are shown in the study, land taxes and pari-mutuel horse racing taxes. Other tax figures were beyond the scope of this study. Racing taxes are taken from statistics furnished by the National Association of State Racing Commissioners. Real estate taxes were estimated, based upon an average of three cents per one hundred dollars of assessed value of land, and an assessment rate of 50 percent. The results are shown in Table 17.

Table 17
Tax Contribution from Horses in 1968

	Million Dollars
Pari-Mutuel Revenue	426.9
Local Real Estate Taxes*	18.9
Total	445.8

*Based on 1.97 million acres of land valued at $1.26 billion

Source: Spindletop Research

VI. RECREATION FROM HORSES

Horses have contributed for years to spectator recreation at racing, but it has been only within the last ten years that they have contributed in a large way to participatory recreation. Not much direct data are available to show the increase in horse recreation, but indirect evidence confirms that growth has occurred in horse recreation. The increased number of horse magazines and their circulation, the increase in number of state breed registry organizations, the growth in the number of suppliers, and the growth in number of smaller horse shows reflect the increased interest in horses. In 1966, the American Quarterhorse Association approved 1239 shows; the number rose to 1416 in 1968. Riding at stables and in 4-H clubs has increased; trail riding is becoming a major sport.

Attendance information on horse races is reported yearly by the National Association of State Racing Commissions. The number of people attending horse races has been fairly stable during the last few years. During 1967, more than 63 million people went to see horses race. Table 18 shows that horse racing attracts considerably more people than any of the other popular professional spectator sports.

The estimated value of pleasure horses is shown in Table 19, based upon minimum and maximum numbers of horses.

Table 18
Selected Professional Recreational Activities
in the United States in 1967

Activity	Attendance (Millions)
Professional Baseball (major league)	24.2
Professional and College Football	43.4
Professional Basketball	3.1
Horse Racing	63.4

Source: Statistical Abstract of the United States 1968, pp. 207

Table 19
Value of Recreation Horses in the United States in 1968

Type Horse	Value Each (Dollars)	Number of Horses† (Thousands) High	Number of Horses† (Thousands) Low	Total Value (Million Dollars) High	Total Value (Million Dollars) Low
Registered*	400	832.0	832.0	332.8	332.8
Grade	100	5000.0	3000.C	500.0	300.0
Total		5832.0	3832.0	832.8	632.8

*Excludes 428,500 registered commercial horses
†Based on upper and lower limits of 6.2 million and 4.2 million horses

Source: Spindletop Research

VII. SUMMARY OF RESULTS

Resources used in the horse industry in the United States in 1968 are summarized in Table 20. These estimates are necessarily conservative because some known activities could not be included. The commercial sector, especially the employment and wage figures shown, are recognized to be understated by some amount. Despite this downward bias, the estimate of resource use presented here is considered to be a sufficiently accurate representation of the impact of horses on the economy of the country.

Table 20
Summary of Findings

I. HORSE POPULATION

Estimate of Non-Registered Horses		5,000,000*	3,000,000+
Registered Horses			
Commercial	428,500		
Recreational	832,000	1,260,500	1,260,500
Total Horses		6,260,500	4,260,500

II. LABOR USED FOR HORSES

	EMPLOYMENT	WAGES
Breeding	32,700	$145,200,000
Training	60,114	359,700,000
Racing	30,953	211,700,000
Horse Shows	685	4,831,901
Rodeos	1,554	12,917,000
Total	126,006	$734,348,901

Suppliers	16,584	11,636	$112,400,000	$ 78,700,000
Services	17,000	13,754	178,250,405	140,700,000
	33,584	25,390	$290,650,405	$219,400,000
	126,006	126,006	734,348,901	734,348,901
	159,590*	151,396+	$1,024,999,306*	$953,748,901+

III. LAND RESOURCES USED FOR COMMERCIAL HORSES

Acres - 1,873,000

Value of Land	$1,211,100,000

*High Estimate
+Low Estimate

Table 20 (Cont'd)
Summary of Findings

IV.	CAPITAL RESOURCES USED FOR HORSE INDUSTRY		
	Breeding		$ 542,800,000
	Training		79,000,000
	Race Tracks		602,000,000
	Horses		1,115,400,000
	Total Capital Investment		$2,339,200,000
V.	TOTAL INVESTMENT IN LAND AND CAPITAL		$3,550,300,000
VI.	REAL ESTATE AND PARI-MUTUEL TAXES		
	Real Estate Taxes		$ 18,900,000
	Pari-Mutuel Revenue		426,900,000
	Total Taxes		$ 445,800,000
VII.	RECREATIONAL		
	Value of Recreational Horses	$832,800,000*	$ 632,800,000†

*High Estimate
†Low Estimate

Source: Spindletop Research

(Whereupon, at 12:55 p.m., the committee was recessed, to reconvene at 2:30 p.m., of the same day.)

AFTERNOON SESSION

Senator ANDERSON (presiding). Senator Smathers, will you introduce your people?

Mr. SMATHERS. Yes, sir.

Senator Anderson, the American Horse Council would like to present a statement for the record on behalf of former Senator Thruston Morton and myself as general counsel and ask that that be made part of the record.

Senator ANDERSON. Without objection it will be so done.

(The document follows:)

STATEMENT OF THE AMERICAN HORSE COUNCIL, INC.

SUMMARY

1. The American Horse Council, Inc., an organization of some 200,000 members, consisting of most of the major horse associations in the United States is unalterably opposed to the farm tax provisions contained in Sections 211, 212 and 213 of H.R. 13270.

2. These provisions, if enacted into law would constitute a serious threat to much of the $12 billion horse industry in America.

3. At stake in that industry are (a) the interests of the 187,000 young boys and girls in 4-H horse projects (b) the well being of thousands of horse breeders-farmers who have no special federal subsidies (c) the investment of capital in rural communities which has created many thousands of jobs for the people of these areas making it possible for them to stay out of our overcrowded cities (d) the horse racing industry which returned $427 million to the 30 states where parimutuel betting was in operation in 1968 and (e) the schools, scholarship programs, hospitals, police and fire protection, new parks and play grounds that these millions make possible.

4. Congress has always championed incentives for the farmer. Since 1915 it has fought for the right of farmers to use the simplified cash method of keeping books. As recently as 1962, Congress specifically exempted livestock from Section 1245—the depreciation recapture rule applicable to personal property.

A. The Horse Industry

It is estimated that there are approximately seven million horses in America. The industry has lived through a virtual revolution in the past 25 years. It has now become a major factor in our economy. According to the Department of Agriculture, horse owners spend $5 billion a year just for items such as feed, drugs and equipment.

Added to that are the moneys generated by breeding farms, payrolls for allied industries such as the manufacturers of saddles, horseshoes, trailers, boots, hats, etc. Additional millions are spent in travel costs to attend horse shows, racing, rodeos and other horse events. The Department of Agriculture has estimated the size of the total horse industry at $12 billion.

B. Contributions of the Horse Breeder

At the heart of this great industry is the breeder of horses. Without him, we would not have witnessed a five million head increase in the horse population in the last quarter century. And without his continuing operations in the future, the industry would slip back into the deteriorated condition it found itself in during the early 1940's.

Horse breeders are often glamorously portrayed as men of great wealth—owners of luxurious stables and million dollar studs.

On the contrary, the average breeder of horses—race horses, pleasure horses, quarter horses, trotting horses, children's ponies—this average breeder more closely fits the mold of the average farmer.

For in fact, the horse breeder is a farmer. The product of his work—like farmers who till the soil and those who breed livestock—is subject to all the vagaries of weather, market fluctuations and, perhaps most importantly, the unpredictability of his crop. One wrong decision during a four year interval can spell disaster for him, just as it can for other breeders of livestock. There's no sure way of knowing in advance which of his foals are going to fall victim to disease or injury or some late developing physical disability. In good times and bad, he has to continue to buy feed, fence posts and fertilizer.

The farmer who breeds horses doesn't enjoy price supports from the Federal Government; he doesn't share in incentive payments such as those afforded to the sheep industry; unlike the dairy and beef industries he has no protection from excessive foreign imports.

The horse breeder has asked for no subsidies from the Federal Government. And he has none. Yet, along with other farmers, he feels the pinch of the skyrocketing costs of farm production.

5. The problem arises today because much publicity has been focused upon what is said to be a great "loophole" in the law. Yet the proposed remedy contained in the farm provisions of H.R. 13270 would raise only $5 million in 1970. *This constitutes only 3/1000 of 1% of the $154 billion in taxes collected by the Federal Government last year. Furthermore for the past 3 years the number of returns showing farm losses declined at the rate of 25,000 each year.* The problem is thus insignificant compared to the overall problem of collecting billions in taxes and closing giant loopholes.

6. We believe the answer lies not in new legislation but in more strongly enforcing the present law such as Section 165 which prohibits the deduction of all farm losses unless a farm is being operated "for profit."

Thruston B. Morton, President, and George A Smathers, General Counsel, submit the following statement on behalf of the American Horse Council, Inc.

Statement

I. Introduction

The American Horse Council is an organization of some 200,000 people who have joined together in the common goal of promoting the interests of the burgeoning horse industry of our nation. It was formed to define and implement program to meet the immediate and long-range needs for the industry particularly those concerned with medical research; studies in regard to its economic impact and contribution; and familiarizing the government and the general public with the industry.

The cohesive factor in the membership of our organization is horse ownership and a direct interest in the horse industry; our ranks cut a wide swath across our country's economic scale, both individual and businesses. Among the associations that have joined in forming the Council are the American Andalusian Association; the American Hackney Horse Society; American Horse Shows Association, Inc.; American Quarter Horse Association; American Saddle Horse Breeders Association; Appaloosa Horse Club, Inc.; Arabian Horse Club Registry of America, Inc., Morgan Horse Club, Inc.; National Association of State Racing Commissioners; The Jockey Club; The Pinto Horse Association of America, Inc.; The United States Trotting Association; Thoroughbred Breeders of Kentucky, Inc.; and Thoroughbred Owners and Breeders Association.

The citizen who devotes his life and money to breeding horses is making a contribution to the well-being of rural America. He is providing jobs, purchasing power and healthy recreation for our people. He is supporting the 187,000 young boys and girls in 4–H horse projects. He has helped to transform dying rural areas into vibrant places to live and work and raise a family.

In the last several weeks, we have heard the term "outside capital" in farming maligned. It has been used interchangeably with "tax gimmickry". We need to remember what capital invested in horse breeding, pure bred livestock operations, and crop improvement has meant to communities where it has been invested.

Henry Matthiesson remembers. He and his father have been cattle farmers in the Blue Ridge Mountains for the past 43 years. He has seen new capital come on the land and make it better—better for farming and better for the people who live and work in the valley they call home. Here is the way the former president of the American Hereford Association described it to the Ways and Means Committee:

"I look back on the origins of the farming community in which I have lived. There are perhaps a half dozen large farms in the small valley today; this, in place of perhaps 20 or 25 farms forty years ago. Most of that land was in the hands of banks in those days, and lying unfarmed. Today, there are perhaps an average of four to six farm families working on *each* of those farms, making a regular, secure living, and these farms are responsible for much of the prosperity of business in the neighboring communities. Much of that valley was an overgrown wilderness, 'farmed out,' when we came there, with none of the modern machinery and know-how that is available to it today. Someone put money in it forty years ago, or it would *still* be marginal support. That application of capital did not wreck *that* farming community or drive people out of it, it preserved the community and the people and made it better."

C. The Horse Racing Industry

The owners and breeders of race horses are making a unique contribution to our economy. Like all other horsemen, they enjoy no federal subsidies. On the contrary, they are subsidizing substantial tax revenues in the 31 states where a parimutuel betting system is in operation.

In Illinois, for example, horse racing returned $40 million to the State treasury in 1968. In New Jersey the figure was $34.4 million; California $57.3 million; and New York $155.7 million.

These moneys support schools, scholarship programs, hospitals, police and fire protection, new parks and playgrounds. They help make the community a better place to live.

Take those millions out of a state's treasury and one of the three things must happen: Either state ad valorem taxes will have to go up; or the Federal Government will have to increase state aid programs; or the quality of life will suffer.

This state tax revenue is always substantially greater than the total purse winnings of horse owners and the income to race tracks combined. In thoroughbred racing last year, total tax revenue exceeded total purse distributions by $160 million.

The cost of maintaining all thoroughbreds in 1968 was greater than all purse distributions by approximately $193 million.

It is apparent then that the horse racing industry is largely subsidized by the owners. Because of their willingness to invest in such a high risk venture, state and local governments can do more for their people.

II. THE CONGRESS HAS ALWAYS SUPPORTED FARM INCENTIVES

Historically, the Congress of the United States has always recognized these values that farming and ranching contribute to the betterment of our society.

Congress has also long been aware that our oldest and largest industry has not yet found its place in the sun—that farming has not shared in the prosperity of our economy generally. Congress has, therefore, deliberately written into the law certain provisions which it felt were essential for the farming and ranching industries.

For example, after capital gains provisions were added to the Code in 1942, the Treasury Department, concerned as always only with the amount of revenue returned to the government, tried for nine years to exclude breeding livestock from property that would qualify for capital gains treatment.

Restrictive Rulings were issued by Treasury in 1944 and again in 1945. Notwithstanding a 1949 Court of Appeals decision to the contrary, Treasury persisted. However, the Conference Committee of the House and the Senate meeting on the Revenue Act of 1950 directed that the Treasury follow the Court's ruling.

The following year, in 1951, the Congress, after deliberation, specifically applied capital gains treatment to livestock held for 12 months or more for draft, dairy or breeding purposes.

When the Congress amended the so-called hobby law in 1954, it recognized that the provisions written into the original amendment ten years earlier could "penalize bona fide business and enterprises." The Congress excluded, therefore, certain costs from computing the basic $50,000 loss figure, among which were those costs that farmers have traditionally been permitted to expense or capitalize.

In 1960, Congress added soil and water conservation, and in 1962, land clearing, to those costs which a farmer can expense or capitalize.

Also in 1962, when Section 1245 was added to the Code, Congress deliberately provided that livestock would not be subject to the recovery of depreciation rules.

A. Cash Accounting

Perhaps in no other tax area has Congress demonstrated greater concern for the farmer than in its insistence down through the years that the farmer may use a cash method of accounting.

Congress has always recognized that the accrual accounting method would impose new and complex difficulties and significantly greater costs on the farmer who is already besieged with an almost untenable burden of ever higher production costs, and low prices for his product.

Congress has, therefore, always fought for the cash method for farmers to help him avoid the necessity of keeping elaborate books and records and the almost impossible burdens of maintaining inventories and properly allocating costs.

Farmers have historically managed their farm operations on a cash basis. The Congress has long recognized this practice as a fact, and 54 years ago, two years after adopting the Sixteenth Amendment to the Constitution, which authorized the personal income tax, approved the Treasury regulations authorizing the right of farmers to operate their farms on a cash basis.

In fact, up until 1958 the Treasury *required* farmers to use cash accounting, if they did not keep complete and precise records. Treasury Regulations further say that the farmer is among those taxpayers who are not expected to keep detailed books of account.

The Treasury Department recognizes the difficulties that an accrual system poses for the farmer. It has, for example, set out in the Regulations how gross profits of a farmer are to be ascertained.[1] It has permitted an exception to the general rule and allowed the farmer to inventory his animals held for draft, dairy and breeding purposes along with those held for sale.[2] It has provided special inventory valuation methods for farmers.[3]

For the past eighteen years, the Congress has steadfastly resisted numerous attempts by Treasury Department officials to require farmers to give up the cash method.

When Congress acted in 1951 to assure that breeding livestock could qualify for capital gains, the following language of the Ways and Means Committee Report was emphatic in its insistence that Treasury not force the farmer to give up the cash method:

"Your Committee believes that the term 'livestock' should be given a broad, rather than a narrow interpretation; *and that the gains from sale of livestock should be computed in accordance with the method of livestock accounting used by the taxpayer and presently recognized by the Bureau of Internal Revenue.*"

The Senate Finance Committee was also unequivocal in laying down guidelines it expected Treasury to follow:

"Your Committee believes that the gains from sales of livestock *should be computed in accordance with the method of livestock accounting used by the taxpayer and presently recognized by the Bureau of Internal Revenue.*"

Following this action by the Congress, the Secretary of the Treasury sent a letter to the then Chairman of the Senate Finance Committee, Senator Walter George of Georgia, requesting that the Congress approve legislation giving the Department the authority to require farmers to adopt the accrual method. Senator George and the Committee refused to accede to the Treasury request and took no action.

In the President's Tax Message to Congress in 1963, the matter was again brought up. The Treasury Department, in its appearance before the Ways and Means Committee that year, urged that farmers who made over $15,000 in nonfarm income be required to establish an "Excess Deductions Account," made up of farm losses less gains. Gain from the sale of capital assets would be treated as ordinary income to the extent of the amount in the account. The effect of this proposal would have been most onerous to the small cash method farmers.

The Treasury was once again notably unsuccessful in changing the long-held position of the Congress about this matter. The Ways and Means Committee refused to act.

III. THE PROBLEM TODAY

Today we find these farm tax provisions once again under attack. It is said that some people are abusing the law—that they are putting money into farming as a "tax gimmick"—scavenging, so to speak, on the cash accounting method and other provisions Congress has authorized to help the farmer.

It is being said that this constitutes a great "loophole" in the tax laws; that

[1] Sec. 1.61–4.

[2] Sec. 1.61–4(b)(7).

[3] Sec. 1.471–6. (A farmer on the cash method may not inventory; one on the accrual method must. (See 1.61–4(b)).

this so-called "loophole" should be closed not by attacking the "tax gimmick operator," but by changing the whole system of farm accounting which Congress has consistently fought to preserve.

At the outset, we should ask ourselves how big is this problem that some say requires extreme remedies in order to cure? The Federal Government collected a total of $154 billion in taxes last year. The largest estimate of revenue loss that this particular problem involves—$145 million—was made by Mr. Surrey. If we accept his estimate. it amounts to less than 1/10 of 1% of the total revenue collected. The spokesmen for the new Secretary of the Treasury estimate that his proposal to solve this problem would raise $10 million in 1970. This comes to less than 1/100 of 1% of the total revenue collected. The proposal passed by the House of Representatives would increase revenues by $5 million in 1970. This represents 3/1000 of 1% of the total revenue collected.

Furthermore, in the last three years the number of returns showing a farm loss declined at the rate of almost 25,000 each year.

We submit, therefore, that this is really an insignificant problem when compared with the overall problem of collecting billions in taxes and in closing giant loopholes. The Surrey proposed pointed to only 2,600 tax returns of wealthy people as the maximum that could be involved. We say could be, because no one has ever claimed that all of those are "tax gimmick" operators, rather than honest, hard-working farmers and ranchers who suffer losses in the legitimate pursuit of improving horse breeds or cattle breeds or crops.

A. What is the Answer?

But even if, out of three million farmers, these 2,600 were all violating the law—the question arises as to what we are going to do to stop it. Do we change the laws which Congress has insisted upon for the benefit of the farmer for 54 years? Do we thus jeopardize the already precarious position of agriculture? Has farming reached such a level of prosperity that we should take away any advantages it may presumably have? We don't think so. We believe that this Congress should and will think as have the other Congresses of the past; that is to say that this is a minor problem that the Treasury presents; that the farmer should not be pilloried and abused; that the law should remain as the Congresses of the past intended it to be.

We recognize that every law the Congress writes—and particularly tax laws—are in time circumvented and abused by a few of the astute and ill-intentioned operators. But we don't think, to quote the ancient aphorism, "we should burn down the barn to catch a few rats." We believe that the answer lies in enforcing the laws already on the books.

We believe that these people who allegedly engage in farming to scavenger on the traditional and essential farm provisions are not covered by the provisions of the law under which they operate. Most of them would fail the "intent tests" spelled out in Sections 1231(b)(3) and 165.[4] There is no doubt that the Treasury Department can move effectively against questionable farm losses. In fact, such losses are now being questioned by the Internal Revenue Service in 47 cases presently pending in the Tax and District Courts under Section 165.

Some of these "tax gimmick" operations are also subject to regulation as investment contracts by the Securities and Exchange Commission. The SEC has already asserted its authority in similar ventures involving beaver, mink and fox.

Therefore we believe it would be a far wiser course for the government to move vigorously under present law against violators of those laws. To change these laws, as proposed, would be to punish all three million farmers in America for the wrongdoing of a few.

IV. ALTERNATIVE REMEDIES ADVANCED TO MEET THE PROBLEM

Let us examine what is proposed as remedies for this problem:

A. *The Surrey proposal* would limit to $15,000 per year the amount of farm losses that could be offset against non-farm income by any farmer who did not adopt the accrual method and capitalize all costs which can now be expensed or capitalized at the taxpayer's option.

B. *The Metcalf Bill* (S. 500) also applies to any farmer who does not adopt the accrual method and capitalize all costs which can now be expensed or

[4] Under 1231(b)(3) livestock must be held for one year *for draft, dairy or breeding purposes.* If they are not held for *one of those purposes* they do not qualify for capital gains. Under Section 165 a farm must be operated "for profit" in order for losses to be deductible.

capitalized at the taxpayer's option. Farmers who do not comply with these conditions would lose their right to offset farm losses against non-farm income on a dollar-for-dollar basis to the extent that non-farm income exceeded $15,000. Thus, a farmer having a $30,000 non-farm income, could deduct no farm losses against his non-farm income.

C. *The Miller Bill* (S. 1560) simply disallows all farm losses, except those attributed to a casualty or research) to any farmer who does not derive at least ⅔ of his total net income from farming. It applies irrespective of whether the farmer is on the cash or accrual method.

D. *The Treasury Tax Reform Proposals of April 22, 1969*, would:

(1) Make the accrual method and capitalization of expenditures such as for soil and water conservation, fertilizer, and land clearing costs (which can now be expensed or capitalized) the standard for determining farm losses which must be included in the computation of "preferences" under the "Limit on Tax Preferences" proposal. Cash method farmers would have to recompute their losses on the accrual method and the difference would constitute "preferences." Farm capital gains could not offset farm losses in the determination of "preferences." (Under the "Limit on Tax Preferences" proposal, a taxpayer can claim certain exclusions and deductions now allowed in full, only to the extent that such "preferences" do not exceed 50% of his total income. In other words, such preferences would be taxable to the extent that they exceeded his income subject to tax from all other sources.)

(2) Livestock was excluded from the depreciation recovery provisions of Section 1245 when the law was enacted in 1962. This exception would be removed, meaning that gain on the sale of livestock to the extent of prior depreciation taken would be treated as ordinary income.

(3) The holding period for livestock *other than race horses* would be extended from the present one year to the shorter of two years or ⅔ of the expected useful life before sales could qualify for capital gains.

(4) Race horses would qualify for capital gains only if (a) "in the hands of a breeder" they had actually been bred or (b) they were used "in the racing business" for two or more years.

(5) Farmers on the cash method would have to establish an Excess Deductions Account (EDA). All losses in excess of $5,000 would go into the account. The account would be reduced by net ordinary farm income in subsequent years. The proceeds of the sale of capital assets would be treated as ordinary income to the extent of the amount in the account in the year in which the sale is made; for example, a taxpayer loses $100,000 in 1969. $95,000 goes into his EDA. In 1970 he sells off livestock which would ordinarily give him a capital gain of $200,000. $95,000 is treated as ordinary income and the $105,000 is capital gains.

(6) Under the Hobby Law (Section 270), certain deductions are disallowed when a taxpayer incurs net losses in excess of $50,000 for five consecutive years. Treasury recommended that the time period be changed to "any three of five consecutive years."

E. *The House-passed bill, sections 211, 212 and 213 of H.R. 13270, would provide as follows:*

(1) A new hobby loss provision (Section 270) would disallow the deduction of *all* legitimate expenses from any business activity carried on "without a reasonable expectation of profit."

Heretofore, the law has always been based upon the "intent" of the taxpayer to make a profit. Under this new provision, the IRS will be permitted to decide whether the taxpayer's *intention* was *reasonable*. This would be a dramatic departure in the law and one that would cause undue hardships, uncertainty, and necessitate costly and time-consuming litigation.

(2) An Excess Deductions Account (EDA) will be required to be established which will cause taxpayers to report as ordinary income what would otherwise be classified as capital gain. This change in the tax rate could be the difference between a 25% and a 70% bracket. All taxpayers who make in excess of $50,000 in non-farm income and whose farm losses exceed $25,000 will be required to establish an Excess Deductions Account. Losses in excess of $25,000 would be entered in the EDA. To the extent of the amount in the EDA, capital gains from the sale of farm assets would be treated as ordinary income. In effect, this could increase a horseman's taxes by almost 200% under the present law.

(3) Depreciation claimed for livestock would be "recaptured" when the animal is sold. Thus, gain on the sale of livestock would be treated as ordinary income rather than capital gain, to the extent of depreciation deductions previously claimed.

(4) Livestock would not qualify for capital gains treatment until it was held at least one year after the animal normally would have first been used for draft, dairy, breeding or sporting (such as horse racing) purposes.

F. *The Treasury Department proposed to the Senate Finance Committee on September 4, 1969 that the farm provisions of H.R. 13270 be amended as follows:*

(1) That the Excess Deductions Account rules apply to any farmer whose non-farm income exceeds $25,000 and whose farm losses exceed $15,000. In such a case, *all farm losses* should be included in the E.D.A.

(2) The term "profit" in the proposed new hobby loss provision should "be specifically defined to include not only immediate economic profit but also any reasonably anticipated long-term increase in the value of property."

V. THE PROPOSED REMEDIES WILL HURT THE AVERAGE FARMER

All of these proposals fall into the following categories:

(a) threat to the cash method of accounting;
(b) limitations on the option to expense or capitalize certain costs;
(c) restrictions on Section 270, the hobby law;
(d) limitations on non-farm income.

Let us look briefly at each of these categories.

(a) Our response to the attack upon *the cash method* farmer is that the issue for the past 20 years has been between the technicians down in the Treasury Department who obviously want to increase tax revenues, and the Congress of the United States which looks at the broad spectrum of what is best and, indeed, what is essential for America's three million farmers.

Congress has always put the welfare of the average farmer first in its deliberations. We don't believe the sordid story of a handful of tax dodgers is going to persuade the Congress that attacks upon the farm community and farm traditions are an appropriate response.

(b) The Surrey and Metcalf proposals provide that, in addition to giving up the cash method, farmers may *not* offset farm losses against non-farm income *unless* they also capitalize all costs which the Congress has heretofore permitted the farmer the option of either capitalizing or currently deducting. These include costs of soil and water conservation, fertilizer and land clearing.

The Treasury proposal calls these expenses "tax preferences" upon which it would place a 50% limitation.

Congress just added the soil and water conservation provision to the Code in 1954. The provision on fertilizer was added in 1960 and that with respect to land clearing in 1962. Have conditions for the farmer improved so much in the past seven years that these provisions are no longer needed by the farm community? It is impossible for us to believe that the Congresses of recent years who wrote these provisions into the law for the benefit of farmers were so ill-informed or short sighted.

(c) The present hobby law provides that if losses in a trade or business exceed $50,000 for five consecutive years, the individual's tax is re-computed for each of those years and limitations are placed on the amount of loss that can be deducted. In computing the $50,000 loss figure, certain deductions are exempted by law. For example, in 1954, Congress excluded from hobby loss computations those expenditures which may, at the taxpayer's option, either be capitalized or deducted when incurred.

The Surrey proposal called Section 270 "ineffectual." However, a few years ago, while teaching at Harvard, Mr. Surrey posed this question about Section 270:[6]

"*. . . how can it be withdrawn without affecting the genuine business activities of an individual with his finger in many pies, or those genuine activities carried on by individuals which generally show red figures for the initial years because of the nature of the business, such as horse breeding, fruit raising, mining or hotel operation or may suddenly show losses for several years due to adverse conditions . . .*"

Thus Mr. Surrey pointed a finger at the heart of this problem. It takes 3 to 7 years before new citrus trees begin to bear fruit. The cycle in purebred livestock operations is 5 years. There is a three year lapse from breeding until a race horse is even eligible to enter a purse race. All of these investments take time before they, hopefully, begin to show a profitable return.

[6] "Federal Income Taxation, Cases and Materials," Stanley S. Surrey and William C. Warren, The Foundation Press, Inc., 1955.

After 25 years experience with Section 270, including at least one relaxation of its potentially penal characteristics, we believe that the Congress will finally decide against tightening its restrictions. If the law were changed, as has been proposed, it is a certainty that many taxpayers, who are making great contributions to our people as a result of their research investments into the rural communities of America, will be driven out of these areas.

(d) The proposals that limit the right to deduct *farm losses* against non-farm income seriously damage and restrict the operations of the long-time genuine farmer.

In today's farm economy, the farmer is increasingly turning to off-the-farm supplementary income. In so doing, he is simply following the recommendation of the Farmers Home Administration, which, through its predecessor agency, began urging the farmer to diversify his farm operations when the agency first opened in 1933. For the past decade, the admonition has been to diversify not his farm but his source of income.

The success of these efforts is reflected in a recent address by Dr. M. L. Upchurch, Administrator of the Economic Research Service, U.S.D.A.:[6]

"Off-farm income has become an increasing factor in the life of farm families. *In 1967, the farm population got $13 billion net from farming and $10.7 billion from non-farm sources. On the average, each farm operator family received $4,526 net from farming, and $4,452 from non-farm sources. Non-farm income per farm family more than doubled between 1960 and 1967.*"

If this rate of increase continues in the future, and it will probably accelerate if tax incentives are granted for industry locating in rural areas, the non-farm income of the average farmer will exceed $15,000 in 13 years. If the Metcalf or Surrey proposals were adopted, the average of all three million farmers in America would then be forced to relinquish the cash accounting method they have been able to operate under since 1915 or be denied the right to offset farm losses against their non-farm income.

The strange anomaly of these proposals is that if the farmer proved to be more successful at farming than he was in his other business investments, he could continue to deduct all his business losses against his income from the farm. We believe that fairness and equity require that the principle should work equally in either direction.

VI. THE QUESTION OF LAND VALUES

The Surrey proposal states that "the price of farmland (is) beyond that which would prevail in a normal farm economy." In effect, it says the price of farmland is too high. Senator Metcalf acknowledged that his proposal would bring farmland prices down "in some areas."

We don't believe there is any citizen, either on or off the farm, who wants the land he presently owns to decline in value. With lower land value, the farmer who desires to expand into contiguous acreage, will have less collateral to offer Banks will be reluctant to loan money. The percentage of the selling price the farmer can get on a purchase money mortgage will decline. He will need more cash for a down payment. If he hasn't got it, and there's equity in his existing holdings, he can put up the land he already owns as collateral. But with declining values, it may not be enough, particularly if, like the average American, he already has that homestead under mortgage. He'll find the same problem when he wants a loan for new equipment, or operating capital.

The many farmers who have been able to sell out to land developers, pocket an amount of money they could never have realized from farming, and move further out into the country where they can and do buy more acreage at a fraction of the price they sold for, have not been heard to complain of increased land values. They can do a lot of things for their wives and children they otherwise could not have done. They can upgrade their total standard of living. They can be sure that their children get the best education.

One of the arguments used by the sponsors of these proposed changes is that outsiders with money come in and buy up land so that locals can't buy it. Surely there is little logic to this. The farmer who covets his neighbor's land does not want the value of *his land* to diminish. Surely he should realize that as all our people grow more affluent, have more leisure time, they will normally move back to the farms or ranches as a second home, and of course this increases the price of the land—his neighbor's and his own. This movement upward of land values, we submit, is desirable overall—surely it's better than a downward movement.

[6] Before the Annual Agriculture Outlook Conference, February 18, 1969.

To allege as some do that "outsiders," "tax avoiders" drive up the price of land and hurt the legitimate farmer, is to ignore the facts of our growing population, our growing wealth, our growing leisure time, our growing opportunities to enjoy the long-sought "country life."

VII. THE FARM COMMUNITY NEEDS OUTSIDE CAPITAL

Implicit in these proposed changes is the belief that outside capital which is good and desirable for all industries is somehow harmful to farming.

Completely overlooked are all the benefits that investment capital have meant to the farmer, the rural community and to the American people in general.

Outside capital built American agriculture. It made new technology possible. It has helped to produce the finest beef and the finest citrus of the world. It seems incomprehensible to suggest that we should, all of a sudden, stop our improvements in the food and nourishment we eat—any more than we should stop the investment of capital in the production of championship race horses which attracted over 65 million people to watch organized racing last year resulting in $427 million in state tax revenues to 30 states.

You can't breed an animal and raise a mature offspring ready for the track or the market overnight, anymore than you can plant a seedling and expect a crop the next day. All this takes time—and money. Farm research, like research in every other industry in America, is considered part of the overhead. It is not expected that research will immediately return a profit. But it is essential for the continued growth and development of the farm industry. Take the research dollars out of the space industry and we would never have put an American on the surface of the moon. Take research out of agriculture and the results will have a far more direct and immediate effect upon the pocketbooks and the dinner tables of all Americans. Take dollars away from rural communities and our rural citizens will be forced to move, in greater numbers, into our already overcrowded urban areas.

The Congress won't do that. As a matter of fact, it has numerous bills pending before it today to sweeten tax incentives for industry that move into rural areas. One of these is the Rural Job Development Act (S. 15) introduced by Senator Pearson and co-sponsored by 35 Senators. We don't think Congress really wants to *increase* incentives for all other rural industry and simultaneously *decrease* incentives for farming.

We applaud the purposes of S.15, but does it make sense to ask the Congress to establish new incentives for industries that move into rural communities and provide jobs, while, at the same time drive other businesses and individuals who are now supplying jobs out of our rural communities?

Our reading of Senator Pearson's bill leads us to believe that the incentives it calls for would be available to farm investors as well as investors in other rural industry. This is as it should be.

The Congress has already created a Small Business Investment Company, industry, to stimulate outside capital into small business. This industry has generous tax advantages which include the authority to write off certain capital losses against ordinary income. Perhaps a Small Farm Investment Act, with equally generous tax advantages, would portend an era of general prosperity for the farmer, especially the family farmer, that has somehow eluded all prior efforts.

VIII. CONCLUSIONS

The farming community today is beset with many problems. With production costs at an all-time record high and parity at only 73%, the farmer is getting far less of a return for his efforts than he deserves for having produced the best beef and pork and vegetables and citrus for the American family dinner table.

The farmer needs help. His industry needs stimulation. It needs innovation. It needs research, it needs capital—it needs money. Surely this is no time to be taking money *out* of the farm community.

Somehow, we need to extract the finest principles of other industries that have made this country the free enterprise model of the world, and apply them to a new revolution in agriculture that would truly benefit all the three million big and little farmers in America.

What the farmer doesn't need is further restrictions and encumbrances that would enevitably diminsh his opportunities to achieve success in his chosen field—what he needs is a greater opportunity to achieve a parity with the rest of our prosperous economy.

We don't believe that the farmer who happens to lose money should be identified with or bear the blame or suffer the consequences of a handful of people who are "tax gimmick operators."

It is they—and not the farmer—against whom action should be taken. There are laws on the books today to put the "tax dodger" out of business. Section 165 of the Internal Revenue Code prohibits the deduction of any losses from a farm that is not being operated for profit. If laws such as these were vigorously enforced, as they should be, we would not have to be considering ways to diminish the few incentives that the farmer, thanks to an understanding Congress, enjoys today.

Mr. SMATHERS. As our second witness, Mr. Chairman, I would like to call on Mr. Ed Honnen, who is the chairman of the American Horse Council. Mr. Honnen is a most interesting person, a genuine rancher, and farmer, and I think he has an accomplishment that nobody else in this room can claim. He is 70 years old, a member of the Rodeo Cowboys Association of America, and can still go out and in 9 seconds rope and throw down a steer.

Mr. Honnen, you just take off.

STATEMENT OF EDWARD H. HONNEN, CHAIRMAN OF THE TRUSTEES, AMERICAN HORSE COUNCIL

Mr. HONNEN. Thank you, George.

Gentlemen, it is an honor to be here. I appreciate the courtesy. I am a businessman from Denver, Colo., operating throughout Colorado. I have several ventures. I merchandise heavy construction equipment. I merchandise engines. I do some land development. I do some building construction, and I also have a horse ranch and racehorses.

All of these operations are run with the same endeavor, to make a profit. They are all run with the same type of bookkeeping. The energy and the effort and the business acumen that I possess is put into all of them equally, I have no problem with most of the ventures as far as the Internal Revenue is concerned, but I am continually challenged on the hobby provision, on the horse racing business.

To me this seems to be discrimination because it is not applied to my other businesses. My auditor tells me that if I have a loss in my engine merchandising business, that I could charge it against profits of my horse business, but I cannot charge off losses of my horse business against profit of my engine business.

I can see very little difference in this operation. Most of the challenging has been through the hobby provision of the present law. I believe that this hobby provision might have had some justification when it was enacted some 30 years ago, but today the horse industry is an entirely different setup.

We are at least a $7 billion industry today involved in many facets besides horse racing. The active participation of the numbers of horses in racing is minimal compared to the total number of horses.

I raise quarter horses, and we do a little racing of those horses, but the major part of our horses are used for utility purposes, recreation, youth activities, rodeo events, showing of horses, and as I say, to a minor extent, horseracing.

The U.S. Department of Agriculture alone is sponsoring through their Extension Service 210,000 horse projects with 4–H kids.

The American Quarter Horse Association alone has more than 1,100 youth shows, and I want to assure you that at these youth shows and at these 4–H projects I do not think that you will find any long-haired youth there. These are children that are gaining a wonderful experience in life from their association with horses.

In the horse industry we are talking about a minimum of 4 to 5 million horses. We are not only a heavy impact on the economy of this country, but we are also of great benefit to the social and the recreational welfare of our people.

To me I see no justification in crucifying an industry that is doing as much good for the United States as it is.

Under the present law of the hobby provision, we have learned to live with it. Ir my 18 years' experience in racing horses, I have been fortunate in being able to show a profit every 4 or 5 years, but it is still challenged each year.

This is a discriminatory clause. In the present legislation as proposed we have other measures in there that are of a similar discriminatory nature. The EDA is a method of bookkeeping that is adopted for people who keep their books on a cash basis that is definitely discriminatory and not applicable to other business.

The tightening and more severe provisions of the hobby provision are not applied in practice, to any other business.

Gentlemen, our business is normally a rather speculative business, a rather risky business, because we are dealing not only with the normal economics of a business but we are dealing with genetics, we are dealing with accidents, we are dealing with normal health catastrophes that we have in any animal industry, so rather than be abused, we should be assisted.

We should have some help from the Federal Government in developing an industry that is doing as much for the country as this is.

If you want to kill the horse industry, adopt the provisions in House bill 13270. If you want to bleed it to death, modify those provisions. But if you wish to help us, leave the statutes as they are, because I am sure that with the proper administration of the present laws, that we can weed out the violators, the loopholes that exist today.

Thank you.

The CHAIRMAN. Mr. Honnen, you said you would not see any long-haired youth at one of those quarterhorse shows?

Mr. HONNEN. Male youth I should have said.

The CHAIRMAN. That is why I started to correct you. You would have seen my daughter, because she loves horses, I bought her a $75 horse and she managed to win a fourth prize at somebody's show with a $75 horse. I bought a $500 horse, it darned near killed the judge kicking up in the air while she was trying to handle him, and then I decided why I would buy a better horse so I bought a $5,000 horse and now she has her place covered with trophies that she won with the better horse. But some farmer sold my daughter three horses. If it is that farmer you are supposed to be helping, all I can say is that there are three horses whose sales might have been in jeopardy.

I do not mind losing the money because it is fine for a young woman to get out and compete with other young women with horses. It is fine, and is the cleanest sport that there is so far as I know.

But I do not see how it is going to help farmers if we make it difficult for families to encourage their young people to buy horses and go out and compete. Do you see how it is going to help a farm?

Mr. HONNEN. It won't.

The CHAIRMAN. This is supposed to tax people out of the farming business so it will only be left for farmers. Well, if young people are not able to buy the horses, then how is that going to help the farmer?

Mr. HONNEN. It is not going to help him.

The CHAIRMAN. It seems to me as though the way it stands now, at least as far as this person is concerned, I would at least be encouraged to buy some horses for my children to go out and compete with. But if we are going to fix it so that in addition to what I lost I cannot deduct it as well, I would think that that hurts farmers, because they will have less sale for their horses.

I think you might also find that there will be a lot of farms up for sale, and whatever that farmer hopes to get for the farm he won't get because there will be nobody else except another farmer, who is just as poor as he is, available to buy the farm from him. So I would think when the farmer goes to sell his farm, or if he dies and the widow has to dispose of it, that there would be no market.

There would be plenty of farms on the market looking for buyers with no buyers to buy them.

Mr. HONNEN. If this provision goes through, my farm will be for sale, and I doubt if I will find a buyer for it either.

The CHAIRMAN. That is part of the problem it seems to me.

Do you want to present your other witnesses?

Mr. SMATHERS. No; we will have questions of this witness, if there are any.

The CHAIRMAN. Any further questions?

Mr. SMATHERS. Thank you, Mr. Chairman, and thank you, Mr. Honnen.

Our third witness is Mr. Harry Farnham, who is the president of the National Association of State Racing Commissioners, and I might add is the chairman of the Nebraska State Racing Commission.

Mr. Farnham, why don't you proceed.

STATEMENT OF HARRY J. FARNHAM, PRESIDENT, NATIONAL ASSOCIATION OF STATE RACING COMMISSIONERS

Mr. FARNHAM. Thank you, Senator.

Gentlemen, let me first apologize to you for having to speak to you today with a very hoarse voice. I hope you will bear with me.

With me today are two other commissioners, Mr. Newton Brewer, who is chairman of the Maryland State Racing Commission and Mr. John Bell, who is a member of the Kentucky State Racing Commission. They will be available for any questions that the Senators might have.

The National Association of State Racing Commissioners is composed of the commissioners from 30 States in the United States that have parimutuel racing. This covers harness racing, thoroughbred racing, quarter horse racing—all types of horseracing.

In each of these 30 States there are from one to nine members on the racing commission. In my State of Nebraska, it is a three-member commission, as it is in most States.

We have a membership of these State racing commissions of from 200 to 300 people, and our job is to regulate horse racing, which happens to be the No. 1 spectator sport in America.

Now the reason that I bring this up, gentlemen, is I think great significance must be placed on the fact that these racing commissioners have unanimously, without a single dissenting voice, expressed their opposition to the horse provisions in the legislation that is before this committee.

I am going to be very brief and just try to emphasize three points in connection with my formal statement that was given to you.

First, what weight should be given such a unanimous position taken by State racing commissioners. Well, I think a great deal, because we deal with the horse business, we deal with the matter of parimutuel racing every day of the year.

There is no element of self-interest involved.

As you know, the vast majority of State racing commissioners are paid nothing. They serve at the pleasure of their Governor. So I think that when a group of men like this take a position in unanimous opposition, that considerable weight should be given to it.

Now, secondly, just what is it that these racing commissioners oppose? What do they base their opposition on?

First of all, they feel very strongly that the legislation that is pending bfore you will seriously endanger the $300 million in direct parimutuel taxes that go into the State treasuries of the 30 States that have parimutuel racing.

These provisions would raise $5 million in revenue, but they would endanger $500 million worth of revenue to the States. If the damage this legislation did were to the extent of 20 percent each year, $100 million would be lost in direct tax revenue to the States, in order to close a supposed loophole that would bring in Federal tax money of $5 million.

Further, this revenue to the States costs less than 1 cent on the dollar to collect.

As Governor Nunn pointed out, this is a time in which we are attempting to restore the Federal-State balance and get more moneys back to the State. This could be a very serious blow to the resources of these 30 States.

Secondly, this $500 million per year that goes to the States in parimutuel taxation is but a drop in the bucket compared to the taxation that goes to the Federal Government and the State governments and the local subdivisions by reason of all of the activity and all of the property of this several billion dollar industry. Hence the tax loss can be phenomenal, and that is what the commissioners base their opposition on.

Now, why would this hurt?

The reason is that without the present system, there is nothing that will encourage investment. As a matter of fact, people have indicated their desire to leave the industry in droves, if such legislation as this is passed.

In the testimony this morning I kept hearing instances of extreme examples of where there had been some abuse. Someone else has said that if there are abuses, isolated abuses, that what is needed is a high-powered rifle, in order to take care of these, not a shotgun that is going to wipe out everybody in our industry.

This, gentlemen, summarizes the position of the National Association of State Racing Commissioners, and on their behalf we appreciate your allowing us to appear before you.

Mr. SMATHERS. Mr. Chairman, we have a letter here from Governor Buford Ellington, of Tennessee. He wanted to be here in person. Originally he thought he was going to be here and so stated, but something came up that prevented his coming, so I would like to read just a portion of the letter if I may.

> As Governor of Tennessee, I submit this statement to you in opposition to the farm tax law changes as proposed in H.R. 13270. If adopted, these restrictive measures will have a stifling effect on the livestock industry in my state and drastically discourage future growth in a segment of our agricultural economy that is having such a positive and greatly needed impact in rural areas.
>
> As one who was farm born and farm-reared in the rural South, I feel I am qualified to give testimony on this matter. I know and appreciate the farmer's problems and the very real and serious threat created by the provisions of this bill which are so harmful to his interests.

I am skipping down. He says:

> The livestock industry in Tennessee amounts to an annual sum in excess of $372 million. The future of cattle and horse raising is bright in my State, unless it is discouraged. Growth of livestock production has expanded the job opportunities in rural areas where jobs are most needed.
>
> My concern as Governor of Tennessee—

And I am skipping again—

> is that the proposed farm tax changes will discourage capital investment so vital to the health and growth of the livestock industry in our State. I have personally seen what new interest and new capital invested in capital in horse farms can do to revive declining agricultural economics. In particular, horse training and horse shows have opened new areas and have injected fresh capital and a vital ingredient into our rural economy.
>
> We need this income for our farmers. We need the jobs. We need the markets created for agricultural products.

Then I skip again:

> I urge you to abolish or to amend the discriminatory farm tax proposals contained in House Resolution 13270.

Mr. Chairman, I would like to make that letter in its entirety a part of the record.

(Gov. Buford Ellington's prepared statement follows:)

STATEMENT OF GOVERNOR BUFORD ELLINGTON OF TENNESSEE, SUBMITTED BY THE AMERICAN HORSE COUNCIL, INC.

As Governor of Tennessee, I submit this statement to you in opposition to the farm tax law changes as proposed in H.R. 13270. If adopted, these restrictive measures will have a stifling effect on the livestock industry in my state and drastically discourage future growth in a segment of our agricultural economy that is having such a positive and greatly needed impact in rural areas.

As one who was farm born and farm-reared in the rural south, I feel I am qualified to give testimony on this matter. I know and appreciate the farmer's problems and the very real and serious threat created by the provisions of this bill which are so harmful to his interests.

The State of Tennessee has many beautiful mountain ranges, but it also has great farmland areas. These rural areas have historically been the home of men and women of independent spirit, who have made the soil the source of their livelihood. We all want to preserve the time honored and basic occupation of farming. We all know that the technology of this age, and the rapid changes in farm production have brought depression to many formerly thriving areas of croplands. It has forced many of our citizens from the land, to seek jobs elsewhere. In recent years, there has been a decided development in new uses of this cropland, through production of horses and cattle. Livestock raising has always been an important part of the agricultural economy of Tennessee, but it has expanded into even greater significance in recent years. Tennessee-raised cattle are known throughout this land, wherever quality cattle are produced. And the famed Tennessee walking horse has become nationally popular, while other horse breeders are finding Tennessee's attractions encourrging to horse farming. The livestock industry in Tennessee amounts to an annual sum in excess of $372 million. The future of cattle and horse raising is bright in my state, unless it is discouraged. Growth of livestock production has expanded the job opportunities in rural areas where jobs are most needed.

We all know the problems of the crowded cities, made worse by the flow of the rural unskilled to the urban areas. Certainly, we should not discourage enterprise that has a tendency to bring jobs and opportunities to those rural residents, in their own environment.

My region of the United States, the south and mid-south, is undoubtedly more sensitive to the effects of laws which discourage rural development because they affect more of our area, more of our people, and more of our economy. We are necessarily becoming more mindful of preserving farm areas, not only for the sake of conservation, but because of the urgency of the economic situation. We need these rural lands for watersheds, for recreation, for limiting pollution, and for our own future. We should not discourage in any way their development as cattle and horse farms, for this form of agricultural pursuit is most compatible with sound conservation. The changes in this tax bill affecting farm taxes will discourage that development more, I believe, than many realize.

My concern, as Governor of Tennessee, is that the proposed farm tax changes will discourage capital investment so vital to the health and growth of the livestock industry in our state. I have personally seen what new interest and new capital invested in cattle and horse farms can do to revive declining agricultural economics. In particular, horse breeding, horse training, and horse shows have opened new areas and have injected fresh capital and a vital ingredient into our rural economy. We need this income for our farmers. We need the jobs. We need the markets created for agricultural products.

I appeal to this committee, to the Congress, to consider carefully changes in tax laws that can have a profoundly detrimental effect on our agricultural industry. I, too, favor tax reform and believe abuses of the farm tax laws should be corrected. But we cannot afford the price of threatening the economic health of an entire industry which contributes so much to our economy, and promises so much for the future. I urge you to abolish or amend the discriminatory farm tax proposals contained in H.R. 13270.

Mr. SMATHERS. Here is a statement from the New Jersey State Department of Agriculture, Governor Hughes who at one time thought he was coming down to testify. He had a number of things he wanted to testify about in this bill, and he finally decided to just send it in the form of a letter through his Department of Agriculture.

I skip through it again.

We have no doubt whatsoever, and there are leading representatives of the horse industry among us, who readily would attach to this that the restrictive and discriminatory provisions of H.R. 13270 will discourage and eventually put an end to the activities of those who are the mainstay of this industry in the State of New Jersey. Already representatives of every segment of the industry have expressed deep concern about this legislation, and more disturbing to us in New Jersey have made it clear that they could not carry on under the provisions of that bill.

To those who may be thinking that this after all really could not be too harmful to an industrial State like New Jersey, let us cite just a few statistics. We mentioned earlier that the horse industry is a vital part of the economy of our State. This is no exaggeration. Interestingly enough, as certain other agricultural endeavors have declined, the horse industry has grown, and each year plays a more important part in their economic development.

The New Jersey horse industry spends more than $1 billion a year in New Jersey. It pays several million dollars annually in municipal, in county and in State taxes. It provides jobs for an estimated 200,000 people in New Jersey.

In the 26 years that parimutuel betting has been in existence in New Jersey, our tracks have provided $491 million for the State treasury. Needless to say, there are many businesses which depend for their very existence or derive considerable income from the horse industry: feed companies, chemical companies, manufacturers of medicines, farm and equipment firms, and even the veterinaries medical professions are just a few of those further growth and economic vitality industries, and they are closely tied and depended upon the horse industry. The New Jersey experience alone would be tragic evidence of the millions wise and billions foolish revenue policies underlying the proposed farm tax changes in the bill now under consideration.

We urge the Senate Finance Committee to repeal them.

Mr. SMATHERS. Well, they have not yet been passed. It was signed by Mrs. Lawrence Yetter, Chairman of the New Jersey Equine Advisory Board, a part of the Department of Agriculture of New Jersey.

I would like to make that a part of the record, Mr. Chairman.

(The letter referred to follows:)

STATEMENT OF NEW JERSEY EQUINE ADVISORY BOARD

Millions wise and billions foolish.

Reasonable and knowledgeable men can so characterize the farm tax changes incorporated in HR-13270.

The Treasury Department's best estimates show an increase in tax revenue of only $5 million in the first year as a result of the proposed farm tax changes. By contrast, we should like to draw from our experience in New Jersey alone to demonstrate clearly that the proposed farm tax changes could jeopardize and ultimately destroy a vital and growing segment of our economy—the horse industry.

We have no doubt whatsoever—and there are leading representatives of the horse industry among us who readily would attest to this—that the restrictive and discriminatory provisions of HR-13270 will discourage and eventually put an end to the activities of those who are the mainstay of this industry in our State. Already, representatives of every segment of the industry have expressed deep concern about this legislation and, more disturbing to us in New Jersey, have made it clear that they could not carry on under the provisions of this bill.

To those who may be thinking that this, after all, really couldn't be too harmful to an industrial state like New Jersey, let us cite some statistics. We mentioned earlier that the horse industry is a vital part of the economy of our State. This is no exaggeration. Interestingly enough, as certain other agricultural endeavors have declined, the horse industry has grown in our State and each year plays a more important part in our economic development.

The New Jersey horse industry spends more than a billion dollars a year in New Jersey. It pays several million dollars annually in municipal, county, and State taxes. It provides jobs for an estimated 200,000 people.

In the 26 years that pari-mutuel betting has been in existence in this State, New Jersey tracks have provided $491,508,499 for the State Treasury.

There are eleven different breeds of horses in New Jersey. A partial survey taken by the New Jersey Department of Agriculture in 1961 shows that there were 18,271 horses and ponies in the State. That figure today exceeds 50,000.

Needless to say, there are many businesses which depend on their very existence or derive considerable income from the horse industry. Feed companies, chemical companies, manufacturers of medicines, farm and equipment firms, and even the veterinary medical profession are just a few whose future growth and economic vitality are closely tied in with that of the horse industry.

Nor can anyone overlook the social and cultural benefits from this industry. The growth of the industry has meant the preservation of open spaces which is so important to a rapidly developing state such as New Jersey and the horse plays a greater role each year in recreational activities of all of our citizens, especially our young people. In 1968, for example, there were 3,637 persons enrolled in 4–H projects in this State. This was an increase of 1,521 over 1963.

We believe that all of this is sufficient evidence that the horse industry is indeed a mainstay in the economic, social and cultural life of our State. Needless to say, we do have our problems—a number of obstacles which must be overcome to assure the vitality of this industry. Up until now, we have been firm in our resolve to overcome these problems and to continue to make an important contribution to the economic and social life of our State. However, the enactment of the legislation now under consideration would be so devastating as to bring an abrupt halt to the activities of those who contribute so much to the very existence of our industry. We contend, as we have said before, that this will have a serious impact on the economy of New Jersey. We are talking now not of a few farms, not of a few horsemen, but of the many millions in jobs and State revenue and in overall economic growth.

The New Jersey experience alone would be tragic evidence of the millions wise billions foolish revenue policies underlying the proposed farm tax changes in the bill now under consideration. We urge that these changes be repealed.

MEMBER ORGANIZATIONS

American Horse Shows Association, Inc.
American Saddle Horse Breeders & Owners Association of New Jersey
Arabian Horse Association of New Jersey.
Crossbred Pony Breeders.
4–H Horse Club
Horsemen's Protective and Benevolent Association.
New Jersey Appaloosa Association.
New Jersey Association of Agricultural Fairs.
New Jersey Hunts Association.
New Jersey Morgan Horse Association.
New Jersey Pinto Horse Association.
New Jersey Professional Horsemen's Association.
New Jersey Quarter Horse Association.
Shetland Pony Breeders.
Standardbred Breeders and Owners Association of New Jersey.
The New Jersey Veterinary Medical Association.
Thoroughbred Breeders Association of New Jersey.
Welsh Pony Breeders.

Mr. SMATHERS. Here is a summary of a letter from the Governor of the great State of Delaware. It says:

DEAR SENATOR LONG: "Since it is impossible for me to appear personally before you and your distinguished colleagues on Monday I wanted to provide a viewpoint that I hope can be made a part of your record. I am referring specifically to those portions of the House-passed tax reform bill that affect racing, particularly the so-called hobby loss feature. Admittedly I am not an expert on racing. I have, however, looked into this matter in some detail and have discussed it with persons who are extremely knowledgeable in this field, and I cannot but conclude that the provisions adopted by the House would strike a severe blow at one of our substantial sources of income.

There is much talk today about the sharing of revenues between the Federal and State governments. There is much talk also about the inability of our State governments to raise the funds needed to carry out essential programs and provide needed services. We certainly cannot afford to lose any major source of tax income.

The legislation at hand according to the best information that I can receive would seriously jeopardize the horse racing and breeding industries in Delaware. Last year the State of Delaware received nearly $4 million, out of a budget of under $200 million, in direct revenue from parimutuel horse racing. This represents an increase of 39.5 percent over the past ten years.

The thoroughbred breeding industry in our State is a fast-growing one. These farms and racing tracks provide employment for many of our citizens. They attract visitors to our State and in general provide many sources of income. The combined racing and breeding industries in Delaware represent an investment of approximately $10 million.

Today there is flat racing in Wilmington, Delaware, Philadelphia, Pennsylvania, New York State, Monmouth, New Jersey, trotting tracks are conducted at Wilmington, Atlantic City, New Jersey, and in Maryland and New York. These tracks are open six days a week and it takes a large number of horses to be able to meet the demand.

H.R. 13270 would have the effect of reducing the number of horses owned by those who supply the bulk of our race horses and thus would mean a worsening of the shortage that exists today. I am certain that you have heard or will hear from those much more familiar with the intricacies of this problem. My only desire is to inform the committee that provisions of the House-passed tax reform legislation would in my opinion be harmful to the State and to the people of Delaware.

Mr. SMATHERS. I would like to make that a part of the record, Mr. Chairman, if there is no objection.

(The document referred to follows:)

LETTER FROM GOV. RUSSELL W. PETERSON TO SENATOR RUSSELL B. LONG

SEPTEMBER 19, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: Since it is impossible for me to appear personally before you and your distinguished colleagues on Monday, September 22, I wanted to provide a viewpoint that I hope can be made part of your record.

I am referring specifically to those portions of the House-passed tax reform bill that affect racing, particularly the so-called "Hobby Loss" feature.

Admittedly I am not an expert on racing. I have, however, looked into this matter in some detail and have discussed it with persons who are extremely knowledgeable in this field. And I cannot but conclude that the provisions adopted by the House would strike a severe blow at one of our substantial sources of income.

There is much talk today about the sharing of revenues between the Federal and State governments. There is much talk also about the inability of our State governments to raise the funds needed to carry out essential programs and provide needed services. We certainly cannot afford to lose any major source of tax income.

The legislation at hand, according to the best information I have received, would seriously jeopardize the horse racing and breeding industries in Delaware. Last year the State of Delaware received nearly $4 million—out of a budget of under $200 million—in direct revenue from parimutuel horse racing. This represents an increase of 39.5 percent over the past 10 years.

The thoroughbred breeding industry in our State is a fast-growing one. These farms, and racetracks, provide employment for many of our citizens, attract visitors to our State and in general provide many sources of income. The combined racing and breeding industries in Delaware represent an investment of approximately $10 million.

Today there is flat racing in Wilmington, Delaware; Philadelphia, Pennsylvania; New York City; and Monmouth, New Jersey. Trotting races are conducted in Wilmington; Atlantic City, New Jersey; and in Maryland and New York. These racetracks are open six days a week, and it takes a large number of horses to be able to meet the demᵖnd.

H.R. 13270 would have the effect of reducing the number of horses owned by those who supply the bulk of our race horses and thus would mean a worsening of the shortage that exists today.

I am certain that you have heard or will hear from those much more familiar than I with the intricacies of this problem. My only desire is to inform the committee that provisions of the House-passed tax reform legislation would, in my opinion, be harmful to the State and people of Delaware.

Sincerely,

RUSSELL W. PETERSON, *Governor.*

The CHAIRMAN. Did you have further testimony?

Mr. SMATHERS. Yes, sir. I want to submit for the files of the committee a petition which has been signed by many people from all over the United States, from Georgia, Virginia, and every State in the Union for that matter, protesting this type of legislation. That petition was circulated by the publisher of Horse World magazine, it is too big and cumbersome to have in the record, but I would like to have it remain in the file if there is no objection.*

The CHAIRMAN. Could you just put in a nutshell why you think that this small revenue of $5 million would do very grievous harm to the industry. Now that is a very big industry, and you might explain just in a nutshell, Senator Smathers, why a tax hoping to raise only about $5 million a year will do very grievous injury to this industry?

Mr. SMATHERS. Mr. Chairman, I will be delighted to do that. On behalf of this horse council, may I first say this, before I address myself precisely to that question: there are 200,000 members of this American Horse Council. I have had the opportunity of talking and visiting with many of them, and I do not know any of them who approve total tax avoidance by people who make profits.

I think, and it has been my observation that these people also believe that everyone should pay a minimum tax. They do not have any sympathy whatever for the 155 people whom Secretary Joseph Barr last fall talked about who had incomes of over $200,000 and who paid no tax at all. Our members are not tax dodgers nor tax avoiders.

However, they firmly believe, and they are in the business, that if the provisions of this House bill are adopted, that it not only threatens the $12 billion horse industry, and that is the Department of Agriculture's figure as to how big it is, but it will be successful in destroying it.

At stake in this particular industry are the interests I might add here of 187,000 young boys and girls who are in 4H clubs today and who have horse projects, and we all know how sympathetic the Congress and particularly the Senate is to these kinds of 4H projects.

We also know that as to the well-being of thousands of horse breeder farmers who have no Federal subsidy, no special subsidy, it affects them, and it affects them very drastically. What I recall most vividly, Mr. Chairman, and which very seriously makes me have the greatest concern about what is going to happen if these provisions of the House bill should become law is that I have seen in my own State from the University of Florida, which was located in Gainesville down to Orlando in the early 1930's that area was a desolate land. It was too far north to be able to grow citrus effectively.

It was a wasteland. The sun would shine on it in the day and make it dry, and the winds would blow the sand away, and then the hurricane season would come along and wash it away and there was nothing there.

I drove over that 150-mile stretch many times when I was at the university going back to my hometown in Miami. However, along came this particular provision in 1943, which was adopted by Congress, under the leadership of this committee, at a time when Senator George of Georgia and Senator Milliken of Colorado, and other distinguished Senators of this great body, whom all of us admired were serving, and Bob Doughton from North Carolina was in the House Ways and Means

*The document referred to was made a part of the official files of the committee.

Committee. They provided some incentive for people to go into these desolate areas and invest their money, in order to try to rescue those areas so that they no longer would be nonproductive insofar as products were concerned, but nonproductive insofar as returning taxes were concerned.

The result was that people who did have money went into this area from Gainesville south, and they began to invest money into what was then very cheap land. We developed at the University of Florida something known as Tifton grass, some other type grasses, and they began to put it into the soil there and it began to make great grazing for cattle, and particularly for horses. Today, 30 years later, you can ride that same trip, and instead of seeing the desolation which once existed, no income returning to the counties or the cities in that area, today you see beautiful farmlands, many more people employed. The land is wealthy, beautiful Angus cattle and Hereford cattle and race horses of every description, and it is a lovely, beautiful productive area.

That has happened not only in Florida but in Delaware, in Louisiana, in Nebraska, in every State in the Union, and certainly here in Virginia and in Maryland and other States, and what has caused it has been the inducements to people who did have money, who were willing to invest their money into these otherwise nonproductive areas.

I would think that if we now change it around, and reverse the opinion of Senator George and others who sponsored this type and character of amendment, and took this provision away—which is what the House bill seeks to do, you are going to find these people just as you heard this gentleman right here say—"They can buy my ranch."

I have had letters and I have talked to the people in this area that I talked about, and without exception they say "We cannot afford to and we will not stay in the business and we will not provide that infusion of capital, and we will not be able to provide that employment and we will not be able to help that area grow as we have done."

Now, what this means, if this happens, Mr. Chairman, is we are going to not only lose the income to the cities and the counties and the State and so forth from that area, but we are going to hasten the migration of people from the rural communities into the cities. We aggravate the problem of the welfare rolls. We aggravate the problem of the ghettos. We aggravate the very problems on which we are spending lots of money and time to avoid today. It does not make a lot of sense to me to hear this or any other administration talk about the fact that they are considering giving a tax credit to business to go into these areas, to provide employment with one hand, and on the other hand to stamp it out, as this bill would do—not the administration, but as this bill would do—to stamp out that capital which is today providing employment in those areas.

Mr. Chairman and members of the committee, I submit to you that if ever there was an overkill bill, this is it. On page 71 of the House Ways and Means Committee report they say that $5 million is all that will be returned to the Government by closing this so-called loophole by 1971, and it is estimated that in 10 years, by 1979, they may get $20 million. When the States themselves derive $427 million from parimutuel racing alone it does not make sense to give up that or any part of that to get back $5 million. It does not make any sense to destroy what can be and is a $12 million business with something like 500,000 employed people in it, in order to get $5 million.

Mr. Chairman, we submit that this bill really does not make much sense in its present form. We beg the full and most prayerful consideration of the members of this committee, because we do think that if it were passed the way the House has proposed it, we are satisfied that it will cut the income from the farm areas. Everybody agrees, and as a matter of fact Senator Metcalf argues that he wants to get the land value down. I cannot help but say to him, you know in Florida the legislature every year appropriates $75 million to advertise our State. We beg people to come there, in order to raise the value of land, because those who have gotten it are better off. They can borrow more against the land. So I cannot understand the position of the Senator from Montana, who says, "We want to keep all these other people out with their money, because we want land cheap so that our fellows can buy it."

I say, Mr. Chairman, it will increase unemployment, if this bill is passed, if these House provisions are passed, it is going to deprive the States of income and revenue. It is going to eventually raise the price of beef, raise the price of cattle because there will be less cattle.

It is going to raise the price of orange juice and grapefruit juice and pecans and all the rest because there will not be any way for anybody to get in business.

This hobby loss bill says that if you lose more than $25,000 in 3 out of 5 years, you are presumed not to be in business with the reasonable expectation of making a profit. And the Internal Revenue can then take away all of your loss deductions. There is no way to make an orange tree grow to fruit-bearing stage in less than 5 years. There is no way you can grow a pecan grove in less than 11 years. So what it means is that if you keep the provisions as they are in this bill, that the people who now have the groves and the orchards, have got a real bounty. They really have it great, because there will be no new competition. Nobody else will be able to get into the business.

I do not think that is what is intended. I know it is not. But that is what will be the result. So, Mr. Chairman, we submit to you that we want this committee to give most prayerful consideration.

I will end with this: There is a section in the law right now, section 165, which provides that if they believe a man is in the farming business without the intention of making a profit, the Internal Revenue can disallow all his claimed deductions for losses. The best proof of it is that today, at this very moment, there are 45 cases in the Tax Court on this same problem.

If Internal Revenue is concerned about Mr. Stevens and his ranch out there in Montana or Mr. Oppenheimer's program, I submit that they already have the authority to eliminate any possible abuses through the active, vigorous enforcement of the laws that we have on the books today.

Thank you very much, Mr. Chairman.

The CHAIRMAN. One thing that some people ought to realize about any law is that the only way you can make money losing money under the tax laws is if you can deduct more than 100 percent of what you lose.

Now that is something you learn. I learned it by losing money. I lost money in farming, and believe you me I did not go into it with that intention. I just found how tough it is to make money out of it.

My impression has been that the people I know in Louisiana, and there have been some who had substantial money and went into horse racing, prize cattle, and things of that sort, did not go into it intending to lose money. They went into it planning to make money and they in fact had made money. But it took them a while to do it.

They not only made money for themselves but they made money for all their neighbors because they demonstrated that this thing would work. The fellows who started this—Louisiana being a State that produces some very fine race horses and that sort of thing—had to actually go in there and take a chance and they had to have a lot of money to do it with. But once they proved it could be done a lot of little fellows could get in and make money. But somebody had to be the icebreaker—somebody had to plough ahead and show that it could be done.

Those that did built a very driving prosperous industry.

Now some people might have thought they were crazy to do it, but they have quit losing money. They are doing very, very well as you have indicated. And I am not sure, as I say, that if those people were put out of the business that it would help the farmer that Senator Metcalf is complaining about. It seems to me that what it would do, by throwing all their stock on the market for sale, would be to depress the value of what every other farmer is holding.

I happen to have a piece of farm property. I could not make any money at it. Some other fellow is running cattle on it. I hope he makes something out of it. But if we fix it so that people cannot afford to go into business, then the land I hold is worth even less than it was before.

So it would seem to me as though the proposition where one thinks he is going to help the farmer who stays out there year in and year out, in the last analysis it squeezes the equity and value out of that man's farm and perhaps even livestock. He has less people to do business with, less people to sell, and the kind of venture capital that tends to make for new markets might not be available to him.

Mr. SMATHERS. Exactly, sir. I agree with you completely, Mr. Chairman.

The CHAIRMAN. Senator Anderson?

Senator ANDERSON. You mentioned that Senator George worked on this legislation.

Mr. SMATHERS. I was told by Mrs. Thompson of the staff that Senator George did; yes.

Senator ANDERSON. I thought it came from the Agriculture Committee of the Senate, of which I was a member.

Mr. SMATHERS. It was in the tax bill, Senator, I mean this provision.

Senator ANDERSON. I do not think it was.

Mr. SMATHERS. I beg your pardon?

Senator ANDERSON. I do not think it was. It was in the agriculture bill. There was a long plea that every cow would be terribly distressed. Now, this provision appears in your brief on page 12, section 270, "This would allow the deduction of all expenses from any business activity carried on without a reasonable expectation for profit." What is wrong with that?

Mr. SMATHERS. Well, we have in the law now that if they do not have a genuine intention of making a profit, that the Internal Revenue can disallow the deductions now. One of the problems with the reasonable expectation of profit is that it is attached to and tied up with a change in the amount. Where it used to be $50,000 a year that you could lose, they have reduced that to 25. They have reduced the 5-year period, in one of which you had to lose less than $50,000—they have reduced that now to 3 out of 5 years. You could not lose more than $25,000 in any 3 out of a 5-year period. So it is the combination of the reasonable expectation of profit and the $25,000 limitation and the further limitation and restriction of a 3-year period. So it is the combination of these three which we think would mean that nobody would invest in a new operation because they could not have a reasonable expectation of making it pay within 3 years.

Senator ANDERSON. A reasonable expectation of profit is not too difficult.

Mr. SMATHERS. Mr. Honnen wants to add something.

Senator ANDERSON. Don't you own cattle?

Mr. HONNEN. No, just horses.

Senator ANDERSON. No cattle?

Mr. HONNEN. No cattle at all, just horses.

Senator ANDERSON. Do you expect to make a reasonable profit from those?

Mr. HONNEN. Yes, definitely.

Senator ANDERSON. What is wrong with this legislation then?

Mr. HONNEN. I did not hear, sir.

Mr. SMATHERS. The problem is that you cannot start out a new operation and have any reasonable expectation of making it pay within 3 years.

Mr. HONNEN. There is a great deal of difference between the word "intent" and the words "reasonable expectation." I would like to cite a case that occurred with me last Saturday night. I participated in a race in Los Alamedos, Calif. in which there was a $100,000 purse.

Senator ANDERSON. That was a tiny purse.

Mr. HONNEN. It is pretty big to me.

Senator ANDERSON. I saw one of $160,000 the other day, one race.

Mr. HONNEN. My horse finished third in this race, and won $12,000 for it. If he had won the race by running 8 inches faster, I would have won $55,000. Now I could very easily have been in a 2-year loss bracket, so that this gain of $42,000 could have been the difference between putting me in a profit year and putting me into a loss year.

Now there is nobody who can deny my intent that I went out to try to win that race. I slept with that horse the night before. I nursed him all during the day. I tried to convey to him my desire to win. My intent could not be questioned. But when he went to the race track, the odds were 21-to-1 against him, so there was no reasonable expectation according to IRS that I had a chance to win.

Senator ANDERSON. You say you did have a reasonable intention. In the horse operation you did have a reasonable intent to make a profit, did you not?

Mr. HONNEN. Yes, definitely.

Senator ANDERSON. That is all this calls for.

Mr. HONNEN. But the decision is not being left under the law to me. The decision is being left to the IRS.

Senator ANDERSON. We find cases going to court all the time. This is nothing unusual. Do you really think you are trying to make a profit? That is all you have to do.

Mr. SMATHERS. The words are reasonable expectation rather than reasonable intent. He had an intent. But the Internal Revenue may say to him that is not a reasonable expectation.

Senator ANDERSON. Then he goes into court if he wants to and tries it?

Mr. SMATHERS. You can go to court, but nobody likes to go to court, Senator Anderson. I am sure you understand that.

Mr. HONNEN. I cannot afford to fight the Government.

Senator ANDERSON. Lots of people do.

Mr. HONNEN. They have got more money than I have got, Senator.

Mr. SMATHERS. And less brains.

Senator ANDERSON. I think it is too bad that you think it turns on that alone.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. Senator Smathers, I am delighted to welcome you back to the committee. I have listened with interest to your presentation. You were reviewing as I understand it the history of this industry over the past 30 or 35 years, how it has been progressively expanding. Has this growth rate and expansion rate been rather even and progressive since the so-called enactment of whatever it was in 1943?

Mr. SMATHERS. Senator Williams, the answer is I think it has grown more rapidly in recent years than it did in the 1940's or the middle 1950's. It may be, Mr. Honnen, do you have any comment to make?

Mr. HONNEN. I think the American quarter horse history is comparable with the normal history of other breeds. In 1941 we had a registry of about 580 horses. Today we have a registry of about 50,000. Now you can realize that in the increase those first foals that were brought out of these 586 horses of the original registry, half of them would be females, and in due time they would be producing colts, and half of that crop would be females and they would be producing colts, so the increase has been a normal genetic increase. Today we are raising 70,000 foals a year in the quarter horse registry alone, and this would easily be duplicated by the combination of the other registries besides all of the unregistered horses.

Senator ANDERSON. The point I am trying to bring out is that this has been a normal expected increase over this period of 30 or 35 years.

Mr. SMATHERS. I believe that is correct, Senator Williams.

Senator WILLIAMS. Well, Senator Anderson mentioned the fact that one of these bills originated in the Agriculture Department and I think the confusion is in this. In the first instance you are referring to the bill enacted by the Finance Committee but as I recall it, about 15 or 18 years ago there was a provision put in an Agriculture bill which extended capital gains provisions to livestock, and it is that new provision which there is some criticism about.

Since this growth of the industry has been over 30 to 35 years rather consistent, could it safely be said that the capital gains provision is not the basis of it? Would it not be wise to eliminate that provision which I think is the heart of the point where it is pointed out that men actually can, by charging off as normal income the costs on these farm operations, convert the profit to capital gains? That seems to be the problem.

Could we not solve that problem we just repeal this latter-day law, which was put in the Agriculture bill, and perhaps make a great step forward toward correcting this problem?

Mr. HONNEN. This is true under the old provision which was normal in a 6-months' period on capital gains. But by changing this law, as proposed, to make you hold an animal to acquire capital gains for a year beyond his eligible racing age, or beyond his age when he would normally be bred is the abusive and the discriminating part, because it is not used against any other industry.

Today the market for horses is basically on yearlings, because the big money and purses is in the futures which are 2-year-olds. So the breeder and the racer of the horse sells them as yearlings so the new owner will be able to get them in training and be able to compete in races as 2-year-olds.

Under the present proposed provision you could not sell that animal until he was a year after his 2-year-old age, which would be at the end of his 3-year-old year, the beginning of his 3-year-old year. The same way with breeding animals. You could not sell them until a year after they were of breeding age which normally with horses is 5 years old so you could not sell him until he started his 4-year-old year.

That means a breeder would have to maintain and hold on his farm these horses for an extra year and an extra 2 years on breeding animals in order to gain advantage of the capital gains there.

Senator WILLIAMS. The point that I am making is that up to about 16 or 18 years ago there was no capital gains provision no matter if you held him 20 years. You trace the growth of the industry, as I understood it, it has been rather systematic and just an average growth over a period of time so I am just asking the question perhaps this was an unnecessary addition to the tax law, and a provision which is not applicable to any other commodity that is produced on farms.

Mr. SMATHERS. I would like to say that you asked me did I know and I responded I did not know whether or not this had been a systematic growth over the years. As I started to say, and I am inclined to think that it has grown much greater in the last number of years as people have become more affluent, and we have more leisure time, as more and more people have gone to the races, there are more members of the Horse Council and everything else.

With respect to the elimination of this capital gain feature, I would certainly not recommend it as the solution to the problem of some abuse. I do not really believe that you should start discriminating in some respects on capital gain against the horse industry, or for that matter the farmer or anybody else.

We do not do it with stocks. You do not do it with bonds. You do not do it with any other kind of property. You have got a 6-months' holding period. You give them capital gain treatment at that point. I just do not understand why then we would say to the farmer to whom we have always given some special place in our economic system, why we say to him or a fellow who aspires to be a farmer, we are going to say we will discriminate against you by not allowing you the capital gain treatment that we allowed to the other people.

Senator WILLIAMS. You might say you are not discriminating necessarily because the farmer takes a year to produce his wheat or any other crop that is on the farm or any other type of crop. He does not get the provision of capital gain. It is only extended to these two items, and as I recall it, it was extended by a floor amendment offered to an agriculture bill.

Senator Anderson. By Senator Thye.

Senator Williams. There was considerable discussion at the time that this may open up a loophole where it would give the whole industry some embarrassment. I think a review of the debate at that time would be well in order. It may show us how we got into this problem that we have.

Mr. Smathers. All right, we will take that review, and I thank the Senator.

Senator Curtis. I will try to be brief because we have many witnesses here. The real nub of your opposition to this bill revolves around the hobby farm?

Mr. Smathers. Yes, sir.

Senator Curtis. At the present time the law prescribes that it has to be 5 successive years without a profit. I would like to ask you gentlemen do you regard this horse business as a business?

Mr. Honnen. Yes, sir.

Mr. Farnham. Absolutely, Senator.

Senator Curtis. It is a business, not a hobby?

Mr. Farnham. Yes, sir.

Senator Curtis. It hires people and so on?

Mr. Farnham. Yes, sir.

Senator Curtis. Now is it true that it takes upward of maybe almost 10 years to start from scratch and build a profitable stable?

Mr. Farnham. In many cases it takes that long, Senator.

Senator Curtis. Is it also true that the average horse breeder only produces three a year?

Mr. Farnham. Last year the horses that ran, speaking of thoroughbreds, Senator, there were 14,000 different breeders listed for the thoroughbred horses that ran at American race tracks, and that worked out to an average of three per breeder.

Senator Curtis. Now if they have to show a profit before the third year, they have got to sell the best stuff they have, do they not?

Mr. Farnham. Absolutely.

Senator Curtis. And then it will go to somebody else?

Mr. Farnham. That is right.

Senator Curtis. If horse raising is a business and not a hobby, why not treat it like a business?

Mr. Farnham. That is all that we are here asking, Senator, is that we be treated like a business.

Senator Curtis. Mr. Farnham, as you know, we have got one other problem in Nebraska.

Mr. Farnham. Yes, sir.

Senator Curtis. Under Nebraska law you cannot carry on parimutuel betting for profit. It either has to be a governmental subdivision or a nonprofit organization. Sometimes you have a county fair which has racing and they come under the governmental subdivision. But if an agricultural association has racing, it is my understanding that the parimutuel will be regarded under the House-passed bill as unrelated business activity.

Mr. FARNHAM. It could be, and it would be to the State of Nebraska a very disastrous thing, Senator.

Senator CURTIS. The nonprofit racing track, after they pay their expenses and the upkeep of their barns and property, turn it back to a youth council, which involves 4–H Club affairs and the promotion of agriculture, is that not right?

Mr. FARNHAM. Either that, or if they bought rescue squad units for almost every small city in Nebraska, charitable, eleemosynary or agricultural purposes, they have to get rid of every dime they make.

Senator CURTIS. Through the years Congress when it needed revenue had been tempted to tax parimutuel betting, but they refrained, because that source of revenue had been over the years given to the State, is that not right?

Mr. FARNHAM. Yes, sir.

Senator CURTIS. And how much did you say it amounts to, Mr. Farnham?

Mr. FARNHAM. Last year it was $426 million, and the projection this year, just from the horse part, Senator, will be well over $500 million to the 30 States that carry on parimutuel wagering, over $500 million in calendar year 1969, and I again emphasize that those are tax dollars to the State that cost less than a penny per dollar collected.

Senator CURTIS. Do you know how many people the racing business employs?

Mr. FARNHAM. Half a million to 1 million, Senator, and I can get a more exact figure on that, but just in the farm portion of the business that supplies these race tracks, it is estimated there are over a half million people employed in all 50 States, because all 50 States are engaged in breeding operations, even though they do not have parimutuel racing.

Senator CURTIS. And many of them are unskilled or come from minority groups, Cuban, Puerto Rican?

Mr. FARNHAM. Many of them have never done anything, Senator, but work as grooms or work with horses, work with livestock, and they are absolutely qualified to do no other work, sir.

Senator CURTIS. And you think that if there is some man of extreme wealth that is not paying any taxes because he is in the business of horse racing, that it could be reached in some other way?

Mr. FARNHAM. We are going to all be shot down this way.

Senator CURTIS. Is there any way a person can go into the horse breeding business and make it pay in 2 years?

Mr. FARNHAM. There is very little chance. Somebody can conceivably get very lucky and do it, Senator, but it just is not in the cards.

Senator CURTIS. Is the land that is used for horse breeding—adding to our surpluses?

Mr. FARNHAM. If it was not used for horse breeding, Senator, most of it would be taken out, put into corn production, and then the next year taken out and it would receive government payments for idle acres, because they have taken the land out of corn or wheat production.

That is what would happen with most of the pastureland that is presently used for horse production.

Senator CURTIS. That is all, Mr. Chairman.

The CHAIRMAN. Senator Miller?

Senator MILLER. On the holding period, are you familiar with the fact that the Treasury represents when they testified before the committee suggested that the 12 months be reduced to 6 months?

Mr. FARNHAM. Yes, Senator, I am.

Senator MILLER. How would that help?

Mr. FARNHAM. Well, Senator personally the other two provisions, this could be harmful to the industry as Mr. Honnen has said, but to me the other two provisions that we are talking about are disastrous, can literally kill the industry. This is something——

Senator MILLER. What is that provision?

Mr. FARNHAM. The reasonable expectation is changed——

Senator MILLER. I do not want to talk about that. I only want you to answer my question. In the House bill it requires the holding of 12 months from the time the animal begins its use as the capital type asset, breeding or racing. I have heard some pretty good criticism of that. But I point out to you that the Treasury representatives, when they appeared before us recently, recommended that it be reduced to 6 months. My question to you is will that be of some help to you or will that hamper you?

Mr. FARNHAM. I am sure it would be better than the House bill but I am interested.

Senator MILLER. You would much rather have 6 months than 12 months, I am sure of that.

Mr. HONNEN. There is very little difference in it, because it would upset the whole marketing program of running type horses, because of the futurities and the money is in them, and if you had to hold the horse for 6 months after he was 2 years old, you are too late then for a new owner to pick him up and train him because it takes 4 months to train him to get him ready to race, so you have got 10 months of the year gone and you would have a chance the last 2 months to run him. In a breeding animal if you are going to hold it 3 years, holding it 6 months or another year, you have passed the breeding period which is from February 1 to about July 1, so the 6 months would not help you in any way at all, because you have completely missed the boat in both cases.

Senator MILLER. Then the answer is, as far as you are concerned, whether it is 12 months or 6 months it does not make much difference?

Mr. HONNEN. Not if the provision was added after his eligible date to race or his eligible period of racing.

Senator MILLER. Sir?

Mr. HONNEN. Or his eligible period of producing, like in a mare. You would not breed a mare until she was in the spring of her 3-year-old and if you had to wait 6 months beyond that you would be beyond the breeding period so you would be in her fourth year before you would breed her anyway.

Senator MILLER. Now you are very persuasive in pointing out that it would be rare that in 3 years you would have a profit operation from horse breeding, if you start out from scratch, but under the Metcalf bill, as I understood him to testify this morning, and I believe you were here, it would be 8 years, as I understand it. What is wrong with 8 years? In other words, you could carry these losses back 3 and over 5, so in the first year if you make a loss, you can carry it back 3 and over 5, the second year you go back another 3 and the third, and so on, so it gives you an 8-year period under his bill, during which time you can offset these losses, as I understand it, against any other farm income. What is wrong with the 8-year period?

Mr. HONNEN. You pick that phase and that portion of the Metcalf bill out alone and not tie the rest of it together it might not be too bad, but when you tie the package together, one offsets the other as far as the abuse and discrimination to the horse industry is concerned.

Senator MILLER. You see what I think he is trying to do is he is trying to take those situations where you can have marketing losses, you can have drought losses, you can have normal losses that might occur in the course of trying to get a business going, and when those occur, he says we will let you carry them back 3 years and over 5 to apply against a profit that you may make eventually.

Of course, if you have just started in the horse breeding business, and you had a loss, there would be no 3 years to carry back, so you would go over a 5-year carryover. Maybe this could be varied so that if you have not been in the business before, instead of a 3-year carryback and a 5-year carryover, you could have your option of having an 8-year carryover, to give you an adequate period of time so that generally it could be said that if the individual who is engaged in this horse breeding had not made some profits after 5 or 6 or 7 years, well then maybe he should not have been in there and have the taxpayers, the general taxpayers, pick up the losses. I am wondering what would be a fair holding period, I mean a fair carryover period, because 3 or 5 is just an arbitrary figure.

We can make it 4 and 7 or 1 and 2. We are asking for information from people like you who are in the business, so that we can arrive at a carryover period that would be fair.

Mr. HONNEN. Senator, I feel this way about it: Being in the business and knowing the type of people that are in the cattle or horse-raising business, we have been so confused with some of the ramifications of the law and the changes in it, and the suggestion of EDA and the suggestion of extended capital gains tax and the change from accrual to cash method or cash to accrual method has brought in so many of these problems that I am just wondering whether the average horse raiser is going to understand what you are talking about with all this carryover and carryback business.

I think all you are doing is confusing him.

Senator MILLER. I can understand your frustrations with all these concepts being carried around and I share your frustrations. I just want to get it down to a simple proposition if somebody who has a pretty good-sized outside income decides he wants to become a horse breeder. Let us say he is in the 70-percent income bracket, and let us say he loses $50,000 in his first year of operations. That is $37,000 of tax saving. That is $37,000 that the general taxpayers around the country are picking up to subsidize.

You would not have to do it that way. Say you cannot get any loss at all, just send the bill to the Federal Government and we will send you a $57,000 check, but we do not do it that way.

He comes along the next year and he has another $50,000 loss and he has $57,000 in tax savings. How long are we going to let this go on, or are we going to put a limit on it?

As I understand Senator Metcalf's bill, he says we will let you do that on a 3-year carryback or a 5-year carryover, and I have talked to enough farmers so that most of them who are in a business like that, they understand carrybacks and carryovers. That is all I am asking about what would be a fair carryback or carryover period, so that an individual like that could look forward to eventually using up these losses, against profit from that operation, without having to write it off against nonfarm income.

Mr. HONNEN. I think I understand your problem. We have gotten used to the present law as it is written now. Normally we have to show a profit every 5 years, and we have learned to live with that law, so with your suggestion there, I do not see why we do not learn to live with that.

Senator MILLER. Well, 5 years frankly sounds a little short to me in the horse-breeding business.

Mr. HONNEN. That is right. We feel it is, too, but we have learned to live with it.

Senator MILLER. I have spoken to some of them as to the 5-year period in livestock and I have seen that become a problem.

Mr. HONNEN. I am not saying we are satisfied with it. We have just learned to live with it.

Senator MILLER. Yes, but I am asking you in your experience and best judgment would a 3-year carryback and a 5-year carryover, or if the person has not been in the business before, an 8-year carryover, would that be a fair approach to something like this?

Mr. HONNEN. It would be a better approach than the one we have now.

Senator MILLER. I am sure it would be, but I am trying to get what you would conclude to be a pretty fair appraisal, because any member of this committee can pull some figures out of a hat. We come to people who are in the business, and ask you what would be a fair, arbitrary figure for you, and I think a fair arbitrary figure from the business would be better than an arbitrary figure taken by somebody who does not know about it.

Mr. FARNHAM. Senator Miller, if I could just interject this, we of the National Association are spending considerable money at the present time doing an economic survey. Mr. Bell, in fact, who is with me is the chairman of this committee. I think that we will have within the near future, by reason of this economic survey which is being carried on in every State in the Nation, that we will have some figures that will supply the answer to this question for you, and we will certainly furnish them to you, sir.

Senator MILLER. Will you do that for the record, then, in say the matter of the next 3 or 4 weeks or the next 3 weeks?

Mr. FARNHAM. If they are available within 3 or 4 weeks you will have them a day or so after they are available.

Senator MILLER. I would like to get something from you, because I understand in our present system of loss carryovers and carrybacks, there are always some taxpayers that end up with losses that have not been used up and that is too bad. That is a hardship. But we have to draw a line somewhere. You cannot have carryovers forever. It is just not administratively feasible to do that. So if you could come up with a suggestion along that line, I know I would appreciate it.

Mr. HONNEN. Senator, any period that you establish, it is going to have to be set on an average, because you find one breeder who will have good luck. He will obtain a nick with a certain stud and a certain mare and another fellow will have hard luck, he will breed the horse for 3 years and find out he has not got anything so he dumps him and picks up another and he goes on from there and then you are going to have an extended period, so when you talk about breeders the period of time that you are suggesting, you are going to have to hit an average in there.

When Mr. Farnham comes up with a figure, it is going to have to be some place in an average of the lucky and the unlucky breeder.

Senator MILLER. I have an idea that Senator Metcalf's 5 years would gear in with the 5 years you say you have been able to live with. That does not sound bad to me, but I can visualize a person who just gets started, they do not have the opportunity to use the 3-year carryback. Why not give him an extra 3-year carryover, it might be fairer.

Mr. FARNHAM. Because there is no way, Senator, of course in the gestation period that it be changed, and by the time you apply the mating that you intend you are in the breeding business and then you add an 11-month gestation period and then 2 to 3 years in the event that mare is in foal and produces a foal, then 2 or 3 years before that first foal gets to the races, and find out if your mating was successful; so it is 4 to 5 years before you can have the first opportunity to determine this, and this cannot be rushed. That is nature.

Senator ANDERSON. Senator Hansen?

Senator HANSEN. I have no questions, Mr. Chairman.

Senator CURTIS. Could I ask just one very brief question and if it takes very long put the answer in the record, because I am mindful of these other witnesses. If an individual makes some money, makes a profit in the racing business and in the horse breeding business, does he pay taxes on it like anybody else that makes ordinary income?

Mr. FARNHAM. Absolutely, and a lot of taxes, because when he reaches that year and he has the big horse, he has the successful horse, in fact then he pays a considerable amount of taxes on it, because he is in a very high bracket, and happy to do so.

Nobody is against that at all. In fact, that is what we are striving for. Every breeder is striving to get into a high tax bracket, Senator.

Mr. HONNEN. This is carried out a little further even to the man who bets on a horserace. If he wins over $600 they will not give him a check until an Internal Revenue man comes up and gets his name and address before they pay him off.

Senator ANDERSON. Is that universal?

Mr. FARNHAM. Yes, sir, it is an Internal Revenue regulation; if it is more than a $600 return for a $2 ticket he must show identification before he can get the money.

Mr. SMATHERS. May I add one other thing to Senator Curtis question. I am new at this business as is evident. But it looks to me that the way these provisions are, they really do not hurt the very successful, the very rich, and the very big man. He has got the good horse. They make money on which they pay substantial taxes. They are glad to do it. But the fellow who gets hurt is the fellow that Mr. Honnen was describing who is trying to get into the business maybe for the first time. He does have the land. He is trying to start himself a farm and he is not very successful.

He is the man who gets punished and would be punished by these provisions of the House bill. It means that the little fellow, or the man who is starting, could not get in and could not make it.

Mr. FARNHAM. Senator, could I make one other comment. Mr. Bell, in charge of our economic survey, just gave me this note, and pointed out that at the time the $50,000 loss limit was established, that since that time the expenses of carrying on a breeding operation have doubled and tripled, and so now under the provisions of this proposed bill, it is now taking 3 out of 5 years, and a $25,000 limit. Yet the expenses have doubled and tripled since the time that the $50,000 limit was put in.

The CHAIRMAN. Senator Hansen?

Senator HANSEN. No questions.

The CHAIRMAN. Thank you very much.

Mr. SMATHERS. Thank you very much, Mr. Chairman.

(Harry J. Farnham's prepared statement follows:)

SUMMARY STATEMENT OF HARRY J. FARNHAM, PRESIDENT, NATIONAL ASSOCIATION OF STATE RACING COMMISSIONERS

Testimony by Mr. Harry J. Farnham, Chairman of the Nebraska State Racing Commissioners, and submitted as President of the National Association of State Racing Commissioners, an association founded in 1934 and comprised of all racing commissioners from all 30 states in which pari-mutuel racing is regulated and supervised by state officials.

The position of the National Association of State Racing Commissioners is one of unalterable opposition to the "farm-loss" federal tax provisions as proposed by Senator Jack Miller in Senate Bill 1560, as proposed by Senator Lee Metcalf in Senate Bill 500, and as proposed by House Bill 13270 and designated therein as Sections 211, 212, and 213.

The conclusion reached by the National Association of State Racing Commissioners after lengthy deliberation is that the aforesaid "farm-loss" proposals will discourage investment in the horse breeding industry resulting in an attrition of good horses and a sharp reduction in number of all horses bred by small breeders; that reduction in the breeding of horses will similarly affect the size and number of racing programs and thereby seriously endanger the racing industry which last year produced in direct state revenue a sum exceeding 426 million dollars; that in addition to the direct state revenue derived from racing, collection of federal, state and local taxes presently generated by the horse industry which employs more than 158 thousand persons with a payroll exceeding one billion dollars also will be curtailed.

It is urged that Sections 211, 212, and 213, of H.R. 13270 be deleted on the basis that fulfillment of the federal government's need for additional revenue should not jeopardize the equine industry's source of funds for our states' pressing needs.

STATEMENT

Mr. Chairman, my appearance before the distinguished members of this Committee is on behalf of the National Association of State Racing Commissioners of which I am President.

I am Chairman of the Nebraska State Racing Commission, an administrative agency charged with the statutory responsibility of regulating and supervising horse racing at the six tracks in Nebraska. I was appointed by Governor Norbert T. Tiemann.

The National Association of State Racing Commissioners was formed in 1934 and its membership comprises all racing commissioners from the 30 states in which pari-mutuel racing is conducted, namely, Arizona, Arkansas, Delaware, Idaho, Illinois, Louisiana, Nebraska, New Mexico, California, Colorado, Florida, Kentucky, Maine, Maryland, Massachusetts, Michigan, Montana, Nevada, New Hampshire, New Jersey, New York, Ohio, Oregon, Pennsylvania, Rhode Island, South Dakota, Vermont, Washington, West Virginia, and Wyoming. Other Association Officials appearing with me are: Mr. J. Newton Brewer, Chairman of the Maryland State Racing Commission, and Mr. John A. Bell, Kentucky State Racing Commissioner. Mr. Brewer is presently First Vice-President of the

Association and will succeed me as President next year. Mr. Bell is Chairman of our Public Relations Committee, and one of his responsibilities is working on a comprehensive plan for a national economic study of racing.

We have been directed to submit for your consideration the position of the National Association of State Racing Commissioners as to the changes in farm tax accounting proposals together with the facts and reasons from which this conclusion is drawn. Our position is presented today after lengthy deliberation and study.

The position of our Association is one of unalterable opposition to the farm tax accounting provisions as proposed by Senator Jack Miller in Senate Bill 1560, as proposed by Senator Lee Metcalf in Senate Bill 500, and as proposed by House Bill 13270 and designated therein as Sections 211, 212, and 213.

While our opposition to these proposals may be similar to others presented to this Committee, it differs in one significant way. The position of the state racing commissioners is not a personal one. It was not determined by self-interest, nor by concern for a racing commissioner's salary. Salaries in those states which provide for remuneration are nominal and the majority of racing commissioners serve without pay. All racing commissioners serve at the pleasure of the various State Governors and are charged with the responsibility of regulating and supervising racing so as to maintain public confidence in the sport. Each racing commission must report annually to the legislature giving a detailed account of state tax revenue gained from pari-mutuel racing. This is a most important part of the commissioner's responsibility.

All racing officials are seriously concerned with the possible side effects of the proposed farm tax changes, consequences perhaps not envisioned by proponents of these changes, but which we as racing officials fear will prove extremely detrimental to racing and which can reduce significantly state tax revenue derived from racing.

As a part of our statement, we would like to include *Statistical Reports on Horse Racing in the United States for the year 1968*, and as reflected in that document, Table 1, the direct state tax revenue derived from racing last year amounted to more than 426 million dollars. As shown on Table No. 5, the direct state tax revenue derived from racing increases each year as racing increases and we expect the direct state tax revenue of more than 426 million dollars in 1968 to approach 500 million dollars this year.

These are *whole tax dollars*, as distinguished from those tax dollars which require 45 cents to collect. This racing revenue costs the states nothing to collect. The racing commissions collect the license fees while the race tracks collect the tax revenue from admissions and pari-mutuel handle in such amounts as shown on Table No. 2 in the reports, and this sum is paid over directly to the states.

This state revenue comes from a *self-imposed* tax, and a state tax which cannot be deducted by the taxpayer against any federal taxes. This is an important source of state tax revenue which provides more than 155 million dollars for schools in New York, more than 57 million dollars for roads in California, and more than 40 million dollars for county projects in Illinois. These are significant budgetary accounts for important services provided by tax revenue from racing.

At this very moment, states, counties, and cities are demanding more federal funds to meet critical local needs. You well know that whatever the states lose in decreased tax revenue will ultimately have to be made up in federal funds. How much federal tax revenue is expected to be gained from these new farm tax accounting provisions? The House Ways and Means Committee report, on page 71, indicates that the "farm-loss" provisions will produce an estimated five million dollars in 1971. If state tax revenue drops only 20 percent, the states would lose 100 million dollars.

Mention has been made here only of the direct state tax revenue derived from racing, a sum expected to approach 500 million dollars this year. This is the readily accountable tax revenue from racing which we report each year as turned over directly to state treasuries from race track operation. Yet this is only a small portion of the federal, state, and local tax revenue generated by the racing industry. The National Association of State Racing Commissioners this year adopted a comprehensive plan for a national economic study of racing. This plan is beiug implemented under the direction of Mr. Bell's Committee, and the economic analysis of the data now being collected is expected to be completed next year.

Surveys preliminary to this comprehensive study indicate that the horse industry in the United States provides employment for more than 158 thousand persons with a payroll exceeding one billion dollars. This is an industry with fixed assets of one billion 261 million dollars in land, one billion 115 million dollars in horses, 621 million dollars in equipment, and 602 million dollars in race track property.

This is an industry which we as racing commissioners fear will be critically affected by the proposed changes in farm tax accounting. Proponents of these measures assert that the EDA, recaptured depreciation, longer holding period to receive capital gains and the $25,000 loss in three of five years, are designed to gain five million dollars in federal taxes from 100 rich people. These provisions, however, will affect not just 100 rich people, but the incomes of 158 thousand grooms, harness drivers, ranch hands, insurance men, Western clothing manufacturers, blacksmiths, hay growers, mutuel clerks, harness makers and parking lot attendants.

Racing and direct state tax revenue from racing depend to a large extent on the good horse. People come out to see the stars. The good horse is a rarity. Statistics compiled by The Blood Horse magazine last year showed that 43,715 Thoroughbreds raced and only 729 of these won a stakes race. That is one good horse out of 60. Statistics compiled by the American Petroleum Institute show that only one out of nine drilled wells produces oil and it is generally conceded that a tax incentive is essential for a man to challenge nine to one odds. Whatever tax incentive there may be for a horse breeder to challenge 60 to one odds is removed by these proposed changes in farm tax accounting.

The proposals will discourage the extremely successful businessman and preclude the moderately successful businessman from investing risk capital in the horse breeding industry. Breeding the good horse today requires a substantial investment in breeding stock and far more than five years of possible losses before a profit can be realized in that one good horse out of 60. However, the vast majority of horses are not produced by the large breeding operations, but by small breeders with four or five broodmares. Statistics compiled by Triangle Publications show that the 43,715 Thoroughbreds which raced last year were bred by 14,369 different persons, an average of three horses per breeder.

Removal of tax incentives from the horse breeding industry will discourage investment by the big breeder, and thereby can seriously curtail the production of good horses. These farm-loss proposals, moreover, can preclude investment by thousands of small breeders, and thereby critically reduce the overall number of horses needed to fill our race programs.

The National Association of State Racing Commissioners, therefore, desires to express its opposition to these proposals in the strongest possible manner. While the proposals are designed to gain five million dollars from 100 rich men, they serve as a deterrent to the more than 14 thousand other breeders who produce the horses for an industry that employs more than 158 thousand persons with a payroll exceeding one billion dollars, an industry that last year produced in direct state tax revenue more than 426 million dollars.

Our Association and all racing officials, on behalf of the industry, strongly urge this Committee to delete sections 211, 212, and 213, of H.R. 13270, that are so damaging to an industry making such a substantial contribution to state revenues—which in the case of 1969–70 are already committed. Although we are cognizant of and sympathetic with the federal government's need for additional revenue, it is our considered judgment and strong feeling that the fulfilling of this requirement should not jeopardize the equine industry's important source of funds for our states' many pressing needs.

STATISTICAL REPORTS ON HORSE RACING IN THE UNITED STATES FOR THE YEAR 1968

Prepared by

THE NATIONAL ASSOCIATION OF STATE RACING COMMISSIONERS
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LEXINGTON, KENTUCKY 40504

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Compiled March 1969 by Secretary of NASRC
from figures submitted by the several
state racing commissions.

Price Per Copy $2.00

Table No. 1

Pari-mutuel Turnover and Revenue to States

State	Racing Days				Attendance				Pari-mutuel Turnover				Revenue to State			
	Total	Thorough-bred	Harness	Qtr. Horse and Fairs	Total	Thorough-bred	Harness	Qtr. Horse and Fairs	Total	Thorough-bred	Harness	Qtr. Horse and Fairs	Total	Thorough-bred	Harness	Qtr. Horse and Fairs
Arizona (1)(2)	202	152		50	470,709	409,799		60,910	$ 20,675,726	$ 19,643,050	$	$ 1,032,676	$ 1,006,346	$ 1,006,346	$	$
Arkansas	50	50			486,704	486,704			35,796,288	35,796,288			2,328,901	2,328,901		
California (3)(4)	682	352	118	111 101	8,436,084	6,018,214	919,591	781,978 716,301	768,186,584	579,483,365	78,601,200	54,721,549 55,380,470	57,326,182	45,833,880	5,186,015	3,426,081 2,880,206
Colorado (3)	143	86		28 29	445,363	350,043		70,259 25,061	19,670,510	15,956,236		3,206,029 508,245	660,184	539,583		101,439 19,162
Delaware	300	61	239		1,842,874	650,666	1,192,208		128,250,004	59,762,224	68,487,780		6,945,727	3,727,270	3,218,457	
Florida (1)(5)	258	169	89		1,626,856	1,412,989	213,867		195,945,624	183,570,440	12,375,184		16,877,543	15,858,290	1,019,253	
Idaho (6)	81	60		21	79,586	64,165	15,421		2,027,880	1,760,341		267,539	101,680	96,642		5,038
Illinois	723	307	416		6,860,835	3,556,175	3,304,660		556,621,386	312,600,150	244,021,236		40,024,116	23,777,144	16,246,972	
Kentucky	438	220	218		1,934,189	1,379,965	554,224		115,413,796	95,469,969	19,943,827		5,505,489	4,636,648	868,841	
Louisiana(1)(7)(8)	173	173			1,107,714	1,107,714			74,908,172	74,908,172			4,340,635	4,340,635		
Maine (9)	272	42	167	63	189,914	189,914	No Record		21,309,621	6,149,789	11,582,254	3,577,578	1,501,772	440,064	811,138	250,570
Maryland (10)(11)	345	159	126	60	2,656,973	1,758,345	509,446	389,182	238,607,993	179,053,502	27,800,190	31,754,301	13,911,393	10,317,806	1,771,681	1,821,906
Massachusetts (10)	216	90	90	36	1,824,971	852,539	737,839	214,593	127,510,221	74,556,270	40,346,815	12,607,136	9,419,423	6,101,449	2,608,312	709,662
Michigan	388	168	220		2,909,308	1,873,121	1,036,187		231,472,394	158,556,947	72,915,447		17,794,513	13,635,781	4,158,732	
Montana (12)(13)	62	62			132,650	132,650			1,461,287	1,461,287			None			
Nebraska	161	161			1,903,160	1,903,160			56,887,376	56,887,376			2,181,209	2,181,209		
Nevada (14)	8			8	11,300			11,300	218,481			218,481	None			
New Hampshire(9)	300	51	241	8	1,759,986	578,214	1,147,793	33,979	115,813,861	55,576,933	59,450,392	786,536	8,306,470	4,482,780	3,774,272	49,418
New Jersey	336	176	160		3,739,351	2,802,272	937,079		391,331,683	317,296,567	74,035,116		34,425,606	29,435,041	4,990,564	
New Mexico (3)(15)	203	203			732,976	732,976			34,083,203	23,961,307		10,121,896	803,016	803,016		
New York	1,331	360	971		15,930,357	7,109,131	8,821,226		1,459,528,840	723,629,731	735,899,109		155,696,563	80,799,092	74,896,471	
Ohio (3)(16)	939	400	398	1 140	3,619,483	1,796,909	1,569,326	4,886 249,332	213,325,689	137,586,835	74,345,311	158,342 1,236,201	15,103,971	10,564,337	4,466,296	11,868 61,469
Oregon (17)	100	50		50	454,000	297,000		157,000	19,264,136	14,256,191		5,007,945	957,768	880,785		76,983
Pennsylvania	248		248		1,762,791		1,762,791		126,737,666		126,737,666		7,407,983		7,407,983	
Rhode Island	150	150			1,206,310	1,206,310			116,232,376	116,232,376			10,560,003	10,560,003		
South Dakota (18)	58	52		6	90,696	74,196		16,500	4,610,347	4,271,704		338,643	143,795	132,415		11,380
Vermont	169	127	42		584,213	456,641	127,572		37,205,714	28,684,554	8,521,160		2,272,133	1,882,814	389,319	
Washington (19)(20)	155	138		17	508,096E	508,096E		No Record	42,943,560	42,691,130		252,430	2,169,009	2,154,002		15,007
West Virginia	541	541			2,122,981	2,122,981			154,714,930	154,714,930			9,090,365	9,090,365		
Wyoming	19	19			30,000E	30,000E			195,000	195,000			13,655	13,655		
TOTALS	9,051	4,579	3,743	729	65,460,434	39,859,973	22,869,240	2,731,221	$5,226,457,141	$3,473,711,604	$1,655,062,687	$181,174,057	$426,856,448	$285,599,953	$131,816,306	$9,440,189

REMARKS:

(1) Arizona, Florida, Louisiana: Reports based on fiscal year, July 1, 1967-June 30, 1968.

(2) Arizona: Fairs—All revenue and breakage to counties.

(3) California, Colorado, New Mexico, Ohio: Bold Face indicates Quarter Horse.

(4) California: Fairs—Thoroughbred, Quarter Horse, Harness and Appaloosa racing.

(5) Florida: Charity and Scholarship days not included in revenue figures above. Thoroughbred—20 days; attendance, 116,526; pari-mutuel turnover, $13,190,224. Harness—3 days; attendance, 4,731; pari-mutuel turnover, $250,163.

(6) Idaho: Thoroughbred, Quarter Horse, Appaloosa, and mixed races at most race meets.

(7) Louisiana: Quarter Horse, 277 races. Evangeline Downs, mixed racing.

(8) Louisiana: Donations to American Red Cross and Retarded Children's Funds not included in revenue figures above.

(9) Maine, New Hampshire: Fairs—All Harness racing.

(10) Maryland, Massachusetts: Fairs—All Thoroughbred racing.

(11) Maryland: Two-day Steeplechase meeting included in Thoroughbred figures. Estimated attendance, 28,000; par stuel turnover, $309,906; revenue to state, $15,964.30.

(12) Montana: Thoroughbred, Quarter Horse and Appaloosa racing at same track, same meet. Some mixed races for Thoroughbred and Quarter Horse.

(13) Montana: State derives no revenue from racing However, 1 per cent of 20% take-out is paid to Commission by licensee and deposited in State Treasury in Commission's account for expenses. Commission also receives toward expenses underpayments and license fee.

(14) Nevada: One per cent of total take-out is paid to Commission for administrative work.

(15) New Mexico: Mixed program each day of Thoroughbred and Quarter Horse racing.

(16) Ohio: Fairs—All Harness racing, except one day Quarter Horse.

(17) Oregon: There were 925 races programmed of which 792 were Thoroughbred, and 133 for Quarter Horse and Appaloosa.

(18) South Dakota: One race per day Quarter Horse.

(19) Washington: Fairs—Both Thoroughbred and Quarter Horse racing.

(20) Washington: Attendance estimated. Approximately 1,000 working passes issued—owners, trainers, jockeys issued two free passes; tax exempted passes issued to state, city and county officials.

Note on Attendance: At some meetings, principally Fairs, attendance records not always reported.

Note on Revenue to State: Totals computed to nearest dollar

(E)—Estimated.

Table No. 2

Breakdown of Revenue to States — 1968

State	From Track Licenses			From Occupational Licenses			From Pari-mutuel Taxes			From Admissions			From Breaks			From Miscellaneous Sources		
	Thoroughbred	Harness	Qtr. Horse and Fairs	Thoroughbred	Harness	Qtr. Horse and Fairs	Thoroughbred	Harness	Qtr. Horse and Fairs	Thoroughbred	Harness	Qtr. Horse and Fairs	Thoroughbred	Harness	Qtr. Horse and Fairs	Thoroughbred	Harness	Qtr. Horse and Fairs
Arizona (1)	$ 18,532.00	$	$	$ 18,582.00	$	$	$ 987,729.61	$	$	$	$	$	$	$	$	$ 84.10	$	$
Arkansas	25,000.00			14,658.00			2,147,777.28			22,936.80			107,202.80			11,327.07		
California (2)				64,544.00	18,002.00	11,317.00 11,821.00	40,761,735.00	4,989,355.00	2,396,707.80 2,819,546.00				4,671,782.00	170,866.00		336,849.00	80,792.00	34,157.80 48,739.00
Colorado (2)				10,450.00		4,862.00 5,045.00	528,327.07		96,943.47 13,467.00							806.40		882.40 650.00
Delaware	5,000.00	1,000.00			1,500.00		3,287,252.00	3,081,950.31		113,626.00	84,311.40		287,078.00			34,214.00	49,995.25	
Florida				67,270.00	18,671.75		14,237,081.12	898,302.88		461,742.48	43,491.70		956,777.63	77,457.72		133,468.70	13,369.40	
Idaho (3)	1,800.00			6,800.00		2,168.00	88,017.05		2,675.30							630.00		196.00
Illinois	41,000.00	59,200.00		55,327.00	40,684.00		21,203,462.36	13,985,115.48		636,419.60	613,667.60		1,620,965.30	1,431,424.07		219,969.75	106,781.00	
Kentucky (4)	212,000.00	27,060.00			11,280.00		4,190,020.38	797,753.08		161,194.05	16,242.22					73,434.00	16,816.00	
Louisiana				32,738.00			4,302,215.59			48,575.90						60,105.50		
Maine	5,000.00	380.00	140.00	2,062.75			430,573.03	810,757.78	250,430.46							2,487.80		
Maryland (5)	156,00.00	3,150.00		53,890.00	10,380.00		8,952,675.10	1,435,070.14	1,605,258.06	79,801.56	30,781.02	1,278.66	879,946.42	306,292.76	190,458.87	195,792.75	26,007.45	24,910.80
Massachusetts	54,000.00	18,000.00	1,800.00	15,017.00	10,856.00	2,280.00	5,591,720.47	2,350,584.65	611,492.56				400,150.20	209,591.28	81,913.76	40,561.20	19,280.10	12,080.60
Michigan	1,000.00	600.00		14,484.00	22,269.00		12,684,555.76	3,645,772.35					838,310.49	438,808.70		97,430.60	51,297.40	
Montana (6)																		
Nebraska	11,800.00			27,395.00			1,995,495.04			130,670.70						15,348.75		
Nevada (6)																		
New Hampshire				11,349.00	15,277.64	286.00	4,168,270.12	3,389,580.50	43,259.50				264,277.59	329,176.25	4,189.12	38,763.40	42,238.10	1,583.10
New Jersey				71,315.00	19,281.00		25,770,306.82	4,211,305.65					3,416,132.80	708,031.84		177,286.20	51,845.10	
New Mexico	57,410.00			30,729.50			695,906.89			14,759.56						4,210.00		
New York (7)	714,625.00	97,100.00		57,683.00	58,487.00		70,205,820.00	68,199,378.36		1,802,987.00	1,636,667.23		6,859,774.00	3,744,601.27		1,066,203.00	1,170,236.67	
Ohio (2)(8)	80.00	80.00	10.00 420.00	38,294.00	32,630.00	1,186.00 2,008.00	10,303,291.61	4,067,833.23	10,671.61 52,141.13				210,553.71	306,285.19	630.44	12,116.00	9,267.98	6,274.83
Oregon	28,000.00		9.00	2,732.00		910.00	831,524.00		75,119.00							1,528.00		945.00
Pennsylvania					26,718.28			6,236,883.30			109,760.50			641,917.27			293,203.84	
Rhode Island				22,000.00			9,879,722.00						593,067.00			65,224.00		
South Dakota (9)	520.00		60.00	2,419.00		1,136.00	128,151.12		10,159.29							1,325.00		25.00
Vermont	8,051.00	6,284.00		680.00	1,878.00		1,689,704.75	331,519.28					156,426.03	43,250.05		27,951.80	6,188.00	
Washington	12,800.00		1,700.00	5,645.00		685.00	2,134,556.50		12,621.50									
West Virginia	138,250.00			51,883.00			8,896,107.48									7,125.00		
Wyoming	950.00			2,067.00			7,763.40						2,140.00			135.00		
TOTALS	$1,467,986.00	$213,044.00	$4,139.00	$678,512.25	$284,504.67	$43,514.00	$256,089,711.54	$118,489,121.99	$8,983,991.95	$3,471,712.35	$2,524,921.67	$1,278.66	$21,266,644.06	$8,417,897.40	$277,192.19	$2,615,384 02	$1,887,013.24	$129,878.73

REMARKS:

(1) Arizona: Fairs—All revenue and breakage to counties. Fairs—Licenses and Miscellaneous Sources included with Thoroughbred.
(2) California, Colorado, Ohio: Quarter Horse figures in Bold Face.
(3) Idaho: Fairs—Exempt from Track Licenses.
(4) Kentucky: Thoroughbred—Occupational Licenses held by Commission for expenses.
(5) Maryland: Occupational Licenses for Steeplechase and Fairs, all included in Thoroughbred. Pari-mutuel Taxes from Ste-plechase, $15.495 40 included with Thoroughbred. Miscellaneous Sources from Steeplecha-e, $463.10 included with Thoroughbred.
(6) Montana and Nevada: State does not derive any money from racing, except 1% of total take-out paid to Commission for administrative expenses.
(7) New York: Thoroughbred—Track Licenses includes $12,625, and $702,000 franchise fees, N.Y.R.A.
(8) Ohio: Pari-mutuel Taxes—Total tax less 25% tax on Breakage.
(9) South Dakota: One per cent of Pari-mutuel Taxes to Breeders' Fund added to purses for state bred and owned horses.

Table No. 8

Breakdown Sheet of Pari-mutuel Take-out and Breakage

State	Total Take-out Permitted			Pari-mutuel Tax to State			Breaks to			Disposition of Breaks to State			Disposition of Breaks to Association		
	Thoroughbred	Harness	Qtr. Horse and Fairs	Thoroughbred	Harness	Qtr. Horse and Fairs	Thoroughbred	Harness	Qtr. Horse and Fairs	Thoroughbred	Harness	Qtr. Horse and Fairs	Thoroughbred	Harness	Qtr. Horse and Fairs
Arizona (1)	18%		18%	4% - 7%		None	10c		10c				100%		100%
Arkansas (2)	16%			6%			10c			33⅓%			33⅓%		
California (3)	14%	14%	14% 14%	5% - 8%	5% - 8%	5% - 8% 5% - 8%	10c	10c	10c 10c	All over 50 million 100%			50% first 24 million—50% purses 24 million-50 million 100% purses		
Colorado (4)	15%		15% 15%	3% - 6%		3% - 6% {3% - 6% {2%	10c		10c 10c				100%		100% 100%
Delaware (5)	15%	17½%		5½%	4½%		10c	5c		50%			50%	100%	
Florida (6)	15%	17%		8%	7%		10c	10c		50%	50%		50%	50%	
Idaho	15%		14%	5%		1%	10c		10c				100%		100%
Illinois	15%	15%		5% - 8½%	5½% - 8½%		10c	10c		50%	50%		50%	50%	
Kentucky	14%	17%		4% - 6%	4%		10c	10c					100%	100%	
Louisiana (7)	16%			5% - 7%			10c			None			66 2/3%		
Maine	18%	18%	18%	7%	7%	7%	10c	10c	10c				100%	100%	100%
Maryland (8)	13%	16%	13%	5%	3½% - 7%	1% - 6%	10c	10c	10c	50%	{100% if daily average exceeds $166,666.67	50%	50%	{100% if daily average below $166,666.67	50%
Massachusetts	15%	17%	17%	7½%	5½% - 9¼%	2% - 3½%	10c	10c	10c	50%	50%	50%	50%	50%	50%
Michigan	15%	15%		8%	5%		10c	10c		50%	50%		50%	50%	
Montana (9)	20%						10c						100%		
Nebraska	14%			4% after first millior			10c						100%		
Nevada (9)			16⅓%						10c						100%
New Hampshire	15%	17%	17%	7½%	5½% - 9½%	5½% - 9½%	10c	10c	10c	50%	50%	50%	50%	50%	50%
New Jersey	14½%	16%		7½% - 8½%	5½% - 6½%		10c	10c		100%	100%				
New Mexico	18%		18%	2% - 6%		2%	10c		10c				100%		100%
New York	16%	16%		{10% 9% 10% - 4%	5½% - 11½%		10c	10c		80% - 75%	50%		20% - 25%	25% & 25%	
Ohio	16½%	17½%	16½% 17½%	4¼% - 8¾%	3% - 7%	4¼% - 8¼% 3% - 7%	10c	10c	10c 10c	25% after the first $2000.			35%&40%	35%&40%	35%&40% 35%&40%
Oregon Option 1 Option 2	12½% 15%		12½% 15%	3% - 6% 5% - 7%		1½% 1½%	10c 10c		10c 10c				50% 50%		50% 50%
Pennsylvania		17%			5%			10c			50%			50%	
Rhode Island	16%			8½%			10c			50%			50%		
South Dakota	15%		15%	4%		4%	10c		10c				100%		100%
Vermont (10)	18%	18%		5½% (Sundays 6½%)	3% - 8% (Sundays 4% - 9%)		10c	10c		50%	50%		50%	50%	
Washington	15%		15%	5%		5%	5c		5c				100%		100%
West Virginia	15%			5¾%			10c						100%		
Wyoming	17%			4%			10c			100%					

REMARKS:

(1) **Arizona:** Fairs—All revenue and breakage to counties.

(2) **Arkansas:** Breakage—One third to state, ⅓ to association and ⅓ to city where track is located.

(3) **California:** Any track operator that handled not more than $125 million qualifies to retain the breakage for purse distribution. Up to $24 million wagered, the track receives 50%, purses 50%. From $24 million to $50 million, 100% goes to purses. The state receives 100% over $50 million wagered.

(4) **Colorado:** Colorado State Fair—State receives only 2% of 15% take-out.

(5) **Delaware:** Thoroughbred—One per cent increase in pari-mutuel commission—50% allocable to purses and 50% to "servicing and repayment of debt and/or for past, present or future capital improvements."

(6) **Florida:** Breakage—One half of breakage to Racing Promotion Trust Fund to supplement purses.

(7) **Louisiana:** Breakage—Full amount used at track where breakage is collected, with 2/3 to track and ⅓ to supplement purses for Louisiana breeders.

(8) **Maryland:** Steeplechase—Total take-out 14%, with 5% to state. All breakage to association.

(9) **Montana and Nevada:** Revenue to State—State receives no revenue, but 1% of take-out goes to Commission for expenses.

(10) **Vermont:** Pari-mutuel Tax to State—State receives 1% more tax on Sunday racing.

Table No. 4

Brief Summary of Tax Methods by States

State	
Arizona	Total take-out 18%. State receives 4% of first $100,000 of daily pari-mutuel pool and 7% all over $100,000. Net underpay to state at end of meeting. Breakage 10c, all to association. FAIRS: County in which fair is located receives pari-mutuel tax revenue, instead of state.
Arkansas	Total take-out 16%. Pari-mutuel tax to state 6%, $500 daily license, 10c tax on admissions. Breaks 10c, divided 33⅓% to city where track is located, 33⅓% to association, 33⅓% to state.
California	Total take-out 14%. State receives 5% of first $10 million handled, 6% of next $10 million, 7% over $20 million to $75 million, 7½% over $75 million to $125 million, 8% over $125 million wagered. Occupational license fees and breakage. Breaks to 10c. Any racing association that handles not more than $125 million qualifies to retain breakage for purse distribution: All under $24 million wagered racing association receives 50%, purses 50%; $24 million to $50 million, 100% to purses. Over $50 million state receives 100%.
Colorado	Total take-out 15%. State receives 3% of first $200,000, 4% of excess over $200,000 which does not exceed $300,000, 5% of all in excess of $300,000 which does not exceed $500,000, 6% of all in excess of $500,000. Breaks 10c, all to association. At Colorado State Fair, state receives 2% of take-out.
*Delaware	THOROUGHBRED: **Total take-out 15%, 1% of which allocated 50% for purses, 50% for capital improvements.** Per season license $5,000. Admissions 20c. Breaks 10c, divided equally between state and association. Unclaimed pari-mutuel tickets payable to state one year following last date of meeting in which ticket was sold. HARNESS: Total take-out 17½%. State receives 4½%. Admissions 10c. Breaks 5c, to association. Uncashed pari-mutuel tickets revert to state after one year.
Florida	THOROUGHBRED: Total take-out 15%. State receives 8%. (3% and admission taxes divided equally among 67 counties after racing commission expenses deducted—5% and ½ breakage to General Revenue Fund. One half of breakage to Racing Promotion Trust Fund to supplement purses.) Breaks 10c, 5c on minus pools. Any track having an average daily handle of less than $400,000 per day for the preceding racing season operates on a fixed daily license fee. HARNESS: Total take-out 17%. State receives 7%. (Of state's commission, 3% and admission taxes divided equally among 67 counties after racing commission expenses deducted, 2% and 50% of breakage to General Revenue Fund, 2% to be divided equally among counties. Fifty per cent of breakage to Racing Promotion Fund to supplement purses.) Breaks 10c.
Idaho	Total take-out 15%. Non-fair associations receive 10% plus breakage and pay $25 daily license fee. Fairs receive 14% plus breakage, and are exempt from license fee. The 4% and license fee from non-fairs is deposited to Public School Endowment Fund. All occupational license fees deposited to General Fund. Associations accrue all monies in unclaimed tickets 30 days after close of race meet. Committee receives 1% of handle for operational expenses.
Illinois	Total take-out 15%. THOROUGHBRED—state receives: At race tracks within county of 500,000 or more or within county of less than 500,000 but within 100 miles corporate limits any city in state of 1 million or more tax rates, except charity: First $5,000,000 of annual handle—5%, $5,000,001 to $10,000,000—6%, $10,000,001 to $30,000,000—7%, $30,000,001 to $40,000,000—7½%, $40,000,001 to $60,000,000—8%, over $60,000,000—8½%. At race tracks within county of less than 500,000 and more than 100 miles of any city in state of 1 million or more tax rate, except charity: First $10,000,000 of annual handle—5%, $10,000,001 to $20,000,000—6%, $20,000,001 to $30,000,000—7%, $30,000,001 to $40,000,000—7½%, $40,000,001 to $60,000,000—8%, over $60,000,000—8½%. Breaks 10c, half to state. Charity meets, tax 7% plus half of breaks. HARNESS—state receives: First $30,000,000 of annual handle—5½%, $30,000,001 to $35,000,000—6½%, $35,000,001 to $40,000,000—7½%, $40,000,001 to $60,000,000—8%, over $60,000,000—8½%. Breaks 10c, half to state. Charity meets, tax 7%. Breakage, both Thoroughbred and Harness, 5c instead of 10c in case of minus pool.
Kentucky	THOROUGHBRED: Total take-out 14%. State receives 4% on all under $18 million wagered during year, 6% thereafter. Daily license $500 if average daily handle at track during year does not exceed $450,000, $1,000 at tracks with average daily handle $450,000 to $600,000, $2,500 at tracks where sum exceeds $600,000. Breaks 10c, to association; 15c on admissions. HARNESS: Total take-out 17%. State receives 4%. Daily license $100 if average daily handle during previous year does not exceed $75,000, $150 thereafter. Breaks 10c, to association; 5c on admissions. Unclaimed tickets to state after two years.
Louisiana	Total take-out 16%. In a parish with population of 450,000 and over state receives: On total daily pools from 1c to $201,000—5%, $201,000 to $401,000, $10,050 plus 6% of that amount exceeding $201,000 up to $401,000, $401,000 and over, $22,050 plus 7% of any amount exceeding $401,000. Daily license fee $1,000. In a parish with population less than 450,000 state receives: On total daily pools up to $200,000—5% of that portion exceeding $30,000, $201,000 to $300,000, $8,500 plus 6% of that portion exceeding $200,000, over $300,000, $14,500 plus 7% of pool exceeding $300,000. Daily license fee $1,000. Admissions 10c. Breaks 10c, 2/3 to association and ⅓ to Louisiana Breeders Fund to supplement purses.
Maine	THOROUGHBRED: Total take-out 18%. State receives 7% sub-divided as follows: 5% to General Fund, 1% to Agricultural Stipend Fund, 1% returned to association to defray cost of operation. License fee $5,000 annually. Any outstanding balance in unredeemed mutuel tickets divided equally between association and state when account is closed. Breaks to 10c, all to association. HARNESS: Total take-out 13% with 6% to state General Fund, 1% to Agricultural Stipend Fund, association 11%. One-sixth of state commission is returned to association for purpose of supplementing purse money. License fee $10 for each 6 days or less of racing. Bond up to $50,000 required for license. Breaks 10c, all to association.
Maryland	THOROUGHBRED (MILE TRACKS): Total take-out 13%. State receives 5%, association 7⅓% of which 4% is allocated to purses and .34 of 1% to Maryland-bred Fund Races. One half of 1% of money wagered to Racing Fund for plant improvements. Daily license fee $1,000. Breaks 10c, divided equally between state and association. COUNTY FAIRS (THOROUGHBRED): Total take-out 13%, with 1% of first $1,500,000 to state, 12% of first $1,500,000 to association, of which 3.66% is allocated to purses and .34 of 1% to Maryland-bred Fund Races. All over $1,500,000, 6% to state, 7% to association, of which 3.66% is allocated to purses and .34 of 1% to Maryland-bred Fund races. Breaks 10c, divided equally between state and association. HARNESS: Total take-out 16%. Of all money wagered not in excess of $125,000 daily average, 3⅓% to state, 12⅔% to association. Of all money wagered in excess of $125,000 daily average, 7% to state, 9% to association. Daily license $25. Breaks 10c. Association retains all breakage if daily average is below $166,666.67, above this figure, state gets all breakage. STEEPLECHASE: Total take-out 14%. State receives 5%, association 9%. Breaks 10c, to association.
*Massachusetts	THOROUGHBRED: **Total take-out 15%. State receives 7½%, association 7½%.** License fee $600 per day. Breaks 10c, divided equally between state and association. HARNESS: Total take-out 17%. State receives on daily handle to $400,000—5½%. $400,000 to $450,000—6¾%. $450,000 to $500,000—7¼%. $500,000 to $550,000—7¾%, $550,000 to $600,000—8¼%, $600,000 to $650,000—8¾%, $650,000 and over—9¼%. License fee $200 per day. Breaks 10c, divided equally between state and association. FAIRS: Total take-out 17%. State receives 2% of daily handle plus 3½% of any amount over $65,000. License fee $50 per day. Breaks 10c, divided equally between state and association.
Michigan	THOROUGHBRED: Total take-out 15%. State receives 8%, association 7%. Breaks 10c, divided equally between state and association. HARNESS: Total take-out 15%. State receives 5%, association 10%. Breaks 10c, divided equally between state and association.

* Portion bold face type indicates change in law 1968.

Table No. 4 (continued)

Brief Summary of Tax Methods by States

Montana	Total take-out 20%. The licensee shall pay to commission 1% of all gross receipts of each day's pari-mutuel betting at each race meet, which sums shall be paid to commission within five (5) days after receipt by licensee. At end of each race meet should report show underpayments to be in excess of overpayments, such balance shall be paid to commission. (No tax paid to State of Montana.)
Nebraska	Total take-out 14%. State receives 4% on all over $1 million. Tax on admissions 15c which, along with monies received in license fees, is distributed among counties of state for county fair premiums. Breaks 10c, to association.
Nevada	Total take-out 16½%. With exception of Fairs, state receives 2% of which 1% is paid to state General Fund and 1% to racing commission. (Daily license $50 per day; however, law provides that a maximum of $200 per day may be charged.) FAIRS: Total take-out 16⅛%, with 1% to racing commission for administrative work. However, after July 1 of following year any amount over $10,000 is to be distributed to agricultural districts conducting horse racing proportionately to the amount contributed by each district. Breaks 10c, to association.
*New Hampshire	THOROUGHBRED: Total take-out 15%. State receives 7½%, association 7½%. No license fee, but bond not exceeding $50,000 required. Breaks 10c, divided equally between state and association. HARNESS: Total take-out 17%, divided as follows: Of total mutuel pool for any one day, state receives 5¼% up to $400,000, 6¾%—$400,001 to $450,000, 7¼%—$450,001 to $500,000, 7¾%—$500,001 to $550,000, 8¼%—$550,001 to $600,000, 8¾%—$600,001 to $650,000, 9¼%—$650,001 and over. One quarter of 1% of total pari-mutuel pools allocated to Agricultural Fairs of state; however, total amount allocated is limited to $150,000 in any one year. Track licenses paid to township where track is located. Breaks 10c, divided equally between state and association.
New Jersey	THOROUGHBRED: Total take-out 14½%. Of first $40 million of handle, state receives 7½%, thereafter 8½%. Breaks 10c, all to state. HARNESS: Total take-out 16%. Of first $40 million of handle, state receives 5½%, thereafter 6½%. Breaks 10c, all to state.
New Mexico	Total take-out 18%. State receives 2% up to $250,000, 3% to $350,000, 4% to $400,000, 6% all over $400,000. New Mexico State Fair, state receives 2%. Daily license fee $300, half to state and half to county in which track is located, except State Fair charged $10 per race day. Breaks 10c, all to association.
*New York	THOROUGHBRED:[1] ~~Total take-out 16%. State receives from Saratoga 9%, from Aqueduct and Belmont 10% of total mutuel handle.~~ From Finger Lakes state receives 10% ~~first $175,000, 8%~~ next ~~$125,000, 7% next $100,000, 6% over $400,000 to $500,000, 5% to $600,000, 4% all over $600,000. Effective April 1, 1968 additional 1% of take-out for purses. Breaks 10c, state receives from Aqueduct-Belmont-Saratoga 80%, from Finger Lakes 75%. Franchise fee $3,000 per racing day paid by non-profit associations. Finger Lakes track~~ license, $100 per day. HARNESS: Total take-out 16%. Of total daily pool, state receives 5½% not exceeding $175,000, 7½%—$175,000.01 to $300,000, 8½%—$300,000.01 to $400,000, 9½%—$400,000.01 to $500,000, 10½%—$500,000.01 to $600,000, 11½% all over $600,000. Breaks 10c, with state receiving 50%, Horse Breeders Fund 25%, association 25%.
*Ohio	THOROUGHBRED: Total take-out 16½%. State receives 4¼% first $10,000 wagered, 5¼% next $40,000, 6¼% next $50,000, 7¼% next $300,000, 8¼% all over $400,000. HARNESS and FAIRS: Total take-out 17½%. State receives 3% first ?10,000, 4% next $40,000, 5% next $50,000, 6% next $300,000, 7% all over $400,000. For both Thoroughbred and Harness, breaks 10c with state receiving 25% after first $2,000 in any year; 40% of breaks retained by track for increase in net purse distribution. Ohio Fair Fund: One half of 1% of total wagered at Thoroughbred, Harness and Fair meetings appropriated for Ohio Fair Fund Tax (tax collected from take-out). Thoroughbred Fund. Four tenths of 1% of total wagered at Thoroughbred and Harness meetings (not collected from Fairs) is appropriated for Ohio Thoroughbred Race Fund. (One tenth of 1% increase for 1968 season.) General Revenue Tax collected from Fairs refunded to Agricultural Societies.
Oregon	Total take-out 12½% in Option 1, 15% in Option 2. Under Option 1, state receives 3% first $66,000, 4% next $67,000, 5% next $67,000, 6% all over $200,000 wagered in one day. Under Option 2, state receives 5% first $133,000, 6% next $67,000, 7% all over $200,000 wagered in one day. Non-profit Fairs, state receives 1½% under either Option. Daily license fee Option 1, $425, Option 2, $500. Per meet license non-profit tracks $1. Breaks 10c, half to association and half for purses Oregon-bred horses.
Pennsylvania	HARNESS: Total take-out 17%. State receives 5%, association 10%. In addition there is a 2% tax at tracks located in cities of first class, paid directly to school district. In all other areas 2% tax paid to Department of Commerce for projects in accordance with law. Breaks 10c, divided equally between state and association, except in case where a minus pool is created, then breaks 5c.
Rhode Island	Total take-out 16%. State receives 8½%, association 7½%. Breaks 10c, divided equally between state and association.
South Dakota	Total take-out 15%. State Special Racing Fund receives 3%, State Breeders' Fund 1%, association 11%. Law also provides that 5% of winning purse will go to South Dakota breeder of winning horse. Breaks 10c, all to association.
*Vermont	THOROUGHBRED: Total take-out 18%. State receives 5½%. Breaks 10c, half to state and half to association. HARNESS: Total take-out 18%, with state receiving on first $150,000 plus 3%, $150,000 to $200,000 plus 4%, $200,000 to $250,000 plus 5%, $250,000 to $300,000 plus 6%, $300,000 to $350,000 plus 7%, $350,000 and over 8%. Breaks 10c, half to state and half to association. On Sunday racing, state's share increased as follows: Tax percentage 6½% instead of 5½%, thoroughbred; tax percentage sliding scale 4% to 8%, harness.
Washington	Total take-out 15%. State receives 5%, association 10%. Breaks 5c, all to association.
West Virginia	Total take-out 15%. State receives 5¾%, association 9¼%. Daily license tax $250 for tracks under one mile, $500 for tracks one mile or more. Unredeemed pari-mutuel ticket money deposited to Special Account to support State Breeders' Awards. Breaks 10c, all to association.
Wyoming	Total take-out 17%, with 1% to commission for operating expenses, 4% and breakage to State General Fund, 2%, on a population ratio, to cities and towns within county where track is located. Association retains 10%. Breaks 10c, all to state. The 1969 Legislature has passed a new pari-mutuel law permitting total take-out of 20%, with 2% to Pari-Mutuel Board, 2% to city where track is located, 16% to racing association. Breakage all to racing association.

* Portion bold face type indicates change in law 1968.

[1] Total take-out 16%. State receives from Saratoga 9%, from Aqueduct and Belmont 10% of total mutel handle. From Finger Lakes state receives 5% first $175,000, 7% next $125,000, 8% next $100,000, 9% over $400,000 to $500,000, 10% to $600,000, 11% all over $600,000. Effective April 1, 1968 additional 1% of take-out for purses. Breaks 10c, state receives from Aqueduct-Belmont 80%, from Saratoga and Finger Lakes 75%. Franchise fee $3,000 per racing day paid by non-profit associations. Finger Lakes track license $100 per day.

Table No. 5

Racing Revenue to States (for U. S.) by Years

1968	$426,856,448
1967	394,381,913
1966	388,452,125
1965	369,892,036
1964	350,095,928
1963	316,570,791
1962	287,930,030
1961	264,858,077
1960	258,039,365
1959	243,388,655
1958	222,049,651
1957	216,747,621
1956	207,456,272
1955	186,989,588
1954	178,015,828
1953	167,426,465
1952	142,489,696
1951	117,250,564
1950	98,366,167
1949	96,327,053
1948	95,803,364
1947	97,926,984
1946	94,035,859
1945	65,265,405
1944	55,971,233
1943	38,194,727
1942	22,005,278
1941	21,128,173
1940	16,145,182
1939	10,369,807
1938	9,576,835
1937	8,434,792
1936	8,611,538
1935	8,386,255
1934	6,024,193

Table No. 6

Monies Distributed in Stakes and Purses for 1968

State	Total Monies Distributed				Amount Contributed by Associations			Amount Contributed by Horsemen		
	Total	Thorough-bred	Harness	Qtr. Horse and Fairs	Thorough-bred	Harness	Qtr. Horse and Fairs	Thorough-bred	Harness	Qtr. Horse and Fairs
Arizona	$1,665,455.24	$ 1,439,171.44	$	$ 226,283.80	$ 1,439,171.44	$	$ 226,283.80	$ No Report	$	$ No Report
Arkansas	1,679,530.00	1,679,530.00			1,659,545.00			19,985.00		
California (1)	28,177,065.00	19,983,507.00	3,105,700.00	**2,239,425.00** 2,848,433.00	19,080,677.00	3,105,700.00	**2,171,700.00** 2,735.222.00	902,830.00	No Report	**67,725.00** 113,211.00
Colorado (1)	1,254,862.45	980,856.39		**175,589.60** 98,416.46	No Report		No Report No Report	No Report		No Report No Report
Delaware	6,660,294.00	2,953,180.00	3,707,114.00		2,865,100.00	3,649,032.00		88,080.00	58,075.00	
Florida (2)	6,679,375.00	6,679,375.00			6,304,600.00			374,775.00		
Idaho	136,940.00	104,229.00		32,711.00	78,143.00		29,162.00	26,086.00		3,549.00
Illinois	21,342,806.00	12,505,735.00	8,837,071.00		11,822,680.00	8,837,071.00		683,055.00	No Report	
Kentucky	6,960,796.50	5,258,364.00	1,702,432.50		4,931,529.00	1,441,254.00		326,835.00	261,178.50	
Louisiana	3,899,077.00	3,899,077.00			3,685,950.00			213,127.00		
Maine (3)	1,424,080.00	374,105.00	789,525.00	260,450.00	374,105.00	789,525.00	260,450.00	No Report	No Report	No Report
Maryland (4)	10,607,312.93	7,786,497.40	1,518,664.25	1,302,151.28	7,443,402.40	1,429,109.75	1,299,826.28	343,095.00	89,554.50	2,325.00
Massachusetts (4)	4,705,793.24	2,670,282.00	1,693,638.99	341,872.25	2,649,332.00	1,664,450.00	341,872.25	20,950.00	29,188.99	
Michigan	8,796,569.00	5,540,774.00	3,255,795.00		5,428,554.00	3,219,895.00		112,220.00	35,900.00	
Montana	164,784.15	164,784.15			139,559.95			25,224.20		
Nebraska	3,001,505.00	3,001,505.00			2,926,075.00			75,430.00		
Nevada	21,421.00			21,421.00			19,954.60			1,466.50
New Hampshire (3)	4,121,857.89	1,985,559.00	2,094,187.89	42,111.00	1,970,909.00	2,090,425.90	42,111.00	14,650.00	3,761.99	
New Jersey	13,009,546.00	9,902,285.00	3,107,261.00		9,254,250.00	3,107,261.00		648,035.00	No Report	
New Mexico (1)	4,442,315.06	2,243,334.24		**2,198,980.82**	1,964,801.54		**877,500.66**	278,532.70		**1,321,480.16**
New York (5)	44,635,511.34	21,843,315.00	22,792,196.34		20,846,650.00	21,253,446.34		996,665.00	1,538,750.00	
Ohio (1)	11,661,266.28	6,586,984.00	3,964,935.00	**58,217.50** 1,051,129.78	6,586,984.00	3,964,935.00	**58,217.50** 1,051,129.78	No Report	No Report	No Report No Report
Oregon (1)	1,023,687.00	560,380.00		**100,138.00** 363,169.00	540,950.00		**64,333.00** 288,892.00	19,430.00		**35,805.00** 74,277.00
Pennsylvania	5,835,016.00		5,835,016.00			5,416,986.00			418,030.00	
Rhode Island (6)	3,561,442.00	3,561,442.00			3,560,252.00			1,190.00		
South Dakota	345,740.00	324,165.00		21,575.00	263,989.00		21,075.00	60,176.00		500.00
Vermont	1,887,396.00	1,438,896.00	448,500.00		1,438,896.00	448,500.00		No Report	No Report	
Washington	2,058,925.00	2,033,925.00		25,000.00	1,944,620.00			89,305.00		25,000.00
West Virginia	6,514,671.00	6,514,671.00			6,484,861.00			29,810.00		
Wyoming	No Report	No Report			No Report			No Report		
TOTALS	$206,275,040.08	$132,015,928.62	$62,852,036.97	$11,407,074.49						

REMARKS:

(1) **Bold Face** indicates Quarter Horse.

(2) **Florida:** Purse and Stakes Distribution not kept by Racing Commission. Figures used supplied from Triangle Publications for 3 tracks—Gulfstream, Hialeah, Tropical.

(3) **Maine and New Hampshire:** Fairs—All Harness.

(4) **Maryland and Massachusetts:** Fairs—All Thoroughbred.

(5) **New York:** Harness—Amount contributed by Horse Breeders' Development Fund, $2,427,797.50, included with Track Contribution.

(6) **Rhode Island:** Purse Distribution obtained from Triangle Publications.

The CHAIRMAN. Gentlemen, it is 15 minutes of 4 and we have heard three witnesses. I would hope we can move more rapidly to hear the full list of witnesses. I would suggest unless there is objection that we limit each Senator to 3 minutes to examine witnesses. If he wants to interrogate them further he can have the witnesses come into the conference room here and he can interrogate them as long as he wants to there.

We have a former member of our committee who has been waiting for a chance to be heard. I believe he will find it very inconvenient to stay over and I would like to hear him now if I may. I would like to call Senator Frank Carlson out of order to present what he has on his mind. We are proud to have you here with us, Senator. Many of us regret that you insisted on retiring last year.

STATEMENT OF HON. FRANK CARLSON ON BEHALF OF THE NATIONAL FEDERATION OF GRAIN COOPERATIVES; ACCOMPANIED BY BRUCE J. HENDRICKSON, VICE PRESIDENT, AND IRVING CLARK, GENERAL COUNSEL

Mr. CARLSON. Mr. Chairman, I would like very much if you have no objection to have Bruce Hendrickson who is executive vice president of the National Federation of Grain Cooperatives and Mr. Irving Clark who is their general counsel to sit with me.

Mr. Chairman, I appreciate very much the opportunity of appearing before this committee. As I sat here listening to this testimony I admire the committee. It was my privilege of serving for 14 years and it is a service I am going to cherish all the rest of my life.

I will appear here this afternoon I trust very briefly because I appreciate the problem you folks are meeting with. I come here this afternoon to express the views of the members of the National Federation of Grain Cooperatives on the proposals that are contained in section 531 of H.R. 13270.

This is a complex subject, and I thought it had been resolved. As the chairman well remembers, we spent much time on this hearing and discussion in the 1962 act. I thought we had written then and I still believe a very fair provision.

Appearing with me as I stated are Mr. Hendrickson and Mr. Clark. I have asked these men to sit with me because there may be some technical questions I am not familiar with.

I am afraid that as our farm marketing cooperatives have become more and more of an effective force in the selling and the processing for sale of grains and oil seeds for the mutual benefit of its members, opponents of this perfectly proper method of doing business have sought by a variety of extremely technical means to drive a "tax wedge" between member-patrons and the institutions they have tirelessly built and financed to further their own economic well-being. It has also been at considerable cost to these farmer-patrons, notwithstanding allegations to the contrary by those who have ceaselessly showered the Congress year after year with "co-op tax reform" schemes designed to deprive member-owners of these institutions of the full economic benefits which both the Congress and executive branches of our federal system have in their wisdom seen fit to encourage over many decades in the interests of sound public policy.

As I recall the many instances in the past when I was personally involved in judgments made with respect to cooperative taxation both in this distinguished committee and on the floor as a Senator from the great State of Kansas, the principle of the payment of a single tax upon the savings—earnings—of a farm cooperative at the investor level was never lost sight of despite the repeated attempts by opponents of these organizations to have them taxed otherwise under the guise of "reform." This has even included successive attempts to impose the "two-tier" system of levying taxes on the "profits" of these farmer-owned and controlled associations.

Despite the repeated efforts of farmers and their cooperative leaders over the years to combat this divisive tactic we have seen successive encroachment by the Government into the conduct of the business affairs of both patrons and their cooperatives as regards tax matters.

This involvement appears to be getting deeper too, judging from the proposals contained in section 531 of H.R. 13270.

Both the proposed phased-in cash payout requirements to 50 percent by 1970 and the statutory directive to treat future contributions of capital—investments—by patrons in their cooperatives as debts of the organization are perfect illustrations of this excessive tendency by some to submerge or sink well established public policies via the taxation route.

It might be pointed out too, that neither proposal serves the interests of the Government from the revenue standpoint since no additional taxes will be collected, according to estimates supplied by the Treasury Department.

Since this is to be the case, and I have no reason to disbelieve their estimates, I am at a loss to understand where any corresponding or redistribution of existing or future tax burdens—the object of tax reform—will come about as a result of the enactment of these proposals.

On the other hand, irreparable harm will be done to both farmers and their cooperatives if section 531 is enacted into law. I can't believe that members of this committe want to see this happen.

This is especially true in the present context of the tremendous demands being put on our limited resources budgetwise, including the U.S. Department of Agriculture. Farmers recognize this hard fact of life even in cases involving our major programs for grains like wheat. Because of this, they are attempting through various means to devise their own programs. A major effort in this direction to eventually relieve the Government of its dominant role in this area is being spearheaded by cooperatives. Most certainly, any program ultimately developed will take time. But experience convinces me that the very institutions which would be destroyed by the enactment of these harsh proposals—our grain marketing cooperatives—represent the most promising vehicle for eventually effecting the transfer of grain programs to the private sector sometime in the distant future.

Now, as to the subject at hand, I well recall the days of service on this committee prior to the enactment into law of the Revenue Act of 1962 when we exhaustively studied this subject.

At that time I remember we were very careful to erect a set of "qualifications" to insure that all noncash patronage allocations would be taxed at their stated dollar value in the hands of the patron or his cooperative would be taxed. In order to be sure that the patron had enough cash to pay the tax on these amounts we required that the cooperative include at least 20 percent of the savings in cash.

That seemed like a reasonable proposition then. It still does, I believe then and still do however, that the financial needs of these businesses is a matter which should be left more properly for them to determine by their own actions and not be impressed on them by some tax authority. This includes such jointly agreed-to decisions as those taken with respect to who is going to pay the tax on patronage distributions too, so long as the proper tax is paid by somebody.

The point which is often overlooked is the fact that these associations are voluntary as to membership. No one is under any compulsion to patronize them either, an item that those unfriendly to this form of business organization never bother to mention for self-serving reasons.

Now, it seems to me that as this committee considers section 531 of H.R. 13270 it ought to weigh very carefully the fatal consequences which it would have on the future ability of local grain marketing cooperatives like my own back in Kansas—the Cloud County Cooperative Elevator Association at Concordia—to provide the badly needed and growing services which its farmer-owners demand and get right there in town.

Of equal, if not of more importance, is FAR-MAR-CO., Inc., headquartered in Hutchinson, Kans. This latter organization, a regional grain marketing cooperative, makes it possible for members of my local to play a significant role in the key terminal and export grain markets where forces of supply and demand operate to establish prices. Markets created day in and day out by this major regional along with markets created by the other 19 regionals comprising the membership of this federation constitute an indispensable service for the 1 million grain producers and 2,680 local cooperatives owning them.

Earnings derived from the activities of these regionals represent a major source of revenue for the locals. At the same time, the locals' major investments (and consequently, their member owners) are generally those made in their regional. These are substantial, too, relative to others in most cases.

With limited exceptions, the capital which has been provided by farmers to build and enlarge their sphere or marketing influence has come from reinvested earnings on which farmers have willingly paid taxes on in order to supply to themselves as a group many of the services they could not economically afford to individually do. This would include such things as building and maintaining grain elevators, plants for processing their grains into more valuable products, owning rail and barge equipment, and even acquiring their own lending institution—the banks for cooperatives—through the systematic repayment of government capital from their own funds.

All of these have cost great sums of money, but they are providing their member owners with an important array of services which is the way they want it.

Thus, as you study and deliberate the pros and cons of section 531 of H.R. 13270 in the weeks and months ahead, I would urge you to ponder very carefully whether, by enacting this proposal you will be helping farmers or hurting them.

After it is all over, my inclination is tha. you will be disposed to agree with me that the wisest course is to have section 531 stricken from the bill.

The CHAIRMAN. Senator Carlson, I have a letter from the Department of Agriculture, not from the Secretary, signed by his Under Secretary but I am sure it represents the position of the Department as a whole. It couldn't be any stronger on your side than it is. It says that—

> This will not add a dime to revenue but it will seriously burden cooperatives. It will damage the cooperative's ability to meet members' demands for increased services with member-owned, internally-generated capital. It will hurt and seriously limit co-ops' ability to borrow money.

I will abbreviate the rest of it. It is discriminatory against farmers. I don't know of any letter that could be stronger in support of your position than that of the Under Secretary speaking for the Department of Agriculture. I would like to put that in the record, and also a statement that I have received from the executive vice president of the American Rice Growers Association who also states that the soybean farmers are in support of that. As far as I can see it is a case that cannot be refuted.

(The documents referred to follow:)

DEPARTMENT OF AGRICULTURE,
OFFICE OF THE SECRETARY,
Washington, September 9, 1969.

HON. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: This Administration is deeply committed to helping farmers increase their net incomes and to bring equity to American agriculture. Section 531 of the proposed Tax Reform Act of 1969 provides for a gradual increase from the present 20 percent to 50 percent (3 percent per year for 10 years) in the amount of cash a cooperative must pay currently to "qualify" its refunds as non-taxable income. The proposed Act also would require that that part of the refund not paid currently in cash must be paid out within 15 years.

This proposal would throttle one of the essential tools for maintaining farm income. If adopted, it will have these results:

1. It won't add a dime to tax revenue, but it will seriously burden cooperatives.
2. It will damage co-ops' ability to meet members' demands for increased services with member-owned, internally-generated capital.
3. It will seriously limit co-ops' ability to borrow. With a 15-year due date on deferred refunds, these become long-term liabilities and would take precedence over any later-issued promissory notes. This added debt would impair co-ops' ability to borrow for constructive purposes.
4. It is discriminatory. Congress doesn't tell other corporations to pay their dividends in cash. They may pay all or part of them in stock, and many do. Nor does Congress tell other corporations how to manage their financial affairs by indicating the nature, time, and form of distributing their annual net margins. If Congress required corporations generally to revolve their equity capital every 15 years, as this Act would require co-ops to do, it would disrupt the economy and destroy capitalism as we know it.
5. It will force co-ops into a tight mold. Some co-ops pay only the required 20% in cash. Others pay 60%, 75%, or 100%, depending on each co-op's plans and its members' preferences for financing facilities and services.

I respectfully urge that the Committee, when it considers H.R. 13270, eliminate this provision from the tax reform package.

Sincerely,

J. PHIL CAMPBELL, *Under Secretary.*

Statement of George B. Blair, Executive Vice-President of American Rice Growers Cooperative Association

My name is George B. Blair. I am the Executive Vice-President of American Rice Growers Cooperative Association, 211 Pioneer Building, Lake Charles, Louisiana. This association, with its predecessors, has been engaged in rough rice marketing for the producers of Louisiana and Texas for over 60 years. I am also the Executive Vice-President of American Rice Growers Exchange which has been supplying fertilizers and agricultural chemicals to rice producers since 1944 and the Executive Vice-President of American Grain Association which has been marketing soybeans for soybean producers in Texas and Louisiana for the past five years. The first two named cooperative associations serve about 2,400 rice producers in Texas and Louisiana and American Grain Association, which is also a cooperative, serves about 600 soybean producers in the two states. Most of the soybean producers are also rice producers.

Our members have seen fit to cause the formation of three different organizations, rather than to try to perform all of the services through one farmers cooperative association simply because they believe that each organization should be of enough merit to "stand on its own feet" operationally and financially.

We are vigorously opposed to Section 521 of H.R. 13270 which proposes to "reform" the tax treatment of cooperatives and their patrons with respect to patronage dividends earned and per unit retains made.

As we understand the present provisions of the bill, a farmer cooperative association would be required to increase its amount of cash paid out by 3% each year beginning in 1970 until the amount of cash paid out is increased from the present 20% each year to 50% each year. This provision would apply both to earnings retained for capital purposes and to per unit retains which went into capitalization of the organization. In addition, as we understand it, those items which were currently retained would have to be retired in not more than 15 years.

Such requirements, if enacted into law, would seriously jeopardize all farmer cooperatives in the United States and, in its final analysis, would result in such associations having to be substantially debt financed instead of equity financed. Since the legislation would not increase revenues nor speed up the payment of revenues to the United States Government, we cannot but consider that it is punitive legislation.

We have heard the argument made that farmers must be protected from the management of their cooperatives. Certainly in our area, and I am sure in most of the rest of the United States, there are enough business organizations with which a farmer can do business that he is under no compulsion whatsoever to do business with his cooperative association if it is not doing a better job for him than he can get done elsewhere or if he is dissatisfied in anyway with its activities.

As we would interpret the effect of the proposed law on our own cooperatives, the effect would be disadvantageous to our members. For many years we have followed a policy in all of our organizations of keeping our operating expenses and amounts retained for capital purposes to an absolute minimum. Those amounts which have been invested for capital purposes in our cooperative associations are permanent capital items and we do not follow a revolving plan of retiring capital. These retainages range from 5% of net earnings in the case of American Rice Growers Exchange to a 2% of gross sales retain in the case of American Grain Association. In the latter organization, this amounts to a little less than 5¢ per bushel of soybeans.

In the case of American Rice Growers Cooperative Association, our net earnings for 1968 were $6,666.38 on almost 17 million hundredweights of rice with a value of 136 million dollars. For the preceding year of 1967 our earnings amounted to $3,371.05. The total of these earnings, less that required to be paid out, was retained as permanent operating capital.

In the case of American Rice Growers Exchange, some $35,000 was retained out of $700,000 of net profits for the year. Of the approximately 1.6 million dollars of net assets of this company, 1.5 million dollars is in permanent investments and there is no way that this company could adopt a policy of retiring retained earnings without entering into a liquidating process of its investments which have provided substantial advantage and made possible the earnings to its members.

American Grain Association operates on a pool basis and pays out all of the earnings of each pool upon liquidation of the pool except for a per unit retain of 2% of the gross sales price as mentioned above; this amounts to less than 5¢ per bushel of soybeans. These per unit retains provide operating and investment capital and are represented to the members in the form of preferred stock on which a minimum of 6% annual dividends have been paid since the organization came into existence. Last year this retain amounted to about $86,000 on 4.3 million dollars. In addition, our cash settlements to farmers was 4.6¢ per bushel over the market price.

At the present time, this association has under construction a river barge loading facility which is financed and will be paid for out of retain capital. There would be no way that the money retained and invested in this facility could be retired without liquidating the facility.

Many of the twenty-five local cooperative associations affiliated with us face the same problems. Some of them have recently built storage facilities costing several hundred thousand dollars each. This was done with the full approval and consent of their members with the full knowledge and understanding that a portion of the earnings or the retains would be used to pay off indebtedness and that the individual member would be required to pay Federal income taxes on that retained portion as provided by current law. Financing arrangements for the construction were based on this approval and the loan repayments are amortized over a period of years in fixed amounts.

Since these facilities are for service rather than profit with limited dividends paid on capital, as required by both Federal and state law and by financing institutions, their stock is not an attractive investment to anyone other than the farmer-user. At the same time, farmers are not in a position to raise the large sums required, in cash, to finance the facilities.

If this Section of the Act is enacted into law, I am sure farmers and their cooperatives would have extreme difficulty in inducing a financial institution to grant a sizable loan in the face of a requirement that one-half of any earnings had to be paid out currently in cash and the other half within fifteen years. Certainly, after the law became fully effective, this would be the rule since all of the earnings would be required to be paid out each year in cash, either as the current cash payment or to redeem equities previously retained.

In each of our companies, it seems to me, our only other alternative would be to approximately quadruple the amount of earnings and per unit retains that we are retaining in order that we might be able to pay out the required fifty per cent and retire the retained earnings of prior years and still be able to carry on with a constructive and progressive program if this Section of the bill is enacted into law.

We believe that the Revenue Act of 1964 which was developed after many years and many thousands of pages of hearings was a fair and equitable resolution of the cooperative tax problem. We believe that the current proposal which was developed without notices or hearings is unfair and inequitable to farmers and will be of benefit to neither the United States Government nor to farmer members of agricultural cooperatives. We urge that these provisions be stricken from the bill.

The CHAIRMAN. Senator Anderson.

Senator ANDERSON. I have no questions but I welcome Senator Carlson.

Senator CURTIS. I think you covered it but you have left out one bit of your credentials and that is your service on the Ways and Means Committee.

Mr. CARLSON. Thank you very much.

Senator MILLER. No comment except to welcome the Senator back. We certainly enjoyed our years of service together.

Mr. CARLSON. Thank you.

The CHAIRMAN. Senator Byrd.

Senator BYRD. No comment. I am delighted to see Senator Carlson again.

Mr. CARLSON. Thank you so much.

Senator JORDAN. No comment. Just it is good to have you with us. Your testimony is constructive.

Senator FANNIN. Mr. Chairman, certainly I concur that it is an honor to have you back with us, Senator Carlson.

Mr. CARLSON. Mr. Chairman, it is a pleasure to get back into my meeting with you here today. It brings back many pleasant memories going back to the days on the House side, Mr. Doughton, how many of you remember, Senator George, Senator Byrd. I do thank you very much.

The CHAIRMAN. I would say with regard to the farm cooperatives the wise thing would be to let the case rest right there.

Mr. CARLSON. Thank you very much.

(Senator Carlson's prepared statement follows:)

STATEMENT BY THE HONORABLE FRANK CARLSON

I appreciate very much this opportunity of appearing before this distinguished Committee, on which I had the pleasure of serving for 14 years while a member of the Senate, to express the views of the members of the National Federation of Grain Cooperatives on the proposals contained in Section 531 of H.R. 13270 dealing with the tax treatment of farm cooperatives. A complex subject, I might add, which I thought had been resolved both equitably and satisfactorily by enactment into law of the Revenue Act of 1962.

Appearing with me this afternoon are the Federation's Executive Vice President, Bruce J. Hendrickson, and the organization's General Counsel, Irving Clark, who is a partner in the law firm of Doherty, Rumble & Butler of St. Paul, Minnesota. I have asked both of these men to sit with me to provide assistance with respect to any technical points which may arise since this has become an increasingly complicated subject as to details.

It was not so at one time. But I am afraid that as our farm marketing cooperatives have become more and more of an effective force in the selling and the processing for sale of grains and oilseeds for the mutual benefit of its members, opponents of this perfectly proper method of doing business have sought by a variety of extremely technical means to drive a "tax wedge" between member-patrons and the institutions they have tirelessly built and financed to further their own economic well-being. It has also been at considerable cost to these farmer-patrons, notwithstanding allegations to the contrary by those who have ceaselessly showered the Congress year after year with "co-op tax reform" schemes designed to deprive member-owners of these institutions of the full economic benefits which both the Congress and Executive branches of our Federal System have in their wisdom seen fit to encourage over many decades in the interests of sound public policy.

As I recall the many instances in the past when I was personally involved in judgments made with respect to cooperative taxation both in this distinguished Committee and on the floor as a Senator from the great State of Kansas, the principle of the payment of a single tax upon the savings (earnings) of a farm cooperative at the investor level was never lost sight of despite the repeated attempts by opponents of these organizations to have them taxed otherwise under the guise of "reform." This has even included successive attempts to impose the "two-tier" system of levying taxes on the "profits" of these farmer-owned and controlled associations.

Despite the repeated efforts of farmers and their cooperatives leaders over the years to combat this divisive tactic we have seen a successive enroachment by the government into the conduct of the business affairs of both patrons and their cooperatives as regards tax matters.

This involvement appears to be getting deeper too, judging from the proposals contained in Section 531 of H.R. 13270.

Both the proposed phased-in cash payout requirements to 50 percent by 1970 and the statutory directive to treat future contributions of capital (investments) by patrons in their cooperatives as debts of the organization are perfect illustrations of this excessive tendency by some to submerge or sink well established public policies via the taxation route.

It might be pointed out too, that neither proposal serves the interests of the government from the revenue standpoint since no additional taxes will be collected, according to estimates supplied by the Treasury Department.

Since this is to be the case, and I have no reason to disbelieve their estimates, I am at a loss to understand where any corresponding or redistribution of existing or future tax burdens (the object of tax reform) will come about as a result of the enactment of these proposals.

On the other hand, irreparable harm will be done to both farmers and their cooperatives if Section 531 is enacted into law. I can't believe that members of this Committee want to see this happen.

This is especially true in the present context of the tremendous demands being put on our limited resourese budget-wise, including the U.S. Department of Agriculture. Farmers recognize this hard fact of life even in cases involving our major programs for grains like wheat. Because of this, they are attempting through various means to devise their own programs. A major effort in this direction to eventually relieve the government of its dominant role in this area is being spearheaded by cooperatives. Most certainly, any program ultimately developed will take time. But experience convinces me that the very institutions which would be destroyed by the enactment of these harsh proposals—our grain marketing cooperatives—represent the most promising vehicle for eventually effecting the transfer of grain programs to the private sector sometime in the distant future.

Now, as to the subject at hand, I well recall the days of service on this Committee prior to the enactment into law of the Revenue Act of 1962 when we exhaustively studied this subject.

At that time I remember we were very careful to erect a set of "qualifications" to insure that all noncash patronage allocations would be taxed at their stated dollar value in the hands of the patron or his cooperative would be taxed. In order to be sure that the patron had enough cash to pay the tax on these amounts we required that the cooperative include at least 20 percent of the savings in cash.

That seemed like a reasonable proposition then. It still does. I believed then and still do however, that the financial needs of these businesses is a matter which should be left more properly for them to determine by their own actions and not be impressed on them by some tax authority. This includes such jointly agreed-to decisions as those taken with respect to who is going to pay the tax on patronage distributions too, so long as the proper tax is paid by somebody.

The point which is often overlooked is the fact that these associations are voluntary as to membership. No one is under any compulsion to patronize them either, an item that those unfriendly to this form of business organization never bother to mention for self-serving reasons.

Now, it seems to me that as this Committee considers Section 531 of H.R. 13270 it ought to weigh very carefully the fatal consequences which it would have on the future ability of local grain marketing cooperatives like my own back in Kansas—the Cloud County Cooperative Elevator Association at Concordia—to provide the badly needed and growing services which its farmer-owners demand and get right there in town.

Of equal, if not of more importance, is FAR-MAR-CO., INC., headquartered in Hutchinson, Kansas. This latter organization, a regional grain marketing cooperative, makes it possible for members of my local to play a significant role in the key terminal and export grain markets where forces of supply and demand operate to establish prices. Markets created day in and day out by this major regional along with markets created by the other 19 regionals comprising the membership of this Federation constitute an indispensible service for the one million grain producers and 2,680 local cooperatives owning them.

Earnings derived from the activities of these regionals represent a major source of revenue for the locals. At the same time, the locals' major investments (and consequently, their member-owners) are generally those made in their regional. These are substantially too relative to others in most cases.

With limited exceptions, the capital which has been provided by farmers to build and enlarge their sphere of marketing influence has come from reinvested earnings on which farmers have willingly paid taxes on in order to supply to themselves as a group many of the services they could not economically afford to individually do. This would include such things as building and maintaining grain elevators, plants for processing their grains into more valuable products, owning rail and barge equipment, and even acquiring their own lending institution—the Banks for Cooperatives—through the systemic repayment of government capital from their own funds.

All of these have cost great sums of money, but they are providing their member-owners with an important array of services which is the way they want it.

Thus, as you study and deliberate the pros and cons of Section 531 of H.R. 13270 in the weeks and months ahead, I would urge you to ponder very carefully whether, by enacting this proposal, you will be helping farmers or hurting them.

After it is all over, my inclination is that you will be disposed to agree with me that the wisest course is to have Section 531 stricken from the bill.

The CHAIRMAN. Next, we will hear from the Honorable Herbert A. Fogel, general counsel of the Pennsylvania State Harness Racing Commission. Senator Carlson's testimony will appear under the cooperative heading.

STATEMENT OF HON. HERBERT A. FOGEL, GENERAL COUNSEL, PENNSYLVANIA HARNESS RACING COMMISSION

Mr. FOGEL. My name is Herbert A. Fogel, counsel for the Pennsylvania State Racing Commission and I am here at the request of our Governor, and with his authorization, who unfortunately could not make this himself.

We wish to thank the chairman and members of the committee for affording Pennsylvania this opportunity to appear before you. Because of the very devastating economic consequences we believe would follow as a result of the enactment of the amendments to section 270 as they are contained in H.R. 13270.

If I may say so, sir, in the first instance, I think that these amendments, a full understanding of them in terms of what it would mean to the State as far as not only revenue but jobs are graphically brought into play when you consider that Pennsylvania is one of the younger States that is going into racing. For example, thoroughbred racing has just started this year, 1969, and standardbred or harness racing commenced in 1963, and yet we now have a source of revenue that this year alone in direct revenues to Pennsylvania will exceed $17 million, of which for example 3.5 goes to the city of Philadelphia for its school system, the city that has the same plight as so many of our other major cities do with respect to revenues for education; $1 million of those revenues go to help the rural areas in connection with sewage and water treatment.

In addition to that, the investment in plant alone is something like $50 million. All of these are the racing associations that of course pay the normal corporate income taxes to the Federal Government as well as to the State itself.

The land investment and horse investment exceeds $100 million. The payrolls directed to racing along, the people who have been discussed, the grooms, the trainers, the waiters and all the others, that exceeds $10 million annually, and in fact given related horseracing endeavors such as the farming, the feed, and the other aspects we believe that the statistics from our department of agriculture show conservatively about $15 million a year in payroll is expended in this way.

These are all people who are employed who are of course paying their Federal taxes, paying their taxes to the State, besides the direct revenues the State is obtaining they are the sales taxes on items of produce and the rest.

I think that this dramatically shows how in terms of economics of Pennsylvania here has been not only a source of revenue but a source of employment, a source of jobs, and a source of all of the other benefits that have accrued that really we have had only in the last 6 years to this extent because we never had racing before then.

With respect to section 270, I think there are two very salient points. As this committee is well aware, probably far more aware than we are, the body of law that has been developed in the last 30 years has made it very clear, to answer I think a question that Senator Curtis put before, that people can't be in this as a hobby, that you have got to be in this as a business. Not only the regulations of the Internal Revenue Service themselves but the additional law of our courts have set up certain standards and guidelines, so that within a realm of reason, a man who is entering this business knows what he can look forward to, knows that which is legitimate and that which would be in the hobby area, and therefore he cannot get away with it.

What the amendment that is proposed in section 13 would do to section A, of 270, is to take it one step beyond there, and I respectfully submit that the language as written would put it into a complete maze, because now the test would be whether or not there is a reasonable expectation that you are intent to make a profit there.

I dare say that I think there is o'ly one group that will economically profit and I think that would be the lawyers who would spend years litigating this. It has been hard enough and difficult enough to establish a body of law with certainty as to what intent to make a profit means, but if we then take that one or two steps beyond, so we are not testing the intent to make it, but whether there is a reasonable expectation that that intent is accurate, I think that this would result in the kind of uncertainty that would certainly drastically reduce the number of people who are willing to invest in this business, and I add in this as a business.

I think the second part with respect to subsection (b) of 270, which would change the existing law wherein 5 consecutive years there cannot be 5 consecutive years of losses exceeding $50,000. I think if we remember that the $50,000 limit which was established in 1940 in effect probably in economic terms and worth really is probably $25,000 in terms of the $50,000 that was established by the Congress in 1940 itself.

And so you have an industry where we know that the risk of losses, because of the hazards of lameness, sickness, soreness, the other things that are beyond anyones control, where we know that the expenses have gone up and these risks have multiplied and yet the standard of the $50,000 standard, which is certainly far less in terms of the 1940 dollar we believe certainly is one that has sufficient guidelines so that we are able to establish not only the business purpose but not have this thing go so wild so that there are no controls.

I think one of the other interesting and significant points is that the mass of people who are in this industry are not a few wealthy people who have this as a hobby. The mass of people who are in this industry, for example, in the thoroughbred field, in the 1967 figures show that out of 28,000 winning horses, the average for the owner for that year was $3,000 of winnings. As a matter of fact the average was $800, but those 28,000 winning horses didn't exceed $3,000 in winnings for the owners in that year.

By the same token in the standard bred industry, out of 20,000 winning horses in 1967, the owners of those 20,000 horses also averaged winnings of $800 a year. The great bulk of the people who are in this field are the people who are in this with relatively modest means, and to whom it is most important that they be in this to win, because they are not people who have the resources to afford doing something where they can keep on losing.

We feel, however, and we know that the very difficult task that this committee has is to strike a balance, whereby the person who is in this as a bona fide business is protected, and that the few people who are abusing things should not be protected.

We would respectfully submit that we think by uniformly treating this in terms of horseracing as a business as other businesses are treated that this would be one solution.

For example, we subscribe to the idea that a capital gains period should be the same as it would be in a business or an industry. We also subscribe to the idea that just as a businessman who would sell his machinery in his business under section 1245 of the code to the extent that he is taking a depreciation on that machinery, and sells the machinery for a price that is above his present basis, that to the extent there has been depreciation, then he ought to pay ordinary income on that part of the profit reserving capital gains for the rest.

We believe that that provision and that proposed amendment to 1245 could certainly apply in terms of the horseracing industry, and at the same time put them on an equal footing with other businessmen.

In sum then we feel from past viewpoints, and we believe this is certainly true of the other States, and I won't repeat those figures, which the committee has before it, but in terms of the economy of these States, we certainly think that 270 would be a tremendously disruptive course and would in effect if not completely destroy, so hamper the horseracing industry that it would have a deleterious effect on the States involved.

Thank you very much.

The CHAIRMAN. Senator Anderson.

Senator ANDERSON. A very fine statement.

Senator CURTIS. I asked all my questions of the previous witnesses.

Senator MILLER. The previous witnesses apparently were very much opposed to this 1-year holding period. In fact they were opposed to a 6-month holding period. Now you recommend a 1-year holding period. How do you reconcile your two views?

Mr. FOGEL. My answer to that, Senator Miller, would be this. First of all, I believe, as you stated, sir, that the Treasury itself was willing to amend this to a 6-month period.

Second, I would say that, if there could be a further amendment, so that the same type of treatment as is given to all other capital assets, it would certainly be preferable—namely, a 6-month period from the time the asset is acquired, that would put it on the same footing with all other capital assets.

Senator MILLER. I agree with you, but that isn't what your recommendation is. As I read your recommendation or understood it, it was to go along with the 1-year holding after the horse becomes a breeder or a racehorse.

Mr. FOGEL. The Commonwealth's position is that, if necessary, we would be willing to see this amendment adopted because we think the real crux of the problem is found in the proposed amendments to section 270. Certainly we think it would be preferable to have a straight 6-month holding period, but, if necessary, we think the people in the industry could live with the holding period as proposed in the amendment by the Treasury of the existing provisions of section 270.

Senator MILLER. Speaking for myself, I just think it would serve to offer more problems than it would solve. I can't see much benefit from what we have now, but I can see some need for some other changes. But after what the previous witnesses testified, it seems to me that this would single out certainly the horse industry for special discriminatory treatment.

It would be completely contrary to the method of operation. You have heard his testimony as to the 2-year-old and how it would have to be held to be a 3-year-old. The 3-year-old would have to be held to be a 4-year-old. I would think that that would be a pretty severe provision to throw at them, and I am not sure that I see the benefits that would flow from it to the Treasury.

Mr. FOGEL. Well, sir, I think our position would be that to the extent that there could be equality of treatment along the line with all other businesses this would be fairer, bearing in mind as you point out and as the previous witness did that there are the facets of each industry that have to be considered, and I think this is one of the reasons why we feel that the broad brush stroke that has been applied in trying to lump everything together has perhaps produced some of these results.

Senator MILLER. Thank you.

The CHAIRMAN. Senator Jordan.

Senator JORDAN. No questions.

The CHAIRMAN. Senator Fannin.

Senator FANNIN. No questions.

The CHAIRMAN. Thank you, sir.

(Herbert A. Fogel's prepared statement follows:)

Statement of Herbert A. Fogel, General Counsel, Pennsylvania Harness Racing Commission

My name is Herbert A. Fogel and I am General Counsel for the Pennsylvania Harness Racing Commission. I have been authorized by the Governor to appear before the Senate Finance Committee on behalf of the Commonwealth of Pennsylvania at these hearings.

May I say, in the first instance, that the Governor and the other administration officials of the Commonwealth of Pennsylvania are most grateful to the Committee for affording me this opportunity to appear because of the grave economic consequences that would follow if the changes proposed by H.R. 13270 as an amendment to § 270 were adopted in their present form.

The changes proposed by H.R. 13270 as an amendment to § 270 wherein "Items attributable to an activity shall be allowed only to the extent of the gross income from such activity unless such activity is carried on with a reasonable expectation of realizing a profit" could rapidly result in drastic curtailment of Standardbred and Thoroughbred horse racing in the Commonwealth of Pennsylvania, with a resultant loss of state revenues, as well as employment to many thousands in the Commonwealth whose economic livelihood depends on Standardbred and Thoroughbred racing and its related industries.

In 1968, the Commonwealth of Pennsylvania received in direct taxes from pari-mutuel harness racing alone a sum in excess of seven million four hundred thousand dollars. Pari-mutuel thoroughbred racing in Pennsylvania commenced for the first time in 1969. It is conservatively estimated that barness racing will yield in excess of eight million dollars in revenue in 1969, and thoroughbred racing another five million, making a total of thirteen million dollars as direct taxes from this source.

In addition, the City of Philadelphia has a dire need for taxes for education, a need that plagues so many other major cities in the country. Philadelphia received almost two million dollars in direct taxes from pari-mutuel wagering for its public schools in 1968. In 1969, it is estimated that this figure, through the combined revenues of harness and thoroughbred racing, will approximate three and one-half million dollars.

In areas of the State other than Philadelphia in which harness racing tracks are located, approximately a million dollars in taxes were raised in 1968 for smaller communities needing funds to improve their sewage and water disposal plants. These sums will also be substantially increased in 1969.

The figures cited do not take into account other substantial revenues which the Commonwealth derives from sales taxes on food and other items sold both on and off the tracks in connection with the conduct of the pari-mutuel racing industries.

Pennsylvania, in this connection, is but representative of the thirty states that have pari-mutuel racing. For the year 1968 alone, the tax revenue from racing to these states were in excess of $426,800,000. The proposed changes will seriously affect, if not destroy this source of revenue, at a time when this Committee is well aware of the monumental problems confronting the states in their efforts to raise the necessary tax revenues in order to continue to furnish necessary services.

Quite apart from the loss of tax revenues, however, the impact upon the economy of the Commonwealth would be even more devastating.

In Pennsylvania alone there is a capital investment in racing plants of approximately fifty million dollars. All facets of the horse industry in Pennsylvania, including the land in use for raising and breeding horses, represent an investment that is well in excess of one hundred million dollars. The payroll at the tracks alone for grooms, trainers, waiters, maintenance men and others who find gainful and useful employment through the operation of pari-mutuel racing in Pennsylvania is in excess of ten million dollars annually. The salaries of all others who are employed in all facets of the horse industry, including the feed and breeding industries, brings the annual payroll to well in excess of fifty million dollars. These figures projected for the thirty states would indeed demonstrate the very substantial contribution to the overall economy made by horse racing and relating industries.

The administration in Pennsylvania is mindful of the purposes behind the Tax Reform Act of 1969 and, indeed, the Commonwealth not only realizes, but supports the need for tax reform in many areas.

The concern, however, is that in attempting to bring about needed reforms in certain areas, the wording of § 270 is such that it could result in bringing about a result which we know is not the intent of the drafters of this legislation; namely, the virtual destruction of the horse racing industry.

§ 213 of H.R. 13270,* in particular, which sets forth the general rule without reference to dollar limits could be interpreted to eliminate the thousands of persons who own horses on an extremely modest scale and whose gross income from this activity in the years in which they do not have good winning horses often does not exceed three to four thousand dollars per year, while their expenses are in excess of that amount.

According to the thoroughbred record on distribution of earnings for all 1967 horsse that started in races, there were 28,743 thoroughbreds with winnings of $3,000.00 or less, and the average winnings of this group were $802.00 for each winning horse. This includes over 70% of the horses starting and does not include the number of horses trained on which expenditures were made that were not even able to enter races due to lameness or sickness.

In harness racing, 20,473 horses earned less than $3,000.00 per horse, with the average earnings of this group totalling only $863.00 per horse. Again, this number represents 75% of the horses that actually started, and does not include horses which were trained and for reasons cited were unable to enter races.

Horse racing, by its very nature, is a hazardous undertaking due to sickness, lameness and other hazards which are unpredictable. § 213 of H.R. 13270, as written, could drive the bulk of the owners out of the business since the bulk of the owners are, indeed, the small owners. The probable result would be that there would not be enough horses to fill the races, thus depriving the Commonwealth of this source of revenue collected in 1968 as the result of the activity of 1,750,000 patrons who wagered a total in excess of 126 million dollars. Indeed, the effect would be the same upon all thirty states, in which 65,460,000 patrons in 1968 wagered in excess of $5,226,000,000.00, to bring about the tax yield of almost one-half billion dollars.

Although the small owners incur losses frequently until they are fortunate enough to develop a horse or horses that can recoup these losses, the over-all picture, including the revenues obtained by the states, is not one of a "loss" industry. In addition to the approximately one-half billion dollars in state taxes, about one-third of a billion dollars in purses will be paid to the owners of competing horses in 1969.

Assistant Secretary Cohen, on page 29 of his statement before this Committee, states:

"The Administration urges the adoption of this proposal as an effective means of dealing with cases where the tax losses are being used to subsidize the hobbies of wealthy taxpayers."

We believe the objective can be attained wtihout destroying the entire industry with the concommitant ill effects on thousands of small taxpayers and thousands of other persons whose livelihood depends on the business of horse racing.

Specifically, we believe that there are several approaches which we would respectfully submit for consideration by the Committee that can achieve the desired result of eliminating the abuses and at the same time not destroy the horse racing industry itself.

First, the proposal that the holding period for horses be at least 365 days after such animal normally would have first been used for its intended purpose before capital gains treatment will be afforded is certainly one that we heartily endorse. We believe that this would go far toward eliminating the abuses of some who are not interested in the sport or the industry, but merely interested in a tax shelter.

Second, we submit that depreciation rules akin to those set forth in § 1245 of the Internal Revenue Code be adopted, as proposed in H.R. 13270, with respect to the sale of horses and other livestock. We believe that it would be equitable for those in the horse business to have the horses treated in the same manner a businessman has personal property, such as machinery, treated upon the sale of that property. Specifically, to the extent that depreciation would be taken (whether straight line or accelerated), upon the sale of the animal, the tax treatment would be as follows: if the price is in excess of the adjusted basis of

*(§ 213 contains the amendments proposed to § 270 of the IRC of 1954.)

the animal, the amount in excess of the adjusted basis which is realized that is equal to depreciation taken should be taxed as ordinary income with capital gains treatment being restricted to the balance received. The enactment of the changes to § 1245 of th Internal Revenue Code which includes livestock would be sufficient to curb any abuses presently in the industry. As such, § 211 of the House Reform Bill relating to the denial of capital gains when there exists a surplus in an excess depreciation account, should be deleted. In short, we feel that there is no need to place a heavier burden on the horse indusrty than is presently placed on other businessmen.

Third, we submit that the proposed changes to § 270 of the Internal Revenue Code be entirely deleted.

We believe that such legislative changes, rather than the changes proposed to § 270, would achieve the result of correcting the abuses and, at the same time would permit the thousands of legitimate and bona fide persons who own and breed horses to remain in this industry.

In enacting these changes, the States would not be losing a vital source of revenue and the thousands of persons employed in this industry would continue to earn their livelihood in this manner.

Again, may I thank the Committee for the opportunity that was afforded me on behalf of the Commonwealth to submit these views.

The CHAIRMAN. Now we will hear from the attorney general of the State of Delaware, the Honorable David P. Buckson. Please proceed.

STATEMENT OF HON. DAVID P. BUCKSON, ATTORNEY GENERAL OF THE STATE OF DELAWARE

Mr. BUCKSON. Thank you, sir. I have been an owner, breeder, trainer, and driver of harness horses for many years.

Insofar as they apply to the racehorse industry, I oppose the various legislative proposals—including H.R. 13270—which would restrict the deduction of farm losses against nonfarm income; would provide for the recapture of depreciation on livestock; and would change the "hobby loss" test from the purpose and motivation to make a profit, to "reasonable expectation" of making a profit.

My basic point is a simple one. Each of the pending proposals—not to mention the totality of them—would ill advisedly and needlessly jeopardize a vital source of important revenue to many States, including Delaware—namely taxes yielded by parimutuel wagering at race tracks. These revenues amounted to $426 million in 1968 and will approximate one-half billion dollars in 1969. At the same time, I would add that on a net basis, the effect will be to shut off a source of substantial Federal income tax revenues.

The State of Delaware has a direct interest in this proposed legislation. It is threatened with the loss of $7 million which it presently realizes from horse racing in the form of direct parimutuel taxes. This is vitally important to a State as small as Delaware. Beyond this, the Delaware Legislature has recently appropriated substantial funds to stimulate race horse breeding in Delaware and this is rapidly becoming an important farm industry to the State of Delaware.

I do not lightly state that the pending proposals threaten the survival of parimutuel racing. My reasons for making this statement are set out below and are based on the knowledge I have accumulated in the many years I have spent in my various capacities in the racehorse industry.

Let me first direct your attention to the Treasury's estimates of the revenue which would be raised by the farm loss, depreciation and hobby loss provisions of H.R. 13270, as recited in Senator Metcalf's testimony before this committee on September 22, 1969. His testimony states as follows—and I quote—that the Treasury's estimate of the total revenue which would be yielded by these provisions after a 10-year interval would be $20 million (and that the ultimate total would be $25 million):

> By 1979, the estimated increase in tax liability under the farm provisions of the House bill are as follows: excess deductions account, $10 million; depreciation recapture, $5 million; holding period of livestock, $5 million; hobby losses, negligible; for a total of $20 million by 1979. It is estimated that sometime after 1979 the increase in tax liability ascribed to the excess deductions account provision would increase an additional $5 million.

And, of course, these estimates take into account all types of farming, not just race horses.

It seems to me that for such a pittance, it is the height of financial folly to jeopardize the huge revenues which the sorely pressed States are now receiving from horse racing—let alone the revenues which the Federal Government is realizing. This is a classic case of throwing the baby out with the bath water.

Now let me direct your attention to the specific reasons why I believe such a loss of revenue would result from the pending proposals.

1. As explained below, the pending proposals seriously endanger a source of enormous public revenues because they threaten to terminate parimutual racing, by forcing breeders and owners of race horses to get out of the business. This threatened loss of sorely needed revenues is needless because race horse owners are, in effect, subsidizing parimutuel racing at their own out-of-pocket expense. (See attached exhibit A, showing earnings experienced on the best bred harness racing stock.)

2. (a) Parimutuel racing provides the States a form of voluntary taxation which yielded them $426 million in 1968 and will yield about $500 million in 1969. (Attached exhibit B, tables 1 and 5.)*

(b) This form of State tax is not deductible against Federal income taxes. If lost, it will have to be replaced by other taxes—for example, income, sales, or property taxes—which are applicable to the public at large and are deductible expenses for Federal income tax purposes.

3. The Federal Government undoubtedly realizes net tax benefits from parimutual racing in the form of income taxes paid by:

(*a*) race tracks, their stockholders, employees and concessionaires;

(*b*) employees of breeding farms and racing stables, and their suppliers of various products—for example, hay, grain, straw, horseshoes, medicines, bandages, harness, sulkies, and so forth;

(*c*) ordinary income on sales of yearlings by breeding farms;

(*d*) capital gains on sale of racing and breeding stock and the sale of breeding farms.

4. (a) The "tax dodges" at which the livestock and hobby reforms are aimed are pointed out in a Wall Street Journal article of March 19, 1969. (Attached ex. C.) They do not apply to the breeding of racehorses or racing stables.

(b) There is no suggestion in that article that such tax avoidance practices apply to horses or that any of the estimated loss of Federal revenue is in any part attributable to horses. In any event, the revenues yielded by the horse racing industry to the States and the Federal Government far exceed the outside estimate of such losses.

*Exhibit B was received by committee and printed as an attachment to a previous witness' statement. See p. 2826.

(c) In contrast to cattle or citrus farms, there are no public investors in horse breeding farms or racing stables. The business is too hazardous to attract public investment capital.

5. There is no more hazardous business than the breeding and/or racing of horses. The chances of losing money are overwhelming. Estimates are that 9 of 10 racehorse breeders and owners lose money. Some of the reasons follow:

(*a*) Overall, the horse race population races for purses amounting to one-half of the operating expense of maintaining them (that is, exclusive of depreciation) and a very substantial part of the purses is furnished by owners by way of stake fees. For this and other reasons, race horses are not income-producing property, but a drain on their owners, as shown by attached exhibit A.

(*b*) Lameness, sickness, and accidents incapacitate or degenerate the great majority of race horses. Many other horses, even if sound, simply cannot race fast enough to pay their way. Horses are insurable only for mortality. If not useful as racehorses, they are worth virtually nothing—what they can bring for dog meat, and so forth, except for the relatively few animals useful for breeding purposes. Hardly any male horses are usable for breeding. The successful stallion is exceedingly rare. Geldings are useless for breeding purposes. Only a minority of females make successful broodmares.

6. (a) A change in the hobby law to "reasonable expectation of making profit" means that the applicable test is no longer the owner's purpose or motive, but his objective prospect of making money. On such a basis, the prognosis can readily be shown to be very dim. This will force owners and breeders out of the business. Virtually, all horse racing losses will likely prove nondeductible. Without breeders and owners, the parimutuel tracks cannot survive.

(b) Race horse breeders and owners can live with the present law. This is stated by the following extract from a recent case, entitled *Valden B. Starr*, which was reported on March 7, 1969 (28 TCM 167 at 172):

> Breeding and raising horses for sale may constitute a trade or business. *Commissioner* v. *Widener* [1929 CCH D-9279], 33 F. 2d 833 (C.A. 3, 1929), affirming [Dec. 2910] 8 B.T.A. 651 (1927); *Theodore Sabelis* [Dec. 25, 390], 27 T.C. 1058 (1962). But this must be determined in each case by whether the taxpayer engaged in the venture with the bona fide intention of conducting it as a business with the motive and purpose of making a profit. *Cf. Lamont* v. *Commissioner* [65-1 USTC ¶ 9124], 339 F. 2d 377 (C.A. 2, 1964); *Schley* v. *Commissioner* [62-1 USTC ¶ 9322], 375 F. 2d 747 (C.A. 2, 1967). It is not necessary that the expectation be a reasonable one; it is sufficient if it is genuine.

7. (a) Contrary to popular belief, the great majority of horse breeders and owners are people of modest means. Rich owners of the few profitmaking commercial farms alone cannot maintain the parimutuel tracks. Even on Kentucky Derby day, there must be eight other supporting races on the program. These are provided by rank and file breeders and owners with limited capital.

(b) More specifically, the commercially successful breeding farms in harness racing provide substantially less than 1,000 horses per year and, as exhibit A shows, most of these do not make the grade. The importance of the small breeder is easily demonstrated. For example, there are five harness tracks operating in New York State alone from early spring to late fall. They need 432 horses to fill their weekly racing cards—that is, nine races, with eight horses per race, 6 days a week. In sum, taking into account the incapacitating factors of lameness and accidents, the New York harness tracks alone require between 3,500–4,000 horses on their grounds to be able to fill their programs. And New York is only one out of 29 States which conduct parimutuel racing.

8. (a) The recapture of depreciation will also force owners out of business. Only by the occasional sale of a valuable, fully depreciated horse can an owner replenish his stable or broodmare barn without depleting his savings.

(b) As applied to racehorses, the recapture of depreciation is wrong in principle. It is the most hazardous of all businesses, since so few horses ever pay their way, let alone make a profit. It is far riskier than the oil business, as shown by the fact that it is shunned by public investors. But under existing law, horsemen do not get anything like the tax benefits provided for oil investors.

A race horse is a wasting natural aspect. It cannot be restored by depreciation funds—but must be replaced. It is not insurable for sickness, lameness or accident. The appropriate comparison is not depreciation, but depletion, which is not recaptured under the tax laws.

9. The restriction of the deductibility of horse racing expenses against nonfarm income will likewise force most owners out. Because of the hazards of horse racing, very few, if any, owners can depend on it for a living. If they must absorb horse losses, they will sacrifice the outside income on which they support themselves and their families. Confronted with the risk that horse losses will be nondeductible for tax purposes, they will have to get out.

10. Without the market provided by racing stables, all breeding farms will be forced out of business—including the very few large commercial breeders that have been profitable. And the racetracks cannot operate without racehorses.

Next, let me explain why there is no such thing as tax-dodge farming in the breeding of race horses or the operation of racing stables—as indeed is intimated by the passages from General Oppenheimer's book, quoted by Senator Metcalf. The initial statement in the chapter "Tax Plays In Race Horses" states the case in a nutshell. It states, "The tax aspects of the horse busines are unique, but in most instances, parallel the cattle business." The important statement is the recognition that the race horse business is "unique". This is an understatement. I could cite a whole host of reasons. I will content myself with two.

First, speaking broadly, the proof of the pudding is that there is no evidence whatever—from my source—that public money has ever been invested in race horse breeding farms or race horse stables. This should be conclusive. If the race horse industry could be used as a form of tax-dodge farming, public money would have long since been attracted to it. It is hard to see any room for rational dispute with the judgment of the public money market that the horse race industry does not yield rewards, by way of the tax laws or otherwise.

The reason is not mysterious. The odds are overwhelming that a race horse or a breeding animal which has failed as an income-producing asset—and this is true of the great majority—will bring far less in the market than the cost incurred during the two or three year period required to establish the animal's inability to earn money, whether for breeding or racing purposes. Consequently, there is no potential capital gain which will put the owner net ahead. An incapable or incapacitated race horse has virtually no market value. There is a simple and homely explanation. A horse is inedible—except as dogmeat.

Now let me give a specific example of the reason why the race horse industry is incapable of tax-dodge farming. One heifer in calf is essentially no different from any other heifer in calf. Each has a market value as a meat animal. As soon as the animal is in calf, there is an immediate incentive to sell, in order to obtain the tax advantage of a capital gain.

In contrast, there is no comparability between one broodmare in foal and another. A broodmare which has proved that she can produce fast race horses is a valuable asset—almost an annuity. There is every incentive to keep her as long as she will breed, and to sell her foals annually on the market—while, incidentally, paying ordinary income rates on the sales price. On the other hand, a broodmare who has proved she does not produce fast race horses is a cull. She must be sold because she is not worth the cost of her upkeep. But there is no profit in selling her. Like a worthless race horse, she will bring less than the cost incurred in keeping her through the 11 months conception period and the two subsequent years—at the minimum—it takes to get her first foal to the races. Most broodmares are culls.

The fact is that the current tax laws allowing the deduction of race horse losses—insofar as they do not exceed $50,000 per annum for 5 successive years*—is not a tax dodge, but a tax trap. It misleadingly entices the investor in race horses, or race horse breeding farms, to believe that it is worthwhile to take the gamble. Again, a classic metaphor comes to mind—this time the legend of the Pied Piper.

On the rationale that losses from the horse business will be tax deductible, the race horse investor convinces himself that it makes sense to take the reckless plunge into an incredibly hazardous business, although all the odds are against a profitable result. In the process, he exposes himself to almost inevitable out-of-pocket losses. To illustrate: assume that a taxpayer in the 50-percent bracket per year loses $25,000 in a tax year on his race horse enterprise. He save $12,500 in taxes, but is out of pocket the same amount. This happens over and over again.

The simple truth is that the horse investor is kept going by the dream of hitting the extraordinary great race horse, which will make his fortune. This happens very rarely, but just often enough to keep enough breeders and owners in business to sustain the race horse industry. If I were to analogize, I would liken the race horse owner to the gold prospector. But there is one vital difference. Every unsuccessful race horse owner is subsidizing a huge industry—that is, parimutuel racing—which makes money for everyone but himself—including the State governments and the Fed ral Government.

The horse investor, in short, is not the source of a loss of tax revenues, but a cornucopia of substantial tax revenues. There is no public purpose to be served by changing this situation. All that will be accomplished is to deprive the States and the Federal Government of an important source of desperately needed funds.

*Or lower losses, if the taxpayer cannot prove a genuine profit purpose.

Why enact any change in existing law which will jeopardize this huge industry supported by private citizens on a voluntary basis, at their own out-of-pocket expense?

I would like to have attachments to my statement included at this point, if I may.

The CHAIRMAN. Certainly.

(The attachments referred to follow:)

EXHIBIT A

EARNINGS OF HANOVER SHOE FARMS CONSIGNMENT OF FEATURE YEARLINGS—CATALOG NUMBERS 952-1008 TO 1964 HARRISBURG AUCTION SALE

Name	Sale price	Earnings at 2, 3, 4 (1965-67)	Earnings (1968)
Gretel Hanover	$3,200		
Ervin Hanover	9,000	[1] $22,787	[illegible],087
Anabela Hanover	13,500	905	
Nugget Hanover	50,000	1,361	20
Jiffy Hanover	6,500	3,088	171
Huntley Hanover	35,000	2,799	
Bonjour Hanover	50,000	[1] 226,821	900
Carolee Hanover	9,000	1,708	
Mikado Hanover	36,500	3,148	794
Marvelous Hanover	5,700		
Blazing Hanover	25,000	[1] 21,087	6,194
Olinda Hanover	6,500		
Deluxe Hanover	17,000	[1] 48,820	21,854
Effrat Hanover	65,000	[1] 76,857	23,413
Fawn Hanover	6,500		
Tracer Hanover	26,000	[1] 30,450	5,488
Pickett Hanover	8,500	37	
Denise Hanover	5,000		
Invictus Hanover	22,000	4,571	
Restless Hanover	8,000	25	
Nassau Hanover	14,000	536	
Quinn Hanover	44,000	1,431	
Lawyer Hanover	4,000		
Idaho Hanover	8,000		
Hustler Hanover	22,000		
Gusher Hanover	15,500		
Towson Hanover	19,000	6,972	
Maryellen Hanover	7,000	[1] 42,212	11,862
Thriller Hanover	12,500	745	693
Elmira Hanover	6,250	8,049	8,049
Larry Hanover	15,000	11,075	955
Telstar Hanover	13,000	2,241	682
Lobo Hanover	14,000	4,046	2,767
Susanna Hanover	30,000	5,432	
Bravado Hanover	45,000	250	
Camelot Hanover	9,500	2,045	
Texan Hanover	17,000	[1] 55,711	16,516
Romeo Hanover	8,500	[1] 658,505	
Ringo Hanover	5,700	9,749	9,749
Sahara Hanover	3,500	625	330
Buzzy Hanover	18,000	[1] 64,433	950
Pappas Hanover	14,500	9,158	4,793
Brinkely Hanover	8,200	3,423	1,554
Ruffles Hanover	3;710		
Cobalt Hanover	35,000	121	
Sizzler Hanover	23,000	16,000	6,948
Satan Hanover	16,500	9,310	
Pat Hanover	15,000	3,499	
Stover Hanover	17,000	[1] 39,457	
Gunsmoke Hanover	5,500	924	
Mantle Hanover	23,000	12,489	
Stylish Hanover	4,500		
Cologne Hanover	5,200	5,104	
Skylark Hanover	7,000	12,443	5,146
Flyer Hanover	19,000		
Anitra Hanover	8,500	11,863	
Cruiser Hanover	12,500	350	

[1] Indicates horses which covered maintenance expenses of $6,000 annually—i.e., exclusive of stake payments and depreciation.

EXHIBIT B

(Exhibit B had been received by the committee and printed as an attachment to a previous witness' statement. This appears at page 2826.)

EXHIBIT C

[From the Wall Street Journal, Mar. 19, 1969]

CITY COWBOYS—BIG INVESTORS ROUND UP TAX SAVINGS ON CATTLE THEY OFTEN NEVER SEE

Herds Yield Huge Deductions While Management Firms Take Care of the Details—Treasury Proposes a Curb

(By Ronald A. Buel)

I'm a rich cowhand, of the Wall Street brand
And I save on tax, to beat the band
Oh I take big deductions the law allows
And I never even have to see my cows
Yippie-i-o-ki-ay!

A growing number of investors could sing that parody of a 1930s tune ("I'm an Old Cowhand From the Rio Grande"). They're customers of agricultural management companies, which help them round up huge tax savings from investments in farming, sometimes fruit and nut groves but most often cattle.

The basic idea is familiar. A high-income taxpayer ($50,000 a year is the minimum to get much benefit from the plan) buys cattle. He then takes generous deductions permitted to farmers—even part-time farmers—writing them off against nonfarm income that otherwise would be taxed at rates up to 70%.

There are some disadvantages, though, for a taxpayer who tries to do this himself. He has to go to the bother of inspecting a herd or a whole ranch, negotiating a purchase, hiring a manager and keeping the books. If his inexperience results in mismanagement, he might even lose enough money on the cattle to cancel the tax benefit.

A DEDUCTIBLE VACATION

Now, for a fee—itself tax-deductible—a farm management company will take over the annoying details. It will buy cattle, arrange for professional ranchers to raise them, negotiate eventual sale of the herd and do the bookkeeping. A client who finds the nontax aspects of cattle boring doesn't even have to go look at the beasts. (A client who buys a citrus grove, however, might as well look it over during a Florida vacation; he can then deduct much or possibly all of the travel cost as the expense of a trip to inspect his property.)

Some of the bigger management companies even guarantee the investor against a loss of more than 3% or 10% (the amount varies with the type of investment) on their farm property. They make the rancher or grove manager who handles the property absorb any greater loss. A rich investor can shrug off a 3% or even 10% loss; it probably will be offset many times over by tax savings on his nonfarm income. Indeed, a small farming loss has its own tax advantage; it can be deducted from taxable nonfarm capital gains, such as stock-market profits.

As of now, all this is perfectly legal. The Internal Revenue Service requires only that a nonfarmer taking farm-expense deductions aim at making an eventual profit out of his sideline agriculture. To run afoul of this provision, an investor would have to show suspiciously large losses for a suspiciously long period or do something as stupid as forgetting to harvest his crops.

TREASURY SEEKS A LIMIT

But the Treasury now is trying to limit farm deductions against nonfarm income to $15,000 a year per person. Sen. Lee Metcalf (D., Mont.) calculates this proposal—one of a package of tax-reform ideas now being considered by the House Ways and Means Committee—would bring in $200 million to $400 million a year in taxes that sideline farmers now legally escape paying.

The proposal's fate is uncertain, however, and it hasn't stopped the rush of nonfarmers into agricultural investments. At least eight corporations, plus dozens of individual farmers who also manage farm property for a fee, now handle well over $100 million of investments for more than 5,000 people. Oppenheimer Industries Inc. of Kansas City, the oldest and largest of the companies, has doubled its clientele to 400 in four years. In December, it was managing 220,000 head of cattle for them and had orders for another 20,000 head it couldn't fill immediately.

Oppenheimer, the principal subsidiary of Atlas Acceptance Corp., Kansas City, began managing cattle in 1952, mostly for movie stars. Over the years, though, the focus of its appeal has shifted to Wall Street; stockbrokers and investment counselors now outnumber the Hollywood figures, such as Jack Benny, who still dot its client lists.

The tax savings these clients can make on cattle purchases compare favorably with the profits they can make on most stock-market investments. Consider, for example, the Kansas City broker for whom Oppenheimer bought a herd of "breeding cattle"—cows used to produce beef cattle—two years ago.

A 90-PERCENT LOAN

The broker paid $3,000 of the $30,000 purchase price in cash, borrowing the other 90% on a loan Oppenheimer arranged. This is a frequent practice for Wall Street cowboys; it allows them to get the full tax savings on a large herd without tying up too much of their own capital. Also, interest on the loan—in this case, $4,400 in two years—is tax-deductible.

The broker by now has paid out $32,000 in cash to cover various expenses of running the herd and deducted all of it from his nonfarm taxable income; at this point, the farm operations themselves have produced no profit. Besides interest, the deductions include a $5,050 management fee paid to Oppenheimer, $2,550 paid for use of bulls or artificial insemination for his cows—and a whopping $20,000 paid to purchase in advance several years' supply of feed.

This last deduction illustrates a special tax advantage of farming: Farmers are allowed to keep their books on a "cash" basis, rather than the "accrual" basis most businesses must use. That means, among other things, that they can deduct the full purchase price of feed in the year it is bought, rather than having to spread the deduction over the years in which the feed is consumed. This benefit was written into the tax laws because most farmers were assumed to have neither the time nor the accounting expertise to keep accounts on an accrual basis, but it applies to sideline farmers who are thoroughly familiar with involved bookkeeping methods.

Farmers also are allowed to take depreciation deductions on some kinds of cattle; in the broker's case, depreciation came to $5,000. That brought his total deductions to $37,000—saving $25,900 in taxes he otherwise would have had to pay at the 70% rate applying to the top slice of his nonfarm income.

That saving, it's true, may aventually be reduced by capital-gains taxes and possibly a paper loss on sale of the cattle. But the broker still figures to come out way ahead.

If he had Oppenheimer sell his cattle at today's prices, for instance—and he may—the broker would receive about $58,000, or about $4,000 less than he would need to recoup his cash outlays and repay the purchase loan. Also, he would have to pay capital-gains tax on $33,000, representing the excess of the $58,000 sale price over the cattle's $25,000 book value (the $30,000 purchase price less the $5,000 depreciation). At the top capital-gains rate of 25%, this tax would be $8,250.

39 PERCENT IN 2 YEARS

Subtracting this tax payment and the $4,000 paper loss from the $25,900 he has saved in income taxes, however, would leave the broker still $13,650 ahead on the deal. That's a two-year return of 39% on his total cash outlay of $35,000—a return not many stockmarket investments can match.

Lucrative as this deal was, it still doesn't illustrate all the advantages of cattle ownership. Investors in dairy cattle get the benefit of greater depreciation deductions than the Kansas City broker took, combined with greater income from their herds.

Modern Dairy Farms, Inc., Fort Madison, Iowa, now has 120 investors in its tax-shelter program, compared with 35 two years ago. One client, a clothing executive in the 50% tax bracket, bought a herd four years ago for $160,000, half of which he borrowed. He already has written the herd's value down to $60,000, saving $50,000 in taxes in four years through the $100,000 of depreciation deductions alone.

SPLITTING MILK INCOME

In addition, he receives income of $40 per cow per year, or $16,000 annually, on his herd of 400 head. (An equal revenue from milk sales goes to Modern Dairy Farms as a management fee; the farmer who raises the cattle keeps any remaining milk income.) With other deductions on the herd offsetting taxes on his milk income and then some, the investor figures to repay his $80,000 purchase loan out of milk revenues in five years, increasing his potential profit on eventual sale of the herd. This investor went to see his cows once: he recalls "slogging through the manure in the rain to take a look at the little beasts."

The permission for farmers to keep books on a cash basis also enables sideline agriculturists to take especially big deductions in years when their nonfarm income, and thus their potential tax liability, is highest. An example is one Oppenheimer client who bought a herd of cattle being fattened for slaughter for $17,684—95% of which he borrowed—in November of a year in which he knew his top tax rate on nonfarm income would be 70%. He immediately paid out $7,000 for a huge supply of feed. Other expenses brought his immediate deductions to $7,925, saving him $5,548 on that year's taxes.

Early the next year this investor made a planned switch to a new nonfarm job that he knew would depress his income enough at the outset to reduce his top tax to 35%. So he had Oppenheimer take advantage of favorable prices and sell the cattle in April. He received enough to recoup his cash expenses, repay the purchase loan and leave a nominal profit of $510.

A 5-MONTH BONANZA

Since he had held his cattle only five months, the investor paid ordinary-income, rather than capital-gains, tax on the excess of the purchase price over the sale price. But at a 35% rate, that tax came to only $3,351. Subtracting this sum from the total of his profit and previous year's tax savings left him $2,197 ahead on a cash outlay of $8,810—a return of almost 25% in five months. And that was without the benefit of depreciation deductions, which aren't permitted on feeder cattle.

Not every investor who signs up with an agricultural management company does that well, of course. Some apparently have been taken by small companies that dont't guarantee their clients against large losses and sometimes mismanage their cattle or groves.

The reputable companies take extensive precautions to protect their clients. To begin with, they set minimums on the investments they will accept to keep away would-be investors with incomes and tax rates too small to benefit much from agricultural property. Oppenheimer won't accept any amount less than $10,000, and Black Watch Farms, a subsidiary of Bermec Corp., an Englewood, N.J., truck-leasing concern, specifies a $100,000 minimum. Black Watch manages registered breeding cattle, whose lineage can be traced; it now manages 18,000 such cattle for investors, against 9,000 last June 30 and 1,900 at the end of 1965.

RESTRICTIONS ON RANCHERS

To make sure its clients' cattle are well cared for, Oppenheimer will make contracts to raise the cattle only with ranchers who have been successful enough to accumulate a net worth of at least $250,000. To prevent the ranchers from getting its clients' cattle mixed up with their own, it insists each investor's cattle bear a "personalized" brand.

Oppenheimer won't give any rancher contracts to raise more than 10,000 of its clients' cattle. It tries to scatter each client's herd over two or three ranches "so that," explains a spokesman, "if an investor gets hit by a drought in New Mexico, he's unlikely to get hit by a blizzard in Montana, too." The 220,000 head of cattle Oppenheimer's clients owned in December were roaming over more than 100 ranches or feed lots scattered across 17 states.

Despite these restrictions and its insistence that ranchers pick up any losses on an investor's cattle in excess of a guaranteed maximum, Oppenheimer has no trouble finding willing ranchers. Leonard H. Purdy, who currently raises 600

Oppenheimer cattle along with 1,700 of his own on a 39,000-acre spread in Picabo, Idaho, says that dealing with Oppenheimer gives him "something of a guaranteed market." He means that he can count on Oppenheimer to buy some of his cattle regularly for its clients at prices he considers reasonable.

Even Oppenheimer, however, concedes that finding ranchers who are capabile as well as willing is difficult. "Neglectful ranchers" who dont' take proper care of a client's cattle "are our biggest problem," says Garrett Cole, Oppenheimer's Midwest sales manager.

The much greater problems that an investor who signs up with a less careful management company can run into are illustrated by the case of Tenn-Tax Land & Cattle Co., Dallas. This company some years ago took mail orders and cash for $900,000 of cattle from more than 300 investors. It won enough attention to be recommended at one point by a prestigious national investment letter.

SECURITIES BOARD'S FINDINGS

The Texas State Securities Board, however, eventually found that Tenn-Tax had no reserve account to replace lost cattle as it had advertised, that it hadn't purchased all the cattle ordered, that the land upon which its clients' cattle "were being grazed was overstocked and that a large number of such cattle had died and were dying from starvation." The board ordered the company to stop soliciting investments and Tenn-Tax went into receivership. Its president, Leighton G. Datsom, pleaded guilty to mail fraud in April 1965 and was sentenced to a three-year jail term, with two and a half years of the sentence suspended.

There are some dangers in grove investments, too. The investor who goes into this type of agriculture "had better be sure he knows how his groves are being managed," says John Tobias, executive director of American Agronomics Corp., one of the biggest management companies specializing in groves. "There are plently of people still out to make a quick buck."

(American Agronomics itself has posted an enviable growth record; it how has over 2,000 clients investing in orange groves, more than double the number two years ago. It is getting increasing competition, though, some of it partly financed from Wall Street. Hayden Stone Inc., a big stock brokerage firm, owns the majority interest in Jasmine Groves Co., which started up in December.)

WOE FOR THE MIDDLING RICH

Even the management-company client whose investments are carefully handled can't always count on getting much benefit from farm property. For the only middling rich, such investments sometimes don't yield enough tax savings to make the outlay worthwhile.

A retired St. Louis investment banker, for example, has laid out $58,700 since 1964 for the purchase price and expenses of a cattle herd that now numbers 340 head. His deductions against nonfarm income (mostly from stock trades) came to $40,000 in the first four years, but since he is "only" in the 50 percent tax bracket, he saved only $20,000. Last year his nonfarm income dropped, and he had unusually high nonfarm deductions, including large medical expenses, to offset it almost entirely. As a result, he got "almost no tax benefit" from cattle deductions, since he didn't need them.

If he sold his herd now, the St. Louisian figures he would just about get back his purchase price and cash expenses and have to pay about $12,000 in capital-gains taxes. Subtracting that from his income-tax savings woud leave him only $8,600 ahead on the investment—a five-year return of less than 14 percent, or less than 3 percent a year, on his cash outlay. "I undoubtedly would have done better putting the money into the stock market," he says.

Why then did he bother investing in cattle? "Some of my smart freinds have cattle programs, so I figured I'd better have one too," he replies.

The CHAIRMAN. Thank you very much, sir. The next witness is Mr. Claude M. Maer, Jr., counsel of the National Livestock Tax Committee, accompanied by Mr. E. H. Shoemaker, chairman of the Tax Committee for American National Cattlemen's Association and Stephen H. Hart, counsel for the National Livestock Committee.

We welcome you.

STATEMENT OF CLAUDE M. MAER, JR., NATIONAL LIVESTOCK TAX COMMITTEE; ACCOMPANIED BY E. H. SHOEMAKER, CHAIRMAN, TAX COMMITTEE FOR AMERICAN NATIONAL CATTLEMEN'S ASSOCIATION; STEPHEN H. HART, COUNSEL, NATIONAL LIVESTOCK TAX COMMITTEE; ALBERT K. MITCHELL, CHAIRMAN, NATIONAL LIVESTOCK TAX COMMITTEE; FRED FERRELL, DIRECTOR, AMERICAN HEREFORD ASSOCIATION; WRAY FINNEY, PRESIDENT, OKLAHOMA CATTLEMEN'S ASSOCIATION; BRENHAM CROTHERS, DIRECTOR, AMERICAN NATIONAL CATTLEMEN'S ASSOCIATION; HENRY MATTHIESEN, PAST PRESIDENT, AMERICAN HEREFORD ASSOCIATION; AND CLARENCE CROSS, DIRECTOR, AMERICAN HEREFORD ASSOCIATION

Mr. MAER. I have with me here at the head table some people who represent about 650 years of active participation in the livestock industry. I would like to introduce them very briefly.

Mr. Albert K. Mitchell of New Mexico, chairman of the National Livestock Tax Committee, Mr. Fred Ferrell, of Oklahoma, a director of the American Hereford Association, Mr. E. H. Shoemaker, Jr., of Nebraska, chairman of the American National Tax Committee, Mr. Wray Finney, president of the Oklahoma Cattlemen's Association, whose family, incidentally, has been in the livestock business since 1720, which is some 250 years by the way that I would calculate it, Mr. Brenham Crothers, a past president of the Louisiana Cattlemen's Association, and Mr. Henry Matthiesen, past president of the American Hereford Association, Mr. Clarence Cross, past president of the Georgia Cattlemen's Association, and Mr. Stephen Hart, longtime counsel to the National Livestock Tax Committee.

Mr. Hart and I can claim to be disinterested, since we are some of the few lawyers in the country who are not in the cattle business. But we have had between us some 50 years of representing the livestock industry as counsel for the National Livestock Tax Committee, and I hope a little of it has rubbed off on us.

We have, in the interests of saving time, and at the request of the chairman, combined our testimony representing over 60 national breed and State associations representing some 300,000 individual farmers and ranchers, and we will try to make it as brief as possible.

When the House Ways and Means Committee held its hearings in February and March of this year, we testified and we were questioned rather closely on whether or not we felt there were any abuses in the livestock industry or any tax profiteering, and we said that we felt that there were some abuses but very few, but obviously they were giving the industry a black eye. We made it quite clear that the National Livestock Tax Committee and the livestock industry generally certainly does not condone the abuses by these very few, and we were asked what was our solution to them. We asked permission of the committee to work with the staff of the committee, the joint committee staff and the staff of the Ways and Means Commitee to prepare and propose some solutions to these problems.

And we did so. And we worked these out and I will reiterate them very briefly in a minute.

We are not here appearing before you saying that all is rosy and that we think that there is nothing wrong. We feel that there are some small abuses, but that we believe that our proposals will take care of them, but at the same time not endanger the entire industry.

The proposals that we make, all of which, incidentally, were adopted by the Ways and Means Committee, with some modifications, were as follows we felt that one of the best ways to eliminate the very few tax promotions and the tax profiteering which had been going on would be——

The CHAIRMAN. I am afraid I am going to have to interrupt you. We are having a vote on the Senate floor. We did obtain consent of the Senate to meet while the Senate is in session but that does not excuse members of this committee from being present to vote when the rollcall votes occur.

We will have to excuse ourselves to go over and vote and we will come back. I will have to stay over there because I am managing the next bill on the Senate floor. As you can see we are up against a very difficult time limit, and we do want to hear you. That is one reason why we have had to ask groups like yours representing 60 organizations and 300,000 people to limit yourselves to 10 minute presentations.

Since I can't come back I particularly want to recognize former Senator Crothers who did a magnificent job in the State legislature when I was old enough to be a clerk at the desk and later on to be a lawyer helping to advise the legislature. He is one of those of whom we are most proud in Louisiana and we are certainly proud to see him here with this group.

His presence along with the others you have here causes me to think there must be much to be said for your side. I will proceed with that assumption until it has been proved otherwise.

We will be back and meet after this rollcall.

Thank you.

(Short recess.)

(A statement of Mr. Crothers follows:)

STATEMENT OF BRENHAM C. CROTHERS, REPRESENTING LOUISIANA CATTLEMEN'S ASSOCIATION

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

Mr. Chairman and Gentlemen of the Committee: We members of the Louisiana Cattlemen's Executive Committee do assure you of our full and complete support of the position being taken by the American National Cattlemen's Association on the TAX REFORM ACT of 1969 presently being considered by you.

We are concerned about many provisions of the House-passed bill but we will not go into detail as this will be more ably handled by representatives of the ANCA. We do feel that the application of the many damaging features of the measure would in due time force many dedicated and experienced cowmen out of business. The bill has been heralded as a most comprehensive tax reform effort but we see it as it applies to the cattle and livestock industry as a headache for the operator and a complexity in general. Cattlemen do not have the time or the accounting ability to properly inventory the cost and values going into the development of animals kept for breeding purposes. The present tax laws governing the livestock industry were designed to minimize the bookkeeping problems of cattlemen and other livestock producers by permitting them to keep their books on a "cash" basis. We think this is as it should be.

Great progress has been brought to all agriculture by people with outside nonfarm income enthusiastically engaging in the development of farms and ranches. These developments extend far beyond their tenure and they add value to their communities. We are informed by a representative of a Federal Land Bank that eighty seven (87) percent of their loans are made to people with nonfarm income. Forcing these many dedicated citizens out of agriculture will certainly adversely affect land values. Almost every rancher needs some outside income and he needs capital gains to generate capital. There is a definite shortage of needed capital in most livestock operations. Our cost have advanced out of proportion to our income.

The Excess Deductions Account as passed by the House of Representatives will be very difficult to maintain. Certainly beyond the ability and training of many operators.

Respectfully submitted,

LOUISIANA CATTLEMEN'S ASSOCIATION,
BRENHAM C. CROTHERS,
Chairman, Executive Committee, Louisiana.

Senator JORDAN. Gentlemen, if you will be seated at the witness table we will proceed.

There are a lot of witnesses to hear yet today, so you just go right ahead with your presentation.

Mr. MAER. As I was saying when the meeting temporarily recessed, the National Livestock Tax Committee representatives did work with the staff of the Ways and Means Committee and the joint committee to propose certain revisions to the existing law which we thought and which we feel would eliminate the tax profiteering that was the subject of the criticsm in the House Ways and Means hearings. Our analysis of this problem was that what profiteering there is, is caused by the "in-and-outers"—taxpayers who get in for a quick deduction and sell out after a few years at capital gains rates. We made five proposals which we thought would constitute a sort of rifle approach aimed at these "in-and-outers" rather than a sawed-off shotgun approach which would severely damage the entire industry. These five proposals very briefly were to include livestock in depreciation recapture, that is recapture at ordinary income rates of so-called excessive depreciation tax, that the holding period for cattle and horses, in order to realize capital gains, should be increased from 1 year to 2 years.

We also suggested that the Ways and Means Committee might include something in its report to the effect that existing law was that there should be no tax-free exchange of male calves for female calves. Similarly we suggested that the committee report might well include a statement that the mere proof that the animal was held for the required time would not be sufficient to prove that it was entitled to capital gains treatment, but that it would be necessary to prove that the animal was held for breeding purposes or draft or other purposes.

Finally, to cover the entire farm area, we also suggested that if land were held for less than 10 years, there would be a sliding scale recapture at ordinary income rates of land improvement expenses which had been previously deducted.

As I say, these proposals were aimed at eliminating from the livestock industry the in-and-outer, the fellow who gets in, spends a lot of money, deducts it against ordinary income, and then gets out after a short period of time at capital gains rates. We believe that these proposals would substantially or completely eliminate the in-and-outer from the business.

The Ways and Means Committee, in H.R. 13270, did in fact adopt all five of those proposals, with some modifications. Without going into details, our written statement covers this, we believe that the modifications that were made were really unnecessary, and were too restrictive.

However, the Ways and Means Committee went further, in an albeit well-intentioned effort to get at the profiteers, what few there are in the livestock area, and enacted four additional provisions which we strongly oppose. Those provisions briefly are the EDA, the Excessive Deductions Act, the hobby loss presumption, the limitation on tax preferences, and the allocation of deductions.

I will not spend the time to explain those, because I am sure the members of the committee are familiar with these provisions. We believe that these are unnecessary. These are unneeded. These go much too far and are really contrary to the basic principles of a sound and equitable tax system, and I will tell you why.

First of all, we believe that these provisions are unnecessarily complex and confusing. They will have a severe impact on a large group of taxpayers who are probably least able to comply with these complex provisions, the ordinary farmer and rancher. He doesn't have the facilities or the help or anything else to comply with all these very, very complex provisions.

We think it is unwise to write a tax law where compliance is difficult or impossible, because that means that enforcement is equally difficult, and it just really causes nothing but controversy between taxpayers and the Government.

Then when you get to the interplay of these four provisions, these unneeded provisions we call them, it is just a real nightmare. We just don't see how it will be possible for the average and small farmer and rancher to comply with them. As a matter of fact, if these are aimed at the big, the so-called big, wealthy ranchers, they are the ones who can comply, but the ones that are going to get hurt are the hundreds of thousands and millions of middle size and small operators. It seems to use that the imposition of such a set of complexities on the agriculture community would be a serious mistake.

Accounting help is just not available in the part of the country where the great majority of livestock are located. For instance, our statistics show, on page 21 of our statement, that in the 21 western States, excluding California as an industrial State, there are listed 20 percent of the certified public accountants. Yet those States comprise 67 percent of the land area of the continental United States, and 64 percent of the cattle population resides in those 21 States.

Finally, these four unneeded provisions really end up by requiring all taxpayers, except the very small, to keep two sets of books. If they are on the cash basis, they are going to have to keep an accrual set of books, also, in order to comply properly with these provisions. They are just really too complex and too confusing for the industry.

Moreover, another problem with these four provisions is discrimination. They discriminate between farmers and ranchers. For instance, the EDA provision provides exemption for individuals, a $50,000 outside income and a $25,000 farm loss, but it does not give a similar exemption to corporations, estates, and trusts. So if your business happens to be conducted in corporate form you would not be entitled to any exemption under EDA whereas you would be if you were an individual.

Also the EDA discriminates between those who report on the cash basis and those who report on the "proper" accrual basis, so that this is contrary to a sound tax policy, where you discriminate between taxpayers in the same business.

Similarly, the hobby loss presumption is arbitrary, in that it discriminates between taxpayers; a man who has a loss of more than $25,000 has certain restrictions put on him; whereas, a fellow who has a loss of $24,000 doesn't, and who is to say, just as the horse-racing people said a minute ago, 8 inches difference might mean the difference between being subject to this hobby loss law or not being subject to it. So here again you are discriminiating between taxpayers.

Finally, allocation of deductions treats corporations differently from estates and trusts, thus discriminating among taxpayers in the same business. It just doesn't seem right that taxpayers living right across the street or right across the road from each other would be treated this differently because of the form used to operate their business.

Finally, the interplay of these four unneeded provisions we are against discriminates against farmers and ranchers as opposed to the entire business community. So far as I know, and I am not a great student of the history of the income tax laws, although I have worked in this area for more than 20 years, this is the first time in history that a concerted attack has been made on one industry. It seems to me that this is very unfair discrimination against the farm and ranch business.

As has been pointed out quite often recently, this cannot be a revenue measure. A tax program is normally aimed at collecting revenue, and it can't be a revenue measure if the small amount of tax money involved amounts to only $5 million or $20 million. Such amounts are really very small in relation to the overall economy.

Finally, we would like to reiterate that our proposals, the five proposals that the National Livestock Tax Committee made, don't fall under any of our objections.

One, they are simple. They are merely extensions of the current law. They are simple to abide by and to administer. They are not complex.

We are living under them right now, under slightly different circumstances. There is no discrimination as between taxpayers in the same or different businesses. All farm and ranch taxpayers are treated similarly.

If I may say just one or two more words, we believe that the Metcalf and the Miller bills, although well intentioned, are unnecessary for the same reasons that the four unneeded provisions in the House bill are unnecessary. Senator Metcalf's bill would discriminate as between taxpayers depending upon the amount of their outside income, and Senator Miller's bill again would discriminate between taxpayers, depending upon the nature of their principal income. It seems to us that this is the wrong way to administer a tax system on such a discriminatory basis.

Senator Gore has introduced a bill which we think is excellent. It qualifies in many respects by meeting the tests of a sound and equitable tax system. S. 2645 is quite simple. However, our proposals in reality go further than Senator Gore's proposals, and we would urge Senator Gore to add at least the rules of depreciation recapture to his bill.

Our statement contains our general objections to these unneeded provisions of H.R. 13270. I won't go into that now in the interests of saving time. We certainly appreciate the opportuity to be before you.

Senator CURTIS. I got over here as fast as I could after the vote. The five things that you suggest to meet current objections, enumerate them again.

Mr. MAER. All right.

Senator CURTIS. You don't need to explain them.

Mr. MAER. I understand. These five provisions include placing livestock under the depreciation recapture rules of present law.

Senator CURTIS. When you sell that particular livestock.

Mr. MAER. When you sell an animal which you have depreciated, then to the extent that you make a profit over the depreciated base, that profit would be ordinary income to the extent of previous depreciation taken or allowed.

Senator CURTIS. All right, what is the second one.

Mr. MAER. The second one is to increase the holding period of cattle and horses from 1 year to 2 years.

Senator CURTIS. From birth?

Mr. MAER. Correct, from birth, as regards raised animals.

Senator CURTIS. You do not subscribe to the Treasury's position that a calf is born at no cost?

Mr. MAER. No.

Senator CURTIS. Children aren't either. And what is the third one.

Mr. MAER. The third one is really merely declaratory of existing law, that the exchange of male calves for female calves is not a tax-free transfer. This is one of the elements of some of these tax profit promotion schemes in agriculture. There is at least one court case which has held the exchange of male animals for female animals as being tax free.

Senator CURTIS. Now number four.

Mr. MAER. The fourth proposal is that a taxpayer must not only prove that he held the animal for breeding purposes the required length of time, but that he also really and truly held the animal for breeding purposes, which again is merely declaratory of existing law.

Senator CURTIS. And the fifth one?

Mr. MAER. The fifth one is in the area of real estate and provides that form and ranch land improvement expenses, that is soil and water conservation, land clearance and fertilizer costs, which are presently deductible more or less against current income, would be recaptured at ordinary income rates to the extent of such deductions if such land were sold within 10 years of its acquisition. So if a taxpayer were a quick in-and-outer, and sold the land, holding it less than 10 years, there would be a sliding scale recapture of those previously deducted expenses on a graduated basis.

Senator CURTIS. Declaring as a business expense, soil and water conservation practices for farmers it was a good thing, but what you propose would prevent someone, and it would probably be a man of great wealth, buying a very rundown tract of land, improving that land as a business expense offset against ordinary income, and getting his profit from the sale of land.

Mr. MAER. That is correct, and would prevent such activity on a short-term basis, by the in-and-outer.

Senator CURTIS. By short term, it would be a long-term gain.

Mr. MAER. I understand, but by short term I mean less than 10 years. What I am talking about is aiming at the in-and-outer, the fellow who gets in for a quick buck, deducts the ordinary expenses against current income and sells out at capital gain rates within a few years.

Senator CURTIS. Do you think the five points which you have enumerated will take care of the glaring abuses, those that are real that have some substance to them?

Mr. MAER. Yes, sir, we do.

Senator CURTIS. Without changing the hobby laws.

Mr. MAER. Correct.

Senator CURTIS. And without going so far as the House bill does in reference to capital gain?

Mr. MAER. Correct. As a matter of fact, it would go further than curing the glaring abuses. We think it will eliminate the tax profiteer from the farm and ranch business completely. He will have to go elsewhere, if he is going to use the tax laws to benefit, and we want that fellow out of the livestock business.

He doesn't do the industry any good.

Senator CURTIS. You are a lawyer.

Mr. MAER. Yes, sir.

Senator CURTIS. Do you know of any other occupation or industry where the losses incurred by the taxpayer cannot be deducted from his other income?

Mr. MAER. No, I don't know of any other business.

Senator CURTIS. Agriculture is the only place where that has been suggested in the House bill, isn't that right?

Mr. MAER. That is correct.

Senator CURTIS. There are a lot of questions I could ask but you have waited a long time today.

Senator Jordan.

Senator JORDAN. Thank you. This is persuasive testimony. Tell me how in your three points that you expect the in and outer as you call him, the fellow who is in for the fast buck, is going to be eliminated from this field of work.

Mr. MAER. One of the popular schemes, and one that was written up I believe in the Ways and Means Committee Report, is the purchase of a breeding aniaml for $3,000, take rapid depreciation on the animal for 3 years, and sell it back to the syndicate that he bought it from for $3,000. This is a break-even economically, but just by this device, he was able—by deducting the depreciation against ordinary high bracket income, and selling the animal back at no economic profit at 25-percent capital gain rate to reap a large tax savings. Depreciation recapture would eliminate this practice almost entirely.

Senator JORDAN. You are not in sympathy with the objectives of the Metcalf bill nor the Miller bill?

Mr. MAER. No, because we believe that those bills are much too broad and that they affect the broad spectrum of the entire livestock industry.

They change the rules of the game which have been accepted and well established for many, many years. Moreover, they are discriminatory as between taxpayers, because in essence, they discriminate against and among taxpayers, depending upon what their outside income is, that is different tax treatment for people depending on the amount of their nonfarm income.

Senator JORDAN. Do you feel—I think you did state that the agriculture industry, including the livestock raisers is the only industry being discriminated against in this bill—this is a statement that you can subscribe to? You said something like that.

Mr. MAER. Yes, probably I wasn't quite clear as to that. I said that it was my belief that the livestock industry, agriculture, farming and ranching was the only industry where there were specific provisions designed to change the tax rules affecting this business.

Mr. SHOEMAKER. Senators, may I try to clarify that just a bit. Under what are referred to as tax preferences in the House bill, farm losses is the only business related item included under tax preferences to be handled under the limited tax preference and your allocation of deductions. Losses in other businesses or professions are not mentioned, and it is very odd that as a tax preference a farm loss is the only item included. I think that explains why we feel it is discriminatory.

Senator JORDAN. To that extent then it is discriminatory.

Mr. SHOEMAKER. Yes, sir.

Mr. MAER. As far as businesses are concerned. Other things listed as tax preferences are not business connected with the possible exception of depletion allowance, but that is only one element of the oil business. It doesn't affect the business overall, like including farm losses as a tax preference.

Senator JORDAN. And you are not opposed to all the provisions of H.R. 13270 with respect to livestock, only with the four exceptions that you have indicated.

Mr. MAER. That is correct.

Senator JORDAN. Thank you.

Senator CURTIS. Senator Hansen.

Senator HANSEN. Thank you, Mr. Chairman. I am sorry I was not able to be here for your formal presentation. Mr. Maer. Let me say that I have read your testimony and I compliment you on the depth of understanding of the industry that is reflected by your statement. I happen to be a cattleman. As a consequence I have a real appreciation for the points you are making.

Earlier today it was brought out that there are some 3 million persons who report income derived from farming and ranching. Is this your understanding generally?

Mr. MAER. That is my understanding from the statistics of the Internal Revenue Service.

Senator HANSEN. And I hear all kinds of estimates as to the number of persons who might be affected under some of the proposals that have been made. I think that Senator Metcalf testified this morning that the Treasury had estimated that some 14,000 taxpayers would be affected by his bill as they interpret its thrust.

I have the feeling that if those figures are essentially correct, we are talking about one out of every 214 people in the business as would be affected by this bill.

In your mind, is there justification to impose the tax treatment that is contemplated in the Metcalf bill upon an industry to reach the one out of around every 214 persons that is in the business today?

Mr. MAER. We certainly do not, and that is why we made our proposal. The five proposals that we made to the Ways and Means Committee which I discussed when you were out of the room are a rifle approach aimed at this one fellow out of the 214 or 213, so that we wouldn't affect adversely the great bulk of the industry; and we believe that our proposals will take care of this tax profit taker.

Senator HANSEN. I hear different reasons given for some of the proposals that have been made. One that I hear bandied about occasionally is that the Metcalf bill might tend to minimize he competition that apparently some regard as emerging now or as existent because of the advantages, the so-called advantages, that presently exist in the law in enabling people in other businesses to get into the livestock business. If you were to single out the most damaging thrust of competition that the industry is experiencing at the present time, would you say it comes from residents of this country who are trying to get into the business, or indeed who are going into the business, or would you think that the imports that come into the United States from foreign countries would be of major significance? Which of these two sources disturb you most?

Mr. MAER. Certainly it is the imports. I think the statistics will show that we are talking about many thousands and hundreds of thousands of pounds of beef imports, whereas we are talking about a very small number of tax profiteers. If Senator Metcalf's figures, and I guess he received those from the Treasury, and far be it from us to quarrel with the Treasury, that 14,000 out of 3 million would be affected by his bill is correct, it is hard to see how 14,000 people could adversely affect any substantial segment of the livestock market.

The statistics that we have, which we cite in our statement, show that in 1966 there were only about 3,600 taxpayers with adjusted gross incomes of $100,000 or over who would be affected by the provisions of the Metcalf bill. So it seems inconceivable that this small number of taxpayers, that is about one one-thousandth of 1 percent of the total farm and ranch taxpayers, could have any substantial effect upon either land prices or livestock prices.

Senator HANSEN. I assume you have talked with a great many people in the ranching business. Generally has it been your observation that the typical rancher would like to see the value of his real estate depreciated?

Mr. MAER. We have talked to a lot of farmers and ranchers, and that is just exactly what they are worried about. If some of these we call unneeded bills and provisions, albeit well intentioned, are enacted, they are just worried about this very thing, and even more worried than the ranchers are their bankers.

Senator HANSEN. Isn't it true that there is quite a turnover in the typical tenancy on a farm or ranch? I have forgotten what the figures are. Do I recall correctly that the average farmer stays on a particular farm about 7 years? Do you recall any figures like that?

Mr. MAER. I don't but I have a number of experts here with me.

Senator HANSEN. Would someone volunteer an answer to that?

Mr. MAER. I guess none of them are familiar with that statistic.

Senator HANSEN. Anyway the point I was going to make is wouldn't it be fair to assume that anything which would bring about a sharp diminution in value of real estate would militate very much against the interests of a big majority of the people in the farming and ranching business, and that the shorter their tenancy is on a farm or ranch, the more severely they would be hurt?

Mr. MAER. No question about it. As a matter of fact I have heard this said over the last few years, and I think Mr. Mitchell could comment on that. Albert, could you just state briefly your impressions over the past few years.

Mr. MITCHELL. Well, there has been a substantial increase in values in ranch properties in the last 10 years, nothing to be greatly disturbed over. It is more or less in keeping with the general economy. But I would think that grazing lands in New Mexico, the area with which I am familiar, has more or less kept pace with the general economy, would probably be just a little ahead of it.

Senator HANSEN. Mr. Mitchell, you have been living in that area for a long time and I believe during that period of time you served on a local school board. I happen to remember that you are a trustee of Cornell University, I believe. What would be the result insofar as the impact is concerned upon the school districts and county units of government if there was a sharp depreciation, a widespread depreciation in values of rural land?

Mr. MITCHELL. Well, right now in New Mexico, with its sparse population, the demands made by our school system to maintain a respectable school system in New Mexico are so great that they are going to have to change, and we have a constitutional convention in progress now, they are going to definitely have to readjust the valuations that will be established for support of the public schools.

Senator HANSEN. And I would assume that greater rather than lesser values will be the goal of that?

Mr. MITCHELL. Inevitably an increase in values in order to raise the money necessary, or for an increase in the level. It will be one or the other.

Senator HANSEN. The livestock or cattle business as such, has not been directly supported by the Government in the normal term or in the normal sense of price supports as compared to other commodities. Is that an accurate statement?

Mr. MITCHELL. Absolutely no support whatsoever. It is a free industry and it gets no support from any source.

Senator HANSEN. It has had its ups and downs, I am sure.

Mr. MITCHELL. Very definitely, yes. We had a very abrupt one last spring that led everybody to think there might be some hope for improvement, but that has dwindled to the point that the market is back even a little lower than it was 6, 7, or 8 months ago.

Senator HANSEN. I think I recall right around the first of this year the average price of fat cattle throughout the United States was around $27.62, and now this past week it was down to $27.50. Are those figures essentially correct?

Mr. MITCHELL. A few cents under what it was the first of the year, yes.

Senator HANSEN. I have no further questions, Mr. Chairman.

Senator MILLER. I would just like to ask one question of what I regard as one of the most distinguished panels of people in an industry that we have had before this committee. Item No. 4 of your recommendations as I understand it is that you would require the taxpayer to prove the purpose for which he held the livestock as well as the holding period, is that correct?

Mr. MAER. That is correct.

Senator MILLER I thought that was already the law.

Mr. MAER. It is. Both items 3 and 4 are in the law. We felt, however, that this would give assistance to the Revenue Service in enforcement.

Senator MILLER. Do you think they need a leg up?

One other question here. On the holding period, you remember the holding period on cattle and horses. What is wrong with the holding period we have got now?

Mr. MAER. One of the popular tax promotion schemes involves the sale to an investor of a group of cows, and he holds those cows for a period of about 5 years, swapping if you will, item No. 3, swapping the male calves for the female calves. The syndicate says this is taxfree but we don't think that is the law. Over the years the taxpayer builds up a large herd of females, and at the end of 5 years he sells out at capital gains.

We believe increasing the holding period from 1 year to 2 years will take most of the tax profit out of that deal, because by arithmetical progression the biggest increase in females occurs in the last 3 years, and so the 2-year holding period would knock out the last 3 years' calf crops.

Senator MILLER. Would that be the only way you could handle that kind of a syndicate operation?

Mr. MAER. Probably not; but it was our thought that this would be a way to get at it directly.

Senator MILLER. That would get at some of it certainly, and it would get at the largest volume perhaps, but I am troubled about this holding period. I have visions of the hog people getting a little unhappy, and if we start making different holding periods for different types of animals, I think we can have a real problem.

Mr. MAER. That certainly is a problem, and of course our proposal did not apply to other than cattle and horses.

Senator MILLER. Yes; but you didn't mention hogs.

Mr. MAER. No; hogs would remain at the current holding.

Senator MILLER. That is right, and you would end up with a different holding period.

Mr. MAER. Correct.

Senator MILLER. You could get into a problem when you start building up different holding periods. I don't know how your recommendations for 24 months would fit with the horse breeders who have been testifying here. You were just talking about the holding period from date of birth, I suppose.

Mr. MAER. That is correct, as under existing law.

Senator MILLER. Whereas they are concerned about any holding period from the date it is converted into a capital asset, so yours wouldn't probably meet as much objection, if any. Have you had a chance to talk to the horse people on it?

Mr. Maer. Yes. We have had a number of conversations with the horse people. I don't know just exactly how they would react to our particular proposal, because of course their reaction is to the Ways and Means Committee bill, so I wouldn't want to speak for the horse people as to whether or not they would favor our provision or not, but I might say just one other thing if I might, Senator Miller.

One of the reasons for limiting our recommendation to a 2-year holding period is again a problem of enforcement. Once an animal passes 2 years, as you well know, of course, coming from Iowa, they become stabilized in weights, and the way that the revenue agents are able to check the age of an animal for holding period purposes, for instance, is generally to look at the bill of sale, and the invoice from the commission house as to what a particular lot of animals weigh. When you increase the holding period to 3 or 4 years, these animals are going to weigh substantially the same amount and you are not going to be able to identify them so it is going to increase the enforcement problem.

Senator Miller. One last question. I am sure you heard Senator Metcalf's testimony this morning. What gives you trouble with the Metcalf approach, if you have any trouble with it, with this proviso for a 3-year carryback and a 5-year carryover?

Mr. Maer. One of the problems we have with that, of course, is the complexity of it. Admittedly we are currently operating on a 3-year net operating loss carryback and carry forward, and to that extent, we are accustomed to it. But we feel that the so-called relief in the Metcalf provision is really more apparent than real, because of the difficulty of keeping records, just the general complexity of it.

We don't think that it is really a practical solution to the problem.

Senator Miller. You mentioned difficulty of keeping records. I don't know what records, additional records you would have to keep, unless you are talking about the keeping of records to take advantage of the 3-year carryback or the 5-year carryover. I don't think you were referirng to those records; were you?

Mr. Maer. Yes; to a certain extent.

Senator Miller. Taxpayers should certainly keep their tax returns for 3 years back at least. as you well know. As a matter of fact, it is ordinarily safe to keep them back, say, for 5 years. I don't know why that should be because any difficulty, at least for 3 years back. Understand I am all for avoiding undue recordkeeping on the part of farmers and ranchers, but I can't see that that is going to require them to keep any more than they are keeping. What I am concerned about is that I can see where the Metcalf bill, by exempting the accrual basis farmer, might cause some farmers to say, "Well, we had better get into accrual basis of accounting as a precaution," although to the extent that he replied to that point this morning I thought that it wasn't so bad. I don't like to see them forestall a cash basis or even particularly be encouraged indirectly to be taken off the cash basis, but I have the feeling that his 3-year carryback and 5-year carryover provision did a pretty good job of protecting the people who incur these losses, especially when in addition to that, you recognize losses due to market conditions and drought and all the kinds of situations that you people are familiar with.

Mr. Maer. Let me make two comments on that, on the last one first, regarding market conditions.

My understanding of Senator Metcalf's bill is that it would not protect a taxpayer, a farmer, against a drop in the price, a mere drop in the price of animals.

Senator MILLER. Not unless he sold.

Mr. MAER. Well, even if he sold them, the only exemptions, as I read the bill, and I could be wrong, is for casualty losses or drought losses or items of that nature. Let us just take a case. Let us just say that it costs this rancher 25 cents to raise this steer, 25 cents a pound, and as long as the steer is selling for 27 cents and 30 cents, he is going to make a profit. But if the market drops, and if he sells this animal for 20 cents he has realized a loss, and I don't see how Senator Metcalf's bill would exempt that loss.

Senator MILLER. Well, in my first reading of the Metcalf bill I reached the same conclusion, but his testimony this morning, in answer I think to Senator Byrd's question, indicated that he was thinking in terms of allowing losses where you have sales of the animal, and that seemed to me to be a fairly reasonable——

Mr. MAER. That is exactly what he said, but it doesn't comport with my understanding of the way his bill reads.

Senator MILLER. Suppose the bill were changed to cover that so that that is exactly what the bill says. Then it seems to me that we have all these contingencies that your people are concerned about, drought, disease, rain storms, flood, pestilence, market conditions, and then a 3-year carryback and a 5-year carryover. I don't know why that wouldn't be thoroughly fair.

Mr. MAER. I would like to comment on the carryover in just a minute, but let me just say this. It would seem to me that if the market price changes are taken into consideration in the Metcalf bill, or just market prices period, then that would not eliminate the tax profit taker, because he could go in and he wouldn't care what he spent to raise these animals or to operate his farm, so that there would be no incentive to keep his costs down, because if his costs are high and he sells low, as long as he sells he has a loss deducted against his ordinary outside income.

Senator MILLER. Oh, no. According to Senator Metcalf it would be deducted against farm income 3 years back and 5 years over.

Mr. MAER. We are talking about two different things. You are exactly right as far as the carryover and carryback is concerned. That is my understanding once you establish a farm loss excluding all of the exemptions. But the point I was making is that if you exclude as true economic loss the fact that he is selling for less than it costs him to raise in the taxable year, then that is an exempted economic loss, and could be deducted against outside income in the taxable year. That was the point I was trying to make.

Therefore it would seem to me that this would not get at the tax profit taker, because he would go in and wouldn't care what he paid to raise his animals, to improve his farm, or to do all these things. He could deduct these expenses against his income in that year, since they are treated as economic losses. But you are exactly right as far as the carryover carryback is concerned. That would apply only against farm profits as I read his bill.

Senator MILLER. Yes. It seems to me that when we have such a period of time as 8 years that we are getting at 8 out of 9 years we may be getting at the bulk of the problem.

Mr. MAER. May I comment on that? Let us make an analogy here that when you talk about agricultural crops, that seed is planted in the soil, is harvested within the year or less, and in reality the soil is your factory. But whereas in livestock we must first of all grow the factory, and that takes 18 months to 2 years. Mares, although I am not too familiar with the horse business, may take perhaps 3 years. Then it takes another 2 years to harvest the first crop. So that you are looking at at least 5 years of start-up losses in the livestock business, and so you are cutting it pretty thin, if you just give him a 5-year carry forward.

Senator MILLER. On that point, you remember my dialog with the last group. If you have a beginning business you can have no benefit from a 3-year carryback, then let him have an 8-year carryover.

Mr. MAER. Yes; that would certainly be an improvement, but the only other comment I would make on that is this, of which I am sure the Senator is well aware. Generally in the livestock business we look at a 11-year cycle, that on the average, in 11 years you are going to reach the peak, and the valley and the peak again, so that to get a full benefit, it would seem to me of a complete economic cycle, we should probably consider even more than 8 years, perhaps even as long as 11 years.

Senator MILLER. And in that case we might have an administrative problem.

Thank you very much.

Senator CURTIS. You gentlemen have made a good presentation here. We could go on longer very well, but with nine witnesses to hear yet, it is 6:15, we thank you very much for your presentation. If there is anything further that you want to add, why, we will be glad to receive it for the record.

Mr. MAER. Thank you, sir.

Senator MILLER. Mr. Chairman, may I make an observation. I think it might be helpful to the witnesses. It has been brought to my attention by the staff that in the Metcalf bill on page 7, paragraph (E), under the category of recognized losses for the purpose of the exceptions is the statement, "recognized losses from sales, exchanges, and involuntary conversions." That might be what the Senator was relying upon in his response to Senator Byrd.

Thank you.

(Claude M. Maer, Jr.'s prepared statement follows:)

STATEMENT OF CLAUDE M. MAER, JR., ON BEHALF OF NATIONAL LIVESTOCK TAX COMMITTEE

The National Livestock Tax Committee feels that certain provisions of H.R. 13270, namely those dealing with an Excess Deductions Account (EDA), a Hobby Loss Presumption, a Limit on Tax Preferences (LTP) and an Allocation of Deductions, are unnecessary and are contrary to the basic objectives of a sound and equitable tax system. These unneeded provisions of H.R. 13270 unfairly discriminate between farmers and ranchers based upon accounting systems used and the size of losses sustained; impose restrictions on capital gains claimed by persons only in agriculture and classify only certain losses from farming, but not from any other business, as "tax preferences"; and make compliance with and enforcement of these unneeded provisions unworkable and in some instances practically impossible.

The Tax Committee is of the opinion that fair and equitable tax treatment of ranch and farm businesses can be achieved by adoption of the proposals made by the Tax Committee which were included in the House bill (in somewhat modified form). These proposals will eliminate the relatively small amount of tax profiteering and will not substantially harm the industry in that they are simple and easy to appy and will not require complicated cost accounting techniques. Furthermore, these proposals of the Tax Committee will not have the effect of: discouraging farmers and ranchers from diversifying into non-farm businesses and investments; isolating agriculture from the rest of the nation's economy; impeding needed agricultural programs; stemming the flow of needed new blood and capital into the industry; and causing meat price increases, as would undoubtedly be the case if the unneeded farm loss provisions of H.R. 13270 were enacted.

I. INTRODUCTION

My name is Claude M. Maer, Jr. I am a partner of the law firm of Holland & Hart, Denver, Colorado, which is and has been counsel for the National Livestock Tax Committee for many years. The National Livestock Tax Committee is a non-profit corporation organized and operating for the purpose of maintaining and assuring equity and equality in the field of federal income, gift and estate taxation for the entire livestock industry, not only beef cattle, but also sheep, horse and dairy interests. The Tax Committee was first formed in 1942 and has been active continuously since then. The Committee is sponsored by 6 national, 11 breed and 45 state associations representing roughly 300,000 individual farmers and ranchers throughout the fifty states. The following is a list of the Tax Committee's sponsors:

National and breed sponsoring organizations:

American Angus Association
American Brahman Breeders Association
American Guernsey Cattle Club
American Hereford Association
American International Charolais Association
American Jersey Cattle Club
American National Cattlemen's Association
American Polled Hereford Association
American Quarter Horse Association
American Shorthorn Association
Holstein-Friesian Association of America
International Brangus Breeders Association
National Society of Live Stock Records Association
National Wool Growers' Association
Pony of the Americas Club, Inc.
Santa Gertrudis Breeders International
Thoroughbred Owners and Breeders Association

State sponsoring organizations:

Alabama Cattlemen's Association
Arizona Cattle Feeders' Association
Arizona Cattle Growers' Association
Arizona Wool Growers' Association
Arkansas Cattlemen's Association
California Cattle Feeders' Association
California Cattlemen's Association
California Wool Growers' Association
Colorado Cattlemen's Association
Colorado Wool Growers' Association
Florida Cattlemen's Association
Georgia Livestock Association
Hawaii Cattlemen's Council
Idaho Cattlemen's Association
Idaho Wool Growers' Association
Kansas Livestock Association
Louisiana Cattlemen's Association
Maryland Beef Cattle Producers, Inc.
Mississippi Cattlemen's Association
Missouri Cattlemen's Association
Montana Stockgrowers' Association
Montana Wool Growers' Association
Nebraska Stock Growers' Association

Nevada State Cattle Association
Nevada Wool Growers' Association
New Mexico Cattle Growers' Association
New Mexico Wool Growers' Association
New York Beef Cattlemen's Association
North Carolina Cattlemen's Association
North Dakota Stockmen's Association
Oklahoma Cattlemen's Association
Oregon Cattlemen's Association
Oregon Sheep Growers' Association
South Dakota Stock Growers' Association
Tennessee Livestock Association
Texas and Southwestern Cattle Raisers' Association
Texas Sheep and Goat Raisers' Association
Utah Cattlemen's Association
Utah Wool Growers' Association
Virginia Beef Cattlemen's Association
Washington Cattlemen's Association
Washington Wool Growers' Association
Western South Dakota Sheep Growers' Association
Wyoming Stock Growers' Association
Wyoming Wool Growers' Association

II. PROPOSALS OF NATIONAL LIVESTOCK TAX COMMITTEE

Earlier this year when hearings on various tax reform proposals were held by the House Ways and Means Committee, the National Livestock Tax Committee presented a statement and testimony on the subject of proposed changes in the federal income tax laws affecting livestock and other agricultural operations. At the request of members of the House Ways and Means Committee, the National Livestock Tax Committee agreed to work with the staff of the Ways and Means Committee in proposing several changes in the livestock tax laws which would eliminate tax profiteering in the industry which is caused by a few persons who enter the business on an in-and-out basis with the only intention being of making a tax profit as opposed to an economic profit.

After an in-depth study of this situation, the National Livestock Tax Committee submitted certain proposals which would help eliminate tax profit schemes in agricultural operations while at the same time provide fair and equitable tax treatment for the whole agricultural industry. These proposals were: (1) apply the depreciation recapture rules of section 1245 of the Internal Revenue Code to purchased livestock used for draft, breeding, dairy or racing purposes; (2) extend the holding period of cattle and horses from 12 months to 24 months in order to qualify for capital gains treatment under section 1231 of the Internal Revenue Code;[1] (3) clarify that male calves or steers cannot be traded tax-free for female calves or cows; (4) require a taxpayer to prove the purpose for which he held livestock in addition to proving the length of time the livestock were held to qualify for capital gains; and (5) establish a sliding scale recapture of land improvement expenses when farm or ranch land is sold within ten years after its acquisition.

III. CERTAIN PROVISIONS OF H.R. 13270 (TAX REFORM ACT OF 1969) PERTAINING TO FARM LOSSES ARE NOT NECESSARY AND ARE CONTRARY TO OBJECTIVES OF AN EQUITABLE AND SOUND TAX SYSTEM

Following hearings on proposed tax reform, the House Ways and Means Committee reported to the House of Representatives its recommendations on tax reform, which recommendations were subsequently passed by the House as H.R. 13270. This bill contained a number of the suggested proposals of the National Livestock Tax Committee, although some of these proposals had been modified. However, H.R. 13270 included several additional provisions pertaining to livestock taxation which went considerably further than the proposals offered by the National Livestock Tax Committee. These additional provisions, all of which relate to farm losses, include an Excess Deductions Account (EDA),

[1] Exempted from this increased holding period requirement would be animals subject to involuntary conversion due to drought or disease, since the premature disposition of such animals results from circumstances beyond the taxpayer's control.

a Hobby Loss Presumption, a Limit on Tax Preferences (LTP), and an Allocation of Deductions. The Tax Committee feels that these additional provisions (hereinafter sometimes referred to as "unneeded provisions") go much too far, are not necessary to prevent tax profiteering, and are contrary to the basic tenets and objectives of an equitable and sound tax system.

A. Objectional Provisions Unnecessary

These unneeded provisions of H.R. 13270 are not necessary for purposes of preventing tax-profiteering, result in an "overkill" approach, would create complexity and confusion throughout the industry, and would cause changes in the overall economics of the livestock industry, all of which would cause serious harm to the entire livestock industry. Unlike the proposals of the National Livestock Tax Committee which single out and clamp down solely on the few persons engaged in tax profiteering in the industry and which provide fair and equitable tax treatment for the whole industry, these unneeded provisions of H.R. 13270 would apply on a broad scale to all livestock operators. In short, these unneeded provisions would "burn down the barn to catch a few rats."

B. Reason these Provisions Objectionable

It is the position of the National Livestock Tax Committee that the essential and basic objectives of an equitable and sound tax system are: (1) to raise revenue; (2) to treat all taxpayers engaged in the same business fair and equitably; (3) to treat all taxpayers in the entire business community fair and equitably; and (4) to provide for efficient and workable compliance and enforcement. The Tax Committee feels that these unneeded provisions of H.R. 13270 are contrary to all of these essential rules.

1. *Not Intended to Raise Revenue*

In the so-called "farm loss provisions" of H.R. 13270, which encompass EDA, Hobby Loss Presumption, depreciation recapture for livestock and increased holding period requirements for livestock, the House Ways and Means Committee Report estimates that all of these provisions would increase revenue by the relatively insignificant sum of $5 million in 1971.

Back in 1963, when the Treasury Department first proposed EDA, it was estimated that EDA alone would yield only $5 million per year in tax revenue. But it is now estimated, nine years later, that all of these "farm loss provisions" would increase revenues by just $5 million. This statement by itself refutes the claim of increasing tax profiteering that allegedly has caused a great loss of tax revenue and evidences the desire to extend these "farm loss provisions" across the board to all farmers and ranchers and not restrict tax reform to eliminating tax profiteering as do the propsals of the National Livestock Tax Committee. Yet, the announced intention of these "farm loss provisions" is to stop the practice caused by "some high-income taxpayers who carry on limited farming activities as a sideline to obtain a tax loss which is then deducted from their high-bracket, non-farm income".

2. *Treats Farm and Ranch Taxpayers Unfairly as Between Themselves*

a. EDA: (1) *Corporations, Trusts and Estates Hardest Hit.*—As written, EDA would apply to all farmers and ranchers on the cash method or using presently acceptable accrual methods of accounting[2] who incurred farm losses or who acquired certain farm property already subject to previously accumulated farm losses. However, no additions would have to be made to EDA by taxpayers operating as *individuals* unless non-farm income exceeded $50,000 and only to the extent farm losses were in excess of $25,000. *All* farm losses incurred by other taxpayers (i.e. corporations, trusts and estates) would generally be added to EDA without these limitations.

Thus, hardest hit by these provisions of EDA would be the numerous small and medium-sized family-owned corporations, trusts and estates engaged in farming or ranching which have even small amounts of non-farm income. Such taxpayers would be unduly penalized just because they received non-farm income, such as rentals, royalties, or other business income, and as other businesses, combine all income and losses from whatever source earned in computing their taxable income.

(2) *Imposition of Burdensome Record Keeping Requirements.*—Furthermore, farmers and ranchers who remained on the cash basis or used presently accepta-

[2] See discussion beginning on p. 16.

ble accrual methods would be required to compute losses each year and maintain a separate EDA. To all of these operators, this would be very troublesome and in many cases virtually impossible because of the complexities involved. Even to those legitimate operators who have access to reliable outside record keeping and tax assistance and can afford to pay for such services, this would impose an additional cost and further reduce their already small margin of profit.

In 1952, the Secretary of the Treasury presented to the Congress a proposal[8] to modify the cash basis so as to require capitalization of all costs of raising breeding herd livestock. At that time, the Tax Committee pointed out the practical necessity for simple accounting methods and Congress agreed by failing to act on the Treasury's contention. There has been no substantial change in conditions which would require or warrant a different approach today.

(3) *Capital Gains Denied.*—In addition to discrimination based upon what form of accounting system was employed and in what form the livestock business was operated, EDA would also categorize individual farmers or ranchers as being "undesirable" by limiting capital gains on the sale of their farm property if they were in a certain non-farm income bracket and sustained farm losses over $25,000. Singling out such farmers and ranchers for this type of treatment even though they are legitimate operators seems most unfair.

(4) *Full Deductibility of Interest and Property Taxes Denied.*—EDA would further and unjustly injure those taxpayers who have borrowed money to obtain working capital for the operation or purchase of farms or ranches, since the interest paid on these loans would increase farm losses. Taxpayers in debt would be discriminated against and persons would be discouraged from entering the industry on a legitimate basis by acquiring farms or ranches subject to a mortgage. Moreover, higher and higher property taxes would also swell the EDA and thus reduce their full deductibility by reason of the required offset of EDA against capital gains.

(5) *Sales of Farm and Ranch Property Hit—Conservation Discouraged.*—In addition to restricting capital gains on the sale of livestock and other farm assets, EDA would tax gain realized on the sale or exchange of farm and ranch land at ordinary income rates, instead of at capital gains rates as under present law, to the extent of land clearing and soil and water conservation expenses deducted during the current taxable year plus the four previous taxable years. As with other provisions of EDA, this would only apply to farmers and ranchers using the cash basis or presently acceptable accrual methods of accounting. This provision not only represents bad economics and bad agricultural policy, but it also would discourage needed and continuing conservation projects which are so vital to the industry. The adverse repercussions such provision could have on the reduction or termination of needed conservation projects would also be felt by other businesses connected with the promotion and operation of such projects and by the consuming public dependent on agricultural products.

b. *Hobby Loss Presumption*—(1) *Would Disallow All Farm Losses to Certain Farmers and Ranchers.*—If farm losses exceeded $25,000 for any three of five consecutive years, even a legitimate farmer or rancher who has been in the business all his life would be presumed to be a "hobby farmer" and *all* his losses could be disallowed under the Hobby Loss Presumption provision of H.R. 13270. This provision would apply to all taxpayers, whether doing business as individuals or in corporate form.

The cyclical nature of farming and ranching, the adverse effect of climate and weather, sporadic and unstable market prices, and continually rising production costs could easily result in farm losses incurred by many legitimate operators exceeding $25,000 for any three of five years. No exceptions or exclusions would be made for death or casualty losses or certain fixed expenses such as taxes and interest.

Thus, a farmer or rancher who sustained losses in excess of $25,000 for any three of five years because of drought, blizzards, falling livestock prices, and increasing operational costs could have *all* his losses disallowed while his neighbor who sold his livestock at a different time or escaped the full blow of adverse weather conditions and had losses of $24,999 for this period would not be subject to the disallowance of such losses under this provision.

[8] Special letter from the Secretary of Treasury to the Chairman of the Senate Finance Committee dated June 27, 1952, 98 Cong. Rec. Pt. 6, p. 8207, 1952 CCH Fed. Tax Rep. ¶ 6230.

(2) *Could Cause Lumping of Income Tax.*—Farmers and ranchers whose farm losses were disallowed under this Hobby Loss Presumption could find their income taxes greatly increased in one year as a result of disallowance of farm losses in prior years. As previously explained, this could apply to and cause a terrific hardship to a farmer or r. ncher who because of factors beyond his control, such as adverse weather conditions, increasing costs or low market prices, had losses in excess of $25,000, while his neighbor with $24,999 of losses would not be subject to such disallowance. Under these circumstances, the farmer or rancher with the disallowed losses could discover that the increased income taxes resulting from the disallowance of such losses in prior years greatly increased his taxes in one particular year. Securing the necessary funds to pay these additional taxes could present a very serious problem to such farmer or rancher.

(3) *To Rebut Presumption Would be Time-Consuming and Expensive.*—To try to rebut the presumption that the farm or ranch was not operated with a profit motive would be both time-consuming and expensive and could even be a recurring event. Furthermore, the uncertainty caused by this provision whereby a farmer or rancher may be treated as a "hobby operator" one year and all his farm losses denied, and as a "legitimate" operator the next year, would be very disruptive and create great uncertainty throughout the whole industry. Because of changing and variable conditions previously noted, a farmer or rancher might be presumed to be a "hobby operator" and *all* his losses disallowed necessitating lengthy and costly protests or litigation, whereas his neighbor whose losses were just a few dollars less would escape this presumption and not have to go to the added expense of contesting the presumption.

c. *LTP and Allocation of Deductions*—(1) *Would Classify Farm Losses of Some Taxpayers as "Tax Preferences."*—Farmers and ranchers (individuals, trusts and estates) on the cash basis or using presently acceptable accrual methods of accounting[4] would generally be subject to additional tax liability and/or to a reduction of personal itemized deductions if certain of their farm losses exceeded $10,000 under the LTP and Allocation of Deductions provisions. In such cases, farm losses would be termed "tax preferences". This would result in different tax treatment for farmers and ranchers based upon the system of accounting they used. In addition, there would be further discrimination between farmers and ranchers on the cash basis or using presently acceptable accrual methods who had certain farm losses under $10,000 and those who had farm losses exceeding this amount.

(2) *Would Adversely Affect Some Farmers and Ranchers but not Others.*—Farmers and ranchers would be caught in an ignominous vise under these provisions in that capital gains realized on the sale of farm assets would not be considered in determining farm loss "tax preferences" although the deductible portion of such capital gain would be treated as another "tax preference" resulting in increased income taxes and restricting itemized personal deductions. Also, death and casualty losses and fixed operational expenses such as interest and taxes would not be deleted from the formula in computing farm losses. In application this would mean that, as under EDA and the Hobby Loss Presumption provisions, farmers and ranchers who fell in hard times or sold their livestock when prices were low would be penalized while neighboring farmers and ranchers who were lucky and escaped these catastrophies would not be subject to additional tax or to a reduction of their itemized personal deductions.

3. *Singles Out Farmers and Ranchers for More Adverse Treatment than Taxpayers in Other Businesses*

a. *EDA*—(1) *Would Restrict Capital Gains on Livestock and Farm Property.*—The principle and provisions of EDA—restricting capital gains treatment of livestock and other farm property—are harmful to most farming and ranching operations, large and small, and would be a most serious blow to the whole livestock industry. This EDA provision constitutes discrimination against farming and ranching. No other businesses are singled out in like manner for such treatment. Yet, livestock are still selling at below parity prices.

(2) *Would Recapture Certain Conservation Expenses at Ordinary Income Rates When Farm or Ranch Land Sold.*—Under EDA, gain realized on the sale of farm or ranch land would be subject to taxation at ordinary income rates, instead of at capital gains rates as under present law, to the extent of land clearing and soil and water conservation expenses deducted in the 5 years prior to the sale. Yet, no

[4] See discussion beginning on p. 16.

other business is subject to such restrictions on the sale of its land used in business operations. Moreover, the Congressional policy of providing farmers or ranchers under present law with the right to deduct these expenses in order to foster and encourage conservation projects would be abrogated.

b. *Hobby Loss Presumption—Would Appear to put "Hobby" Label on Agricultural Operations.*—Including the Hobby Loss Presumption section under the "farm loss provisions" of H.R. 13270 appears to be an attempt to place the tag of "hobby" on the agricultural industry and subject it to unreasonable and deleterious tax provisions. Yet, agriculture today is big business and remains near the top in size of all businesses in the country.[5] More importantly, it is one of the most vital of our nation's industries, for a country without adequate supplies of food and fiber would soon cease to exist. In this regard, it should also be recognized that agricultural operations require vast amounts of capital and are not entered into by the great majority of taxpayers just to lose money, as this provision of H.R. 13270 erroneously implies.

c. *LTP and Allocaion of Deductions—Would Unjustly Single out Farm Losses as "Tax Preferences".*—The Limit on Tax Preferences (LTP) and Allocation of Deductions provisions of H.R. 13270 unfairly label certain farm losses as "tax preferences". Yet, losses from no other *business* are termed or treated as "tax preferences" under these provisions of H.R. 13270.

Farming and ranching are one of the highest risk businesses in the country. The vagaries of weather, an unstable and sometimes non-existent labor force, and unsteady market prices make the farming and ranching business subject to elements beyond its control not experienced by any other industry. Under these conditions, and considering the absolute dependency of the nation's health on an adequate supply of food and fiber, it is not only dangerous tax policy but also precipitous agricultural and economic policy to term farm losses as "tax preferences" when all but a very few persons in the country are legitimate operators.

d. *Farming and Ranching Subject to Specific and General Provisions.*—Farming and ranching, with possibly only one or two exceptions, is the only business that is singled out for both special and general tax treatment under H.R. 13270. The so-called "farm loss" provisions of H.R. 13270 apply specifically to all agricultural operations. Yet, certain farm losses are also treated as "tax preferences" under LTP and Allocation of Deductions. The singling out of agriculture for this sort of dual treatment appears to be an unreasonable discrimination against farming and ranching.

4. *Compliance and Enforcement will be Neither Efficient nor Workable*

a. *New and Difficult Accounting System Prescribed for Livestock Industry*—(1) Livestock Operators Discouraged To Use Cash Basin and Presently Acceptable Accrual Accounting Systems.—Under EDA, it is provided that farmers and ranchers who use a "proper" accrual method of accounting (i.e. "by using inventories and by charging to capital account all expenditures chargeable to capital account" which can under present law be either deducted currently or capitalized) would in general not be subject to the provisions of maintaining an excess deductions account under EDA. This could have the tendency of forcing many farmers and ranchers on to this impossibly complex "proper" accrual system. In any event, this would pose a Hobson's choice to farmers and ranchers who would have to decide between maintaining a complex accounting of farm losses by establishing an excess deductions account and being subject to the restrictions spelled out under EDA or employing the even more complex "proper" accrual system and not being permitted to deduct certain expenses as under present law. Similarly, under the LTP and Allocation of Deductions provisions of H.R. 13270, all farmers and ranchers operating in other than corporate form and who in general incur farm losses in excess of $10,000 would be forced to use a "proper" accrual system, since if they do not use such accrual system they would be required to keep two sets of accounting records—one on their present method and one on the "proper" accrual method.

Under this "proper" accrual system, it would appear that farmers and ranchers would have to use inventory methods based upon actual costs of raising farm livestock and produce instead of on amounts "which reasonably account for the normal costs incurred in producing the animals" under the unit livestock price

[5] See *Food Costs—Farm Prices,* Committee on Agriculture House of Representatives (90th Congress, 1st Session July, 1967) at 15.

method of the present Treasury Regulations. This would mean that costs of raising crops and livestock would have to be separately computed and would not be deductible until such crops or livestock were sold. Furthermore, the effect of such system would be to abolish in one fell swoop and arbitrarily to deny to farmers and ranchers the important and heretofore Congressionally recognized provisions of the Internal Revenue Code dealing with the deductibility of soil and water conservation expenditures (section 175), fertilizer costs (section 180), and land clearing expenses (section 182).

Most alarming of all is the fact that for the first time in the history of federal taxation of agriculture, Congress has attacked the cash basis method of accounting and also apparently the use of presently acceptable unit livestock price inventory methods, by the suggestion in the House Ways and Means Committee Report that these are not "proper accounting rules". This represents a marked and radical departure as Congress has consistently recognized and sanctioned the use of the cash basis accounting method since inception of the federal income taxes in 1913. Furthermore, the unit livestock price method of valuing livestock using values based upon reasonable estimates of normal costs of producing animals has been sanctioned by the Treasury Department since 1944 as being required by the problems of valuing livestock inventories. It seems both unjust and without merit to deny the time-honored and workable cash basis and the presently-used unit livestock price methods of accounting to legitimate farmers and ranchers, simply for the purpose of eliminating the relatively few tax profiteers, particularly when they can be eliminated by the proposals of the National Livestock Tax Committee.

(2) *"Proper" Accrual Method of Accounting by Livestock Operators is Virtually Impossible to Achieve.*—Due to the nature of and conditions surrounding livestock operations, the Tax Committee is of the opinion that simplified record keeping and accounting methods, such as the cash basis, are absolutely essential. The great majority of farmers and ranchers use the cash basis system of accounting because of its simplicity. Even the cash basis method of accounting is not easy for some farmers and ranchers to maintain. To force cash basis farmers and ranchers on to a "proper" accrual system would be imposing an impossible requirement on most and a burdensome and unnecessary requirement on all.

This "proper" accrual system would be a virtual impossibility even for the most sophisticated accountants. This is due to the fact that it would be impossible for the farmer or his accountant to differentiate between and properly segregate the costs of raising his breeding livestock from the costs of raising animals held for sale, which would be most essential since gain on the sale of breeding animals held for the requisite holding period is taxed at capital gains rates. In many instances, the farmer or rancher is unable to determine for a significant period of time whether to place an animal with his sales herd or to retain it as a member of the breeding herd. Attempting to allocate costs in these circumstances would test the ingenuity of even the most complex accounting equipment. Similar and greater problems would develop where, as is commonly the case, the farming or ranching operation includes the raising of livestock as well as the growing and harvesting of crops and other agricultural activities. To allocate in a proper manner the costs of the overall agricultural business to the multifaceted operations involved would be a nightmare and exercise in futility. In the final analysis, it would be an impossibility.

(a) *Accurate Inventories Impossible.*—Unlike other businesses where the production and sale of merchandise is a significant factor and the "proper" accrual method of accounting is required for income tax purposes, ranching and farming is not the type of business where accurate inventories can be made at periodic intervals and meaningful cost accounting methods employed. On many ranches covering thousands of acres, livestock cannot be conveniently located and inventoried on December 31 of each year or at any other such specific date for accounting purposes. The same would seem to apply equally to other agricultural activities.

A number of the most prominent livestock tax accountants in the country have confirmed to the Tax Committee that it would be a virtual impossibility for the livestock operator to conform to the "proper" accrual method of accounting. Furthermore, these accountants stated that the multiple accounting problems involved in attempting to comply with such a "proper" accrual method would be practically insuperable.

(b) *"Proper" Accrual Accounting Very Expensive.*—Even if the "proper" accrual method of accounting were feasible and could be complied with, this would substantially increase the operational costs of the farmer and rancher which are already at a record level. With such additional costs to cope with, and viewing the already existing thin overall profit margin of livestock operations, it is conceivable that the added burden of increasing the complexity of their record keeping and attendant costs would cause many farmers and ranchers to cease operation.

(c) *Expert Accounting Assistance Not Available.*—Furthermore, in a large number of rural areas there are no accountants, or an insufficient number of accountants, to perform the complex bookkeeping chore that would result from imposition of the "proper" accrual method of accounting on farmers and ranchers. For instance, available statistics published by various accounting societies show approximately less than 20% of the total number of certified public accountants in the continental United States practice in the twenty-one states west of the Mississippi (excluding California), yet those twenty-one states comprise about 67% of the land area of the continental United States. It is in these same states that approximately 64% of the nation's cattle population is located according to U.S. Department of Agriculture statistics, yet it is obvious that competent accounting assistance necessary for accurate accrual reporting would be hard to come by at least in the western states. Even if the services of qualified cost accountants could be obtained, the additional time and expense which would be spent in trying to justify to the Internal Revenue Service or to a court the method of cost allocation used, which would obviously be subject to very close scrutiny, could be most substantial.

b. *Present Law has Built-in Presumption—No Statutory Presumption Needed.*—Replacing present section 270 of the Internal Revenue Code with this new Hobby Loss Presumption provision would not add any extra arsenal for enforcement of present tax law. This is because under present tax law disallowance of any business loss by a revenue agent is already *presumed* to be correct until rebutted by the taxpayer. The fact that the Internal Revenue Service has not fared too well in the farm and ranch "hobby loss" area of litigation is probably due to the unfamiliarity of revenue agents with the essential elements of a legitimate operation. A statutory presumption, such as that created by this new provision, would appear to add nothing constructive to present law. It would merely provide a convenient and speedy means by which an examining agent would disallow *all* losses, regardless of the operator's actual good faith and length of time in the business; and it would substantially increase the time spent by taxpayers and the Internal Revenue Service in extensive tax protests and litigation of such cases.

c. *Cost of Enforcement.*—In the Hobby Loss Presumption provision, no reference is made as to how farm losses are to be computed. Whether such losses will be computed as under present section 270 of the Internal Revenue Code, whether capital gains will be excluded or included and whether farm income will include income from farm land use is not indicated. This lack of direction in this provision will certainly invoke considerable protests and litigation. Furthermore, protests and litigation rebutting the presumption created by this provision will probably be numerous, necessitating a larger staff and additional funds for the Internal Revenue Service.

In addition, protests and litigation resulting from attempts to rebut the presumption created by the Hobby Loss Presumption and from attempts to police and audit the use of a "proper" accrual accounting system, the excess deductions account, and the carryforward and basis adjustments of LTP will probably be numerous, requiring additional personnel and larger administrative funds for the Internal Revenue Service.

As a matter of conjecture, the Tax Committee wonders whether this cost of enforcement will not exceed the small additional revenue which these provisions may raise.

C. General Objections to Unneeded Provisions of H.R. 13270

1. *Would Create Extreme Complexity and Confusion to Livestock Operators.*—Unraveling, comprehending and applying these unneeded provisions of H.R. 13270 would even be a major undertaking for a professional tax adviser. It would be a virtual impossibility for most farmers and ranchers.

The extreme complexities of and the virtual impossibility of farmers and ranchers complying with the "proper" accrual system of accounting under the EDA, LTP and Allocation of Deductions provisions of H.R. 13270, previously discussed, would only serve to add to the confusion of attempting to comply with these provisions.

Further, the right of such farmers and ranchers under LTP to increase the basis of their farm assets in computing gain or loss by the amount of disallowed farm loss "tax preferences", but limited to the basis of such farm assets computed on a "proper" accrual system or determined by use of reasonable estimates of unit costs, would result in unending confusion. Also, the five-year carryforward provisions of LTP with respect to any remaining disallowed farm loss "tax preferences" would create similar problems. The unreasonable requirement of keeping two sets of separate accounting records would also be necessary in order to determine the "proper basis" adjustment for these farm assets in computing gains or losses.

Maintaining an accurate EDA by all farmers and ranchers not on a "proper" accrual method of accounting would entail further and additional record keeping duties and expenses, which a large number of stockmen would be unable to perform or pay for. Preparing income tax returns, much less keeping the type records required under these provisions, would be a monumental task. In short, most farmers and ranchers would just not be able to grasp, understand or comply with these additional and complex complications imposed by these provisions of H.R. 13270.

Because of this complexity and the impossibility of maintaining accurate records and properly allocating costs on a "proper" accrual system, farmers and ranchers would be left to the mercy and whims of individual revenue agents. If past events are any indicator, these agents are usually uninformed of the facets of livestock operations and accounting which portends farther confusion and expense for stockmen should these provisions be enacted.

As one Treasury Official has stated, perhaps H.R. 13270 should be entitled the "Lawyers and Accountants Relief and Pension Act".

Attached hereto as an exhibit is a statment by Mr. N. E. Tamplin, a partner with the accounting firm of Ernst & Ernst, briefly explaining the complexities and confusion which these unneeded provisions of H.R. 13270 would cause.

2. *Would Discourage Diversification by Farmers and Ranchers into Non-farm Businesses*—a. *Farmers and Ranchers Must Diversify.*—For the past several years, because of depressed livestock and crop prices and rising production costs, many farmers and ranchers have had to seek off-farm employment in order to supplement their farm income.

> "The farmer more frequently is moonlighting. The farm housewife more frequently is participating in the nonfarm labor force. Better roads and easier access to town, increasing demand for nonfarm labor in many areas, increasing need for income by farmers themselves, all play a vital role in this trend. Farmers are diversifying, but off the farm, rather than on it."[6]

This indicates that off-farm income has become an increasingly important factor in the lives of farm families. For example, in 1967, farmers received $10.7 billion from non-farm sources. Between 1960 and 1967, non-farm income per farm family more than doubled.[7]

Diversification by legitimate farmers into non-farm activities has become almost a necessity because of the fact that parity is only about 74%. Additionally, it is becoming increasingly apparent that it makes good economic business sense not to have "all your eggs in one basket". Such diversification by long-time legitimate farmers and ranchers in non-farm businesses, of course, means larger off-farm income.

These figures and the move toward diversification show not only the important role non-farm income is presently playing in the farming and ranching economy, but also portend that non-farm income will, as it increases in the future, play even a more vital part in agricultural economic stability.

[6] M. L. Upchurch, Administrator of Economic Research Service, U.S.D.A., Address to Annual Agricultural Outlook Conference on February 18, 1969.

[7] Upchurch, *Ibid.*

b. *EDA Could Discourage Diversification.*—Corporations, trusts and estates engaged in farming or ranching and subject to the provisions of EDA would be discouraged to diversify since the offsetting of *any* farm losses against income from any non-farm source would result in increasing the amount in EDA. Non-farm income could include income from land rentals, royalties, dividends, interest on savings and other similar sources, which are becoming increasingly common to more and more of such legitimate farming and ranching operations.

c. *EDA Could Discourage Thrift and the Investing of Non-farm Income in Livestock Operations.*—When such a typical farm or ranch enterprise has a profitable year resulting perhaps from good moisture and higher selling prices, the prudent operator will want to invest some of the profits so that there will something to fall back on when a bad year comes along. Often this investment of profits is in a non-farm business because of the desire to diversify. The EDA provisions would tend to discourage such investments, since the income from such non-farm investments would swell the amount in EDA to the extent used to offset farm losses.

Furthermore, non-farm income is often plowed back into the livestock operation to make it more effective. By discouraging diversification, such non-farm income would not be available for increasing the effectiveness or productivity of the operation, and with increasing interest rates, many of such legitimate farmers and ranchers might have to terminate their operations if credit sources dried up.

These are just further indications of the economic unsoundness of this particular provision of H.R. 13270.

d. *Existing Government Programs Could be Impaired by EDA.*—By the same token, these EDA provisions fly directly in the face of existing government programs, such as those sponsored by the Farmer's Home Administration, which are designed to encourage farmers to increase their non-farm income. The objects of such programs are to establish non-farm trades and businesses such as recreational uses and thus provide rural communities with services previously unavailable, while increasing non-farm income. As previously explained, the EDA provisions affecting corporations, trusts and estates engaged in farming and ranching would mean that such taxpayers would be discouraged to receive any non-farm income no matter what the source.

3. *Would Isolate Agriculture From Rest of Nation's Economy.*—These unneeded provisions of H.R. 13270 would have the effect of isolating the livestock industry, and agriculture in general, from the mainstream of our country's economy by discouraging needed outside capital from entering the industry and by hindering many existing legitimate farming and ranching operations to remain economically sound by diversifying into non-farm businesses and investments. This would result in a situation which would be very damaging to this industry which constantly needs new blood and new capital and which has heretofore not been discouraged to diversify into non-farm businesses or investments.

Instead of saving agriculture from outside forces which supposedly distort farm and ranch economies, these unneeded provisions of H.R. 13270 would inflict damage on the legitimate operator who is trying to expand his business and remain on the farm, by reducing his supply of available capital and placing restrictions in one form or another on the deductibility of farm losses. It would, in fact, appear to inflict the most severe damage on the small and medium-sized livestock operations which, unlike the large operations, could not afford to comply with or pay the price exacted by these provisions in the form of additional record keeping and professional tax assistance.

4. *Would Impede Vital Agricultural Programs.*—Many research programs in the fields of agricultural production on farms and ranches are in large part supported by funds from non-farm sources.[8] These unneeded provisions of H.R. 13270 would seriously impair these programs which are beneficial to the entire economy, farmers and consumers alike, by discouraging investment and participation in research. The reason these programs reflect losses is for the simple reason that they are not designed to show immediate profitable returns in cash, but are profitable in long-term breed and biologic improvements for the whole industry.

Closely related to these research programs is the vital role played in the livestock industry by purebred operations. These operations, which are analogous to engineering and research departments in certain industrial businesses, are

[8] See Logan, *Evaluating Financial Support of Research Programs, Journal of Farm Economics* (Feb., 1964).

the foundation of the entire livestock industry since they provide the seed livestock for all livestock operation. Because of the extensive research and experimentation involved in these operations, the profit reflected is often very small and in many instances there are sustained losses for a number of years until an improved seed stock animal is developed and recognized by the industry. To restrict or deny the full deductibility of the losses incurred in these operations in any manner, whether by reducing capital gains on the sale of livestock under EDA, by a hobby loss presumption, by increasing taxable income under LTP, or restricting the deductibility of certain itemized personal expenses under Allocation of Deductions, would be unfortunate; it would discourage, and possibly eliminate, the needed flow of capital from non-farm sources into these research programs, and it would have the resultant and adverse effect of restraining the production and development of needed seed stock. Already there seems to be developing a trend away from cow-calf operations to steer operations because of lower operational costs associated with raising steers. This forecasts a far more serious development, since there has to be some entity or group producing seed stock for the livestock industry.

5. *Would Dry Up Needed Sources of Outside Capital and Restrict Entry of New Blood into Industry.*—Enactment of these unneeded provisions of H.R. 13270 would almost certainly place a restriction on the availability of capital for farming purposes from outside sources. This could be severely damaging to agriculture which has been largely dependent upon the availability of outside capital.

a. *Large Amounts of Outside Capital Necessary.*—Livestock operations need large amounts of capital to begin and continue operations, and very often this capital is not available from the farmer's or rancher's own resources or borrowings. Thus, attraction of outside capital always has been important to the livestock industry. Any law, such as these unneeded provisions of H.R. 13270. which would discourage new capital investment, could prove catastrophic to the whole industry. Productivity could decrease, operation costs would increase, husbandry and agricultural practices would deteriorate, and local communities and other businesses would disappear. The entry of new capital into the livestock business, particularly in the western states, has a long historical background.[9] American agriculture was built largely by outside capital. It is this capital which makes efficiencies resulting in the United States being the most productive agricultural nation in the world.

Further, it should be recognized that the small and medium-sized family farm or ranch is having its hardest financial time in history.[10] The increased cost of machinery, supplies, feed, and such other necessary products and equipment is such that a small operation cannot justify it. For this reason, many such operations are amalgamating with the assistance of outside capital and thereby developing efficient and larger units over which the costs of operation can be more economically spread. To effect this, such farmers and ranchers need and are entitled to operate under the tax laws without these detrimental provisions.

b. *Essential Flow of New Blood into Industry Would Be Stifled.*—The average age of a farmer today is about 55. With expanding and lucrative opportunities in other businesses, agriculture has not kept pace with encouraging new people to enter the industry on a legitimate basis. With an average rate of return on capital investment of between 1% and 3% (and in certain areas of the country the rate of return is below 1%).[11] there need to be *incentives* not barriers placed in the way for such new people to come into agriculture. Instead of creating such essential incentives, these unneeded provisions of H.R. 13270 erect barriers. Start-up costs for any legitimate livestock operation could and usually do result in losses for the initial years of operation, subjecting the operations to some if not all of these unwarranted and deterimental provisions of H.R. 13270.

In addition, these unneeded provisions of H.R. 13270, in combination or in single application, would make it virtually impossible for a person to borrow sufficient capital to purchase a farm or ranch or to acquire a farm or ranch subject to a mortgage. This is because the interest on the mortgage and the higher and higher property taxes being levied against agricultural property would increase farm losses. Under EDA, this could result in reduction of the full deductibility of such expenses by reason of the required offset of EDA against capital gain. Under

[9] See Gray, *Ranch Economics* (1968).

[10] See generally *Food Costs—Farm Prices*, Committee on Agriculture House of Representatives (90th Congress, 1st Session, July, 1967).

[11] Based upon compilation of studies conducted by U.S. Department of Agriculture, national livestock associations, and colleges and universities.

the Hobby Loss Presumption, it could result in *all* farm losses being disallowed if they exceeded $25,000 for any three of five consecutive years, as they well might in the initial years of operation. Under LTP, these losses could result in increasing the taxable income of the farmer or rancher. Under Allocation of Deductions, these losses could cause the reduction of the farmer's or rancher's itemized personal deductions.

6. *Could Result in Substantial Meat Price Increases to Consuming Public*—a. *Livestock Currently Produced at Low Prices.*—Improvement of livestock breeds through dedicated research programs, as previously noted, has produced overall meat prices at lower prices to the consuming public than practically anywhere else in the world. However, the livestock business receives no governmental subsidy for raising meat. The livestock producer operates as an individual with no bargaining power and is unable to set the price at which he buys or sells his livestock. As a matter of fact, livestock producers who are still operating at below parity prices subsidize the consumers. Still, the livestock business, because of its high capital investment requirements and slim profit margins caused by increasing operational costs and fairly static livestock prices, receives one of the lowest returns on its investment of any business.

b. *Food Costs Presently a Bargain.*—Under the present income tax system, and notwithstanding the distressed economic condition of the industry, American agriculture has done an outstanding job in fulfilling the nation's food and fiber needs. In fact, food and fiber have been supplied by the industry to the consuming public at bargain prices. This is evidenced by the fact that according to the American Meat Institute Bulletin of May 20, 1969, the working man today spends 17% of his income for food, whereas 20 years ago he spent 26% of his income for food. In contrast, the average family in Italy spends about 38% of its disposable income for food, and Peruvian and Russian families spend about 56% of their income for food.

Even in light of these bargain food prices for the American public, operators are still receiving prices below parity for their livestock. Until the slight upsurge in livestock prices a few months ago, livestock prices were about the same as 20 years ago[12] although production costs have increased by about 105%.[13] As a matter of fact, since 1950 livestock prices received by operators were on the average *below* the total costs of production for most of these years.

c. *Provisions of Act Could Increase Meat Prices.*—Enactment of these unneeded provisions of H.R. 13270 could well result in a substantial increase in meat prices to the consuming public. By discouraging the entry of needed outside capital and new blood into the industry and by driving many small and medium-sized operators out of the business, it is very likely that as a result of these provisions, livestock numbers will be substantially decreased, causing a corresponding rise in meat prices.

IV. SOME SECTIONS OF H.R. 13270 ARE SIMILAR TO PROPOSALS OF NATIONAL LIVESTOCK TAX COMMITTEE AND WOULD PREVENT TAX PROFITEERING WHILE NOT HARMING LIVESTOCK INDUSTRY

Included in H.R. 13270 are two specific provisions extending depreciation recapture rules to livestock and increasing the holding period for livestock to qualify for capital gains treatment. The provision on depreciation recapture is the same as one of the proposals offered by the National Livestock Tax Committee, while the provision relating to an increased holding period for livestock has been modified slightly from that proposed by the Tax Committee.

A. Depreciation Recapture Rules Applied to Livestock

Depreciation allowed or allowable on purchased livestock used for dairy, breeding or racing purposes would, under the provisions of H.R. 13270, be subject to the depreciation recapture rules of present law, as are all other similar business assets. This would mean that gain realized on the sale of such livestock would be taxed at ordinary income rates to the extent of depreciation claimed or allowable on such animals, and the remainder of the gain, if any, would be taxed as capital gains, if holding period requirements had been satisfied.

The Tax Committee feels that this proposal is fair and equitable in that it equalizes the tax burden among livestock operations and other businesses and since it will discourage the entry of tax profiteers into the livestock industry.

[12] See *Food Costs—Farm Prices,* Committee on Agriculture, House of Representatives (90th Cong. 1st sess. July, 1967).

[13] See Agricultural Statistics, U.S. Departmnet of Agriculture Table 695 (1967), Table 684 (1968).

B. Increase in Holding Period for Livestock

H.R. 13270 provides that, in order to qualify for capital gains treatment, the holding period required for livestock held for draft, breeding and sporting or dairy purposes will be at least 365 days after such animal normally would have been used for any of such purposes.

The Tax Committee feels that, although some modifications are called for, this proposal in the main is fair and equitable and will help prevent tax profiteering.

Such modifications would include a clarifying provision that the use of animals for breeding, dairy or racing purposes from which the 365-day holding period is measured, shall be based on the time in each taxpayer's own operation that such use normally commences. This will assure equitable treatment of all farmers and ranchers, since the first use of animals for such purposes normally varies from region to region and from farm to farm within a given region.

The second modification which would be included is that there be a presumption of First In, First Out, as under the present unit livestock price method of inventorying livestock if the animals are not individually identifiable (as in most commercial range operations). Such presumption would assist in determining the age of raised livestock, since such age is difficult to determine by weight (method commonly used) after an animal exceeds two years of age. Inclusion of such a provision would also make administration of this provision easier and more effective, including verification of returns by revenue agents.

A third modification would be to exempt from this increased holding period requirement, as does the proposal of the National Livestock Tax Committee, animals subject to involuntary conversion due to drought or disease. The reason for this exemption is that premature disposition of such animals results from circumstances beyond the taxpayer's control.

C. Proof of Intention for Holding Livestock

One of the proposals suggested by the Tax Committee was that to claim capital gains on the disposition of livestock, a taxpayer be required to prove the purpose for which he held the livestock in addition to showing the length of time they were held. In adopting this proposal, the House Ways and Means Committee Report refers to the fact that ". . . the mere satisfaction of the holding period requirement in the case of livestock should (not) . . . be considered to conclusively demonstrate that the animals were held for breeding purposes (or any of the other specified purposes). . . . This determination should be made on the basis of all the facts and circumstances which may indicate the purpose for which the animal was held."

D. Tax-Free Exchange of Livestock

Another proposal offered by the Tax Committee was that present law be clarified to show that it is not proper to exchange male calves or steers tax-free for female calves or cows. This proposal was also adopted by the House Ways and Means Committee and appears in its Report on H.R. 13270, where it is stated that ". . . Congress did not intend this type of exchange to be considered a like-kind exchange."

E. Treatment of Land Improvement Expenses

Under EDA, gain realized on the sale of farm or ranch land would be recaptured and taxed at ordinary income tax rates to the extent of land clearing and soil and water conservation expenses deducted in the five years previous to the sale. Since such expenses are frequently incurred and deducted on a continuing yearly basis, this would result in the gain realized on the sale of much farm or ranch land, which is presently taxed at capital gains rates, being taxed at the higher ordinary income rates, thereby reducing the overall profit. Such a provision could cause considerable harm to a large number of farmers and ranchers who only reap a substantial profit when their land is sold.

Adoption of the National Livestock Tax Committee's proposal for recapturing these land clearing and soil and water conservation expenditures on a graduated basis if farm or ranch land is sold within 10 years after acquisition would be more equitable and would not cause harm to the legitimate long-term farmer and rancher, since such proposal is based on the length of time the farm or ranch land was held and not when these expenses were sustained. In addition, the National Livestock Tax Committee's proposal would have the beneficial effect of encouraging the improvement of farm and ranch land by permanent operators, yet discouraging the purchase of farm and ranch land by tax profiteers on a short-term basis.

F. Income Averaging Provision Would Be Beneficial to Industry

The Tax Committee supports the sections of H.R. 13270 improving and simplifying the income averaging provisions of the tax law.

V. TAX PROFITEERING NOT WIDESPREAD AND IS DECREASING

A. Basis for "Farm Loss" Provisions is Incomplete

The basis and reason for enactment of the "farm loss provisions" of H.R. 13270 is found in the statement in the House Ways and Means Committee Report that according to Treasury Department data for the years 1964 to 1966, "as the taxpayer's adjusted gross income level increases, the size of the average farm loss also consistently increases."

This statement is incomplete and fails to recognize the entire economic picture. For the years 1963–66, the 1966 *Statistics of Income, Individual Income Tax Returns* compiled and reported by the Treasury Department, analyzing individual income tax returns filed and sources of income, reveals that returns filed by individuals showing net farm losses amounted to only about *one-third* of the total returns filed showing farm income and losses. The 1966 Report further indicates that the number of returns reporting net farm losses has *decreased* from 1,086,000 in 1963 to 1,012,000 in 1966. Also significant is the fact that these returns reflect a slight *decrease* from $1,902,000,000 in farm losses in 1963 to $1,853,000,000 in such losses in 1965. If as alleged, a large number of high-income-tax bracket individuals are being attracted into farming for tax write-off purposes, it would apepar that the number of returns showing farming losses would have increased substantially since 1963 inasmuch as the total number of tax returns filed in 1966 by all classes of taxpayers increased 9.7% over 1963.

From the all inclusive application of these "farm loss provisions" of H.R. 13270 to farmers and ranchers, it might be concluded that tax profiteering operations were widespread. This is not true as the 1966 Report shows that, except for the $600 and under adjusted gross income bracket, where the aggregate amount of net farm losses exceeded net farm profits, only in the $100.000 and above bracket did net farm losses exceed net farm profits. Further significant is the fact that only *3.598 returns* (.001% of total farm returns) were filed showing net farm losses in the $100,000 and above tax bracket.

B. Farm Losses Not Significantly Different From Other Business Losses

Also relevant is the fact that the 1966 Report reveals that more losses were reported by individuals in the $100,000 and above adjusted gross income bracket with respect to *other businesses and professions* than by individuals in the same income bracket who reported net farming losses. This is revealed in the following except from the 1966 Report:

Adjusted gross income classes	Business or profession (net loss)	Farm (net loss)
$100,000 under $200,000	$43,473,000	$38,375,000
$200,000 under $500,000	32,047,000	25,605,000
$500,000 under $1,000,000	10,304,000	9,207,000
$1,000,000 or more	16,045,000	3,729,000

However, no other businesses are singled out for discriminatory tax treatment by subjecting them to an EDA or by including their business losses as "tax preferences" under the LTP and Allocation of Deductions provisions of H.R. 13270.

If the basis for enactment of these "farm loss provisions" of H.R. 13270 is predicated on the statement that the size of the average farm loss increases consistently as adjusted gross income rises, then closer scrutiny of such Treasury Department data is required. This is because this same Treasury Department data set forth in the following table reveals that the size of the average loss from *non-farm businesses and professions* also increases consistently as adjusted gross income rises.

1965

AGI classes	Number of returns	Net business loss (thousands)	Average loss
0 to $5,000	448,749	$1,034,775	$2,372.76
$5,000 to $10,000	282,121	256,116	907.82
$10,000 to $15,000	99,319	114,895	1,156.83
$15,000 to $20,000	28,692	49,787	1,735.22
$20,000 to $50,000	29,951	101,444	3,387.00
$50,000 to $100,000	6,176	53,460	8,656.09
$100,000 to $500,000	2,728	63,115	23,136.00
$500,000 to $1,000,000	149	8,471	56,852.35
$1,000,000 and over	97	14,591	150,422.68
1966			
0 to $5,000	429,151	$1,117,336	$2,603.59
$5,000 to $10,000	306,737	328,222	1,070.04
$10,000 to $15,000	115,863	140,939	1,216.42
$15,000 to $20,000	38,350	64,358	1,678.17
$20,000 to $50,000	36,910	134,968	3,656.68
$50,000 to $100,000	7,265	64,558	8,886.17
$100,000 to $500,000	3,128	75,520	24,143.22
$500,000 to $1,000,000	180	10,304	57,244.44
$1,000,000 and over	99	16,045	162,070.70

Yet, these non-farm businesses and professions are not subjected to EDA or are these non-farm losses classed as "tax preferences" under the LTP or Allocation of Deductions provisions of H.R. 13270.

C. Average Farm Profit also Increases Consistently as Adjusted Gross Income Levels Rise

An examination of this same Treasury Department data further shows that the size of the average farm profit also generally increases as adjusted gross income rises. This is reflected in the following table.

1965

AGI classes	Number of returns	Farm net profit (thousands)	Average profit
0 to $5,000	1,243,666	$1,767,545	$1,421.23
$5,000 to $10,000	532,485	1,760,012	3,305.27
$10,000 to $15,000	135,458	754,027	5,566.50
$15,000 to $20,000	42,776	352,551	8,241.79
$20,000 to $50,000	39,003	474,633	12,169.14
$50,000 to $100,000	4,984	83,027	16,658.71
$100,000 to $500,000	1,045	23,521	22,508.13
$500,000 to $1,000,000	32	518	16,187.50
$1,000,000 and over	17	1,671	98,294.12
1966			
0 to $5,000	1,100,435	$1,618,827	$1,471.07
$5,000 to $10,000	596,475	2,058,458	3,451.03
$10,000 to $15,000	186,213	1,055,339	5,667.37
$15,000 to $20,000	57,004	504,127	8,843.71
$20,000 to $50,000	49,889	630,545	12,638.95
$50,000 to $100,000	5,642	92,852	16,457.28
$100,000 to $500,000	1,201	25,191	20,975.02
$500,000 to $1,000,000	27	620	22,962.96
$1,000,000 and over	15	172	11,466.66

From the foregoing statistics showing the relative size of net farm profits and losses, it would appear that in general the larger the operation the greater are the sizes of both profits and losses. This is because a business such as farming and ranching which is subject to so many elements beyond its control can either have a profit or a loss in any given year, and the amount of the profit or loss of a particular operation can be and is frequently in direct proportion to its size. Under these conditions, and based on the foregoing statistics, singling out the entire livestock industry for discriminatory tax treatment under these unneeded provisions of H.R. 13270 is not warranted or justified.

D. Drawing Farm Loss Demaracation Line at $15,000 or $25,000 not justified

H.R. 13270, under its Hobby Loss Presumption and EDA provisions, would treat even legitimate farmers and ranchers who incur farm losses in excess of $25,000 for one year or a period of years as "hobby operators" and restrict the amount of capital gains they could claim on the sale of their livestock or other farm property.

In similar manner, the official position of the Treasury Department as stated by Mr. Edwin S. Cohen before this Committee on September 4, 1969 is to treat even legitimate farmers and ranchers as non-bona fide operators if farm losses exceed $15,000 under EDA and to include *all* losses in EDA if such farmer's or rancher's non-farm adjusted gross income is also in excess of $25,000. As an apparent basis for this conclusion, Mr. Cohen stated 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." [Emphasis added.]

This statement is too general. For instance, there are no statistics cited by Mr. Cohen or of which the Tax Committee is aware that show that large farm losses generally represent capital expenditures which have been deducted under the cash basis. Further, the cash basis is under present law allowed to all farmers and ranchers, regardless of their size, and is necessary because of the nature of livestock operations. To restrict or deny farm loss deductions or use of the cash basis by legitimate farmers and ranchers who, because of the size of their operation, incur large losses (or profits) in a certain year or period of years is not justified. Many legitimate and lifetime farmers and ranchers have farm losses in excess of $15,000 or even $25,000. One bad storm alone can cause this much of a loss in one year.

To classify legitimate lifetime farmers and ranchers as "wealthy investors" seeking a tax shelter just because their farm losses exceed $15,000 or $25,000, besides being unsubstantiated, is not warranted. The amount of farm losses (or even the amount of non-farm income) a farmer or rancher sustains is no indication, nor should it be, of whether he is in the business on a legitimate basis.

Mr. Cohn stated that under the Treasury-modified EDA only 9,300 individuals, with farm losses aggregating $418 million, would be affected. This statement implies that this is an insignificant number of farmers and ranchers and only a relatively *few* wealthy taxpayers will be affected. Yet, according to Treasury Department data for 1966, there are 9 states where there were about 9,300 or less returns filed by farmers and ranchers. These states are: *Arizona* (6,784), *Connecticut* (5,299), *Delaware* (5,010), *Hawaii* (4,002), *Maine* (9,753), *Massachusetts* (5,483), *Nevada* (1,941), *New Hampshire* (2,766 and *Vermont* (5,918). Further, this same Treasury Department data reveals that a $418 million farm loss would be approximately 22% of *all* farm losses in 1966 and would represent about 7% of the total net farm profit reported for that year.

VI. TAX COMMITTEE ALSO OPPOSED TO PROVISIONS AND PRINCIPLES IN METCALF AND MILLER BILLS

In addition to the unneeded provisions of H.R. 13270, the Tax Committee is also opposed to the provisions and principles embodied in S. 500, introduced and sponsored by Senator Lee Metcalf of Montana and S. 1560, introduced and sponsored by Senator Jack Miller of Iowa, which would restrict or totally deny the deduction of farm losses. Although these bills are obviously intended in good faith to help the livestock industry, the Tax Committee feels that these bills would seriously harm the whole industry and perhaps cause the greatest damage to the small and medium-sized family farms and ranches.

Under Senator Metcalf's bill, farm loss deductions would be restricted or totally denied to farmers or ranchers who were not on a "proper" accrual method of accounting and who had non-farm income in excess of $15,000. Legitimate farmers or ranchers who earned $30,000 of non-farm income would have *all* farm losses disallowed. Treasury data for 1966 reveals that this bill would adversely affect at least 79,263 returns (reflecting adjusted gross income above $15,000) and possibly more,[14] a number equal to approximately the total returns reflecting farm income or loss filed by all persons in the State of Oklahoma.

[14] Since losses from business operations, including farming and ranching, are deducted from gross income in arriving at adjusted gross income, it is possible that the number of farming operations affected by this proposal could be well in excess of 79,263.

Legitimate farmers and ranchers who are elected to political office and who receive more than $15,000 would find their farm loss deductions restricted and in some cases completely disallowed. The ramifications of this could discourage qualified legitimate farmers and ranchers from entering public life.

In recent Congressional hearings on federal grazing fee increases, Senator Clifford Hansen of Wyoming, noting that profits in the livestock business have been low, stated that: "I've had to find outside employment to keep my livestock business going." This statement is generally applicable throughout the livestock industry and is supported by statistics which reveal that in recent years, non-farm income received by each farm operator family almost equals total net farm income.[15]

The previously discussed adverse and detrimental effects of the unneeded provisions of H.R. 13270 are also generally applicable to Senator Metcalf's bill. They would include forcing many farmers and ranchers on the impossible "proper" accrual system; restricting the flow of needed new blood and legitimate outside capital into agriculture, discouraging diversification and investment in non-farm businesses by farmers and ranchers; impairing existing and proposed Government programs; impeding vital agricultural research programs; isolating agriculture from the rest of the nation's economy; and jeopardizing the credit base of agricultural lands.

Senator Miller's bill would in general prevent the deduction of farm losses if farm income did not equal or exceed two-thirds of total net income. Although this bill would not have the effect of forcing farmers and ranchers on to a "proper" accrual method of accounting, it follows basically the same underlying and objectionable principle of Senator Metcalf's bill in that it would base disallowance of farm losses on the amount of non-farm income earned by a legitimate farmer or rancher.

VII. SENATOR GORE'S BILL (S. 2645) A PARTIAL SOLUTION

S. 2645 introduced by Senator Albert Gore of Tennessee contained a specific provision (Section 13) pertaining to suggested changes in the livestock tax laws. Senator Gore's bill would: (1) provide that the Secretary of the Treasury could not prescribe in his regulations for the useful life of livestock held for breeding purposes to be less than 10 years; and (2) extend the holding period for livestock from 12 months to 24 months in order to qualify for capital gains treatment.

Because of its simplicity and ease of application, and the fact that it would be at least a partial solution to eliminating tax profiteering in the livestock industry, the National Livestock Tax Committee feels there is considerable merit in the provisions and approach taken by Senator Gore's bill.

However, the Tax Committee is of the opinion that in order to meet the objectives of an equitable and sound tax system, the depreciation recapture rules of present law which apply to all depreciable personal property, other than livestock, should also be extended to livestock. In this sense, including livestock under the depreciation recapture provision of present law would make the restriction of useful life provision in Senator Gore's bill unnecessary.

VIII. CONCLUSION

Proposals of National Livestock Tax Committee would eliminate tax profiteering while not substantially harming industry

Si the National Livestock Tax Committee is convinced that this Committee is intent on maintaining an equitable and sound tax system and not inflicting harm on the entire industry, it is the urgent request of the Tax Committe that this Committee amend H.R. 13270 to include just those proposals offered by the Tax Committee, with the suggested modifications previously noted, that are contained in this bill and referred to in the House Ways and Means Committee Report. These proposals would preserve for the serious permanent farmer and rancher the time-honored and essential cash basis and presently used unit livestock price methods of accounting, retain capital gains for livestock, and permit all farmers and ranchers the right to deduct currently the costs of soil and water conservation, fertilizing and land clearing under sections 175, 180 and 182 of the Internal

[15] M. L. Upchurch, Administrator of Economic Research Service, U.S. Department of Agriculture, Address to Annual Agricultural Outlook Conference on February 18, 1969.

Revenue Code. At the same time, these proposals would put an end to tax profiteering by a few whose only motive is to enter the livestock and farming business on a short-term basis to make a tax profit.

The National Livestock Tax Committee strongly feels that the enactment of the unneeded provisions of H.R. 13270 would be contrary to an equitable and sound tax system, would constitute an "overkill," would add complexity and confusion to the tax law, would radically change the accounting and economics of the industry, and could result in higher meat prices to the consuming public.

EXHIBIT

DENVER, COLO., *September 13, 1969.*

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.

GENTLEMEN: The proposed income tax law now being considered by you creates unrealistic complexities of computation in the agricultural area. Not only does the taxpayer engaged in agriculture have to cope with the inordinate complexities of the entire reform proposal, he alone has the problem of maintaining an excess deduction account with its carry-over provisions and limitations and special rules on farm land. This coupled with a limited tax preference, with carryover provisions, and allocation of deduction rules that apparently forces an individual taxpayer to compute a loss on profit on agricultural operations on a strict accrual method seems to involve more computation and record keeping than seems practical, or even possible, in the normal agricultural operation. The interplay and interrelation of these complex provisions, which will not be understood or even interpreted for years, coupled with the already complex and little understood rules on operating loss and capital loss (this being changed also) carryforwards will obviously result in lack of compliance and difficulty in enforcement. Tax reform does not imply simplicity, but it should not create impossible complexities such as this.

Very truly yours,

N. E. TAMPLIN.

Senator CURTIS. Mr. Marvin McLain of the American Farm Bureau.

Mr. McLain, you have been very helpful to the Congress, to the Senate and to this committee on many occasions. You represent a fine organization. We are delighted to have you here. We are sorry that you had to wait so late in the day. Is Mr. Anderson with you?

STATEMENT OF MARVIN L. McLAIN, LEGISLATIVE DIRECTOR, AMERICAN FARM BUREAU FEDERATION

Mr. McLAIN. No, he isn't.

Senator CURTIS. You may proceed in your own manner.

Mr. McLAIN. I will brief this statement, Senator Curtis.

The Farm Bureau has long included the broad subject of taxation and tax reform on its list of major concerns. Earlier this year, when the House Ways and Means Committee conducted hearings on the entire subject, Farm Bureau presented testimony on several occasions.

Several aspects of the tax reform proposal now before you are of considerable concern to Farm Bureau members throughout the country. At the time this legislation was under final consideration in the House, our organization made this concern clear publicly and expressed determination to seek changes in the bill when it is considered in the Senate.

Most taxpayers view taxation as a means of raising the revenue necessary to carry out the essential functions of government. The growing use of taxation as a means of regulating the economy has resulted in a great deal of confusion and misunderstanding among taxpayers. At the same time sharply rising rates of taxation at nearly all levels of government and the progressive nature of the Federal income tax have created both a tremendous pressure for so-called tax shelters and a critical reaction to such shelters. These factors are responsible for the current drive for various tax reforms.

In our view, and we believe it is a view held by most citizens, the most pressing tax reform needed is a general reduction in Federal taxation. For this to be possible, more effort will have to be made to bring spending under control. This committee, whatever its final conclusion may be, should make every effort to facilitate and encourage future general reductions both in the proportion of national income that is preempted by the Federal Government and in the progressivity of our tax system.

Likewise, it is also urgent that the tax laws be simplified. It is a poor tax system which results in overtaxation of millions simply because they do not understand the tax laws and cannot afford to hire someone who does. The complexity of the tax laws is directly related to the high level of current taxes and the progressive nature of the rate structure. H.R. 13270 would introduce many new complications into an already complex tax structure. For this reason, if for no other, we urge this committee to act slowly and deliberately to make sure proposed tax reforms represent true reform and not new complications and frustrations for the average taxpayer. If necessary to allow time for adequate study, the features of H.R. 13270, which face time deadlines, such as the excise and surtax extensions, should be removed from the bill and given separate consideration. You have already done that with the 7-percent investment credit, of course.

Underlying Farm Bureau's basic attitude toward taxation is a statement in the "Monetary, Spending, and Tax Policies" section of the Farm Bureau policies for 1969 which reads in part as follows:

> A stable domestic economy must be maintained in the interests of a high level of employment and a proper rate of economic growth as well as the protection of the value of the dollar.
>
> Inflation is a serious threat to continued economic stability. To bring inflation under control and halt the decline in the value of the dollar, we must follow wise tax, budget and monetary policies.

It is with this broad economic goal in mind that Farm Bureau sets forth its specific recommendations relative to H.R. 13270.

TAX TREATMENT OF FARM LOSSES

Original suggestions for dealing with the matter of tax loss farming included elimination of both cash accounting for farmers and ranchers and capital gains treatment for livestock used for breeding. Since Farm Bureau members believe the elimination of these features of present tax law would be extremely harmful to a large segment of agriculture. Farm Bureau proposed that the tax loss problem be dealt with by placing a simple limitation of $15,000 on the amount of farm losses that can be used as an offset to nonfarm income. This approach was introduced by several Members of the House.

Subsequently, House included in H.R. 13270 two provisions which, while alleged to be methods of dealing with the abuse of farming losses by taxpayers with nonfarm income, actually would work to the detriment of thousands of full-time farmers. We refer specifically to the provisions which would (1) extend the holding period required for livestock to be eligible for capital gains treatment, and (2) repeal the livestock exemption from the depreciation recapture provisions of current law. Nowhere in the report of the House Ways and Means Committee or in the debate on the floor of the House is there any evidence of excessive "tax dodging" or other abuses resulting from these provisions of present law.

While the proposed extension of the holding period for capital gains might not work a serious hardship on the producers of cattle and horses, it would work an extreme hardship on farmers engaged in the breeding and production of livestock with a shorter lifespan, namely, hogs and fur-bearing animals.

It also should be noted that the bill as drafted by the House does not specifically state whether the 1-year holding period would begin at the beginning or end of normal gestation. This in itself has caused some confusion. If the holding period is to begin at the end of gestation, capital gains treatment would largely be eliminated for most of the smaller species of livestock. For example, most hog breeders maintain female stock for only one or two farrowings.

The proposed extension of the depreciation recapture provisions of the current law to livestock fails to recognize that livestock is different from other personal property, that is, the maintenance of livestock is a fairly high risk business for which adequate insurance is not available. Even though some may view this matter differently, farmers faced with a disastrous cost-price squeeze during the current inflationary period view this change as one which would only increase their costs without contributing a great deal to the economy as a whole or the goal of tax reform.

Farm Bureau does not oppose the proposed creation of an excess deductions account for taxpayers with farming losses provided the exemption from this requirement is not reduced below the $15,000-level which has been suggested by the Department and which is the level previously proposed by Farm Bureau as a ceiling on the deduction of farm losses from nonfarm income. We have no objection to the proposed tightening of the so-called "hobby" loss provision of the current law.

TREATMENT OF COOPERATIVE PATRONAGE REFUNDS

This matter was not included in the House hearings on tax reform. Therefore, when these changes were proposed in the Ways and Means Committee, Farm Bureau asked that action be delayed until interested parties could be heard. Now that this committee is giving the matter a hearing, our position is as follows:

Over the years Farm Bureau has taken an active part in improving and strengthening farmer cooperatives. In 1962 we actively supported changes in the law which clearly defined the tax status of cooperative allocations to member patrons.

We believe changes made at that time were sound and that current law with respect to cooperative activities is adequate, and should not be changed. We oppose the changes made in the House bill.

The provisions of H.R. 13270 would unnecessarily increase the Federal Government's role in the management of cooperative fiscal affairs. The purpose clearly is to restrict cooperative activities rather than to improve the equity of the tax system.

Among other things, the provisions of H.R. 13270 seek to force cooperatives to adopt a 15 year pay-out requirement for retained patronage allocations. This, in effect, would force cooperatives to treat these allocations as debt rather than equity, and thereby reduce their borrowing capacity. A mandatory pay-out requirement for all patronage allocations also would make it difficult for cooperatives to give priority to the redemption of allocations held by retiring members and the estates of decreased members. Recognizing that cooperatives are owned and controlled by member-patrons, we believe patron allocations also would make it difficult for cooperatives to give priority to the redemption of allocations held by retiring members and the estates of decreased members. Recognizing that cooperatives are owned and controlled by member-patrons, we believe such matters should be left to the decision of the members themselves.

CAPITAL GAINS

We have already addressed ourselves to the matter of capital gains treatment of livestock. Official Farm Bureau policy includes a statement on the general subject of "capital gains" as follows:

> The tax treatment of capital gains should encourage investment without creating tax loopholes or discouraging the sale of property.
>
> The present law results in the taxation of "gains" which reflect in part a decline in the value of the dollar. In periods of rising prices this penalizes property owners and discourages the sale of property.
>
> As a partial answer to this inequity we recommend that the rate of tax on capital gains be reduced as the length of the holding period increases. We favor retention of the present minimum holding period.
>
> Where farmland is acquired for public use by eminent domain or private treaty, the owner should be permitted a period longer than one year to reinvest in farming or another business with the same tax treatment. We support the present law with respect to capital gains treatment for sales of breeding livestock.

We are opposed to the proposed extension of the capital gains holding period to 12 months because it would discourage the investment that is needed to sustain economic growth. The fact that capital gains can be taken at the end of 6 months makes investors more willing to supply risk capital to new ventures, even though they may have no intention of turning over their investments at such a rapid rate.

We are also opposed to the proposed elimination of the alternative tax rate on capital gains. While the alternative rate is normally of little concern to farmers, a great many farmers benefit from it when they sell a farm or liquidate their farming operations. The capital gains realized by farmers in the sale of a farm or a herd of livestock often represent a lifetime of work which ends up being taxed all at once. In such instances we believe the alternative rate is not only beneficial, but fair to both the taxpayers and the Government. This is particularly true in times such as the present when much of what the law defines as "capital gains" is the result of inflation. Excessive taxation of inflation-created gains represents destruction of capital and should be avoided.

TAX TREATMENT OF TAX-EXEMPT BONDS

We are opposed to the section of H.R. 13270 which deals with the tax treatment of income from presently tax-exempt State and municipal bonds. We view this newly proposed Federal subsidy of such bonds as being nothing more than a "gimmick" which would result in still further involvement of the Federal Government in the fiscal affairs of St te and local units of government.

We also ask the committee to exempt income from State and municipal bonds from the provisions of H.R. 13270 which would establish a limit on tax preferences and require the allocation of deductions. These provisions are clearly a backhanded effort to impair the tax-exempt status of State and municipal bonds. We believe that these bonds should remain tax exempt, and that their status should not be impaired by indirection. If local governments are forced to pay higher interest rates to borrow money, a part of the cost will fall on overburdened property owners, including farmers.

The uncertainty created by House actions affecting tax-exempt bonds has made it difficult for State and local governments to sell new bonds. We urge the committee to take prompt action to remove the cloud on the future treatment of the income from such bonds.

CONCLUSION

Many have argued that tax reform has been too long in the making and that we must have action now. But, with our own economy and that of the entire Western World in a rather delicate balance, hasty action could prove disastrous. Again, we urge that the committee move forward cautiously in order to avoid actions that might disrupt important segments of our economy and to insure that the actions finally taken are based on sound premises rather than emotion.

We thank you for this opportunity to express our views.

Senator CURTIS. I yield the chairmanship to the distinguished Senator from Virginia, Mr. Byrd.

Senator BYRD. I would much prefer that the distinguished Senator from Nebraska continue to serve as chairman, if he will permit me to say a few words to the witness.

Mr. McLain, the committee staff summarized your statement section by section, but in summarizing the statement as a whole, it says that you feel that the most pressing tax reform needed is general reduction in Federal taxation.

Mr. MCLAIN. That is correct. I omitted that in my briefing of the statement because of time limit, but it is in our statement and our members firmly believe it.

Senator BYRD. The Senator from Virginia feels the same way. It says further that you feel that for this to be possible it is necessary to bring spending under control. The Senator from Virginia agrees with you 100 percent on that.

You have also urged the committee to act slowly and deliberately to make sure that proposed tax reform is not complicated for the average taxpayer, and I think that is very important. I think your testimony is most interesting and I am glad I was here when you testified.

Mr. MCLAIN. Thank you.

Senator Curtis. Your statement is very sound. I am going to waive questions because of the hour.

Senator Miller.

Senator Miller. No questions.

Senator Curtis. Senator Hansen.

Senator Hansen. Mr. Chairman, if I may, just let me pose this one question. There has been a lot said about real estate values, Mr. McLain, and many people have different solutions for this situation. Some are apparently disturbed over the accelerating values of land, and others think that it would bring about a serious disruption and an economic dislocation of a great many rural people if land values were not rising. Do you think that the increase in land values is a reflection of the interest on the part of some who, in the eyes of some are using "tax loopholes" to get into the farm business, or is it, rather, that, in an effort to hedge against inflation, people have found real estate to be a pretty effective hedge. Which of these two would you say is the real reason?

Mr. McLain. By all means the latter, Senator Hansen. I am 63 years old. I have been through some inflationary periods as you have before, during other war periods, and obviously this is primarily caused by the general inflation and, as Senator Byrd indicated, by spending, by the Federal Government, a lot more money than we take in. It is going to continue as long as we do that. That is why our great organization wants to do something about stopping deficit spending. I have yet to see a farmer that isn't greatly concerned, or he would put it the other way. He would be gravely concerned if you did anything here that all of a sudden would deflate the value of his land.

Senator Hansen. He would be, you say?

Mr. McLain. He would be very concerned about it. To many farmers this is the only equity they have, and if you do anything here that is going to drastically reduce the value of their land, you have them in real trouble.

Senator Hansen. In that regard, Senator Metcalf noted that one of the arguments that had been advanced by supporters of his bill was that it would tend to reduce the competition for real estate, and thereby would make it easier for a young person to buy into a livestock operation because the price of land would be lessened. What is your feeling about the desirability of that approach?

Mr. McLain. Well, may I say on the point of the outside interests, I think people that are interested in housing developments and the multitude of things we have all over this Nation has in many instances, as you would agree I am sure, created an artificial value on land as far as its use for farm purposes, and certainly on the eastern seaboard here, we see this all over, and we see it in other places.

I don't share the worry that Senator Metcalf has in the area you are mentioning here. There might be some isolated cases where this happened, but as you ably brought out this morning, I think they are isolated, and are not of major concern to farmers generally.

Senator Hansen. When you use the term "artifical values" of land, while I think you and I might agree that these values do not reflect productivity——

Mr. McLain. Right.

Senator Hansen. Insofar as the payment of an inheritance tax is concerned, they are not artificial in the eyes of the Government.

Mr. McLain. Oh, by no means they are not. I meant from the standpoint of productivity and a farmer trying to make a living, for farming purposes.

Senator Hansen. Thank you very much, Mr. McLain. That is all I have, Mr. Chairman.

(Marvin L. McLain's prepared statement follows:)

Statement of Marvin L. McLain, Legislative Director, American Farm Bureau Federation

SUMMARY

Farm Bureau has long included the broad subject of taxation and tax reform on its list of major concerns. At the time this legislation was under final consideration in the House, our organization made this concern clear publicly and expressed determination to seek changes in the bill when it is considered in the Senate.

Rising rates of taxation at nearly all levels of government and the progressive nature of the federal income tax have created both a tremendous pressure for so-called tax shelters and a critical reaction to such shelters. These factors are responsible for the current drive for various tax reforms.

The most pressing tax reform needed is a general reduction in federal taxation. For this to be possible, more effort will have to be made to bring spending under control. Likewise, it is also urgent that the tax laws be simplified.

H.R. 13270 would introduce many new complications into an already complex tax structure. For this reason, if for no other, we urge this Committee to act slowly and deliberately to make sure proposed tax reforms represent true reform and not new complications and frustrations for the average taxpayer. If necessary to allow time for adequate study, the features of H.R. 13270 which face time deadlines, such as the excise and surtax extensions, should be removed from the bill and given separate consideration.

TAX TREATMENT OF FARM LOSSES

Farm Bureau has proposed that the tax loss problem be dealt with by placing a simple limitation of $15,000 on the amount of farm losses that can be used as an offset to non-farm income.

H.R. 13270 would (1) extend the holding period required for livestock to be eligible for capital gains treatment, and (2) repeal the livestock exemption from the depreciation recapture provisions of current law. Nowhere in the report of the house Ways and Means Committee or in the debate on the floor of the House is there any evidence of excessive "tax dodging" or other abuses resulting from these provisions of present law. We oppose both provisions.

Farm Bureau does not oppose the proposed creation of an Excess Deductions Account for taxpayers with farming losses provided the exemption from this requirement is not reduced below the $15,000-level. We have no objection to the proposed tightening of the so-called "hobby" loss provision of the current law.

TREATMENT OF COOPERATIVE PATRONAGE REFUNDS

In 1962 we actively supported changes in the law which clearly defined the tax status of cooperative allocations to member patrons. The provisions of H.R. 13270 would unnecessarily increase the federal government's role in the management of cooperative fiscal affairs. The 15-year pay-out requirement for retained patronage allocations would force cooperatives to treat these allocations as debt rather than equity, and thereby reduce their borrowing capacity.

Recognizing that cooperatives are owned and controlled by member-patrons, we believe such matters should be left to the decision of the members themselves.

CAPITAL GAINS

We are opposed to the proposed extension of the capital gains holding period to 12 months because it would discourage the investment that is needed to sustain economic growth. We are also opposed to the proposed elimination of the alternative tax rate on capital gains. While the alternative rate is normally of little concern to farmers, a great many farmers benefit from it when they sell a farm or liquidate their farming operations.

TAX TREATMENT OF TAX-EXEMPT BONDS

We are opposed to the section of H.R. 13270 which deals with the tax treatment of income from presentiy tax-exempt state and municipal bonds. We view this proposed federal subsidy of such bonds as being nothing more than a "gimmick" which would result in still further involvement of the federal government in the fiscal affairs of state and local units of government.

We also ask the Committee to exempt income from state and municipal bonds from the provisions of H.R. 13270 which would establish a limit on tax preferences and require the allocation of deductions. If local governments are forced to pay higher interest rates to borrow money a part of the cost will fall on overburdened property owners including farmers.

CONCLUSION

Again, we urge that the Committee move forward cautiously in order to avoid actions that might disrupt important segments of our economy and to insure that the actions finally taken are based on sound premises rather than emotion.

STATEMENT

Farm Bureau has long included the broad subject of taxation and tax reform on its list of major concerns. Earlier this year, when the House Ways and Means Committee conducted hearings on this entire subject, Farm Bureau presented testimony on several occasions.

Several aspects of the tax reform proposal now before you are of considerable concern to Farm Bureau members throughout the country. At the time this legislation was under final consideration in the House, our organization made this concern clear publicly and expressed determination to seek changes in the bill when it is considered in the Senate.

Most taxpayers view taxation as a means of raising the revenue necessary to carry out the essential functions of government. The growing use of taxation as a means of regulating the economy has resulted in a great deal of confusion and misunderstanding among taxpayers. At the same time sharply rising rates of taxation at neary all levels of government and the progressive nature of the federal income tax have created both a tremendous pressure for so-called tax shelters and a critical reaction to such shelters. These factors are responsible for the current drive for various tax reforms.

In our view, and we believe it is a view held by most citizens, the most pressing tax reform needed is a general reduction in federal taxation. For this to be possible, more effort will have to be made to bring spending under control. This Committee, whatever its final conclusion may be, should make every effort to facilitate and encourage future general reductions both in the proportion of national income that is preempted by the federal government and in the progressivity of our tax system.

Likewise, it is also urgent that the tax laws be simplified. It is a poor tax system which results in overtaxation of millions simply because they do not understand tax laws and cannot afford to hire someone who does. The complexity of the tax laws is directly related to the high level of current taxes and the progressive nature of the rate structure. H.R. 13270 would introduce many new complications into an already complex tax structure. For this reason, if for no other, we urge this Committee to act slowly and deliberately to make sure proposed tax reforms represent true reform and not new complications and frustrations for the average taxpayer. If necessary to allow time for adequate study the features of H.R. 13270 which face time deadlines, such as the excise and surtax extensions, should be removed from the bill and given separate consideration.

Underlying Farm Bureau's basic attitude towards taxation is a statement in the "Monetary, Spending, and Tax Policies" section of the Farm Bureau Policies for 1969 which reads in part as follows:

"A stable domestic economy must be maintained in the interests of a high level of employment and a proper rate of economic growth as well as the protection of the value of the dollar.

"Inflation is a serious threat to continued economic stability. To bring inflation under control and halt the decline in the value of the dollar, we must follow wise tax, budget, and monetary policies."

It is with this broad economic goal in mind that Farm Bureau sets forth its specific recommendations relative to H.R. 13270.

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Original suggestions for dealing with the matter of tax loss farming included elimination of both cash accounting for farmers and ranchers and capital gains treatment for livestock used for breeding. Since Farm Bureau members believe the elimination of these features of present tax law would be extremely harmful to a large segment of agriculture. Farm Bureau proposed that the tax loss problem be dealt with by placing a simple limitation of $15,000 on the amount of farm losses that can be used as an offset to non-farm income. This approach was introduced by several members of the House.

Subsequently, the House included in H.R. 13270 two provisions which, while alleged to be methods of dealing with the abuse of farming losses by taxpayers with non-farm income, actually would work to the detriment of thousands of full-time farmers. We refer specifically to the provisions which would (1) extend the holding period required for livestock to be eligible for capital gains treatment, and (2) repeal the livestock exemption from the depreciation recapture provisions of current law. Nowhere in the report of the House Ways and Means Committee or in the debate on the floor of the House is there any evidence of excessive "tax dodging" or other abuses resulting from these provisions of present law.

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It also should be noted that the bill as drafted by the House does not specifically state whether the one-year holding period would begin at the beginning or end of normal gestation. This in itself has caused some confusion. If the holding period is to begin at the end of gestation, capital gains treatment would largely be eliminated for most of the smaller species of livestock. For example, most hog breeders maintain femals stock for only one or two farrowings.

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The provisions of H.R. 13270 would unnecessarily increase the federal government's role in the management of cooperative fiscal affairs. The purpose clearly is to restrict cooperative activities rather than to improve the equity of the tax system.

Among other things, the provisions of H.R. 13270 seek to force cooperatives to adopt a 15-year pay-out requirement for retained patronage allocations. This, in effect, would force cooperatives to treat these allocations as debt rather than equity, and thereby reduce their borrowing capacity. A mandatory pay-out requirement for all patronage allocations also would make it difficult for cooperatives to give priority to the redemption of allocations held by retiring members and the estates of deceased members. Recognizing that cooperatives are owned and controlled by member-patrons, we believe patronage allocations also would make it difficult for cooperatives to give priority to the redemption of allocations held by retiring members and the estates of deceased members. Recognizing that cooperatives are owned and controlled by member-patrons, we believe such matters should be left to the decision of the members themselves.

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"The present law results in the taxation of 'gains' which reflect in part a decline in the value of the dollar. In periods of rising prices this penalizes property owners and discourages the sale of property.

"As a partial answer to this inequity we recommend that the rate of tax on capital gains be reduced as the length of the holding period increases. We favor retention of the present minimum holding period.

"Where farmland is acquired for public use by eminent domain or private treaty, the owner should be permitted a period longer than one year to reinvest in farming or another business with the same tax treatment. We support the present law with respect to capital gains treatment for sales of breeding livestock."

We are opposed to the proposed extension of the capital gains holding period to 12 months because it would discourage the investment that is needed to sustain economic growth. The fact that capital gains can be taken at the end of 6 months makes investors more willing to supply risk capital to new ventures, even though they may have no intention of turning over their investments at such a rapid rate

We are also opposed to the proposed elimination of the alternative tax rate on capital gains. While the alternative rate is normally of little concern to farmers, a great many farmers benefit from it when they sell a farm or liquidate their farming operations. The capital gains realized by farmers in the sale of a farm or a herd of livestock often represents a lifetime of work which ends up being taxed all at once. In such instances we believe the alternative rate is not only beneficial, but fair to both the taxpayers and the government. This is particularly true in times such as the present when much of what the law defines as "capital gains" is the result of inflation. Excessive taxation of inflation-created gains represents destruction of capital and should be avoided.

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We are opposed to the section of H.R. 13270 which deals with the tax treatment of income from presently tax-exempt state and municipal bonds. We view this proposed federal subsidy of such bonds as being nothing more than a "gimmick" which would result in still further involvement of the federal government in the fiscal affairs of state and local units of government.

We also ask the Committee to exempt income from state and municipal bonds from the provisions of H.R. 13270 which would establish a limit on tax preferences and require the allocation of deductions. These provisions are clearly a back-handed effort to impair the tax-exempt status of state and municipal bonds. We believe that these bonds should remain tax exempt, and that their status should not be impaired by indirection. If local governments are forced to pay higher interest rates to borrow money a part of the cost will fall on overburdened property owners including farmers.

The uncertainty created by House actions affecting tax-exempt bonds has made it difficult for state and local governments to sell new bonds. We urge the Committee to take prompt action to remove the cloud on the future treatment of the income from such bonds.

CONCLUSION

Many have argued that tax reform has been too long in the making and that we must have action now. But, with our own economy and that of the entire Western World in a rather delicate balance, hasty action could prove disastrous.

Again, we urge that the Committee move forward cautiously in order to avoid actions that might disrupt important segments of our economy and to insure that the actions finally taken are based on sound premises rather than emotion.

We thank you for this opportunity to express our views.

Senator CURTIS. Thank you very much. We have a rollcall over there. It is now 25 minutes to 6. It seems to me that if there is any witness scheduled yet to appear tonight, and cannot appear tomorrow, if he would see the staff about inserting their statement. I am very sorry; we assure you this was not planned. But I do not think it would be fair to any of the parties involved to go on past 6 o'clock. If you want to insert your statement, see the staff.

Mr. VOORHIS. Senator, I just want to ask will we be heard tomorrow if we stay over?

Senator CURTIS. Mr. Voorhis, Mr. Miller says he will come back.

Senator HANSEN. I will be happy to come back.

Senator CURTIS. If Mr. Graham, Mr. McDonald, Mr. Frederick, Mr. Jaenke, Mr. Voorhis, Mr. Sims, Mr. Healy, Mr. Clark, if you want to give your testimony, we will come back. We will recess to answer the rollcall.

(Brief recess.)

Senator MILLER. The committee will come to order.

Mr. Harry Graham.

STATEMENT OF HARRY L. GRAHAM, LEGISLATIVE REPRESENTATIVE, NATIONAL FARMERS ORGANIZATION

Mr. GRAHAM. Thank you, sir. The NFO would specifically like to record its endorsement for the provisions of S. 500 covering farm losses and tax shelters.

We would also point out that the organization is also in favor of a major modification of the oil-depletion allowance. We are not convinced that this will restrict oil exploration which is now more of a science than in the old wildcatting days. The sale of oil claim land in Alaska indicates the industry is not completely pessimistic about the future. We would point out that oil royalties granted by American companies to foreign governments frequently greatly exceed the U.S.A. oil-depletion allowance.

The National Farmers Organization is an association of farmers which is engaged in collective bargaining in an effort to improve farm income.

We accomplish our marketing objectives by blocking together enough production in any commodity to enable us to have some influence on the market.

The policy of the organization is to support the family-size owner-operator farms both because they represent the greatest economic efficiency and the maximum social and political stability which is essential for the welfare of our Nation.

We therefore support legislation which will accomplish our economic, social and political goals, and we oppose those acts which contribute to the weakening of our desirable and essential objectives.

With this background, this distinguished committee will not be surprised that the NFO opposes any tax law or its implementation which will give an economic advantage to the farms and their owners who do not depend upon the farming operation for their profits and especially those which enable those who have large losses in their farming operations to deduct these losses from their other economic losses from their other economic operations.

The use of short-term capital gains as a means of creating a paper loss or to avoid taxes which would be collected if this income was treated as corporation income is particularly objectionable to us as it should be to the Congress.

The preferential tax treatment extended to farmers by the Congress was a justified attempt to help alleviate the lock of economic equality with the rest of the economy which has been the lot of farmers except during wartime for over 50 years.

It seems to the NFO that the Congress should do two things; first it should limit the farm losses which may be charged off against nonfarm income; second, it should tighten up the privileges being extended to reduce taxes by the application of capital gains to relatively short term investments.

If an animal is simply fed out for the market, there probably is no justification for treating the profit from this operation as capital gains. If an animal is held to maturity and used for breeding purposes, the profits which accrue to the operation should be treated as capital gains.

There is a problem in this area which troubles us. The 2-year minimum is certainly justified in the case of cattle. Maybe it could even be increased. However, in the case of swine, the time which it takes for the animal to mature, be bred, and reproduce is less than 2 years. Good gilts can be bred at about 4 months and produce a litter in 9 or 10 months. Thus, in about a year, the gilt has become a sow and is at the maximum size to sell without taking a substantial loss due to size for which there is not much demand.

We would therefore recommend that the maximum time requirements to make swine eligible for capital gains be reduced to 1 year.

We also would like to make recommendations on two other matters which are before this committee.

First, we urge that the investment tax credit be continued for agriculture until such time when the income for the factors of production—risk, labor, investment, and management reaches a reasonable equality with the return of these factors when they are committed to the other segments of our economy.

Second, we would point out that the NFO is not effected by tax laws as they apply to cooperatives. However, we believe that cooperatives usually use their earnings in a way which contributes to the welfare of their membership. We, therefore, believe that the tax proposals in section 531 are such as to cause hardship and damage to the cooperatives and we urge that this section be eliminated and the present law, which was only recently enacted by the Congress, be retained.

We commend the committee for its efforts to improve the tax laws. We have great confidence in the ability, integrity and wisdom of this committee. We hope that you will agree with the positions which we commend to you as also being reasonable and fair.

Thank you, sir.

Senator MILLER. Thank you Mr. Graham. The next witness is Angus McDonald, director of research for the National Farmers Union.

It is nice to have you with us, Mr. McDonald.

STATEMENT OF ANGUS McDONALD, DIRECTOR OF RESEARCH, NATIONAL FARMERS UNION

Mr. McDONALD. Mr. Chairman, we certainly appreciate your coming back, because we have been waiting all day, and we do want to get in our 2 cents worth.

I will comment briefly on two parts of the tax bill approved by the House, S. 500, which relates to the farm loss tax provisions of the House bill. I will comment also on the provisions approved by the House of Representatives which relate to farm cooperatives.

I might say at the outset, Mr. Chairman, that our primary concern is with farm income. Farmers are subject to inflation, just as everyone else is. The farmer is the only businessman who can't pass on his costs. The buck stops at the farm.

When the farmer goes to sell his products in the marketplace, he faces usually an oligopoly, a small group of businesses who set his price. When he goes to buy a tractor or other implement or other things necessary to farm production, he must pay the price which is set usually by a small group of men, 1,000 or 2,000 miles away. So he has no way in which he can alleviate his economic situation.

He can, of course, petition the Congress as he has done, and the Farmers Union, as the Senator knows, has been very much interested in farm legislation over the years. It is our No. 1 priority.

Secondly, the farmer can pool his economic power in farm cooperatives. The Congress has been sympathetic to the farmers economic position, and for over a long period of years the Congress has approved legislation which encourages and protects farmer cooperatives. The Congress has authorized the building of certain institutions which protect the farmer in the cooperative way. The farm credit institutions, for example, the Farmers Home Institution, the REA, just to mention a few things represents an interest of the Congress in cooperatives.

The Congress also, of course, has enacted certain laws to prevent abuse of the cooperative. The relation of the farmer to the cooperative to antitrust laws have been spelled out by the Capper-Volstead Act and other laws. I want to establish this point. The Congress has always been solicitous of the farm cooperative, and has time and time again said that we want cooperatives, we think they are necessary, we think they are good. Now we have, like a bolt out of the blue, the provisions in the tax bill approved by the House of Representatives. In 1962 the Congress unwisely, we felt at the time, as I recall I testified on this matter before this committee, required the farmer to pay 20 percent in cash, but now under the tax bill this would be increased over a period of years to 50 percent in cash.

Another provision would require that the paper issued to the patron be redeemed within a period of 15 years. So you have the remaining patronage refunds which the cooperative didn't have to pay out in cash, the cooperative must redeem this paper and pay the rest of the original equity, so the whole development you might say, the whole equity which is available for capital over a period of time is wiped out. We look on these provisions as punitive, as unnecessary, as provisions which will not produce any additional revenue, and the only reason that we can think of that they were inserted in the bill is that the other body doesn't like cooperatives, wants to penalize them and harass them, and thinks perhaps that the farmer is dishonest. There must be other things, more stringent provisions built around the cooperative and the farmer to see that the member gets his dues under the rules of cooperation.

Mr. Chairman, we recommend that these provisions be deleted.

The other matter I will address myself to concerns S. 500 introduced by the Senator from Montana and sponsored I believe by 22 Senators, relating to farm losses of "tax farmers." Farmers Union has been interested in this matter for several years. Several years ago my attention was attracted to a report of the Treasury, to the IRS report in which the statistic said that of the 119 millionaires in 1965 who had farm developments, 103 of them lost money. Of the individuals whose net income was between $500,000 and $1 million, 202 of them invested in farming. One hundred and seventy of them lost money. I am sure the Senator is familiar with these statistics. I have tables in my statement. And it will be noted that the lesser the income, the bigger proportion of farmers or those in the farming business show a profit.

We think that the material in the various documents that have come out of the IRS studies, I have a couple of them here, the material in the report of the Ways and Means Committee and even in the presentation made by the Secretary of the Treasury documents the fact that something should be done about this gigantic loophole in our tax laws.

Senator MILLER. Do I understand you support the Metcalf bill?

Mr. McDONALD. Yes, sir. I know it is very late. I am going to conclude by just making one comment.

Senator MILLER. On that point, I don't know whether you were here this morning when I asked Senator Metcalf about the possibility of a loophole in the Metcalf loophole-closing bill.

Mr. McDONALD. No, sir; I wasn't.

Senator MILLER. I pointed out that the Metcalf bill exempts accrual basis farmers.

Mr. McDONALD. That is correct.

Senator MILLER. If an accrual basis farmer values his inventory at fair market value, I don't have a problem. But if he uses the unit livestock price, which could be greatly under the fair market value, as long as it is used consistently down through the years, I can see quite a slippage of revenue. I can see quite a substantial amount of the losses being incurred, and then that is converted into capital gain when you have a livestock selloff.

Doesn't that appear to you to possibly be a loophole?

Mr. McDONALD. Well, I am not familiar, Senator, with this particular accounting method. I just have to answer that I don't know. I don't know anything about that point that you raise.

Senator MILLER. If there is one, you would have——

Mr. McDONALD. I will look into it, and if you desire, I will write a letter to you and to the committee giving our opinion.

Senator MILLER. I think that would be helpful, because I detect that you want the loopholes closed and if there is a loophole in the Metcalf loophole-closing bill, I think you would want that taken out, too, wouldn't you?

Mr. McDONALD. Certainly.

Senator MILLER. Thank you.

Mr. McDONALD. I just want to conclude by saying that there has been a good deal of discussion today; in waiting out in the hall this morning some people came out talking about the Senator from Montana wanting prices to go down, land values to go down, and they were laughing about it, and so forth, and I heard comments here today when I finally got into the room.

Senator Curtis. May I interrupt? We will have a bigger room tomorrow, because we meet in the auditorium.

Mr. McDonald. Senator, I appreciate that, but I won't be here. At least, I won't be waiting to testify. I just wanted to say, Senators, that I am perturbed a little bit by the opinion on the committee that an inflated land value is always of benefit to the farmer, at least some individuals think so.

I have here a study, I just happened to have it in this folder, the University of Minnesota, the Agricultural Economics Department made a survey, and they found that the recorded land purhcases made in 1967, and in Minnesota there were 1,406 land purchases made by operating farmers, there were 246 made by investors. I assume those would be the people we have been trying to get after.

My point is this: that in this day of expanding technology, the farmer, if he is to compete and he is to survive, he must expand his landholdings, and in some areas the price of land is so high that the working farmer is unable to buy more land that he needs.

Now, the other side of the coin is that some corporations have come in, such as the Gates Rubber Co. in western Colorado on a gigantic scale, and are undertaking to raise sugar beets among other things, and I am told by our people in Colorado that land out there is inflated, they tell me $120 an acre.

Well, the farmers out there don't like that because they are not planning to sell out. They would like to stay there. They would like to apparently buy more land. So that I would say this: that if the farmer wants to sell out, why, sure. If land is inflated, particularly if he is near a city, and I had a farm here near Washington some years ago. I sold that farm. I wish now I had waited. But I made a nice profit on it. But that is outside of agriculture, really.

The farmer who goes to the bank to borrow money, the banker wants to know what is the productivity of that farm, and will he be able to repay his loan, and so forth and so on. Senators, I just wanted to bring that point out. I do not think it is an unmixed blessing that land values are inflated.

Senator Curtis. We thank you, and we are sorry that you could not appear sooner.

(Angus McDonald's prepared statement follows:)

Statement of Angus McDonald, Director of Research, National Farmers Union

SUMMARY

1. National Farmers Union is unequivocably opposed to the punitive, non-revenue producing cooperative provisions of the Tax Reform Act of 1969. These provisions were inserted in the bill without warning and with no opportunity for affected groups to present their views.

2. The National Farmers Union supports S. 500, sponsored by Senator Metcalf and 22 other Senators. This legislation would stop one gigantic loophole in our tax laws which permits wealthy individuals to avoid payment of their fair share of taxes. The so-called "tax farmers" engage in activities adverse to working farmers. They inflate the price of land and enter into competition with farmers who have no off-farm income.

3. The enactment of the cooperative provisions of the tax bill would reverse and repudiate the 50-year policy of Congress in regard to cooperatives. They would work such a hardship on cooperatives that many would be forced out of existence.

4. The cooperative provision which would ultimately require 50 percent of the patronage refund to be paid in cash is an unwarranted intrusion into a business. It would penalize cooperatives regardless of the wishes of a majority of their members and would entail additional bookkeeping.

5. The provision requiring all redemption of paper within 15 years would affect adversely the capital needs and credit of cooperatives.

6. The suggestions made in regard to farm-loss abuses are unsatisfactory and cannot be accepted by the Farmers Union. The Excess Deductions Account provision in the House bill would affect very few tax dodgers and bring in little additional revenue.

7. The Metcalf bill would, on the contrary, bring in additional revenue and would effectively close the loophole during the year when tax-dodging was resorted to. It would not foreclose taxpayers using the accrual method which is required of other businesses. It would, contrary to the House and Administration recommendations, protect the farmer in regard to losses incurred because of drouth, flood and in regard to certain other deductions.

Statement

Mr. Chairman and members of the committee, I will comment briefly on two subjects before this Committee. One relates to farm cooperative provisions in the tax reform bill and the other to S. 500, introduced by Senator Lee Metcalf and sponsored by twenty other Senators. Our comments on all legislation reflect our concern over the decline of farm income due to inflation, to lack of bargaining power, to discrimination against cooperatives and against farmers.

Historically the farmer has always been a second class citizen. His income has consistently been much lower than those of persons in other industries. Senator Proxmire characterized this situation some years ago as being the shame of America. The farmer has not shared in our so-called "affluent society." President Harry S. Truman, it was reported, had a sign on his desk as follows: "The buck stops here." The American farmer should post such a sign on his mailbox. He has no one to pass his costs on to. He has little to say about what he is paid in the marketplace. He is caught in an economic vise.

In the marketplace he faces oligopoly. How can he dictate the price of his eggs or his cattle or his grain when he faces a group of corporations who tacitly or otherwise have agreed on the price they will pay him. How can he bargain over the price of a truck or a tractor when the price is administered by a small, tight group of manufacturers who control 50 to 90 percent of production?

The farmer may resort to two courses of action—he may petition Congress to enact laws which introduce some kind of rationale into the marketing of his commodities. He may ask that certain devices be instituted which will shore up prices which often fall below cost of production. The other action available to the farmer is to pool his bargaining power by means of cooperatives. The history of the farmer's effort to build a countervailing power to offset the gigantic power of corporations is long and tortuous. He has been persecuted; he has been discriminated against, and he has even been charged with criminal activities when he and his neighbors pooled their economic resources.

Congress has recognized the farmer's right to organize cooperatives. Beginning with the year 1968 Congress has passed laws which attempted to clarify and support the farmer's inalienable right to join with his neighbor in his economic activities. These laws attempted to clarify the farmer's constitutional right to bargain, but they also attempted to clarify the relationship of cooperatives to the antitrust laws. Here is a partial list of laws which set forth they policy of the Congress. They repeatedly stated that cooperatives were good, were legal, and should be encouraged, fostered and preserved by our Government:

(1) War Revenue Act of 1898 (30 Stat. 448, 461).

(2) Corporation Tax Statute of 1909 (36 Stat. 11, 113).

(3) War Finance Corporation Act of 1918 (42 Stat. 181, 182).

(4) Federal Reserve Act Amendment 1923 (42 Stat. 1479, 1480, 12 U.S.C.A. 351).

(5) Federal Intermediate Credit Banks Act of 1923 (42 Stat. 1454, 12 U.S.C.A. 1021).

(6) Agricultural Marketing Act of 1929 (46 Stat. 11, 12 U.S.C.A. 1141).

(7) Farm Credit Act of 1933 (48 Stat. 257, 261, 12 U.S.C.A. 1134, 1134f).

Here is what Congress said in the Agricultural Commodity Act of 1929:

"It is hereby declared to be the policy of Congress to promote the effective merchandising of agricultural commodities * * *.

"(3) By encouraging the organization of producers into effective associations or corporations under their own control for greater unity of effort in marketing and by promoting the establishment and financing of a farm marketing system of producer-owned and producer-controlled cooperative associations and other agencies."

Congress not only stated very clearly its policy in regard to cooperatives, but set up institutions for the specific purpose of assisting cooperatives. In the Federal Farm Board Act and in the Farm Credit Act of 1933, it set up organizations for the specific purpose of helping cooperatives. Among these were the 12 regional banks for cooperatives and the Central Bank for Cooperatives. Mindful of the fact that abuses might arise, the Farm Credit Act set forth certain rigid rules in regard to cooperatives as follows:

"As used in this act, the term 'cooperative association' means any association in which farmers act together in processing, preparing for market, handling, and/or marketing the farm products of persons so engaged, and also means any association in which farmers act together in purchasing, testing, grading, processing, distributing, and/or furnishing farm supplies and/or farm business services: PROVIDED, HOWEVER, That such associations are operated for the mutual benefit of the members thereof as such producers or purchasers and conform to one or both of the following requirements:

"First. That no member of the association is allowed more than one vote because of the amount of stock or membership capital he may own therein; and

"Second. That the association does not pay dividends on stock or membership capital in excess of 8 percentum per annum.

"And in any case to the following:

"Third. That the association shall not deal in farm products, farm supplies, and farm business services with or for nonmembers in an amount greater in value than the total amount of such business transacted by it with or for members. All business transacted by any cooperative association for or on behalf of the United States or any agency or instrumentality thereof shall be disregarded in determining the volume of member and nonmember business transacted by such association."

In order that the often meager savings which resulted from buying and selling in large quantities might not be suoject to corporation taxes, certain rules were set up by the Congress and by the Treasury. In 1962 the tax law relating to cooperatives was changed to require that 20 percent of patronage refunds be paid in cash and that the consent of the member in regard to investment of patronage refunds in the cooperative be authorized in writing by the individual member or by a provision in the by-laws which must be agreed to by a maority of the members. Farmers Union opposed this provision, believing that it was an unwarranted interference in the private affairs of the business.

It should be made clear that all patronage refunds under our tax laws, in whatever form, must be reported to the Treasury as income. The only excuse for requiring a patronage refund to be paid in cash is that the cooperative unlawfully withholds payment from the member or that the member does not report his patronage refund to the Treasury when it is not paid in cash. We strongly believe that the American farmer is as honest, even more honest, than other taxpayers and that the inference that he is dishonest is unwarranted.

Now, like a bolt out of the blue comes the recommendation of the House of Representatives. No opportunity was given for cooperatives and other interested groups to present their views in regard to the punitive, non-revenue producing provisions inserted almost at the last minute in the House Tax Reform Act of 1969. Protests to the Committee and to the House of Representatives were unavailing.

Yet, we do not think that the importance of these damaging recommendations can be exaggerated. One requirement says that three percent a year beginning with 1970 is to be added until 50 percent of the refund is paid in cash to the patron. This provision ignores the fact that a majority of the members may have indicated that they wanted all of their patronage refunds, or at least a larger part, reinvested in the business. One can imagine the bookkeeping entailed in obtaining funds represented by checks from individual members for reinvestment in the cooperative. Red tape and inefficiency would inevitably result from such procedure.

The other provision which says that investment in the cooperatives must be repaid in cash within 15 years is even more damaging. It changes on the books of the cooperative an asset to a liability. It would make difficult, we are told by experts, the obtaining of loans from banks. It would involve the raising of cash from time to time which might not be available, particularly when large investments have been made in necessary equipment. In these days of rapidly developing technology a large capital investment is absolutely necessary if a business is to grow and compete.

If the Congress enacts this provision it is saying in effect, "We repudiate all past policies in regard to cooperatives. We disagree with many laws on the books which encourage and assist voluntary cooperation among farmers. We are, in effect, opposed to the Farm Credit Administration and the Rural Electrification Administration, which are agencies established to fulfill that governmental policy."

These provisions in the House bill strike at the backbone of hundreds of rural communities and forestall the possibility of organizing new cooperatives to furnish farm supplies and market and process farm products.

During the last few years there has been a great deal of publicity in regard to the gigantic loopholes in our tax laws. One of the most notorious is that loophole which allows wealthy individuals to invest in farming activities for the purpose of tax avoidance. The Farmers Union has been studying various proposals which have been made in regard to this loophole which affects directly and adversely the welfare of farmers. Our attention was called to certain statistics published by the Treasury Department which indicate that wealthy individuals were purposely losing money in the farming business. These tables, attached hereto as Exhibits A and B, substantiate this belief.

Attached also as Exhibit C, is a table published in the Congressional Record of October 4, 1968, which proves that an economic net income of $10,000 can be converted into a $10,000 net loss for tax purposes.

The Treasury Department has published much statistical information to illustrate this point. One example is given: Assuming that the expenses of raising a herd of cattle are $200,000, it is obvious that the taxpayer in the top tax bracket will incur a tax saving of $140,000. On the sale of the herd, however, the entire sales price, including the $200,000 representing the recovery of these expenses, will be taxable only at the 25 percent capital gains rate. The capital gains tax on $200,000 is $50,000, or less than half the tax savings realized in the earlier years. Thus, the taxpayer in this situation would realize a $90,000 tax profit from a transaction which economically is merely a break-even.

S. 500 would go far in eliminating abuses engaged in by wealthy individuals and corporations. It would limit the losses of a farm entrepreneur to $15,000 plus taxes, interest and losses resulting from natural disasters. It would not, as its opponents say, require that all farmers resort to the accrual method. Under this legislation taxpayers would still have the option of selecting the method they prefer. However, if they did not restrict themselves to the restrictions under the $15,000 rule they would be required to report their inventory as do other businesses.

The suggested alternatives in regard to farm losses are not acceptable to my organization. The Excess Loss Deductions Account would allow the taxpayer to deduct his losses during the current tax year, no matter how huge. As we understand the House-passed measure, only those losses above $25,000 would be set aside in the deduction account. Furthermore, only those individuals whose outside income was in excess of $50,000 a year would be required to set up the account. Thus, all other taxpayers would escape even the Excess Deduction Account method which postpones the time when the taxpayer would be required to report capital gains as regular income up to the amount of the Excess Deductions Account.

The recommendations of the Administration in regard to the EDA treatment are somewhat of an improvement over the House version. Recently Secretary Kennedy recommended that the EDA rules apply to any taxpayer with non-farm adjusted gross income in excess of $25,000 losses which exceeded $15,000. Originally the Treasury's suggestion was that this latest figure be $5,000. It appears that the alternative to S. 500 in some respects has gone from bad to worse.

Another provision in the House bill is also objectionable. It requires that capital gains treatment can only apply to livestock after it has been held one year after reaching breeding age. This provision would no doubt work a hardship on many small operators.

It should be emphasized that the Metcalf bill takes into account certain hazards which are unique to farming operations. It would not, for tax purposes, include in the $15,000 ceiling deductions attributable to taxes, interest, the abandonment or theft of farm property, losses of farm property arising from fire, storm or other casualties, losses or expenses attributable to drought, and losses from sales, exchanges and involuntary conversions of farm property.

EXHIBIT A

The following statistics lead us to believe that wealthy individuals have been using farm investments to escape payments of taxes:

ALL 1965 INCOME-TAX RETURNS OF INDIVIDUALS RELATING TO FARMING, BY ADJUSTED GROSS INCOME CLASSES

	Net profit		Net loss	
	Number of returns	Amount (thousands)	Number of returns	Amount (thousands)
Taxable returns, total	1,151,882	$3,951,260	661,860	$1,001,106
Under $1,000	6,548	4,338		
$1,000 under $2,000	65,519	69,113	16,603	13,739
$2,000 under $3,000	107,019	168,442	35,891	32,770
$3,000 under $4,000	139,737	259,685	64,020	63,354
$4,000 under $5,000	140,030	314,961	80,522	92,672
$5,000 under $6,000	132,512	345,937	83,450	84,166
$6,000 under $7,000	114,602	334,594	80,887	85,396
$7,000 under $8,000	96,434	293,086	68,302	64,550
$8,000 under $9,000	72,525	267,080	47,547	50,125
$9,000 under $10,000	57,875	242,904	39,555	50,706
$10,000 under $15,000	132,109	724,204	79,564	123,177
$15,000 under $20,000	42,160	347,490	23,843	60,292
$20,000 under $50,000	38,752	471,138	30,380	133,187
$50,000 under $100,000	4,974	82,700	7,424	76,852
$100,000 under $500,000	1,040	23,464	2,874	54,872
$500,000 under $1,000,000	32	518	170	6,625
$1,000,000 or more	16	1,606	103	7,630

Source: Statistics of income, 1965, individual income-tax returns, U.S. Treasury Department, Internal Revenue Service.

ACTIVE CORPORATION INCOME-TAX RETURNS, JULY 1965-JUNE 1966

Number of returns with and without net income	18,526
With net income	10,387
Without net income	8,139
Form 1120-S	4,862
Without net income (form 1120-S)	2,330

Source: Book of Statistics of Income, U.S. Treasury Department, Internal Revenue Service.

EXHIBIT B

ALL 1966 INCOME TAX RETURNS RELATING TO FARMING, BY ADJUSTED GROSS INCOME CLASSES

[Dollar amounts in thousands]

	Farm returns			
	Net profit		Net loss	
	Number of returns	Amount	Number of returns	Amount
Taxable returns, total	1,280,274	$4,816,041	674,220	$1,023,640
Under $1,000	7,357	5,368		
$1,000 under $2,000	62,996	63,922	13,846	8,800
$2,000 under $3,000	101,077	156,069	32,625	36,417
$3,000 under $4,000	142,674	265,644	54,468	46,642
$4,000 under $5,000	140,953	324,578	69,685	74,080
$5,000 under $6,000	128,965	340,690	78,951	73,197
$6,000 under $7,000	124,300	362,437	76,057	81,706
$7,000 under $8,000	110,725	358,421	70,246	78,998
$8,000 under $9,000	88,926	338,673	57,179	65,461
$9,000 under $10,000	78,989	353,168	42,090	50,269
$10,000 under $15,000	180,645	1,007,111	100,209	137,525
$15,000 under $20,000	56,150	495,227	30,520	73,530
$20,000 under $50,000	49,658	626,047	35,621	150,365
$50,000 under $100,000	5,622	92,412	8,580	73,457
$100,000 under $200,000	986	19,833	2,357	36,663
$200,000 under $500,000	209	5,049	895	24,507
$500,000 under $1,000,000	27	620	201	7,816
$1,000,000 or more	15	172	88	3,563

Source: Book of Statistics of Income, U.S. Treasury Department, Internal Revenue Service.

EXHIBIT C

TAX ADVANTAGES OF CATTLE OPERATIONS[1]

Economic situation:	
Gain from sale of breeding cows classified as sec. 1231 property	$40,000
Ordinary income from sale of feed and gain from sale of calves and steers	70,000
Gross profit	110,000
Less ordinary expenses including depreciation	100,000
Economic net income	10,000
Tax situation:	
Ordinary income from sale of feed and gain from sale of calves and steers	70,000
Loss: Ordinary expenses including depreciation	100,000
Ordinary loss	(30,000)
Sec. 1231 gain	40,000
Less long-term capital gain deduction	20,000
Taxable portion of capital gain	20,000
Net loss for tax purposes	(10,000)

[1] Prentice-Hall, Inc., "Tax Ideas," July 3, 1968.

Senator CURTIS. Mr. Robert M. Frederick, legislative representative, representing the National Grange.

Mr. Frederick, we welcome you here. We regret that not every witness could be the first witness today, but I assure you and all the other witnesses who will appear that we follow a system here through the work of our staff that no one's recommendation will fail to be brought before the committee at the time we vote. You may proceed.

STATEMENT OF ROBERT M. FREDERICK, LEGISLATIVE REPRESENTATIVE, NATIONAL GRANGE

Mr. FREDERICK. Thank you, and I certainly want to thank the Senators for coming back and hearing us tonight, because a great deal of testimony was put in the record today that the National Grange is certainly not in accord with.

We welcome the opportunity to record our position on H.R. 13270. I am Robert Frederick, the legislative representative of the National Grange, an organization which needs no further explanation to the Senators present.

In general, we support H.R. 13270, a bill to reform the income tax laws to the extent that the provisions of the bill conform to Grange tax policy. However, there are several provisions of H.R. 13270 with which we are in total disagreement.

We would like to take the time allotted to us to discuss these provisions.

H.R. 13270 undertakes to correct a situation in which some high-income taxpayers, not primarily engaged in farming, have used farm losses to obtain a deduction in their high-bracket nonfarm income.

To do this, H.R. 13270 requires the taxpayer to maintain an excess deductions account to record his farm losses. In the case of individual farm losses would be added to the excess deductions account only if the taxpayer had income from nonfarm sources of more than $50,000 for the year, and only to the extent that the farm loss for the year exceeded $25,000.

In our judgment, the FDA account approach does not strike at the heart of the "tax-loss" farming loophole. It only postpones the issue and strikes at all farmers, big and small, bona fide as well as the investor who is investing in agriculture truly for a profit. In doing so, it includes, accidentally, the "tax-loss" tax-dodging farmer. In referring to the latter, we use the word "farmer" rather loosely.

It is our firm belief that the provision of the amendment No. 139 introduced by Senator Metcalf on August 13, 1969, will correct the abuse of the liberal tax rules provided to the Internal Revenue Code for the use of bona fide farmers. Therefore, we respectfully urge that amendment No. 139 be inserted in H.R. 13270 in place of part of subtitle B-farm loss, et cetera, starting at line 10, page 139, of the bill and striking all that follows through line 6 on page 152.

In our judgment, this method will be more in line with true tax reforms in providing more revenue for the Federal Treasury, a shifting of the tax burden and expediting the closing of tax loopholes that allow revenue losses.

It is our understanding that the EDA and other farm tax proposals of the House bill will only apply to an additional 3,000 persons and bring into the Federal Treasury an additional $25 million by the year 1979, such increase to come from correction in the tax-loss farming, depreciation recapture, holding period for livestock and a negligible amount from hobby farm losses.

The amendment proposed by Senator Metcalf, amendment No. 139 would apply to 14,000 taxpayers—and may I point out that this would not include the farming that is done by corporations that is not now being picked up on income tax returns—thereby shifting the tax burden, and would bring in an additional $205 million per year as soon as the bill became effective. In our opinion, this is true tax reform, because it increases Federal revenue at the same time it shifts the tax burden and the effect is immediate, and as we pointed out earlier in our testimony, it hits at the "jugular vein" of the tax-dodge farming.

This corrective amendment will affect only nonfarmers with large amounts of nonfarm income who invest in farming to obtain tax losses.

Senator Metcalf has explained that he considered the EDA approach when he first began to look into ways to correct the tax-dodging farm problem. In remarks before the Senate August 13, he said:

> After a great deal of technical discussion with experts, I was convinced that the most effective way to get at this problem without hurting the legitimate farmer would be to take the loss limitation approach. Under this method, a dollar limit would be placed on the amount of artificially created farm losses that could be used as an offset against non-farm income in any given year.

The family farm structure in American agriculture must be given an even break with others engaged in agriculture for profit. It is our opinion that amendment No. 139 will give us equality of income tax treatment and preserve for agriculture the liberal provisions of the Internal Revenue Code that were meant for farmers who farm for a livelihood.

It is the opinion of the National Grange that the provisions of amendment No. 139 meet the needs of the American farmer far better than the first part of subtitle B of H.R. 13270, thereby making any further changes in the Internal Revenue Code pertaining to agriculture unnecessary.

I repeat this corrective amendment will affect only nonfarmers with large amounts of nonfarm income who invest in farming in order to obtain tax losses which may be set off against their nonfarm income.

To save your time, I would like to make a brief reference to hobby loss farming as it appears in our statement. I also call your attention to the holding period for livestock which we suggest changing a line. Lines 7 and 8, page 153, which would strike "for at least 365 days," which would make that line read, "but only if held by him after such animal normally would have first been used for any of such purposes."

This, we think, would make it more equitable with other holding periods for other capital.

We are also opposed to the cooperative tax revisions as they have come out of the house. We were quite shocked to learn that it had been included in the House bill, since it had not been announced by the House Ways and Means Committee that tax reform or even tax treatment would be a part of the hearings on the House side. Then this amendment to the provisions of the House bill came out of the House Ways and Means Committee in the last 1 or 2 days of the executive hearing of the committee, without the opportunity of public hearing.

We appreciate the fact that we have an opportunity here on the Senate side to express our opposition to the punitive anti-co-op tax provisions.

It is too bad that we must once again be asking busy Senators to devote time to matters which seemingly were settled in 1962 after lengthy hearings and debate. Here you are confronted with what has been called the most sweeping tax reform in history.

Among the many sections is the measure which has nothing to do with tax reform, would not yield any additional tax revenue, without any additional tax benefits but which would greatly restrict the growth of farm cooperatives——

We see no justification for the new laws regarding cooperative financing or taxation. We urge in the strongest possible appeal that the entire section on cooperatives be deleted from the Tax Reform Act of 1969.

There is one final statement that appears in our summary that is not covered in the House bill as referred to. Simply stated, the House did not have time to consider the Federal estate tax. Here we are considering the most sweeping tax reform bill, and the Federal estate tax is not covered.

I think this is of vital importance to agriculture, because of the present inheritance tax provisions. A boy who wants to take over the family farm finds it impossible because the value of the land is appraised, not at its value in the terms of production return, but because of its commercial development value; therefore he has to pay a tremendously high Federal estate tax, and in some cases State estate taxes which go along with Federal taxes, making it impossible for that boy to take over the farm.

He has to sell the farm in order to pay the estate taxes.

This is something that is left out of the House bill, and we urge that the Senate take it under consideration. I think our generalizations speak for themselves in our statement. I appreciate the opportunity for allowing us to present the Grange views, and I especially thank the Senators for returning so that we could be heard.

The CHAIRMAN. Thank you very much, sir.

Senator MILLER. You heard my question of the previous witness about the loophole in the Metcalf bill?

Mr. FREDERICK. Yes, sir, I did, Senator. I am not sure about accrual tax accounting. We will look into it.

I would think, and I am not a tax expert, far from it, but if he can assign any unit value that he sees fit to assign, then we would say that this is wrong and it should closed. I would think that in the accrual method of tax accounting, that the market value should be used.

The CHAIRMAN. Thank you very much, sir.

Mr. FREDERICK. Thank you.

(Robert M. Frederick's prepared statement follows:)

STATEMENT BY ROBERT M. FREDERICK, LEGISLATIVE REPRESENTATIVE OF THE NATIONAL GRANGE

SUMMARY

I. TAX-LOSS FARMING

H.R. 13270 undertakes to correct a situation in which some high-income taxpayers, not primarily engaged in farming, have used farm losses to obtain a deduction in their high-bracket non-farm income.

To do this, H.R. 13270 requires the taxpayer to maintain an excess deductions account to record his farm losses. In the case of individual farm losses would be added to the excess deductions account only if the taxpayer had income from nonfarm sources of more than $50,000 for the year, and only to the extent that the farm loss for the year exceeded $25,000.

In our judgment, the E.D.A. account approach does not strike at the heart of the "tax-loss" farming loophole. It only postpones the issue and strikes at all farmers, big and small, bona fide as well as the investor who is investing in agriculture for a profit. In doing so, it includes the "tax-loss" tax-dodging farmer. In referring to the latter, we use the word "farmer" rather loosely.

It is our firm belief that the provisions of the Amendment No. 139 introduced by Senator Metcalf on August 13, 1969 will correct the abuse of the liberal tax rules provided in the Internal Revenue Code for the use of bona fide farmers. Therefore, we respectfully urge that Amendment No. 1-39 be inserted in H.R. 13270 in place of part of Subtitle B—Farm Loss, etc., starting at line 10, page 139 of the bill and striking all that follows through line 6 on page 152.

In our judgment, this method will be more in line with true tax reforms in providing more revenue for the Federal Treasury, a shifting of the tax burden and expediting the closing of tax loopholes that allow revenue losses.

It is our understanding that the E.D.A. and other farm tax proposals of the House bill will only apply to an additional 3000 persons and bring into the Federal Treasury an additional $25 million by the year 1979, such increase to come from correction in the tax-loss farming, depreciation recapture, holding period for livestock and a negligible amount from hobby-farm losses.

The amendment proposed by Senator Metcalf, Amendment No. 139 would apply to 14,000 taxpayers, thereby shifting the tax burden, and would bring in an additional $205 million per ye?. as soon as the bill became effective. In our opinion, this is true tax reform, because it increases Federal revenue at the same time it shifts the tax burden and the effect is immediate, and as we pointed out earlier in our testimony, it hits at the "jugular vein" of the tax-dodge farming.

This corrective amendment will affect only non-farmers with large amounts of nonfarm income who invest in farming to obtain tax losses.

Senator Metcalf has explained that he considered the E.D.A. approach when he first began to look into ways to correct the tax-dodging farm problem. In remarks before the Senate August 13, he said:

"After a great deal of technical discussion with experts, I was convinced that the most effective way to get at this problem without hurting the legitimate farmer would be to take the loss limitation approach. Under this method, a dollar limit would be placed on the amount of artificially created farm losses that could be used as an offset against nonfarm income in any given year."

The family farm structure in American agriculture must be given an even break with others engaged in agriculture for profit. It is our opinion that Amendment No. 139 will give us equality of income tax treatment and preserve for agriculture the liberal provisions of the Internal Revenue Code that were meant for farmers who farm for a livelihood.

It is the opinion of the National Grange that the provisions of Amendment No. 139 meet the needs of the American farmer for better than the first part of Subtitle B of H.R. 13270, thereby making any further changes in the Internal Revenue Code pertaining to agriculture unnecessary.

This corrective amendment will affect only non-farmers with large amounts of non-farm income who invest in farming in order to obtain tax losses which may be set off against their non-farm income.

II. HOBBY LOSSES

We believe that if the Metcalf amendment is adopted by this Committee there will be no need to make further provisions in the law for the so-called "hobby farmers".

As stated by Senator Metcalf before the Senate on August 13, 1969 when he introduced his amendment, ". . . The loss limitation approach would include the hobby loss farmer and would limit the current deduction of his farm losses."

There exists the mistaken impression that H.R. 13270 would discourage hobby farming to a greater extent than the amendment introduced by Senator Metcalf. In the opinion of the author and the Grange, this is not the case.

III. HOLDING PERIOD FOR LIVESTOCK

In H.R. 13270, livestock for dairy, draft or breeding purposes are discriminated against in only this one major provision. It requires that such animals be held for at least *365 days after* such animals would have first been used for such purposes. There is no similar provision for other personal property, such as machinery. Basically the requirement is that the item not be held for customers in the ordinary course of business.

We do not believe that the tax rules should be made more stringent against the farm industry at a time when it is undergoing severe economic problems. We therefore believe that the same rules regarding holding period for capital gains should apply to livestock.

This can be accomplished by striking the following in lines 7 and 8 on page 153, "for at least 365 days". Lines 7 and 8, page 153, would then read "but only if held by him after such animal normally would have first been used for any such purposes."

We realize that one of the problems of our proposal would be one of intent. However, we believe our proposal fully meets the necessary requirements in this respect. In essence, under our proposal, until an animal became a draft, dairy or breeding animal, it *would not* qualify for long-term capital gains treatment. Once it had reached such status (draft, dairy or breeding) it would clearly show that this was the intent of its owner and that he was not primarily holding it for sale to customers in the ordinary course of business.

IV. COOPERATIVE TAX REVISIONS

The National Grange was *shocked* to learn of the proposed changes in co-op tax treatment contained in H.R. 13270 as passed by the U.S. House of Representatives and now pending in the tax reform legislation before this Committee. Quite frankly, we do not see that co-op tax treatment has any connection whatsoever to "tax reform", the announced reason for holding these very hearings.

In our opinion "tax reform" should meet the following tests: (1) increase revenue to the Federal Treasury; (2) expedite the collection of the tax; and (3) shift the tax burden to those who are not carrying their share of the tax burden from those who are presently paying more than their proportionate share. The cooperative tax treatment in H.R. 13270 meets none of these tests.

We followed each press release of the House Ways and Means Committee regarding tax measures to be heard by the Committee and not once did we find the subject of co-op tax treatment listed as a subject for discussion. Therefore, neither we nor any other farm organization was permitted the privilege of open debate on such an important matter to agriculture as the tax treatment of farm co-ops, that was accorded the anti-co-op lobbyists who were permitted to have the subject introduced during the closing days of the executive hearings of the House Ways and Means Committee.

Our last ditch efforts in the Ways and Means Committee were successful only in extending the time in which *small* co-ops will be permitted to live and serve agriculture and rural America. Such hasty action on a subject of vital concern to the lifeblood of all small co-ops can have a devastating effect and completely wipe out many such co-op marketing organizations. In attacking the "giants", the "Davids" will also be slain, quite contrary to the Biblical story.

We would all agree it is desirable that the farmer receive as big a cash refund as possible, as quickly as it can be paid. This already is being done. Farmers, through an elected board of directors, decide each year what amounts they can take in cash and what amounts they must defer in order to provide capital for the cooperative.

But the proposed new regulations would take that decision away from the farmer and instead write a 15-year limit into law. This would put a "due date" on the farmer's investment in the co-ops and change the nature of that investment from "equity" to "debt capital". This could completely disrupt the capital structure of the cooperative and impair its ability to borrow money.

The 15-year payout provision is one of the least-understood yet potentially the most damaging of the new rules being proposed for cooperatives.

Secretary of Agriculture, Clifford Hardin, in addressing the annual meeting of the American Institute of Cooperation, in Urbana, Illinois on August 4, 1969, stated:

"Cooperatives are a positive and dynamic force in rural development. They have proved themselves an effective instrument in helping farm families make more effective use of their agricultural resources. Many cooperatives are also providing the original impetus for new community enterprises. In some communities the cooperative is the area's biggest industry.

"But cooperatives can, and must, do more, not only to increase job opportunities and income, but to be a positive force in helping local communities initiate and carry out new development projects."

We suggest to this Committee that cooperatives cannot aid farmers or rural America if they are "bled" to death by such measures as contained in Sec. 531 of H.R. 13270.

Official figures buttress our case. They show, for example—

• That the income of farm families is about 75 percent as much as that of non-farm families.

• That prices paid by farmers increased 28 percent from 1957–59 to mid-1969, compared with a 17 percent rise in the overall consumer price index and a 24 percent increase in retail food prices.

• That food prices have risen only two-thirds as much as those of all other consumer goods in the past 10 years.

• Agricultural output per man-hour increased 82 percent between 1957–59 and 1968.

• One farm worker in 1967 supplied the needs of 43 people compared with 23 in 1957–59.

• Farmers in recent years have increased their productivity by 5.3 percent, a rate twice that of industry.

To date we, as producers of this abundance of food and fiber, have not shared in the benefits of our labors. Farm cooperatives are one way and perhaps the best way that farmers can increase their economic position in relationship to other segments of our society—and now this avenue of economic improvement is being threatened by so-called "Co-op Tax reforms". The destruction of cooperatives appears to be the only purpose of the measure as it would deny cooperatives the same right to use their earnings for legitimate business purposes that corporations have had from the beginning of corporate history.

It's too bad that we must once again be asking busy Senators to devote time to a matter which seemingly was settled in 1962 after lengthy hearings and debate. Here you are confronted with what has been called the most sweeping tax reform measure in history. And among the many sections is a measure which has nothing to do with tax reform; which would not yield any additional tax revenue nor any additional tax benefit; but which could greatly restrict the growth of farmer cooperatives.

We see no justification for new laws governing cooperative financing or taxation. We will urge—in the strongest possible appeal—that the entire section on cooperatives be deleted from the Tax Reform Act of 1969.

V. FEDERAL ESTATE TAX

We are cognizant of the fact that the Committee report of the Ways and Means Committee of the House of Representatives states the following:

"Other income tax problems have had to be postponed for further analysis and study. Moreover, your committee found that the time available did not permit the inclusion of reform measures relating to revision of the estate and gift tax laws or the related problem of the tax treatment of property passing at death. Estate and gift taxes are an area of the tax laws your committee will undertake to study as soon as possible, with the expectation of reporting out a bill on this subject in this Congress."

However, we fail to understand how the most revolutionary tax reform legislation since the enactment of the Federal Income tax law can ignore and fail to deal with the problem of Federal Estate tax; especially as it affects the family-owned farming operation or a closely-held business.

As we indicated earlier, long overdue legislation has been introduced in both Houses to correct this tax inequity, in the House by Congressman Price and in the Senate by Senator Dole.

The present inheritance tax laws were enacted in the emotion-laden depression years when men were selling apples in the streets at a time when a few heirs and heiresses came into their inheritances which they proceeded to flaunt with worldwide publicity. Thus, the legislation was to prevent this from happening in the future.

But the result has been that the extremely wealthy have developed means of escaping the full impact of the law while the closely-held business and the family farm, the backbone of the middle-class, bears the brunt.

There is a distinct area of discrimination in the valuation of an estate that is comprised of a business or a farm and one that is comprised of publicly traded stocks and securities, the Texas Congressman maintains. While in an estate consisting of stocks, the earning power of the shares are the basis for valuation, on business enterprises or farms the value is placed on the presumed market value of the property with no attention given to whether or not speculation has substantially and unrealistically inflated the going price.

We therefore respectfully request that this Committee include in the Tax Reform Act of 1969, the provisions of Congressman Price and Senator Dole. The American family-held farm needs this tax relief if we are to maintain the family farm structure in American Agriculture and aid, not obstruct, young farmers continuing in agriculture.

VI. CONCLUSIONS AND RECOMMENDATIONS

The tax structure should be so constituted as to fall as equally as possible on all individuals and all segments of the economy according to the income and resources of each. Accordingly, no individual or industry should enjoy unduly favorable or unreasonable advantages nor should any industry or individual be penalized by unfair tax levies or regulations.

It is generally recognized that deficit financing is a prime cause of inflation at the Federal level and jeopardizes the ability of state and local governments to meet the needs of their areas in the future. We, therefore, reaffirm our position favoring a balanced Federal budget at the earliest possible time.

We urge the Congress to review the budget with the purpose of reducing the budget deficit by eliminating or modifying programs not absolutely essential to the economy and immediate welfare of the nation. If budget reductions thus effected are not sufficient to relieve the inflationary pressures now threatening the welfare of the nation and its citizens, then we favor a surtax levey to decrease the pressures that are resulting in high interest rates and serious and damaging inflation. These steps are necessary to avoid wage and price controls which are not consistent with our free enterprise system and a growing and expanding economy.

The Grange believes there definitely is merit and justification for mineral depletion allowances. However, it is our opinion that present legislation and regulation in this regard should be carefully reviewed.

Remove the tax-exempt status for industrial development bonds issued by state and local governments.

No favored property tax treatment for religious, educational, fraternal or eleemosynary institutions on their property held for enterprises conducted primarily for profit in competition with taxpaying private enterprises.

As it becomes apparent that reductions in revenues received from Federal income taxes may be justified by reasons of reduction in expenditures, the means employed in achieving such reductions should include: (a) elimination of the recently-enacted income surtax; and (b) a substantial increase in the personal exemption of individual taxpayers for themselves and their dependents. The present exemptions provide less than half the "buying power" that they did when they were incorporated in the Code.

It is one of the basic precepts of our legal system that a person is innocent until proven guilty; however, in cases involving the Internal Revenue Service, a person is, in effect, guilty until proven innocent. Therefore, the Grange favors legislation which would place the burden of proof on the Internal Revenue Service whenever that agency takes action against a taxpayer.

The National Grange would also like to go on record at this time in favor of the 6 months' continuation of the surtax at 5% or more after December 31, 1969—if the nation's economy is still superheated and that in addition to taxation, every means be used, short of Federal controls on prices and wages, to slow down and level off the nation's economy.

STATEMENT

Mr. Chairman and Members of the Committee, I am Robert M. Frederick. Legislative Representative of the National Grange, with offices at 1616 H Street, N.W., Washington, D.C. The National Grange is a farm and rural-urban community and family organization, representing 7,000 community Granges located in rural America. Our membership lives in rural-urban areas in 40 of the 50 States and has a vital interest in the legislation being considered by this Committee. Our interest in tax legislation has continued over a period of 102 years.

In a general sense, we support H.R. 13270, a bill to reform the income tax laws, to the extent that the provisions of the bill conform to Grange tax policy. However, there are several provisions of H.R. 13270 with which we are in total disagreement. We would like to take the time allotted us to discuss with the Committee the changes which the Grange believes should be made.

The most glaring differences between the position of the Grange and H.R. 13270 are in the following areas: (1) tax-loss farming; (2) hobby losses; (3) holding period for livestock; and (4) cooperatives' tax treatment.

In addition to these areas, there exists in present tax law an inequity in the Federal inheritance tax apparently not dealt with in H.R. 13270. We believe a corrective provision should be included in any tax reform bill. Corrective legislation has been introduced by Senator Robert Dole of Kansas and Representative Robert Price of Texas.

With the Committee's permission, we would like to discuss briefly each of these areas, and in some instances to point out what we think are better alternatives to the provisions of H.R. 13270.

Taking up in order the areas which we have enumerated, let me comment first on the question of tax-loss farming.

H.R. 13270 undertakes to correct a situation in which some high-income taxpayers not primarily engaged in farming have used farm losses to obtain a deduction in their high-bracket nonfarm income.

To do this, H.R. 13270 attempts to provide that a gain on the sale of farm property is to be treated as ordinary income, rather than capital gains, to the extent of the taxpayer's previous farm losses.

The taxpayer would have to maintain an excess deductions account to record his farm losses. In the case of individuals, farm losses would be added to the excess deductions account only if the taxpayer had income from nonfarm sources of more than $50,000 for the year, and only to the extent that the farm loss for the year exceeded $25,000.

In our judgment, the E.D.A. account approach does not strike at the heart of the "tax-loss" farming loophole. It only postpones the issue and strikes at all farmers, big and small, bona fide as well as the investor who is investing in agriculture for a profit. In doing so, it includes the "tax-loss" tax-dodging farmer. In referring to the latter, we use the word "farmer" rather loosely.

It is our firm belief that the provisions of the Amendment No. 139 introduced by Senator Metcalf on August 13, 1969 will correct the abuse of the liberal tax rules provided in the Internal Revenue Code for the use of bona fide farmers. Therefore, we respectfully urge that Amendment No. 130 be inserted in H.R. 13270 in place of part of Subtitle B—Farm Losses, etc., starting at line 10, page 139 of the bill and striking all that follows through line 6 on page 152.

In effect, what we are suggesting is the adoption of Amendment No. 139 in place of the House bills E.D.A. approach to solving tax-loss farming.

In our judgment, this method will be more in line with true tax reforms in providing more revenue for the Federal Treasury, a shifting of the tax burden and expediting the closing of tax loopholes that allow revenue losses.

It is our understanding that the E.D.A. and other farm tax proposals of the House bill will only apply to an additional 3000 persons and bring into the Federal Treasury an additional $25 million by the year 1979, such increase to come from correction in the tax-loss farming, depreciation recapture, holding period for livestock and a negligible amount from hobby-farm losses.

The amendment proposed by Senator Metcalf, Amendment No. 139, would apply to 14,000 taxpayers, thereby shifting the tax burden and would bring in an additional $205 million per year as soon as the bill became effective. In our opinion, this is true tax reform, because it increases Federal revenue at the same time it shifts the tax burden and the effect is immediate, and as we pointed out earlier in our testimony, it hits at the "jugular vein" of the tax-dodge farming.

This corrective amendment will affect only non-farmers with large amounts of nonfarm income who invest in farming to obtain tax losses.

There are numerous safeguards in the amendment to protect the family farmer who depends upon his farm to produce a living for his family.

Senator Metcalf has explained that he considered the E.D.A. approach when he first began to look into ways to correct the tax-dodging farm problem. In remarks before the Senate August 13, he said:

"After a great deal of technical discussion with experts, I was convinced that the most effective way to get at this problem without hurting the legitimate farmer would be to take the loss limitation approach. Under this method, a dollar limit would be placed on the amount of artificially created farm losses that could be used as an offset against nonfarm income in any given year."

Amendment No. 139, as introduced by Senator Metcalf, is identical to S. 500, the legislation introduced by Senator Metcalf and 26 other Senators and endorsed by all major farm organizations and many of the commodity groups, plus many other trade associations.

The family farm structure in American agriculture must be given an even break with others engaged in agriculture for profit. It is our opinion that Amendment No. 139 will give us equality of income tax treatment and preserve for agriculture the liberal provisions of the Internal Revenue Code that were meant for farmers who farm for a livelihood.

It is the opinion of the National Grange that the provisions of Amendment No. 139 meet the needs of the American farmer far better than the first part of Subtitle B of H.R. 13270, thereby making any further changes in the Internal Revenue Code pertaining to agriculture unnecessary.

This corrective amendment will affect only non-farmers with large amounts of non-farm income who invest in farming in order to obtain tax losses which may be set off against their non-farm income.

There is an important exception to the dollar limitation in the amendment introduced by Senator Metcalf. This amendment in no event prevents the deduction of farm losses to the extent they relate to taxes, interest, casualty losses, losses from drought, and losses from the sale of farm property. An exception is made for those deductions. In general they are deductions which would be allowed to anyone holding property without regard to whether it was being used in farming or because they represent deductions which are clearly beyond the control of the farmer, such as losses from casualty and drought.

Under provisions of the amendment, if the total of these deductions is higher than fifteen thousand dollars, then the higher figure may be used without any reduction because of nonfarm income above fifteen thousand dollars. In other words, the fifteen thousand dollar limitation is directed solely at the type of deductions that are artifically created through the abuse of the special accounting rules designed for ordinary farmers.

We are confident that the suggested amendment will not have a detrimental effect on *legitimate farmers or non-farmers who invest in farming to earn farm profits*. The amendment is unique, in that it is pointed directly at the abuse of the liberal tax accounting rules of the Internal Revenue Code, provided by Congress for ordinary farmers or those interests outside of agriculture that make investments in farming for a profit.

The amendment also provides for the large commercial farming interests in cattle, citrus and other farm specialty crops to be exempt from the provisions of the Act if they follow standard accrual accounting methods. Surely, such large privately-owned agricultural interests or investors in agriculture that use either grove management firms or cattle management firms have available to them the accounting expertise to follow such accounting methods.

The National Grange would be the last organization to support legislation to prohibit persons outside of agriculture from entering agriculture as full-time farmers or as investors supplying capital for those already engaged in agricultural production. We have insisted, however, and will continue to insist, that the rules for playing the game be the same. The adoption of Amendment No. 139 will equalize the rules and make farming a fair game for all interested in agriculture for profit.

Invasion by conglomerates

We realize that the elimination of tax loopholes in the Internal Revenue Code as it applies to individuals and corporations investing or engaged in agriculture will not stop the conglomerate corporation invasion. It will, however, eliminate the financing of such mergers and take-overs by some taxpayers through the use of "tax shelter" windfalls.

The real control over conglomerate corporate invasion can be done by tightening of the anti-trust laws, which we realize does not come under the jurisdiction of this Committee. However, we feel that this intrusion into agriculture is part of the same kind of problem which the Committee is considering today and perhaps is a far greater danger to the family farm structure of American agriculture. Curtailing tax abuse is the first step, and a necessary step, in controlling conglomerate corporation invasion of agriculture. We welcome this and similar tax legislation to ιake the "tax profit" out of such acquisitions by non-farm interests.

Benefits from tax shelters

We, as responsible members of the agricultural society, would be remiss if we did not consider any possible economic benefit to agriculture and rural America of the so-called "tax incentives" provided in the Internal Revenue Code.

Those who are in opposition to plugging the Internal Revenue loopholes that permit "tax-loss" farming present the following arguments in favor of a continuation of the laissez faire:

1. They are not tax loopholes but are tax incentives to attract into agriculture outside "risk" money;

2. That outside capital investments in agriculture have assisted in improvement in livestock breeds;

3. That farmers have benefited by outside capital in that they can expand their operations, buy more cattle, more land, which in turn benefits rural America.

We cannot help but agree that outside capital has benefited *certain individuals in agriculture* as well as *certain specific rural communities.* However, we hasten to ask, is it worth the total cost to the *Federal Treasury of approximately $205 million in lost revenue?* The total increase in Federal revenue would be much higher since farm operations carried on by corporations usually are not separately reported on the corporation tax return. Consequently, data concerning the number of corporations and revenue effect with respect thereto are not available.

Thousands upon thousands of family farms, the backbone of rural communities, are adversely affected by the activity of a small percentage of individuals who are lucky enough to have benefited directly from outside "risk" capital.

Improvement in livestock breeds has been and continues to be a major research function of our land grant colleges. These institutions are supported by public funds and devote time, money and labor into herd improvement by breeding as well as scientific feeding. We suggest that these laboratories of animal research have made major contribution to breed improvement, feeding improvement and similar advancements in the livestock industry far in excess of contributions made from outside "risk" capital.

We submit to this Committee that the interest of American agriculture and rural communities will be best served if the family farm structure does not have to compete with a select few individuals who are deriving direct benefit from the loopholes in the Internal Revenue Code.

Three categories of people receive direct benefit from the abuse of the liberal provisions in the Internal Revenue Code created for the use of the ordinary farmer: the investor, the financial manager and the farmer who manages the livestock or agricultural crops in which outside risk capital is invested, this at a tremendous loss to the Federal Treasury and the further economic loss to the family farm structure that is dependent upon profit for its very existence. Gentlemen, can we afford this kind of "Cowboy Economics"?

An unwholesome trend

The National Grange recognizes the importance of preserving and protecting the integrity of the owner-operator-manager farm, as a guarantee to the Nation of the efficient and abundant production of high-quality food and fiber at reasonable prices for the domestic and world market.

We seek to obtain for American farmers a return for their labor, management, risk and investment which bears a reasonable relationship to that received for these same economic factors in any other segment of our economy, as well as adequate compensation for their contribution to the general welfare.

The activities of conglomerate corporations and other non-farm interests in agriculture are not consistent with long-range Grange objectives and have resulted in commodity market price manipulation, unrealistically high prices for farm land and increased farm real estate taxes, (which have made it increasingly difficult to pass farms on to heirs). The net result has been a loss in rural America of farm families. These farm families are frequently forced to migrate to urban centers and into situations for which they are ill-prepared, which further aggravates the explosive problem of our central cities and urban areas, including flooding of the labor market with additional unskilled workers.

If large corporations and non-farm interests become predominant in agriculture, the need for many Main Street businesses, schools, churches and municipal facilities will be eliminated. It will destroy job opportunities in rural America and will not be in the best interest of long-term national objectives.

This impact on community life makes the non-agricultural corporate farm invasion a human as well as an economic problem. It is a problem that should concern all Americans and demand their immediate attention.

Incidentally, the Grange has a long history of interest in this problem. At the 73rd Annual Session of the National Grange, held in 1939 in Peoria, Illinois, the Delegate Body adopted the following resolution:

"In order to discourage corporation farming and capitalists acquiring large acreage of farm land, we recommend that the Federal income tax be amended to provide that losses on agricultural operations can be deducted only from incomes derived from agricultural operations."

The policy of the National Grange, adopted 30 years ago, was a lone voice against the inequities contained in the Internal Revenue Code. The continuing validity of this objective has been subsequently recognized by action of the Delegate Body taken in 1963, 1964, 1965 and again in 1967, at the 100th Anniversary of the founding of the National Grange.

At our 102nd Annual Session held in Peoria, Illinois, in November 1968, as we started our second century of service to rural America, the Delegate Body once more reaffirmed Grange position on this important and vital matter of great concern to family farms and rural communities.

The Taxation and Fiscal Policy Committee that considered tax revision resolutions made the following statement:

"The mounting concern of the family farm operator over the accelerating acquisition of agricultural lands by individuals and organizations for the purpose of building up a loss position from farming operations conducted on the lands acquired and deducting such losses from income tax liability is indicated by the fact that resolutions to prevent this practice have been received at this Annual Session of the National Grange from eighteen of the 38 State Granges.

"Farmers and their families engaged in bone fide farming operations are being forced to leave the farm, as a result of net income being at a depressed level.

"Competition of non-farm investors inflating the price of agricultural land and using loss on farming operations as a deduction against non-farm income is a factor in this lower net farm income.

"Resolved, that the National Grange vigorously support amending the Internal Revenue Code to prohibit any substantial portion of farm operating losses being used as a tax deduction or write-off against non-farm income."

Hobby losses

We believe that if the Metcalf amendment is adopted by this Committee there will be no need to make further provisions in the law for the so-called "hobby farmers".

As stated by Senator Metcalf before the Senate on August 13, 1969 when he introduced his amendment, ". . . The loss limitation approach would include the hobby loss farmer and would limit the current deduction of his farm losses."

There exists the mistaken impression that H.R. 13270 would discourage hobby farming to a greater extent than the amendment introduced by Senator Metcalf. In the opinion of the author and the Grange, this is not the case.

The Grange is not against any individual having a hobby, be it farming or wood craft; we only want fair and equitable tax treatment and to ask that such a hobby not be used as a tax dodge. We feel that the Metcalf amendment does just this.

Holding period for livestock

Previously, livestock for draft, dairy or breeding purposes had to be held one year to qualify for long-term capital gains treatment, while other capital items had to be held only six months. Conformity has been reached by requiring all capital items to be held at least one year before qualifying for long-term capital gains. However, this provision will still discriminate against many raised farm animals by increasing the holding period for them, in some cases to periods in excess of three years, or three times the general holding period.

In H.R. 13270, livestock for dairy, draft or breeding purposes are discriminated against in only this one major provision. It requires that such animals be held for at least *365 days after* such animals would have first been used for such purpose. There is no similar provision for other personal property, such as machinery. Basically the requirement is that the item not be held for customers in the ordinary course of business.

We do not believe that the tax rules should be made more stringent against the farm industry at a time when it is undergoing severe economic problems. We therefore believe that the same rules regarding holding period for capital gains should apply to livestock.

This can be accomplished by striking the following in lines 7 and 8 on page 153, "for at least 365 days". Lines 7 and 8, page 153, would then read "but only if held by him after such animal normally would have first been used for any of such purposes."

In our judgment, this would more completely bring the treatment of livestock in line with the treatment of other property used in a trade or business.

We realize that one of the problems of our proposal would be one of intent. However, we believe our proposal fully meets the necessary requirements in this respect. In essence, under our proposal, until an animal became a draft, dairy or breeding animal, it *would not* qualify for long-term capital gains treatment. Once it had reached such status (draft, dairy or breeding) it would clearly show that this was the intent of its owner and that he was not primarily holding it for sale to customers in the ordinary course of business.

Cooperative tax revisions

The National Grange was *shocked* to learn of the proposed changes in co-op tax treatment contained in H.R. 13270 as passed by the U.S. House of Representatives and now pending in the tax reform legislation before this Committee. Quite frankly, we do not see that co-op tax treatment has any connection whatsoever to "tax reform", the announced reason for holding these very hearings.

In our opinion "tax reform" should meet the following tests: (1) increase revenue to the Federal Treasury; (2) expedite the collection of the tax; and (3) shift the tax burden to those who are not carrying their share of the tax burden from those who are presently paying more than their proportionate share. The cooperative tax treatment in H.R. 13270 meets none of these tests.

We followed each press release of the House Ways and Means Committee regarding tax measures to be heard by the Committee and not once did we find the subject of co-op tax treatment listed as a subject for discussion. Therefore, neither we nor any other farm organization was permitted the privilege of open debate on such an important matter to agriculture as the tax treatment of farm co-ops, that was accorded the anti-co-op lobbyists who were permitted to have the subject introduced during the closing days of the executive hearings of the House Ways and Means Committee.

Our last-ditch efforts in the Ways and Means Committee were successful only in the extending the time in which *small* co-ops will be permitted to live and serve agriculture and rural America. Such hasty action on a subject of vital concern to the lifeblood of all small co-ops can have a devastating effect and completely wipe out many such co-op marketing organizations. In attacking the "giants", the "Davids" will also be slain, quite contrary to the Biblical story.

In 1952, the same anti-co-op lobby was successful in writing into the tax code the requirement that the tax must be paid on dividends earned by the patron for or by his patronage. At that time the Internal Revenue Code called for at least 20% of such dividend to be paid in cash so as to provide to the patron the money to pay the income tax on the dividend. The remainder could be retained in the capital structure of the co-op.

The proposal now before you, although it is a compromise, still means slow death to the small-to-medium farm cooperatives, especially those that have been organized less than 5 years.

Farmers will lose another measure of the right to say how their own businesses are to be run unless Sec. 531 is deleted from H.R. 13270.

The proposal would dictate the amount of a cooperatives' earnings that must be returned to a farmer in cash each year. It also would state when the remaining patronage refund certificates must be redeemed. Refunds not paid in accordance with the new requirements would be subjected to a current corporate federal income tax.

The borrowing power of farmer-owned businesses will be jeopardized if the proposed restrictions on cooperative financing are allowed to remain in the Tax Reform Act of 1969.

We would all agree it is desirable that the farmer receive as big a cash refund as possible, as quickly as it can be paid. This already is being done. Farmers, through an elected board of directors, decide each year what amounts they can take in cash and what amounts they must defer in order to provide capital for the cooperative.

But the proposed new regulations would take that decision away from the farmer and instead write a 15-year limit into law. This would put a "due date" on the farmer's investment in the co-ops and change the nature of that investment from "equity" to "debt capital." This could completely disrupt the capital structure of the cooperative and impair its ability to borrow money.

The 15-year payout provision is one of the least-understood yet potentially the most damaging of the new rules being proposed for cooperatives.

The co-op tax provisions of H.R. 13270 completely ignore the role farm cooperatives play in improving the incomes of farmers by providing them with alternative methods of marketing their crops or of purchasing new farm equipment, machinery and other farm supplies at reasonable prices.

Also, as pointed out in the "Summary of H.R. 13270, The Tax Reform Act of 1969" prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, "There is no showing that the present balance between farm cooperatives and regular businesses should be upset to the detriment of the cooperative movement."

The cooperative movement in the United States has had the encouragement and support of every Administration as far back as President Theodore Roosevelt, who stated:

"Wherever farmers themselves have the intelligence and energy to work through cooperative societies, this is far better than having the state undertake the work. Community self-help is normally preferable to using the machinery of government for tasks to which it is unaccustomed."

President Nixon at the start of his Administration stated:

"Some of the things that will be done in my Administration to help farmers include:

"—encouragement of farmers to improve their bargaining positions through their corperatives,

"—assistance to farm cooperatives, including adequate funding of the rural electric and telephone programs. . . .

"—Improvement of credit programs within the Farm Credit System and the Department of Agriculture to meet the capital requirements of modern agriculture, especially young farm families trying to get a decent start. . . ."

Secretary of Agriculture, Clifford Hardin, in addressing the annual meeting of the American Institute of Cooperation, in Urbana, Illinois on August 4, 1969, stated:

"Cooperatives are a positive and dynamic force in rural development. They have proved themselves an effective instrument in helping farm families make more effective use of their agricultural resources. Many cooperatives are also providing the original impetus for new community enterprises. In some communities the cooperative is the area's biggest industry.

"But cooperatives can, and must, do more, not only to increase job opportunities and income, but to be a positive force in helping local communities initiate and carry out new development projects."

We suggest to this Committee that cooperatives cannot aid farmers or rural America if they are "bled" to death by such measures as contained in Sec. 531 of H.R. 13270.

All farm leaders agree that more income for farmers should be the objective of any national program, taxation or farm policy. Our ideas on how to achieve this objective may differ as to farm policy, but not on co-op tax treatment.

Official figures buttress our case. They show, for example—

- That the income of farm families is about 75 percent as much as that of nonfarm families.
- That prices paid by farmers increased 28 percent from 1957-59 to mid-1969, compared with a 17 percent rise in the overall consumer price index and a 24 percent increase in retail food prices.
- That food prices have risen only two-thirds as much as those of all other consumer goods in the past 10 years.
- Agricultural output per man-hour increased 82 percent between 1957-59 and 1968.
- One farm worker in 1967 supplied the needs of 43 people compared with 23 in 1957-59.
- Farmers in recent years have increased their productivity by 5.3 percent, a rate twice that of industry.

To date we, as producers of this abundance of food and fiber, have not shared in the benefits of our labors. Farm cooperatives are one way and perhaps the best way that farmers can increase their economic position in relationship to other segments of our society—and now this avenue of economic improvement is being threatened by so-called "Co-op Tax reforms". The destruction of cooperatives appears to be the only purpose of the measure as it would deny cooperatives the same right to use their earnings for legitimate business purposes that corporations have had from the beginning of corporate history.

It's too bad that we must once again be asking busy Senators to devote time to a matter which seemingly was settled in 1962 after lengthy hearings and debate. Here you are confronted with what has been called the most sweeping tax reform measure in history. And among the many sections is a measure which has nothing to do with tax reform; which would not yield any additional tax revenue nor any additional tax benefit; but which could greatly restrict the growth of farmer cooperatives.

We see no justification for new laws governing cooperative financing or taxation. We will urge—in the strongest possible appeal—that the entire section on cooperatives be deleted from the Tax Reform Act of 1969.

Federal estate tax

We are cognizant of the fact that the Committee report of the Ways and Means Committee of the House of Representatives states the following:

"Other income tax problems have had to be postponed for further analysis and study. Moreover, your committee found that the time available did not permit the inclusion of reform measures relating to revision of the estate and gift tax laws or the related problem of the tax treatment of property passing at death. Estate and gift taxes are an area of the tax laws your committee will undertake to study as soon as possible, with the expectation of reporting out a bill on this subject in this Congress."

However, we fail to understand how the most revolutionary tax reform legislation since the enactment of the Federal income tax law can ignore and fail to deal with the problem of Federal Estate tax; especially as it affects the family-owned farming operation or a closely-held business.

At the 102nd Annual Convention of the National Grange, held in Peoria, Illinois, on November 11, 1968, the Delegate Body adopted the following resolution:

"FEDERAL ESTATE TAX

"Whereas, in suburban and rural-urban areas farm real estate is currently appraised for inheritance tax purposes on the value of the land for non-farm uses in the areas; and

"Whereas, a high appraisal value per acre for federal estate tax purposes results in a burdensome levy upon those who wish to remain in farming; and

"Whereas, placing such high taxable values upon farms for either property or inheritance tax purposes is not a realistic approach and when applied generally to all farms in an area, it is a futuristic value concept which adversely affects the continuation of farming in areas of prime agricultural land and needed open spaces; therefore, be it

"*Resolved*, that we recommend that appraisals of farm real estate made for inheritance and estate tax purposes be made on the basis of agricultural use value."

Under present inheritance, or death tax laws, when the principal owner of a family, or closely-held, business approaches the end of his life span, a crisis results. Knowing on his death the business will be forced to pay an inheritance tax far in excess of any existing cash position, and often not even in line with its earning record, the usual procedure is to seek a merger to avoid liquidation.

The family head of a family-owned farming operation faces the same situation, inasmuch as today's inflated land and property values are not all in line with the profitability of the enterprise, whether it be an independent business firm, or a farming operation.

As we indicated earlier, long overdue legislation has been introduced in both Houses to correct this tax inequity, in the House by Congressman Price and in the Senate by Senator Dole.

The Greeks did have a word for it—Harpyiai—which translates to "snatchers". The Greek word, subsequently anglicized to Harpies is apparently, in the opinion of many Americans, synonymous with the inheritance tax collector.

While we may not go that far, we do agree with Congressman Price of Texas' legislation to drive the Harpies away by ending what has been a major cause of mergers, as well as the liquidation of the family-held farm.

The bills by Congressman Price and Senator Dole would permit the value of an estate for inheritance tax purposes to be set, at the option of the executor, either on the basis of the deceased's costs, or on the basis of the profit of the enterprise as revealed by income tax returns.

Congressman Price cites the hypothetical example of a family-owned cattle ranch that under the present system of appraising at today's inflated values would be assessed at $300,000 leaving the inheriting son liable for $110,500 in taxes, according to his computations.

Using this hypothetical example, to further illustrate, the Texas legislator says the actual profit being realized is only $7,500. Thus, using a reasonable factor for determining value, the estate should only be valued at $105,000 which would result in a death tax liability of $22,500.

On top of the Federal death tax, most states also assess a similar tax, but usually the states will follow the Federal pattern.

Operation of the inheritance tax has and continues to create many problems which are probably more middle-class in nature than those of the very wealthy who have learned to use foundations and other loopholes to escape the full weight of the tax laws.

The present inheritance tax laws were enacted in the emotion-laden depression years when men were selling apples in the streets at a time when a few heirs and heiresses came into their inheritances which they proceeded to flaunt with worldwide publicity. Thus, the legislation was to prevent this from happening in the future.

But the result has been that the extremely wealthy have developed means of escaping the full impact of the law while the closely-held business and the family farm, the backbone of the middle-class, bears the brunt.

Perhaps the comparison between this situation and Greek mythology is even more pertinent. In early ancient mythology Harpies were considered somewhat semibeneficial but in the later era of the Argonautic sagas Harpies had degenerated into foul and loathsome creatures. The inheritance tax appears to have followed the same course.

Whether or not Congressman Price and Senator Dole will be able to emulate Calais and Zetes who drove off the Harpies, remains to be seen. Not only must they secure support from fellow legislators, but they must also educate the less knowledgeable that the inheritance taxes are no longer a "soak the rich" device, but a powerful destructive force of the middle-class backbone.

There is a distinct area of discrimination in the valuation of an estate that is comprised of a business or a farm and one that is comprised of publicly traded stocks and securities, the Texas Congressman maintains. While in an estate consisting of stocks, the earning power of the shares are the basis for valuation, on business enterprises or farms the value is placed on the presumed market value of the property with no attention given to whether or not speculation has substantially and unrealistically inflated the going price.

We therefore respectfully request that this Committee include in the Tax Reform Act of 1969, the provisions of Congressman Price and Senator Dole. The American family-held farm needs this tax relief if we are to maintain the family farm structure in Americal. Agriculture and aid, not obstruct, young farmers continuing in agriculture.

CONCLUSIONS AND RECOMMENDATIONS

It is the opinion of the National Grange that tax reform should be effected, but only in accordance with certain economic principles.

Recognizing that the economic policy of the Federal Government has a direct and important impact on the economy of the nation and affects all citizens, it is essential that these policies be sound and in keeping with the obligations of the various units of government and the services rendered by the respective units of government.

The tax structure should be so constituted as to fall as equally as possible on all individuals and all segments of the economy according to the income and resources of each. Accordingly, no individual or industry should enjoy unduly favorable or unreasonable advantages nor should any industry or individual be penalized by unfair tax levies or regulations.

It is generally recognized that deficit financing is a prime cause of inflation at the Federal level and jeopardizes the ability of state and local governments to meet the needs of their areas in the future. We, therefore, reaffirm our position favoring a balanced Federal budget at the earliest possible time.

We urge the Congress to review the budget with the purpose of reducing the budget deficit by eliminating or modifying programs not absolutely essential to the economy and immediate welfare of the nation. If budget reductions thus effected are not sufficient to relieve the inflationary pressures now threatening the welfare of the nation and its citizens, then we favor a surtax levy to decrease the pressures that are resulting in high interest rates and serious and damaging inflation. These steps are necessary to avoid wage and price controls which are not consistent with our free enterprise system and a growing and expanding economy.

The following tax reforms are recommended by the Grange:

1. We appreciate the steps that have been taken to simplify the tax report form. Further change and simplification, we believe, can have the effect of making reporting easier for the taxpayer, and will result in more exact reporting. An easy-to-understand form will also benefit the government by bringing more accurate reports and thus save on auditing costs as well as the expense of refunds and billing.

2. The Grange believes there definitely is merit and justification for mineral depletion allowances. However, it is our opinion that present legislation and regulation in this regard should be carefully reviewed.

3. The Grange approves of giving the farmer the option of choosing limitation of losses that are deductible or reporting his farming operations on an "accrual accounting" basis, but we oppose any action that would *mandate* that farmers report to the I.R.S. on an accrual basis.

4. Remove the tax-exempt status for industrial development bonds issued by state and local governments.

5. No favored property tax treatment for religious, educational, fraternal or eleemosynary institutions on their property held for enterprises conducted primarily for profit in competition with tax-paying private enterprises.

6. As it becomes apparent that reductions in revenues received from Federal income taxes may be justified by reasons of reduction in expenditures, the means employed in achieving such reductions should include: (a) elimination of the recently-enacted income surtax; and (b) a substantial increase in the personal exemption of individual taxpayers for themselves and their dependents. The present exemptions provide less than half the "buying power" that they did when they were incorporated in the Code.

7. The Grange does not favor sharing Federal income tax with the states. It is the opinion of the Grange that there is little to be gained by having the Federal Government collect taxes for blanket re-distribution to the state governments, and therefore we recommend the policy of special appropriations by the Congress to care for any necessary sharing in state financial difficulties.

We believe that the present distribution and control of Federal funds coming into states for specific community development or similar projects should be free of Federal control. These funds, according to Grange policy, should be placed under the control of state, county or local units of government and be used for the specific programs designated in the allocation of the funds.

Until permanent and equitable "in lieu of tax" legislation is enacted, the Grange recommends that present law be amended to provide that states shall receive a percentage of gross, rather than net, income from sales, rentals and other revenue from national forest lands.

8. It is one of the basic precepts of our legal system that a person is innocent until proven guilty; however, in cases involving the Internal Revenue Service, a person is, in fact, guilty until proven innocent. Therefore, the Grange favors legislation which would place the burden of proof on the Internal Revenue Service whenever that agency takes action against a taxpayer.

Innocent people have found it necessary to wage costly court battles in order to defend themselves from unfounded charges by the Internal Revenue Service. This has caused them to suffer severe financial hardship through no fault of their own and is unjust and inconsistent with the stated principles of our society.

Therefore, the Grange favors legislation which will make the Internal Revenue Service financially responsible (at the discretion of the courts) for the legal costs of any cases which are decided against them.

The National Grange supported the immediate passage of the ten-percent surtax when it was before this Committee believing that it would be followed by meaningful and equitable general tax reform legislation. We now respectfully urge that this Committee, as soon as possible, while making the necessary corrections in H.R. 13270, as requested by us and other witnesses appearing before this Committee, report to the floor of the Senate the best and most progressive Tax Reform Bill in history and work with the Senate leadership to enact such legislation into law before the end of this Session of the 91st Congress.

The National Grange would also like to go on record at this time in favor of the 6 months' continuation of the surtax at 5% or more after December 31, 1969—if the nation's economy is still superheated and that in addition to taxation, every means be used, short of Federal controls on prices and wages, to slow down and level off the nation's economy.

Agriculture can never hope to walk side by side with other segments of the nation's economy as long as we have inflation eating up the small gains we are able to obtain through agricultural program planning, export marketing and increased efficiency of the commercial family farm.

We thank this Committee for the many hours they will have to spend to bring forth a tax reform act that meets the needs of our nation. We especially thank the Chairman for his leadership in tax legislation and respectfully urge early action on tax reform legislation.

Thank you, Mr. Chairman, for permitting the National Grange to present its views on this most important matter.

The CHAIRMAN. The next witness will be the Honorable E. A. Jaenke, Governor of the Farm Credit Administration.

STATEMENT OF HON. E. A. JAENKE, GOVERNOR, FARM CREDIT ADMINISTRATION; ACCOMPANIED BY PAUL O. RITTER, GENERAL COUNSEL, FARM CREDIT ADMINISTRATION; AND EARL R. KITTREDGE, COOPERATIVE BANK SERVICE

Mr. JAENKE. We appreciate your staying so late, giving us a chance to be heard. I have prepared a short summary. I am going to summarize my short summary, if that is all right with you.

The CHAIRMAN. As you know, we will print your entire statement in the record, as well as the summary that has been prepared.

Mr. JAENKE. I have with me the General Counsel of the Farm Credit Administration, Mr. Ritter, and Mr. Kittredge of the Cooperative Bank Service.

I am here as a representative of the Farm Credit Administration, the Federal Farm Credit Board, a Board appointed by the President, confirmed here by the Senate, which sets the policy for the Farm Credit Administration in the overall boundaries of course set by Congress in creating the bank system, and also the banks for cooperatives which are one portion of the system, and the directors which serve and guide those banks.

We have two or three major points that we would like to present to the committee. No. 1, to urge the committee to strike from the bill section 531, that relating to special new provisions of taxation that would apply to cooperatives. Our purpose, the Board's purpose for urging this upon the Congress, is twofold.

First, as it affects the banks for cooperatives themselves, but more important as it affects the stockholders, the owners, and the borrowers from these banks, that is the co-ops who own and borrow from these banks.

If I might start with the latter, I think this is perhaps more important. This provision in the bill, 531, strikes at the very basis of the capital structure of the cooperatives, who are the owners and the borrowers and the stockholders of the banks' cooperatives.

By switching their reinvested earnings from equity capital to debt capital, it can seriously impede the opportunities to grow, and in some cases of smaller and newer struggling co-ops could actually result in their elimination.

As such, naturally the banks for co-ops have a great concern. There are some provisions, very complicated provisions, which are in section 531 which also, and these are covered in my statements, which would adversely affect the banks for co-ops themselves.

For these reasons, the Board believes that it would be in the public interest to strike this provision.

Now, if I might just touch on two other minor points, but important. These are not in the nature of changes in the legislation itself, but in the way of clarification. We have suggested in our Sept. 12 statement that these two provisions could be handled by language in the report; language of clarification. These have to do with treatment of reserves for losses and patronage dividends.

During that period when, pursuant to congressional mandate in the act the banks for co-ops began to pay off the federally invested capital and become privately owned, and then become subject to Federal income tax, during the first taxable years there is some question as to how the reserves for losses should be treated. We are asking that they be treated just the same as commercial banks; the treatment accorded commercial banks during the same period.

On the second matter of clarification, which again is in our prepared statement, it has to do with the dealing with a small amount, generally 5 percent or less of the total income of the banks for cooperatives, which do not come from normal patronage business, this is from overnight deposits in commercial banks, and so forth, we are asking that this be clarified for tax treatment also.

These two provisions, we believe, and as I indicated, can be handled by legislative history in the report rather than by specific legislation. Again repeating the Federal farm credit board, the Federal farm credit system, and particularly the banks for co-ops would urge this committee to strike section 531 in the interests of fair treatment of co-ops.

Thank you, sir.

Unless there are questions, we are through.

Senator CURTIS. I think your statement was very well put. I understand your position. No questions.

Senator MILLER. Mr. Jaenke, what banks come under your administration?

Mr. JAENKE. There are three phases to the farm credit system, sir, the Federal land banks, which provide mortgage money to farmers, long-term money, the Federal intermediate credit banks which provide short and intermediate term credit, and which supervise the Production Credit Associations, the local associations, and then going to the matter which concerns us primarily today, the banks for cooperatives. There are 13 of these, one in each of the 12 districts, and a——

Senator MILLER. Where are the PCA's?

Mr. JAENKE. PCA's are supervised, and fit in with the Federal intermediate credit bank. They provide short- and intermediate-term credit.

Senator MILLER. You have pointed out that the 13 banks for cooperatives recently became taxable when they retired their Government capital. Have the intermediate credit banks retired their Government capital, too?

Mr. JAENKE. All capital, all seed money put in by the Federal Government initially has been repaid now.

Senator MILLER. And are they taxable, too?

Mr. JAENKE. Yes; as to the PCA's.

Senator MILLER. So the local PCA pays a tax just like any other cooperative?

Mr. JAENKE. That is right.

Senator MILLER. What about the Federal Land Banks? Have they retired their Government capital?

Mr. JAENKE. May I ask Paul Ritter to comment on this, please?

Mr. RITTER. They have retired their Government capital, the last of it in 1947, but their tax exemption continues, because the Federal Farm Loan Act so provides.

Senator MILLER. You say the Federal Farm Loan Act so provides?

Mr. RITTER. As to the Federal Land Banks; yes.

Senator MILLER. Was that provision written in before they retired their Government money?

Mr. RITTER. Originally, in 1916, there was a general tax exemption given to the Federal Land Banks, and that was not made conditional on having Government Capital, and therefore the general exemption continues.

Senator MILLER. So there is a difference between the three banks under your administration in the tax treatment, and that exemption that was written into that original Act has continued without change, whereas in the case of the intermediate credit bank, PCA's, and the banks for cooperatives, they are subject to tax now?

Mr. RITTER. No, the Federal intermediate credit banks have the same tax position as the Federal Land Banks, where general exemption continues.

Senator MILLER. Mr. Jaenke said that the PCA's were subject to tax.

Mr. RITTER. The Production Credit Associations are.

Senator MILLER. But not the intermediate credit banks.

Mr. RITTER. That is right, sir.

Senator MILLER. But the banks for cooperatives are.

Mr. RITTER. The basic provision in the Farm Credit Act of 1933 provided—and this also applied in the case of the Production Credit Associations—that after retirement of their Government capital, the exemption should no longer apply as to the bank or the association, its income or its property.

Senator MILLER. Could you provide for the record an analysis of the difference in those provisions between the three banks?

Mr. JAENKE. Of course, we will.

(Hon. E. A. Jaenke's prepared statement and information requested follows:)

STATEMENT OF E. A. JAENKE, GOVERNOR, FARM CREDIT ADMINISTRATION

SUMMARY

The Federal Farm Credit Board, which sets policy for the Farm Credit Administration, and the 13 banks for cooperatives consider it to be in the public interest that section 531 should be stricken from the tax reform bill.

The additional requirements which would be imposed by section 531 of H.R. 13270, in order to qualify patronage dividends of cooperatives generally for deduction in computing income subject to Federal income tax, would seriously impair the ability of both the 13 banks for cooperatives and the farmer cooperatives to which such banks make loans to serve farmers effectively.

The reasons for these conclusions follow:

(1) The increased money payment requirements of section 531 (from 20 to 50 percent with the remainder to be paid within 15 years) would present special problems for a bank for cooperatives which must operate as provided in the Farm Credit Act of 1933, as amended.

> (a) Alternatively, the 30 percent increased money payment requirement of section 531 may be met by payment on *qualified* outstanding patronage dividends. However, the Farm Credit Act requires that the oldest outstanding patronage dividends be retired first, and those issued by a bank for cooperatives since 1956 and before it recently became subject to Federal income tax (between 1965 and 1969) are *not qualified* under the Internal Revenue Code.
>
> (b) In the event of a year with net losses, the Farm Credit Act provides that they shall be absorbed by charges against or impairment of outstanding patronage dividends, which might make the amount payable thereon less than their value when issued. If this possibility were considered to preclude a bank for cooperatives from meeting the additional 15-year money payment requirement of section 531, it would mean that none of its patronage dividends, except those paid in money, could qualify for deduction.

(2) A general problem for all cooperatives, including a bank for cooperatives, under the 15-year money payment requirement of section 531, is whether their financial position in the year that the money payments are due, will be such that the payments can be made.

(3) The additional requirements imposed by section 531 would seriously impair both the financial strength and the debt repayment capacity of many farmer-owned cooperatives which borrow from a bank for cooperatives and they also would seriously impair the capacity of a bank for cooperatives to carry or make a loan to a farmer cooperative on a self-sustaining basis, particularly term loans.

Therefore, section 531 would greatly hamper farmers' efforts to build strong cooperatives or even maintain existing organizations that farmers designed to help themselves solve many of their own problems, as Congress has long encouraged them to do.

Scope of statement

Inasmuch as section 531 of H.R. 13270, the Tax Reform Act of 1969, would impose additional requirements on cooperatives generally, if their patronage dividends are to qualify for deduction from gross income in computing their income that is subject to Federal income tax, it concerns both the 13 banks for cooperatives, which operate under the supervision of the Farm Credit Administration in making loans to farmer cooperatives, and the farmer cooperatives which borrow from the banks for cooperatives. In the circumstances, after noting the additional requirements in section 531, this statement will undertake to review the application of those requirements to the banks for cooperatives and to the farmer cooperatives which borrow from the banks. Comment will also be made relative to the lending operations of the banks for cooperatives. Before doing so, though, it may be helpful to have in mind the present tax status of the banks for cooperatives.

Tax status of banks for cooperatives

The 13 banks for cooperatives are established under the Farm Credit Act of 1933 to make loans to eligible farmer cooperative associations as therein authorized; and since 1955, the Act requires that the banks themselves also operate on a cooperative basis, with the borrowing cooperatives investing in capital stock and surplus of the banks by retention of patronage dividends and by direct stock purchase. Such investments have been used during the past 14 years largely to retire Government stock. Each bank for cooperatives first became subject to Federal income tax when it retired all of its Government capital and, for each bank, this was during the period June 30, 1965, to December 31, 1968. The banks for cooperatives, therefore, are subject to the Federal income tax treatment provided in the Internal Revenue Code for organizations doing business on a cooperative basis, as are the farmer cooperatives which borrow from the banks.

Proposed amendment of Internal Revenue Code by section 531

(1) As passed by the House of Representatives, section 531 of H.R. 13270, the Tax Reform Act of 1969, would amend the Internal Revenue Code to change the Federal income taxation of organizations doing business on a cooperative basis, and their patrons, as respects patronage dividends (and per-unit retains) from a cooperative to its patrons.

(2) Under existing law, patronage dividends (and per-unit retains) which meet the specific requirements of the Internal Revenue Code to qualify for such treatment, are excludible or deductible from gross income in computing the taxable income of the cooperative, for the year for which paid, and are includible in the gross income of the patron for the year in which received·

(3) Section 531, as passed by the House, without increasing tax revenues in any respect, would impose additional requirements if patronage dividends (and per-unit retains) are to qualify for the foregoing tax treatment for taxable years beginning after 1969. One additional requirement, noted under (4) below, would apply only to patronage dividends; a second additional requirement, noted under (5) below, would apply to both patronage dividends and per-unit retains.

(4) One additional requirement would be to increase to 50 percent (from the present 20 percent at the rate of 3 percent each year for 10 years) the portion of annual patronage dividends to be paid in money in order to qualify them for deduction, although the added (up to 30 percent) money payment requirement could be met by payment on qualified patronage dividends issued for earlier taxable years.

(5) A second additional requirement, as to the remainder of annual patronage dividends or per-unit retains not already paid in money, would be (a) that the bylaws of the cooperative provide for payment of the remainder in money within the next 15 years, or (b) that an unconditional written evidence of indebtedness, to mature within the next 15 years, be issued for such remainder.

Application of proposed amendment (section 531) to a bank for cooperatives

If the present 20 percent money payment requirement in the Internal Revenue Code should be increased to 50 percent, as proposed in section 531, the increased money payment would also be required to be made by banks for cooperatives under the Farm Credit Act. Under the bill the additional 30 percent cash payout could be treated in one of two ways: (1) As current patronage refunds, or (2) to retire *qualified* patronage refunds resulting from earnings in prior years. As a practical matter the banks for cooperatives probably would not distribute the additional amounts as patronage refunds because of the underlying intent of the Farm Credit Act that new capital inputs should be used to retire the oldest outstanding equities of cooperatives. Insofar as the alternative is limited to payment on *qualified* patronage dividends issued for earlier taxable years, there would be a special problem for the banks for cooperatives.

The Farm Credit Act requires that retained patronage dividends of the banks for cooperatives be issued in the form of allocations of surplus and class C stock. The Act also provides that after the retirement of all class A (Government) stock, class C stock also may be retired in money at par by the board of directors of a bank calling the oldest outstanding stock. When the surplus account of a bank exceeds 25 percent of total capital stock, the excess amount of allocated surplus may be distributed in the form of class C stock. However, it was only as each bank for cooperatives retired all of its Government capital and became subject to Federal income tax starting with the period June 30, 1965, to December 31, 1968, that a bank issued patronage dividends that *qualified* for deduction under the terms of the Internal Revenue Code. Accordingly, although section

531 would permit the additional 30 percent money payment requirement to be met by payment on outstanding qualified patronage dividends, the Farm Credit Act in effect requires that *unqualified* patronage dividends, issued since 1956 and before a bank for cooperatives became subject to Federal income tax, must be retired first.

Since the Farm Credit Act requires that retained patronage dividends of a bank for cooperatives be in the form of allocations of surplus account and class C stock, such patronage dividends cannot be issued in the form of an unconditional written evidence of indebtedness to mature within the next 15 years. Such banks can adopt a bylaw providing for payment of the remainder of its patronage dividends for years after 1969 within the 15 years after issue. However, such a bylaw would be subject to the provisions of the Farm Credit Act concerning allocated surplus and class C stock, and special problems occur under these circumstances.

First, the banks for cooperatives could have difficulty in meeting the 15-year limitation on retained patronage dividends. At the present time the revolving periods for the allocated equities vary by banks and range from 8 to 14 years. Four of the banks are at the 14-year level since they have just recently repaid all Government capital and have not yet had the opportunity to consider the retirement of their oldest outstanding capital held by cooperatives. There is no assurance that the amount of patronage dividends to be earned in future years will be sufficient to retire equities on a 15-year basis without weakening the financial structure of a bank. In such circumstances a bank might not be able to fully serve the needs of farmer cooperatives as intended by Congress.

Secondly, in the event of a net loss in the operations of a bank for cooperatives in any succeeding fiscal year, the Farm Credit Act requires that such loss be charged to allocated surplus and, to the extent not absorbed by surplus, to the impairment of class C stock. The above losses, therefore, would reduce the amount of patronage dividends to be retired at a future date. If there are sufficient earnings in succeeding years, any impairment of the class C stock would be restored, but there is no provision in the Farm Credit Act as to the restoration of any losses charged against allocated surplus. Conceivably, the amount payable on at least the allocated surplus portion of the patronage dividends some years hence might be less than when the patronage dividends were issued. If this possibility were considered to preclude a bank for cooperatives from meeting the additional 15-year requirement of section 531, although a reasonable interpretation could be otherwise, it would mean that none of its patronage dividends except those paid in money, could qualify for deduction.

These provisions would give the banks for cooperatives two poor alternatives. Either they would have to accept a weakened financial structure and, thus, a curtailment of their ability to serve agriculture, or accept tax burdens that were not contemplated in 1955 when Congress, in effect, asked cooperatives to take over the ownership of the banks by providing a plan under which cooperatives would invest their funds in the capital of the banks in order to retire the Government stock.

Lending operations of the banks for cooperatives

The banks for cooperatives provide seasonal and term loans to about 3,000 of the nation's 8,100 farmers' marketing, supply, and business service cooperatives. Such loans constitute about 60 percent of all borrowed funds by these organizations. At June 30, 1969, the banks had loans outstanding of $1.6 billion of which $650 million were seasonal loans, generally due within one year, and $945 million were term loans maturing in from one year to about 15 years. Since the banks began operations in 1933, loans totaling $22 billion have been made. The banks extend credit on a sound business basis and they counsel with borrowers on developing sound financial structures and operating programs. Encouragement to farmers to build cooperatives through which they can improve the profitability of their farm operations has been restated on many occasions as an intent of Congress.

The proposed requirements for the method of payment of patronage dividends unquestionably will weaken the financial structures of many cooperatives, particularly those that are smaller and newer. It will become more difficult for them to even maintain their present capital structure when, in many cases, they are in dire need to build additional capital. Consequently, many of the loans could develop into serious weaknesses and possibly result in losses, thus adversely affecting the operations and financial condition of the banks for cooperatives.

Effect of section 531 on cooperative borrowers

The cooperative approach has been effectively utilized by farmers to improve the profitability of their farm operations which have historically been and are yet typically small, independent enterprises with extremely limited bargaining power in the marketing of their products and purchase of production supplies and services. By associating together in cooperatives, farmers have created organizations which they control as member-owners and from which they benefit as patrons. The borrowing capacity justifying the credit required to make these cooperatives effective has largely been created by the implicit and explicit commitments of their members to reinvest portions of their allocations on an *equity* basis, as distinguished from a *debt* basis as section 531 would require. Term loans can be made on a sound basis by a lender only if he is reasonably assured that earnings, or in the case of cooperatives, savings or per-unit retains, will be generated in the future *and* that some portion of these inputs or savings will be capitalized and retained in the business as risk capital, thus creating repayment capacity. The result to be expected if section 531 is enacted that some term loans will not be made that otherwise would have been made, such loans may be smaller and not fully responsive to the financial requirement, amortized installments no doubt will be larger than practical and maturity periods will be shorter than otherwise. These restrictions in the extension of credit will obviously be harmful to most cooperatives and to the farmers they serve and to the communities in which they operate.

Most cooperatives have some type of capitalization plan which provides for the replacement of savings or retains capitalized in prior years with current margins or per-unit retains. The objective and effect of each of these plans is to place the burden of capitalizing the cooperative on those current patrons who are benefiting from the operations of the cooperative in direct proportion to their utilization of the cooperative. The length of time for which capitalized savings must be retained in the cooperative is dependent on many factors including the capacity of the cooperative to generate net margins, whether or not new investments in facilities and equipment are being made, and the extent to which the cooperative can and desires to utilize leverage on its member-owned capital. The critical element in the capitalization programs of all cooperatives is that the retention and retirement of retained net margins is entirely at the discretion of the board of directors and, ultimately, the membership to which it is directly accountable.

The prime effect of this section of the bill is to deny to cooperati·es and their members the right to capitalize earnings allocated to members which are retained in the cooperatives. The capitalization programs of the vast majority of cooperatives are based on the right and willingness of cooperative members to reinvest in equity form portions of the earnings of their cooperatives which have been allocated to them. Enactment of these provisions of section 531 would seriously jeopardize the continued financial stability, borrowing capacity, and effectiveness of many cooperatives in improving the profitability of their members' farming operations. This judgment is based on our conclusions regarding the implications of the above-mentioned prime effect of these provisions as illustrated by the following brief example.

Table 1 compares the financial condition of a cooperative at the end of 15 years on the basis of present laws and on the basis of the provisions of section 531. This comparison shows that the financial condition has changed substantially for the cooperative operating under section 531 and that any requests by it for term loans at that point must be given considerable analysis, and if made, must be on a much more conservative basis than to the other cooperative. This is true because the risk to the lender is greater, there being no net worth to protect the lender.

TABLE 1.—COMPARISON OF CHANGE IN FINANCIAL CONDITION, 15 YEARS OF OPERATIONS UNDER SEC. 531 AND PRESENT LAW

Balance sheets	Present	15 years later— Under sec. 531	15 years later— Under present law
Total assets	$500,000	$500,000	$500,000
Current liabilities	100,000	100,000	100,000
Term liabilities:			
Outside borrowings	100,000	100,000	100,000
15-year member investments		300,000	
Total liabilities	200,000	500,000	200,000
Net worth	300,000		300,000
Total liabilities and net worth	500,000	500,000	500,000

Assumptions

1. Net earnings of $25,000 annually.
2. Cash payment of 20 percent of savings each year ($5,000).
3. Remaining $20,000 each year retained as capital and a like amount of a prior issue of member capital retired in cash.

Note: The total cash payments in items 2 and 3 would fulfill the 50 percent cash requirement of section 531.

Table 2 compares the financial conditions 5 years later after experiencing a period of reduced savings from that of the previous 15 years. During the 5-year period, the cooperative operating under section 531 would need to retire $100,000 of 15-year member investment ($20,000 per year was retained in each of the first 15 years), but savings available for retention would total only $20,000. The deficit of $80,000 in capital funds is shown as being borrowed on a term basis. Although this period of reduced savings has seriously affected the financial condition of the cooperative operating under section 531, if it were operating under present tax laws it would remain financially sound with its borrowing capacity and ability to render service to its members unimpaired. This is because the board of directors has limited the retirement of equities retained in prior years to the amount of funds available from savings. This has necessarily increased the revolving cycle of equities to more than 15 years but this flexibility is essential if cooperative members are to assume the ownership risks of their own cooperative ventures, thus creating the borrowing capacity their cooperatives require to be effective.

TABLE 2.—COMPARISON OF FINANCIAL CONDITION FOLLOWING 5 YEARS OF UNFAVORABLE OPERATIONS UNDER SEC. 531 AND PRESENT LAW

[Based on figures shown in table 1]

	Balance sheets Under sec. 531	Balance sheets Under present law
Total assets	$500,000	$500,000
Current liabilities	100,000	100,000
Term liabilities:		
Outside borrowings	180,000	100,000
15-year member investments	220,000	
Total liabilities	500,000	200,000
Net worth		300,000
Total liabilities and net worth	500,000	500,000

Assumptions

1. Net earnings of $5,000 annually.
2. Cash payment equal to 20 percent of earnings each year ($1,000).
3. Cooperative under present law uses excess cash ($4,000 per year) to retire old equities to maintain net worth at $300,000.

4. Cooperative operating under section 531 retains $4,000 per year but must retire $20,000 per year of 15-year investments.

Note: The total cash payments in items 2 and 4 would fulfill the 50 percent cash requirement of section 531.

Enactment of section 531 would, as shown in Table 1, transform the character of the member investment in most cooperatives from owners' equity to debt. The most salient and injurious implication of this result is that the term borrowing capacity of cooperatives would be greatly reduced if not destroyed by their inability to financially withstand periods of unfavorable operating results as demonstrated in Table 2.

A bank for cooperatives or any other lender contemplating a term loan to a cooperative operating under section 531 cannot avoid giving prime consideration to two unfavorable facts: (1) The cooperative is faced with annual obligatory retirements of member investments pursuant to section 531 which are equal to 80 percent of its average long-term annual savings and substantially greater than its recent capacity to generate savings; and (2) no repayment can be anticipated unless and until net savings exceed the long-term average or as it may become possible for the cooperative to achieve its long-term average net saving with a lower asset investment. Obviously, the term lender would be forced to tailor his lending policies regarding loans to cooperatives in recognition of the fact that as long as a term loan is outstanding to a cooperative operating under the provisions of section 531, he must be prepared to realize on security in satisfaction of the loan. The potential for rapid deterioration of the financial condition of the cooperative and his position would be continual and, to a great extent, beyond his control or that of the organization's board of directors allowing, at best, a restricted grace period during which necessary adjustments to operations can be identified and effected.

The inescapable conclusion is that the enactment of section 531 would do serious harm to most cooperatives and might actually destroy a number of them. While the purpose of section 531 appears on the surface to assure cooperative members of receiving their allocations in cash within a stated period of time, it would in actuality deprive many cooperative members of the organizations which they have been encouraged by Congress to build in their own interest. Additionally, the enactment of this section of the House bill would effectively preclude farmers from acting together in the future to alleviate their income problems on their own initiative.

Inasmuch as section 531 would not increase tax revenues, but would impair the capacity of farmers through their cooperatives to provide, and obtain financing for, marketing, purchasing, and farm business services for themselves, the Federal Farm Credit Board and the banks for cooperatives consider it to be in the public interest that section 531 should be denied from the tax reform bill.

Tax Status of Farm Credit Banks and Associations (September 22, 1969)

I. PRELIMINARY

(a) What follows was prepared at the request of the Senate Committee on Finance to show the differences in the present tax status of the banks and associations which are under the supervision of the Farm Credit Administration, namely:

Federal Land Banks and Federal Land Bank Associations;
(Authorized in 1916 and make long-term farm mortgage loans)

Federal Intermediate Credit Banks;
(Established in 1923 and finance production credit associations and other institutions in making agricultural loans)

•Production Credit Associations; and
(Authorized in 1933 and make short- and intermediate-term loans to farmers)

Banks for Cooperatives.
(Established in 1933 and make loans to farmer marketing, purchasing, or service cooperatives)

(b) At the hearings, September 22, 1969, on H.R. 13270 (Tax Reform Act of 1969), there was a question as to whether the tax status of such banks and associations changed when their Government capital was retired. Except for the Federal land bank associations, all of the banks and associtions were started with

Government capital (capital stock owned by the United States). The Federal land banks completed retirement of their Government capital by 1947; the Federal intermediate credit banks by the end of 1968; each production credit association during the period 1945 to 1969; and each bank for cooperatives during the period 1965 to 1968. Such tax exemption as is granted by the Federal land banks and Federal land bank associations, and the Federal intermediate credit banks, by the Federal Farm Loan Act, continues as before they retired their Government capital. On the other hand, the tax exemption granted a production credit association or a bank for cooperatives or its property or income by the Farm Credit Act of 1933 no longer applies when such a bank or association is without Government capital. Mostly the difference is that the production credit associations and the banks for cooperatives became subject to income and similar taxes, Federal and State, when they retired their Government capital; but that the other banks and associations did not.

(c) After a separate explanation for the different banks and associations, this statement concludes with some of the relevant statutory provisions as printed in the United States Code.

II. FEDERAL LAND BANKS AND FEDERAL LAND BANK ASSOCIATIONS

(a) As provided in the Federal Farm Loan Act, as amended (12 U.S.C. 931-3), the real property of every Federal land bank and every Federal land bank association is subject to State, county, and municipal taxes, to the same extent, according to its value, as other real property is taxed (12 U.S.C. 933). Otherwise, such banks and associations are generally exempt from Federal, State, municipal, and local taxation (12 U.S.C. 931). Their exemption from Federal income taxes is specifically recognized in the Internal Revenue Code (26 U.S.C. 501 (a), (c) (1)).

(b) Mortgages executed to the Federal land banks are exempt from Federal, State, municipal and local taxation (12 U.S.C. 931).

(c) Consolidated Federal farm loan bonds issued by the Federal land banks and the income derived therefrom are exempt from State, municipal, and local taxation. Since the Public Debt Act of 1941, interest on such bonds is not exempt from taxation by the United States Government. Gain from the sale or other disposition of such bonds and transfer of the bonds by inheritance, gift, etc., are not exempt from either Federal or State taxation. (12 U.S.C. 931; 31 U.S.C. 742a).

(d) The Federal Farm Loan Act includes a provision, added in 1953, that any Federal land bank with outstanding capital stock held by the United States shall pay a franchise tax to the United States (12 U.S.C. 903). However, because the United States has not held any capital stock in a Federal land bank since 1947 and its authority to again purchase such capital stock was repealed in 1955, no franchise taxes have been paid.

(e) In addition to State and local taxes on real estate, the Federal land banks and Federal land bank associations pay employment taxes as do other employers under the Federal social security program and the Federal-State unemployment insurance program. However, for those land bank employees who continue under the Civil Service Retirement Act (a declining group), the banks contribute under that Act instead of paying social security taxes.

III. FEDERAL INTERMEDIATE CREDIT BANKS

(a) As provided in the Federal Farm Loan Act, as amended (12 U.S.C. 1111), each Federal intermediate credit bank has the same tax exemption accorded to Federal land banks and Federal land bank associations, and consolidated collateral trust debentures issued by the Federal intermediate credit banks enjoy the same tax exemptions as are accorded bonds issued by the Federal land banks. This is as more fully described in paragraphs (a) and (c) under II.

(b) Annually since 1923, except for the years 1932–36, and until the last of their Government capital was retired at the end of 1968, the Federal intermediate credit banks have paid a franchise tax to the United States. Under existing law, each bank is subject to payment of a franchise tax for any year during which any of its outstanding capital stock is held by the United States. Since 1956, the amount of the franchise tax is the lower of either (a) the interest cost to the United States on its investment in the capital stock of the bank as certified by the Secretary of the Treasury or (b) 25% of any net earnings of the bank for the year which are available after restoring any impairment of its capital stock, participation certificates, and surplus account, and adding 25% of the net earnings then remaining to its reserve account (12 U.S.C. 1072(a)). No further franchise tax will be payable by any Federal intermediate credit bank so long as it continues without Government capital.

(c) In addition to State and local taxes on real estate, the Federal intermediate credit banks pay employment taxes as do other employers under the Federal social security program and the Federal-State unemployment insurance program. However, for those credit bank employees who continue under the Civil Service Retirement Act (a declining group), the banks contribute under that Act instead of paying social security taxes.

IV. PRODUCTION CREDIT ASSOCIATIONS

(a) As provided in the Farm Credit Act of 1933, as amended (12 U.S.C. 1138c), any real property and any tangible personal property of the production credit associations has always been subject to Federal, State, Territorial, and local taxation to the same extent as other similar property is taxed. In a production credit association, the Government capital may be in the form of class A stock (which results in partial tax exemption) or class C stock (which has no effect on tax status). While the Government holds class A stock in such an association, its property, its franchises, capital, reserves, surplus, and other funds, and its income, are exempt from all taxation now or hereafter imposed by the United States or by any State, Territorial, or local taxing authority. However, the exemption does not apply with respect to any production credit association or its property or income after the class A stock held in it by the Government has been retired, as is now the case for all of the associations.

(b) Presently, therefore, the production credit associations are subject to taxes as is any other corporation doing business as they do. The most significant change because of the retirement of their Government capital is that the associations now pay Federal income tax and State income or similar taxes, in addition to taxes on real property and tangible personal property. They also pay employment taxes under the Federal social security program and the Federal-State unemployment insurance program.

V. BANKS FOR COOPERATIVES

(a) As provided in the Farm Credit Act of 1933, as amended (12 U.S.C. 1138c), any real property and any tangible personal property of the 13 banks for cooperatives has always been subject to Federal, State, Territorial, and local taxation to the same extent as other similar property is taxed. While the Government holds any stock in such a bank, its property, its franchises, capital, reserves, surplus, and other funds, and its income, are exempt from all taxation now or hereafter imposed by the United States or by any State, Territorial, or local taxing authority. However, the exemption does not apply with respect to any bank for cooperatives or its property or income after the stock held in it by the United States has been retired, as is now the case for all of the banks for cooperatives.

(b) The Farm Credit Act of 1933, as amended (12 U.S.C. 1138c), provides further that consolidated collateral trust debentures issued by the banks for cooperatives shall be exempt both as to principal and interest from all taxation (except surtaxes, estate, inheritance, and gift taxes) imposed by the United States or by any State, Territorial, or local taxing authority; however, under the Public Debt Act of 1941, as amended (31 U.S.C. 742a), the income derived from the debentures and gain from the sale or other disposition thereof are subject to all taxation imposed under the Internal Revenue Code or laws amendatory or supplementary thereto. This separate provision continues applicable as to the debentures and is not changed by the retirement of Government capital from the banks for cooperatives.

(c) Annually since 1953 each bank for cooperatives has paid a franchise tax to the United States, until the last of its Government capital was retired during the period 1965 to 1968. This is required for any year during which any of the outstanding capital stock of a bank is held by the United States. The amount of the franchise tax is the lower of either (a) the interest cost to the United States on its investment in the capital stock of the bank as certified by the Secretary of the Treasury or (b) 25% of any net savings of the bank for the year which are available after restoring any impairment of its capital stock and adding 25% of the net savings then remaining to its surplus account (12 U.S.C. 11341(a)). No further franchise tax will be payable by any bank for cooperatives so long as it continues without Government capital.

(d) Presently, therefore, the banks for cooperatives are generally subject to taxes as is any other corporation doing business as they do. The most significant change because of the retirement of their Government capital is that the banks now are subject to Federal income tax and State income or similar taxes, in addition to taxes on real property and tangible personal property. They also pay employment taxes under the Federal social security program and the Federal-State unemployment insurance program. However, for those cooperative bank employees who continue under the Civil Service Retirement Act (a declining group), the banks contribute under that Act instead of paying social security taxes.

VI. STATUTORY PROVISIONS AS PRINTED IN UNITED STATES CODE

Federal land banks and associations

Section 26 of Federal Farm Loan Act, as amended, as codified in Title 12 of United States Code.

EXEMPTION FROM TAXATION

§ 931. Federal land banks and associations; mortgages and bonds as instrumentalities of Government.

Every Federal land bank and every Federal land bank association, including the capital and reserve or surplus therein and the income derived therefrom, shall be exempt from Federal, State, municipal, and local taxation, except taxes upon real estate held, purchased, or taken by said bank or association under the provisions of sections 761 and 781 of this title. First mortgages executed to Federal land banks, or to joint stock land banks, and farm loan bonds issued under the provisions of this chapter, shall be deemed and held to be instrumentalities of the Government of the United States, and as such they and the income derived therefrom shall be exempt from Federal, State, municipal, and local taxation. (July 17, 1916, ch. 245, title I, § 26, 39 Stat. 380; Aug. 18, 1959, Pub. L. 86–168, title I, § 104(h), 73 Stat. 387.)

§ 932. Joint-stock land banks; State taxation of shareholder, limitations on.

[Obsolete inasmuch as all joint stock land banks have been liquidated.]

§ 933. Federal and joint-stock land banks; real property not exempt.

Nothing in sections 931–933 of this title shall be construed to exempt the real property of Federal and point-stock land banks and Federal land bank associations from either State, county, or municipal taxes, to the same extent, according to its value, as other real property is taxed. (July 17, 1916, ch. 245, title I, § 26, 39 Stat. 380; Aug. 18, 1959, Pub. L. 86–168, title I, § 104(h), 73 Stat. 387.)

Federal intermediate credit banks

Section 210 of Federal Farm Loan Act, as amended, as codified in Title 12 of United States Code.

TAX EXEMPTION

§ 1111. Capital and income; debentures instrumentalities of Government.

The privileges of tax exemption accorded under section 931 of this title shall apply also to each Federal intermediate credit bank, including its capital, reserve, or surplus, and the income derived therefrom, and the debentures issued under this subchapter shall be deemed and held to be instrumentalities of the Government and shall enjoy the same tax exemptions as are accorded farm-loan bonds in said section. (July 17, 1916, ch. 245, title II, § 210, as added Mar. 4, 1923, ch. 252, title I, § 2, 42 Stat. 1459.)

Banks for cooperatives and production credit associations

Section 63 of Farm Credit Act of 1933, as amended, as codified in Title 12 of United States Code.

§ 1138c. Tax exemption; realty and tangible personality as subject to taxation; termination of tax exemption after retirement of Government-owned stock.

The Central Bank for Cooperatives, and Production Credit Association, and Banks for Cooperatives, organized under this chapter, and their obligations, shall be deemed to be instrumentalities of the United States, and as such, any and all notes, debentures, bonds, and other such obligations issued by such banks, or associations shall be exempt both as to principal and interest from all taxation (except surtaxes, estate, inheritance, and gift taxes) now or hereafter imposed by the United States, or by any State, Territorial, or local taxing authority. Such banks, and associations, their property, their franchises, capital, reserves, surplus, and other funds, and their income shall be exempt from all taxation now or hereafter imposed by the United States or by any State, Territorial, or local taxing authority; except that any real property and any tangible personal property of such banks, association, and corporations shall be subject to Federal, State, Territorial, and local taxation to the same extent as other similar property is taxed. The exemption provided herein shall not apply with respect to any production credit association or its property or income after the class A stock held in it by the Governor has been retired, or with respect to any bank for cooperatives or its property o. income after the stock held in it by the United States has been retired. (June 16, 1933, ch. 98, title VI, §63, 48 Stat. 267; Aug. 11, 1955, ch. 785, title II, § 205, 69 Stat. 663; July 26, 1956, ch 741, title I, § 105(*o*), 70 Stat. 666.)

From Internal Revenue Code as codified in Title 26 of United States Code.

§501. Exemption from tax on corporations, certain trusts, etc.

(a) Exemption from taxation.

An organization described in subsection (c) or (d) or section 401 (a) shall be exempt from taxation under this subtitle unless such exemption is denied under section 502, 503, or 504.

* * *

(c) List of exempt organizations.

The following organizations are referred to in subsection (a):

(1) Corporations organized under Act of Congress, if such corporations are instrumentalities of the United States and if, under such Act, as amended and supplemented, such corporations are exempt from Federal income taxes.

* * *

From Public Debt Act of 1941, as amended, as codified in Title 31 of United States Code.

§742a. Same; by Federal tax Acts

(a) Interest upon obligations, and dividends, earnings, or other income from shares, certificates, stock, or other evidences of ownership, and gain from the sale or other disposition of such obligations and evidences of ownership issued on or after March 28, 1942, by the United States or any agency or instrumentality thereof shall not have any exemption, as such, and loss from the sale or other disposition of such obligations or evidences of ownership shall not have any special treatment, as such, except as provided under the Internal Revenue Code of 1954; except that any such obligations which the United States Maritime Commission or the Federal Housing Administration had, prior to March 1, 1941, contracted to issue at a future date, shall when issued bear such tax-exemption privileges as were, at the time of such contract, provided in the law authorizing their issuance. For the purposes of this subsection a Territory, a possession of the United States, and the District of Columbia, and any political subdivision thereof, and any agency or instrumentality of any one or more of the foregoing, shall not be considered as an agency or instrumentality of the United States.

(b) The provisions of this section shall, with respect to such obligations and evidences of ownership, be considered as amendatory of and supplementary to the respective Acts or parts of Acts authorizing the issuance of such obligations and evidences of ownership, as amended and supplemented.

(c) Nothing contained herein shall be construed to amend or repeal sections 114 and 115 of the Revenue Act of 1941. (Feb. 19, 1941, ch. 7, § 4, 55 Stat. 9; Mar. 28, 1942, ch. 205, § 6, 56 Stat. 190; June 25, 1947, ch. 147, 61 Stat. 180; Sept. 22, 1959, Pub. L. 86–346, title II, § 202, 73 Stat. 624.)

The CHAIRMAN. Thank you very much, gentlemen.

Mr. JAENKE. Thank you, sir.

The CHAIRMAN. Our next witness will be Mr. Jerry Voorhis, past president of the Cooperative League of the United States.

Senator CURTIS. Mr. Chairman, Mr. Voorhis was a hardworking and respected Member of the House of Representatives for many years, with whom I had the opportunity to serve.

The CHAIRMAN. We are very happy to have you here, Mr. Voorhis, particularly with that introduction from Senator Curtis.

STATEMENT OF HON. JERRY VOORHIS, PAST PRESIDENT, COOPERATIVE LEAGUE OF THE UNITED STATES; ACCOMPANIED BY SHELBY EDWARD SOUTHARD, A WASHINGTON REPRESENTATIVE OF THE COOPERATIVE LEAGUE

Mr. VOORHIS. May I introduce Mr. Shelby Southard, local representative of the Cooperative League, who is sitting with me.

I would like to add, Mr. Chairman, if I may, to Senator Curtis' very kind reference to service in the House, that it ended by my defeat by a certain gentleman named Richard M. Nixon.

I appreciate very much indeed the members of the committee remaining here until this late hour to hear a witness like myself, but I believe what I have to say is of some importance to our country.

I want first to associate myself completely with the testimony of former Senator Carlson, and with the letter the chairman made reference to from Mr. Phil Campbell, the Under Secretary of Agriculture.

These points, together with the testimony of Mr. Jaenke, told the story pretty well.

My appeal is that section 531 be stricken from the bill. I think it has no place in the bill.

I think it has nothing to do with tax reform, with revenue, and I think it was put there, an obviously bad circumstance, because the persons most affected were given no opportunity to be heard, which underlines my thanks to this committee for this hearing now.

By the way, Mr. Chairman, I ask consent that my statement be included in the record, and I am not going to read it.

The CHAIRMAN. That will be done. We do that in all cases, both the statement and the summary.

Mr. VOORHIS. I think I need not underline the great value to this country of cooperatives as one of our forms of business. They are the best chance, if not the last chance, for the American pattern of owner-operated agriculture to survive in this economy so largely monopolistic as it is.

The farmer, when he buys and when he sells, has got to stand in the marketplace not alone as an individual, but together with his fellows.

Every other major industry in this country has been integrated. Agriculture has a right to a degree of relationship between a farm operation on the one hand and the related business on the other, and this is what the farm cooperative is.

I take it we are interested in preserving the most efficient, productive method known to man; namely, the American pattern of agriculture. Cooperatives are important also because they make it possible for all kinds of people, including very poor people, to own a share of the American free economy, and this is being urged upon our poor people right now as a means of overcoming their poverty by their own effort.

Now then, section 531 strikes a bitter blow at the opportunity of cooperatives to obtain capital. Cooperatives are different from other businesses. Cooperatives are obligated to return what would be profit to another business back to their patrons in patronage refunds. They don't choose to do this. They must do it.

Consequently, it is obvious that the average investor is not interested in investing in cooperatives for gain. The value of cooperative securities is of value only to the member of that cooperative, the person who wants to use its services, and those who contend that they are doing him a favor by getting him cash forget that he is much better off if he can have ownership of a new, up-to-date fertilizer plant, a new petroleum facility, a new cottonseed or soybean oil mill, a new rice mill or something of the kind than he would be just to have cash for his wife perhaps to spend on a color television set.

And so it is not a kindness to that member to deny him or curtail his right to contribute capital to his cooperative. The one time these members have a good chance to do that is at the time the cooperatives pay them its patronage refund, and the extent to which those patronage refunds are accepted by the member in noncash form represents his contribution to the capital of his own business, and a matter of great value to him.

The other way in which cooperatives might obtain capital is by borrowing the capital. What does section 531 do? It says that you cannot over a period of time pay more than 50 percent in noncash form. You must pay that much in cash. This is not true with any other kind of business.

It says, in the second place, that cooperatives, unlike all other businesses, must resolve their capital, their equity capital, within a 15-year period. It is obviously discriminatory to say that to co-ops and not to say it to other businesses.

This strikes, as Mr. Jaenke has just said, directly at their borrowing power, because it turns what would be the equity capital provided by the members into debt capital and cripples them for that reason.

Mr. Chairman, there is much more that I could say. I will not prolong this any further, as a means of expressing my further appreciation to the committee for hearing us at this late hour.

The CHAIRMAN. Thank you very much.

Any questions?

Thank you very much for a very fine statement.

(Hon. Jerry Voorhis' prepared statement follows:)

STATEMENT OF JERRY VOORHIS OF THE COOPERATIVE LEAGUE OF THE USA

SUMMARY

Recommends deletion of Section 531 of H.R. 13270.

Points out that this section is discriminatory to cooperatives.

That no hearings on this provision were held to permit cooperatives to explain their opposition.

That cooperatives would be handicapped severely in raising development capital.

That this legislation preempts a proper function of the cooperative's board of directors.

That it would place a roadblock in front of cooperative development at a time when government policy is to encourage cooperatives as a means of shoring up farm income and assisting those in urban poverty to escape by means of cooperative enterprises.

STATEMENT

The Tax Reform Bill, as it passed the House of Representatives, contains provisions affecting cooperatives which are ill conceived, discriminatory, extremely damagng to American farmers, and which, if finally enacted into law would be punitive in nature.

One such provision would require after a short period of years that cooperatives must pay out fifty per cent of their patronage refund in cash. Another would require that capital investment of cooperative members be returned to them in cash within 15 years. These provisions were inserted in the Tax Reform Bill without any notice whatsoever having been given to cooperative organizations or businesses. They were inserted after the Committee on Ways and Means had, however, heard testimony from professional opponents of cooperative business enterprises. I shall not in this statement undertake to expand on the obvious unfairness of this procedure. For it is plain to see. I will only express deep appreciation to this distinguished Committee of the United States Senate for inviting testimony from Cooperatives on this vitally important subject.

Neither shall I dwell at any length upon the values and contributions to the health of our national life and economy which cooperative institutions have made and are making today. I shall only point out that agricultural cooperatives are the one best hope, if not the only substantial hope, which the independent owner-operated farmers of this country have to survive in an economy dominated by huge monopolies, some of which are attempting at this very moment to invade the field of agriculture and drive the independent farmer out of business. Concerning cooperatives in general, it may be pointed out that they are a legitimate and unique form of voluntary enterprise which make it possible for millions of people, including even very poor ones, to participate as owners of their own businesses in our American economic life. Something like a quarter of our American families are owners of businesses today only because the cooperative form of business enterprise opens that door to them.

Surely this is something that Congress does not want to destroy. In fact the Government of the U.S. is right now urging the formation of cooperatives by low-income people as one of the most constructive ways of enabling them to work their way out of poverty. The critical problem is how to secure enough capital to make such cooperatives viable institutions. Every encouragement should be given to these cooperatives to accumulate capital. And it need hardly be pointed out that investors aren't going to rush to provide it. It must be supplied basically by the members.

But if Section 531 were to be permitted to remain in the Tax Reform Bill a fatal blow would be struck at the hope of cooperatives of low-income people to accumulate the modest capital which they must have.

The provisions in the pending legislation would not raise a single cent of additional revenue. The Revenue Act of 1962 which was well and thoughtfully hammered out by the Congress makes absolutely certain that both cooperatives and their patrons will pay their full share of taxation. Indeed that Act already requires that twenty per cent of all patronage refunds be paid in cash to members and contains requirements of the strictest character which require cooperatives to obtain from their members their consent to receive a portion of their patronage refunds in stock or certificates of investment before the cooperative is allowed to treat those payments as "qualified patronage refunds." While this provision laid very onerous additional burdens upon cooperatives, it nonetheless received almost general support from cooperative organizations, and I am confident that practically every member of Congress believed when that Act was passed that the question of taxation of cooperatives had been well and thoroughly settled for a long time to come.

I feel, therefore, Mr. Chairman, that cooperatives in this country are entitled to regard as ill timed, ill conceived, and a breach of faith the inclusion of this discriminatory provision in the pending legislation.

Congress does not presume to tell the other segments of the business community how they must dispose of their dividend payments or their patronage refund rebates if they make any. Why, then, should cooperatives be singled out in this manner? It is important to bear in mind that cooperatives cannot, in the nature of the case, raise capital in the same manner that other businesses do. The sharec and securities of cooperatives never rise above par, are not, therefore, in any way objects of investment for the average investor, and are of real value only to those who need and use their services.

Patronage refunds paid in non-cash form constitute the member-patron's contribution to the capital of his cooperative. The nature of that as a capital subscription cannot be blurred without seriously damaging the opportunity of cooperatives to secure the financing they must have to stay in business. The 15-year pay out requirement would probably do that very kind of damage. The enemies of cooperatives know this very well indeed. That is why they have proposed it.

And again—why should Congress place such a requirement on cooperatives when it does not propose doing the same thing with respect to their competitors? Such a provision—across the board—would have to provide that all corporations retire their outstanding stock every 15 years and begin all over with their financing.

It is pertinent at this point to recall that the obligation to return as patronage refunds to patrons their proportionate share of earnings is no exclusive province of cooperatives. Any business, including the large corporations, may obligate itself if it chooses to pay back earnings to patrons in proportion to their patronage just as cooperatives do.

The pertinent fact is that other businesses do not choose to do this. Cooperatives by their very nature must so choose.

Opponents of cooperatives make it their business to misrepresent the essential differences between cooperatives and other businesses. They deliberately call patronage refunds dividends and speak of the net margins of cooperatives as profits. They speak of member-patrons and shareholders as if they were the same. They are not. They disregard the essential fact about a cooperative business.

That fact is that the cooperative is formed, owned, and controlled by the same people who patronize it and by no one else.

Hence the cooperative binds itself to operate on a non-profit basis so far as business with its members is concerned. The earnings which result from business with members legally belongs to those members, not to the cooperative. In other businesses the earnings belong to the business not certainly to it customers or patrons. Such a concept sounds ridiculous on its face.

The cooperative business must return to its members all of their share of the earnings.

On any business a cooperative does beyond this and which it is not obligated to return to members it is fully taxed at regular rates.

But the second point is that any business may if it chooses operate as cooperatives do—provided it obligates itself *ahead of time* to return to its customers—not its stockholders—their share of profits. Other businesses want to keep their profits or to pay them in dividends to shareholders—mostly the former.

They can do that.

Cooperatives cannot.

This is an essential basic difference and the tax laws have always recognized it. So have the courts.

It should not now be blurred by action of this Congress, hastily taken.

Neither should it penalize cooperatives nor deny them their main opportunity to gain the working capital they so badly need.

Remembering that hardly any cooperative members are in any sense wealthy people, it should be quite clear that the one best time for them to make investments in their cooperative businesses is when they receive their patronage refunds. What in practical terms it means when a portion of these patronage refunds are paid in shares or certificates of ownership is this: it means that instead of simply receiving a certain number of cash dollars, the cooperative member receives his share of a new or improved fertilizer plant, milk processing plant, cotton seed oil mill, petroleum facility, feed mill, or other facility, which will strengthen basically his economic position and enable him to stand taller in the market place.

Again, in practical effect, what the bill as it came from the House proposes to do is to tell cooperative members that they are forbidden to authorize their cooperative to invest their patronage refunds, above the 20% cash requirement, in any kind of plant that would expand or improve the services of that cooperative to its members.

I do not believe the Senate, or indeed the House on reflection, wants to say a thing like that to American citizens. It is, however, precisely what some of the most clever opponents of cooperatives and those who would like to cripple their competitive position would indeed like to have Congress say.

For all of the foregoing reasons, it is the earnest hope of the Cooperative League of the United States and certainly of your present witness, that this distinguished Committee will in its wisdom eliminate Section 531 from this Tax Reform Bill because it is a punitive provision against cooperatives, and raises not one cent of additional revenue.

The CHAIRMAN. Our next witness will be Mr. Melvin Sims, president of the National Council of Farmer Cooperatives.

STATEMENT OF MELVIN E. SIMS, PRESIDENT, NATIONAL COUNCIL OF FARMER COOPERATIVES; ACCOMPANIED BY KENNETH D. NADEN, EXECUTIVE VICE PRESIDENT, NATIONAL COUNCIL OF FARMER COOPERATIVES; AND L. JAMES HARMANSON, JR., GENERAL COUNSEL

Mr. SIMS. Mr. Chairman, I am accompanied by Mr. Kenneth D. Naden, executive vice president of the National Council of Farmer Cooperatives and Mr. L. James Harmanson, Jr., general counsel of the National Council of Farmer Cooperatives. I have prepared a statement which has been submitted to the committee which I understand will be included in the record. I will proceed with my oral summary.

The CHAIRMAN. We will print the entire statement, and then the oral summary as well.

Mr. SIMS. I am Melvin E. Sims, president of the National Council of Farmer Cooperatives. This is a national organization representing approximately 4,500 farmer cooperatives who serve several million farmers throughout our Nation.

I am also an active farmer, living on and operating, in partnership with my brother, a livestock and grain farm in west-central Illinois. I have been deeply involved in cooperative activity for the past 23 years and have experienced firsthand the substantial contribution which farmer cooperatives have made toward improving the profitability of my farming business.

Section 531 of the tax reform bill is the most serious threat to the continuation of this self-help program that has occurred since I began farming in 1946. I respectfully request that this entire section be removed in its entirety from the tax reform bill for the following reasons:

1. It is based upon the erroneous premise that farmers must be protected from their own organizations. Farmers own and control their cooperatives and direct them through the democratic processes. Farmers can influence the direction and policies of their organization in a number of ways; namely, by changing the bylaws or articles of incorporation at an annual meeting, by electing directors who represent them. These directors employ the manager, and I have yet to see a manager defy the board of directors or flagrantly violate policy and survive, and finally and perhaps most effectively, the farmer may choose to do business elsewhere. I might add that there are numerous representatives of competing firms who are spending full time trying to convince farmers to do just that—to leave their cooperative and do business with them.

There is virtually no way a cooperative can be out of tune with a majority, or even a sizable number of its members, and successfully survive. As a farmer and a cooperative director, I would like to pay out a large cash patronage dividend each year—it stimulates cooperative growth. But I was not elected to liquidate the cooperative, but to exercise prudent judgment in providing a continuing service. Distributing more cash than is prudent reminds me of the old fable where they killed the goose that laid the golden egg.

2. Section 531 is an arbitrary and unwarranted dictation by the Federal Government to the members of a cooperative as to how they should finance and operate their business. This legislation is in effect

a mandatory corporate financing plan, and I know of no other such restriction which is imposed upon any of the remaining three forms of doing business. The legislation is punitive and discriminatory as far as farmers and their cooperatives are concerned. As a farmer, this section takes out of my hands how I choose to finance my cooperative.

3. The legislation is not, in my opinion, tax reform and should not be a part of this bill. There is little change expected to result in net revenue to the Government and the burden of the tax bill will remain essentially as before. It has the appearance of attempting to legislate an operating handicap for cooperatives.

4. The proposed legislation seems to be contradictory to the national policy of supporting and promoting self-help programs to help farmers and alleviate rural poverty. Farmer cooperatives generally build their facilities in small villages or open country, employ rural people, return their earnings to farmers, and generally stimulate the rural economy.

5. Section 531 will, by weakening the small cooperative, put more economic power in the hands of the large industrial corporation, which is not in the best interests of farmers or the public in general. Contrary to what some have said, cooperatives are quite modest in size when compared to many corporations. As a farmer, I am very much aware of the imbalance of the bargaining position which exists between farmers and the many corporations with which they must deal. The cooperative approach is the most promising solution to this dilemma. We must not destroy this valuable tool and deny farmers the benefit of their cooperative institutions.

6. The proposed legislation will make it extremely difficult, in some cases impossible, for the cooperative to provide both the equity and debt capital to finance the growing farmer demand for facilities and services. A fixed date of redemption on capital stock changes its character from equity to debt capital and causes a double impact on the debt to equity ratio. As has already been pointed out, it would greatly reduce and in some instances eliminate the borrowing capacity of the cooperative business.

7. The proposed legislation would, in fact, hurt farmers at a time when they are already caught in a severe cost price squeeze. Farmers would be hurt in the following ways:

A. This could lead to the forced liquidation or bankruptcy of many cooperatives and the resultant loss of the farmers investment in his cooperative.

B. The ultimate elimination of his cooperative would deny the farmer the future benefit of his cooperative.

C. Many cooperative members are now receiving dividends on their stock investment. Most cooperatives would be forced to eliminate stock dividends if they were required to revolve all patronage securities in a limited period of time.

D. Many farmers are now able to redeem their stock or other securities upon moving from the territory, upon retirement, in settlement of estates and even upon demand. The implementation of this legislation would force all to conform to a fixed and rigid revolvement period. A farmer who now retires at age 65, and can in many cases redeem his stock upon retirement, would under section 531 be forced to wait 15 years for revolvement of his investment.

8. All previous Congresses and administrations have recognized the substantial benefit that farmer cooperatives can make toward the improvement of the welfare of farmers and ultimately of the consumer in the form of increased efficiency in food production. If the Congress wanted to destroy the cooperative form of business, this would be a logical first step. I view this proposal as I view terminal cancer. This section must be removed in its entirety if cooperative life is to be sustained.

In conclusion, I mention the fact that we have the unique situation in which every organized group representing farmers and their cooperatives are, to the best of my knowledge, unanimously opposed to section 531 of this bill and seek its removal. It is a bit ironic that all groups representing farmers are unanimously opposed to section 531 while those outside of farming who support this bill are doing so. purporting to speak for farmers.

The CHAIRMAN. Thank you very much, sir.

Are there any questions?

Senator CURTIS. Not at this time.

Senator MILLER. I have one. Mr. Sims, one of the most telling arguments that you used is that, if this provision of the bill stayed in, it would by law take from the farmers their power of decisionmaking in the cooperative.

The essence of the cooperative is that it is a democracy.

Mr. SIMS. That is right.

Senator MILLER. The decisions are made by the members, by the majority of the members. I don't know what the situation over in the House was on this, but I am wondering, and I don't know what the situation would be in the conference committee, if, say, the Finance Committee knocked this out, I don't know what the conference would come up with, but if the power of decision on this matter of holding these earnings in a cooperative was made annually by a majority of the members, if that was a requirement, would that pose any particular difficulties? Would not that be in line with the philosophy of the cooperative?

Mr. SIMS. I am assuming that you mean the majority of those present at the annual meeting.

Senator MILLER. Not necessarily those present, but a majority either at the annual meeting or a majority of the membership by mail solicitation, so that you have in fact, a majority of the members of the co-op making the decision every year.

Mr. SIMS. Of course, farmers presently have this privilege of sponsoring a motion at the annual meeting to amend the articles or bylaws to conform to any capital plan that they desire, and it would then be acted upon by those present.

This procedure you asked about, it seems to me, might present a hardship, if it were a majority of all members. This might involve the solicitation of proxies and rather extensive work, which would be an added burden.

Also this would create an uncertainty as far as their long-term capital program is concerned, and lenders might be hesitant to loan long-term funds, if the repayment of this loan were based upon a capital program or financing program that must be submitted to the membership for annual approval.

Senator MILLER. Why would they be any more uncertain with that than they are now, if the members can get together now and change the situation?

Mr. SIMS. Yes. I think there would be some added uncertainty, in view of the fact that this would come up each year, and would be an annual decision and previous committment.

Senator MILLER. But isn't that a part of the concept of the cooperative being in control of the majority of its members?

Mr. SIMS. Yes, and this we cherish very much. I would like to have the opportunity to research the idea that you have presented. I believe that you introduced this when the Secretary of the Treasury was testifying. I think it would be well to research this and see what the impact of this kind of a proposal might be.

Senator MILLER. Let me say this. You represent the National Council of Farmer Cooperatives. I have had occasion to attend a good many annual meetings of cooperatives out in my State.

I must say that it has been my observation they are all operating quite above board. Of course, in any organization or any group of organizations, you may have some abuses that occur.

I don't know, as I say, what the House had in mind, but it is conceivable that there might have been some abuses where it might be very difficult for a period of time at least for the members to assert their authority, until maybe after it is too late, but if they do this on an annual basis, by majority vote, I can't see how anybody can object to that, this concept of the cooperative.

Mr. SIMS. The democratic processes do have some weaknesses. For instance, I am not always in agreement with the decisions made by my local schoolboard. But I am quite willing to abide by the decisions of the elected representatives.

I become active times in seeing who it is that is elected to these boards, but I am reasonably well satisfied with the democratic processes, and I would agree with you that for the most part they do function very effectively, and cooperatives are responsive.

I repeat again that I don't think there is any way that a cooperative can be out of tune with a majority or a sizable number of their members, and successfully survive. It is just not in the picture.

Our experience has been that we have to poll them, we have to inform our members, we have to be understanding and be responsive to their desires, in order to survive.

Senator MILLER. Thank you.

Senator HARTKE. I understand that about five of the cooperatives in the country are on the list of the 500 largest corporations in the country as listed by Fortune magazine. What do you have to say about that?

Mr. SIMS. It is true that five cooperatives are on the list of the 500 largest industrials. I believe, according to the 1968 listing, the largest cooperative was in 175th position. Size, as you know, is a relative term: and we ought to bring this into proper perspective. First, let's take a look at the share of market which is currently represented by cooperative organizations. According to the Farmer Cooperative Service of the U.S. Department of Agriculture for the year 1966, the most recent statistics which are available, cooperatives had 28 percent of the marketing volume and 16 percent of the farm producion supplies volume.

Marketing volume includes values of a very diverse nature, including those in which the farm product is taken from the farm all the way through processing and marketing of the final product and those which involve only a very simple one-step transaction. Twenty-six of the top 50 industrials in Fortune's list are now competitors with cooperatives for the farm market. These 26 cooperatives have combined sales of $79 billion, combined assets of $87 billion, and combined net income of $6 billion. The after-tax net income of these 26 corporations is nearly double the total farm supply gross sales value of the 8,300 farmer cooperatives in the United States. When people say, "farm cooperatives are getting too big," I am inclined to ask "compared to whom."

Senator HARTKE. I understand when Mr. Mortimer Caplin, former Commissioner of Internal Revenue, testified before our committee last week, he referred to a study that he had made for the National Tax Equality Association to the effect that it is constitutional to subject the net margins of cooperatives to a corporate income tax. What does your organization, and what do you personally, have to say concerning this?

Mr. SIMS. As you know, I am a layman, not an attorney, but it seems to me that this particular section (531) of the tax reform bill is not a question of constitutionality, but rather a question of basic policy for the Congress to decide. This policy decision was resolved after lengthy hearings and extensive research in 1962. The decision seemed to be reasonable and fair, and I believe it to be adequate today. Now, the National Council of Farmers Cooperatives did have a study on this subject made in 1962 by Mac Asbill, Jr., a well-known attorney of Washington, D.C., and it was his opinion that Congress has the power to tax to patrons the noncash patronage refunds at face amount. His opinion was made part of the 1962 hearings, and I have attached a copy of the opinion to my statement. Would Mr. Harmonson, our general counsel, desire to add any further comments?

Mr. HARMONSON. I think that is sufficient. It might be said that when Mr. Caplin testified on September 12, at the request of a member of the committee, there was introduced in the record a study made by the staffs of the Treasury and the Joint Committee on Internal Revenue Taxation in 1951. There was also introduced in the record a study that Mr. Caplin had made on behalf of the National Tax Equality Association. Although it is true that there is no relation between these opinions that Congress has the power under the Constitution to tax cooperatives on net margins and section 531 of the bill that question was raised in connection with a bill which has been introduced by Senator Ribicoff.

Senator HARTKE. Thank you.

Senator RIBICOFF. Mr. Sims, under the present law, I understand that the cooperative patron is taxed on the entire amount of the cooperative's paper allocation to him even though he may only receive 20 percent in cash. I also understand that it is possible that a patron may be taxed on the paper allocation to such an extent that because of his high tax bracket, the actual cash he receives from the cooperative is not enough to cover his tax bill to the Government on his paper allocation. If we were to raise the 20-percent payout provision would you not agree that this would alleviate the position of the patron?

Mr. Sims. In my testimony which was presented for the record, we cite examples of average income and the resulting tax. Under the present income tax rate, a single farmer receiving average net farm income—and you might add that the single farmer is the exception—and would be in the highest tax bracket. If he received the average net farm income of $4,841 in 1968 the effective tax rate would have been 18.8 percent. I do not believe that the 50-percent cash payout is justifiable, nor is it desired by farmers who understand the need for a capitalization program to finance their cooperative. A 50-percent cash payout requirement would force an undue hardship on the farmers' off-farm business and could lead to the eventual liquidation of his cooperative institution. Those farmers who understand the financial and capital problems of their cooperative are more interested in maintaining the long-term benefit from their cooperative than they are in seeking an immediate payout. As a farmer, I certainly subscribe to the 1962 tax treatment, and I believe it is fair and just and that it should remain in effect.

Senator Ribicoff. The ultimate goal of our tax system is to tax in similar measure those who are in similar economic circumstances. The House bill has adopted several provisions to assure that some tax-exempt organizations and foundations pay their way when they enter the competitive marketplace. I have introduced legislation, S. 2646, which would place an ordinary corporation tax on cooperatives and provide protection to the patrons through a $300 dividend exclusion. From a policy standpoint, it seems fair to me that when cooperatives engage in normal business activities in the marketplace—and when they reach the size where several are included in the Fortune Directory of the largest 500 corporations—they should also pay normal corporate taxes. What is your view on this?

Mr. Sims. I do not ask for any preferential treatment, and I do not want any discriminatory treatment for cooperatives. I only ask for fair treatment and a recognition of the different purpose for which cooperatives are formed. Cooperatives are an extension of "barn-raising and threshing bee." It is a self-help program. In it, farmers join together to do what they cannot do alone. Industrial corporations have long organized their structure on a functional basis. For instance, many have a purchasing department, a marketing department, and so forth. Now, many farmers recognize that they cannot be experts in all fields. For instance, I want to delegate the purchasing responsibility to a purchasing department—but the size of my operation will not permit my farm to establish an efficient purchasing department. But I can organize an effective purchasing department jointly with my neighbors in the form of a cooperative. It is merely an extension of my farm business beyond the "line fence" of my farm. The long-term interest of a farmer and his cooperative are identical and separable. There should be a single tax paid by the farmer because the cooperative is an integral part of the total farm business. This policy decision was established in 1962 after considerable dialog and research. Although some cooperatives are not particularly happy with this arrangement, I believe it is fair and the National Council of Farmer Cooperatives is in support of the single tax principle.

Senator Ribicoff. Would you want to add any comment with respect to my bill.

Mr. SIMS. Certain parts of your bill might be appealing to farmers at their first reaction. However, any legislation which restricts a farmer's cooperative, will in the long-term be detrimental to the farmers' interest. Those who study this proposal will in my opinion support the philosophy of the 1962 legislation rather than this approach. I have not had the opportunity to read your bill, but judging from your question, I would anticipate that I would oppose your bill and expect the vast majority of the members of all farmer cooperatives to oppose your bill.

Senator RIBICOFF. Thank you, sir.

(Mr. Sims' prepared statement follows:)

SUMMARY OF STATEMENT OF MELVIN E. SIMS, PRESIDENT, NATIONAL COUNCIL OF FARMER COOPERATIVES

I. Identification of Witness and Organization.
II. Position.
III. What Section 531 Provides.
IV. Background to Inclusion of this Section in the Bill.
V. Why Section 531 Should be Deleted.
1. It is based on the erroneous premise that the members and patrons of a farmers' cooperative do not individually have a choice as to investment of part of their patronage refunds in the cooperative.
2. It is arbitrary and would be an unwarranted dictation by the federal government to the members of cooperatives as to how to finance and operate their business.
3. The proposed requirement that cooperative corporations retire the capital contributions by members and patrons within 15 years or any other specific period of time is discriminatory and punitive in that no such requirement is made of other corporations, partnerships or other business enterprises.
4. While Section 531 is not estimated to yield any revenue gain or loss to the federal government, it will actually result in the loss of revenue.
5. The required conversion under Section 531 of membership capital from equity to debt would seriously and immediately impair and ultimately detroy the borrowing ability of cooperatives to soundly finance growing farmer demand for services and facilities.
6. Section 531 would produce grave and costly enforcement problems for the government and compliance problems for farmer cooperatives.
VI. Conclusion.
VII. Appendix:
A. Section 531 would undermine the "Capital Fund Method of Financing" which has been adopted by an increasing number of cooperatives with approval of the Internal Revenue Service.
B. Section 531 would impose hardships and inequities on the members and patrons of many cooperatives through the proposed limitation of the application of cash payments in excess of 20 percent to retirement of "any qualified written notice of allocation."
C. Opinions on the Constitutional Question.

STATEMENT

I am Melvin E. Sims, President of the National Council of Farmer Cooperatives. The Council is a national organization whose members are farmer-owned and farmer-controlled cooperative associations engaged in marketing practically every type of agricultural commodity and furnishing the major types of farm supplies to their members and patrons. Approximately 4,500 farmer cooperatives serving several million farmers are represented in the Council membership.

I myself am a farmer and reside at Liberty, Illinois. Since my return from active duty in World War II, I have in partnership with my brother operated our family farm in Adams County, Illinois. My livelihood comes from farming and I am not now and have never been a salaried employee of any of the cooperatives with which I have been affiliated.

I became interested in cooperative work when I began farming in the 1940's because I learned early that only through cooperation can farmers hope to get a fair return for their products and share equitably in the national income. I have contributed much time, effort and capital to the local, state and regional cooperatives of which I have been a member and an officer. I have done this because I have learned through experience that self-help is the only sound and enduring basis on which farmers can hope to protect their interests in building a stronger agriculture free from government aid and domination.

In appearing before you today on behalf of the Council, I speak as one of hundreds of thousands of farmers who cannot be here in person but who are seeking daily through their own cooperative business organizations to get a fair return from their farming operations through their own efforts. I speak as one of that laıge group of farmers who have built their own cooperative organizations and whom the sponsors of the cooperative section of this bill profess they seek to help. I know that their proposal would do us irreparable harm.

POSITION

We are opposed to Section 531 of H.R. 13270 which would substantially and adversely change the present methods of financing cooperatives and we urge your Committee to delete this section in its entirety when you report the bill to the Senate. In support of our position I shall summarize what the section provides, shall discuss the background to inclusion of this section in the bill and shall explain the substantive reasons why the section should be deleted.

WHAT SECTION 531 PROVIDES

The present minimum 20 percent required to be paid in cash of patronage refunds of all cooperatives and non-patronage distributions of "exempt" cooperatives in order to qualify the total patronage refunds and non-patronage distributions for deduction by the cooperatives would for taxable years beginning in calendar 1970 and for ten years thereafter be increased 3 percent annually. Thus for taxable years beginning in 1979 and thereafter the required total minimum cash payment would be 50 percent of the total patronage refunds of all cooperatives and non-patronage distributions of "exempt" cooperatives instead of the present 20 percent in order to qualify the total patronage refunds and such non-patronage distributions for deduction by the cooperatives. However, the amounts in excess of 20 percent required to be paid out in cash in future years could be paid to patrons of the current year or could be paid in redemption of past allocations.

In addition, for taxable years beginning in calendar year 1970 and thereafter (1) that part of patronage refunds of all cooperatives and non-patronage distributions of "exempt" cooperatives not paid currently in cash and (2) permit retain allocations, in order to be qualified and thus deductible currently by the cooperative would have to be payable in money within a 15-year period beginning with the close of the taxable year. This requirement, under the bill, could be met by appropriate By-Law provisions requiring such payment or by an unconditional written evidence of indebtedness issued for the remainder not paid in cash which matures within the 15-year period.

BACKGROUND TO INCLUSION OF THIS SECTION IN THE BILL

The present basic tax treatment of cooperatives and their patrons was enacted by the Congress in the Revenue Act of 1962. Preceding this enactment there were public hearings on the subject before the House Ways and Means Committee on 13 hearing days in the consecutive years 1958–61 at which 1,090 pages of public testimony were presented. Thereafter, 272 pages of public testimony were presented before your Committee on two hearing days in 1962 prior to the enactment in the Revenue Act of that year of the current tax treatment of cooperatives and their patrons.

Section 531 of the current bill comes to you from the House without one word of public testimony or without any opportunity for one word of public testimony by any representative of any cooperative in the country on the subject before *the House Ways and Means Committee.* Our search of the 5,690 pages of the fifteen volumes of the printed hearings before the House Ways and Means Committee on Tax Reform, 1969, discloses reference to the subject by only one witness.

That witness, Mortimer M. Caplin, of the law firm of Caplin and Drysdale, a former Commissioner of Internal Revenue when the Revenue Act of 1962 was enacted, testifying on behalf of the National Tax Equality Association on February 24, 1969, before the House Ways and Means Committee, advocated that which the National Tax Equality Association has advocated unsuccessfully for over 20 years—that the earnings generated by farmers through their cooperatives should be subjected to a double tax, first at the cooperative level and that what then is left at the farmer level. This long time aim of the National Tax Equality Association was rejected clearly and we thought finally by the Congress in 1962 when it established a detailed procedure for the obtaining of a single income tax either at the cooperative or patron level on all earnings generated by the operations of the cooperative.

This plea for double taxation of cooperatives by Mr. Caplin at the House Ways and Means Committee hearings was clearly extraneous to the announced subject of the hearings. In the press release of January 29, 1969, by the Chairman of the House Ways and Means Committee, announcing the public hearings to begin on February 18, 1969, there was given a complete outline of the subject matter of the hearings on which "*Testimony will be received.*" Under the 17 subjects including 62 sub-subjects announced in the press release there was not one word which directly or indirectly suggested that *any testimony would be received* or *any action would be considered* on the subject of taxation of cooperatives in development of a tax reform bill this year. There was sound reason why this subject was not included and was not contemplated to be included within the scope of action by the House Ways and Means Committee in the area of tax reform.

An honest effort has been made by cooperatives and their farmer members throughout the country to comply with the spirit and the letter of the provisions of the new tax treatment of cooperatives and their patrons provided by Congress in 1962. The complaints concerning this tax treatment have been few and have come largely from the competitive business interests which want to handle a larger share of the farmers' business. There has been practically no litigation over these provisions.

Secondly, and more important, there has been no published study on a nationwide basis by the Internal Revenue Service, the U.S. Department of Agriculture, any government agency or anyone else as to the capital structures and methods of financing of all farmer cooperatives in the country for *any year* or for the full six-year period since the current tax treatment of cooperatives became effective for fiscal years beginning after December 31, 1962. Congress did have full facts before it in 1962 in the form of two studies by the Farmer Cooperative Service, U.S. Department of Agriculture, "Methods of Financing Farmer Cooperatives," published as General Report No. 32 in June, 1957 and "Revolving Fund method of Financing Farmer Cooperatives," published as General Report No. 41 in March 1958. Your Committee and all interested parties then had recent facts as to the pertinent operations of farmer cooperatives upon which to base decisions. But they do not have any such facts today.

Suddenly, in the absence of any published or known facts on which to base an informed decision, after the executive session of the Ways and Means Committee on July 23, 1969 as it was nearing the end of its executive sessions, it was announced that the Committee had decided tentatively to increase the current required cash payment of cooperatives to members and patrons beginning in 1970 from 20 percent to 50 percent within a three year period and to require cash payment of all retained earnings in five years. After the members of the Committee heard from the grass roots as to how quickly such a requirement would liquidate most of the farmer cooperatives in the country, the Committee, six days later on July 29, in its final decision adopted the proposal which is now before you.

I shall now discuss the substantive practical reasons why this proposal should be rejected in its entirety.

WHY SECTION 531 SHOULD BE DELETED

1. *It is based on the erroneous premise that the members and patrons of a farmers' cooperative do not individually have a choice as to investment of part of their patronage refunds in the cooperative.*

The Ways and Means Committee report accompanying this bill states in part as to reasons for the changes proposed by Sec. 531 that under the methods of consent by the patron to contribute part of the patronage refund to the capital of the cooperative, "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." The report also states that "This 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." These statements are not in accord with present law and practice.

Of course the members of every business enterprise adopt rules and operating procedures for the conduct of the business. Those rules and operating procedures are, as to cooperatives, adopted by their members or by the members of the Board of Directors elected by the members in accordance with the specific requirements of the governing state statutes. Those rules and operating procedures when adopted by the majority or other legally required percentage of the Board or of the members are binding upon all members and not only on those who favor their adoption. In such mannet are all democratic business enterprises operated. Indeed, decisions by a majority permeate the whole fabric of our economic, political and social structure.

But with respect to the part of a patronage refund that a member or patron is required by a cooperative to invest in the capital of his association and include in his taxable income, he does have *individual choice*, indeed an "independent" choice. Under Sec. 1388(c) of the Internal Revenue Code, adopted by the Congress in 1962, members of cooperatives have to be furnished "*a written notification and copy of such bylaw*" requiring capital contributions of parts of their patronage refunds *before* the obligation is effective as to them. Indeed, the Income Tax Regulations (§ 1.1388–1 (c) (3) (ii) issued by the Internal Revenue Service for the administration of this provision in the law go a step further to insure that members and prospective members of a cooperative have an individual and fully informed choice by providing that:

> "The written notification from the cooperative organization must inform the patron that this bylaw has been adopted and *of its significance*. The notification and copy of the bylaw shall be given *separately* to each member (or prospective member); thus, a written notice and copy of the bylaw which are published in a newspaper or posted at the cooperative's place of business are not sufficient to qualify a written notice of allocation under this subdivision." (Emphasis added)

Thus, it is up to *each member* or *prospective member* to make an *individual* and fully informed decision under existing law whether he will retain or obtain membership in the cooperative with the obligation for capital contribution accompanying it. If he makes the individual, independent and voluntary choice to obtain or retain membership after receiving written notice of the required capital contribution accompanying membership, he thereby consents to the investment in the capital of the association from his patronage refund income.

As to patrons of a cooperative who are not members but deal with it as nonmember patrons they have the right under Sec. 1388(c) of the Code enacted in 1962 to decide individually whether they will make a comparable contribution to the capital of the cooperative and include it in their taxable income. As to those individual nonmember patrons who do not elect to do so they incur no current tax liability with respect to the patronage refund. As to these nonmember patrons who do not thus consent the cooperative and not the patron pays the current income tax thereon.

Contrary to statements on page 168 of the House Ways and Means Committee Report on this bill, under present law the members of a cooperative "*as a group*" do not and cannot make the choice for a patron who is not a member between investing his patronage allocation or per-unit retain allocation, or a part thereof, in the cooperative or retaining it for his own use. The nonmember patron must give his consent *individually* in a written agreement and if such consent is not given the cooperative pays a current corporate tax on the patron's patronage refund, or part thereof, which is not paid in cash. (Sec. 1388(c) (2) (A) I.R.C.)

Members of a cooperative have an *individual* choice under existing law (Sec. 1388(c) (2) (B) I.R.C.) as to whether they want to continue membership in the cooperative and assume the obligations as well as reap the benefits of membership *after* they have received "a written notification and copy of [the] bylaw." advising them of the required capital contribution of all members.

Thus, the members and the members alone and the nonmember patrons of cooperatives make the *individual* decisions whether they remain or become members and patrons of a cooperative and whether they thus assume the obligations for capital contributions that accompany their membership and patronage.

2. *It is arbitrary and would be an unwarranted dictation by the federal government to the members of cooperatives as to how to finance and operate their business.*

It is clear on the basis of the recorded action of the House Ways and Means Committee that the final selection of the additional mandatory minimum cash payment of 3 percent per year for 10 years until a minimum of 50 percent is reached and the final selection of 15 years as the period within which the remainder not currently paid in cash must be paid are *arbitrary*. We use this word thoughtfully on the basis of its dictionary meaning of "*selected at random and without reason.*"

First, the Ways and Means Committee announced a tentative decision following an executive session on July 23, 1969 to propose an increase in the present requirement for cash payment of 10 percent per year in 3 years to reach the 50 percent figure and to propose payment of the remainder in cash in 5 years. Then 6 days later, the committee changed the period in which the increase in cash payment from 20 to 50 percent should be accomplished from 3 years to 10 years. Likewise, in the same short period of 6 days the time within which the retained capital must be paid out was increased from 5 to 15 years.

Not one "reason" is given by the Ways and Means Committee for the selection of any of these increased percentages or periods. There is no indication that the Committee gave any consideration whatsoever as to the effect upon the operations of farmers' own business associations of such dictation to them of how much the members should contribute to the capital of their associations and when they must pay out the capital thus contributed.

The Ways and Means Committee Report states only the *conclusion* that:

> "Your committee believes that patrons should be given assurance of a larger share of the patronage allocations that are included in their taxable income, and that amounts retained by the cooperative which have been included in a patron's income, whether patronage allocations or per-unit retains, should be paid to him not later than 15 years after the close of the taxable year with respect to which the allocation is made or the retain certificate is issued."

In striking contrast to the absence of any known or stated "reason" for adoption of the proposed ultimate minimum 50 percent cash payment figure by the House Ways and Means Committee, the Senate Committee on Finance in 1962 had and stated *a specific reason* for adopting the 20 percent figure which became law and is now in the statute.

Some of you who were members of this Committee in 1962 will recall that when the Revenue Act of 1962 (H.R. 10650) came to your Committee from the House of Representatives it provided for withholding on interest, dividends and patronage dividends at the rate of 20 percent. The specific changes on this point which were made by your Committee and later enacted into law were reported at page 112 of the Report of the Committee on Finance on H.R. 10650 (Report No. 1881, 87th Congress, 2d Session) as follows:

> "Your committee's bill has substituted for the withholding provision a reporting system for dividends, interest, and patronage dividends. However, in the case of patronage dividends, withholding also served the purpose of providing the patron with at least enough funds to pay the full first bracket tax on any qualified allocations taxable to him. Your committee believes that it would be unfortunate to require the patrons to report these qualified allocations for tax purposes without being sure that the cooperative made available to the patrons *enough cash to pay at least the first bracket income tax*. To give assurance that the cooperative provides the patron with *at least enough money to pay this first bracket tax*, your committee has provided that cooperatives must pay at least 20 percent of their patronage dividends (and in the case of tax-exempt cooperatives other income distributed on a patronage basis) in cash if the cooperatives are to receive any deductions for allocations (and the patrons are to be required to include any such amounts in their income)." (Emphasis added)

Let us look at the results of the application of the reasoning of your Committee in 1962 to the situation today. For 1968, I am informed that the first bracket income tax rate was 15.4 percent, including the surtax. Under the provisions of the bill as sent to you from the House of Representatives, I understand the effective first bracket rate would be substantially less.

Let us examine the pertinent factual situation a bit further. The *average* realized net farm income per farm operator in the U.S. in 1962 was $3,424.[1] For the *average* farm operator with such farm income in 1962 who was single and took the standard deduction, his net taxable income would have been $2,481.60 with a tax of $496.32 at an effective rate of 20 percent.

How does this compare with the current situation?

The *average* realized net farm income per farm operator in the U.S. in 1968 was $4,841.00.[1] For the *average* farm operator with such farm income in 1968 who was single and took the standard deduction, his net taxable income would have been $3,756.90 with a tax of $708.19 at an effective rate of 18.8 percent.

From 1965 to 1968, net taxable income of at least $22,000 would be required to be subject to an effective tax rate of at least 50 percent.

Hence it is unmistakably clear on the basis of these facts and the *reasons* stated by your Committee in 1962 for setting the minimum required cash payment at 20 percent, that there is no justification for the proposal to increase the minimum cash payment in order to qualify the patronage refunds for deduction by the cooperative.

We have been unable to learn any *reasons* for the selection of the 50 percent cash payment figure or the 15-year figure. There has come from some members of the House Ways and Means Committee reference to one point that might have had some influence on the action taken.

Mention has been made of a Report issued in 1966 by the Canadian Royal Commission on Taxation which *recommended* in effect that the Canadian law be changed so that patronage dividends would be deductible by cooperatives in computing taxable income only to the extent that half of them had been paid in cash. We are informed that this and the other far-reaching recommendations of the Canadian Royal Commission on Taxation are *recommendations* and *recommendations only* and that many of the recommendations of this Commission are unlikely to be adopted when a bill is proposed by the Canadian Government. Aside from the fact that there is no relationship between a *recommendation* of a Canadian Commission and the formulation of a fair tax treatment for cooperatives and their farmer members in the United States, it is significant that even this Commission in Canada has *not recommended* any time limit on the retirement of cooperatives' membership capital as is now proposed in Sec. 531 of the bill before you.

3. *The proposed requirement that cooperative corporations retire the capital contributed by members and patrons within 15 years or any other specific period of time is discriminatory and punitive in that no such requirement is made of other corporations, partnerships or other business enterprises.*

It is quite clear that the capital invested in non-cooperative corporations or other business enterprises is subject to no regulatory or other requirement by the federal government that it be retired at any particular time or within any specified period as is now proposed for cooperatives.

The practices and policies of cooperatives vary widely in their capitalization plans as determined by their members on the basis of their individual needs. In some cooperatives there is a continuing need for new and improved facilities to efficiently serve the marketing and purchasing needs of their members. Cooperatives cannot find outside of their members and other patrons adequate sources for providing the capital to meet these needs. Hence farmers know and are willing out of the earnings of their cooperatives to contribute this needed capital to furnish the base on which to finance the needed facilities. They do this in many cases with the intent to provide a permanent or long-term capital base and with no expectation that their capital investment will be retired at any specific time in the future.

By thus singling out cooperatives in compelling retirement of equity capital by arbitrary federal edict, the 15 year retirement requirement would greatly restrict or cause abandonment of beneficial services historically provided by cooperatives to farmer patrons which benefit not only themselves but consumers and the entire public.

The historical method by which farmers have generated the needed capital to finance their cooperatives is from their operations. Sale or issuance of securities

[1] Farm Income Situation, July, 1969, Table 3D, page 70, Economic Research Service, U.S. Department of Agriculture.

to the investing public has not been feasible or practicable for cooperatives. Limited permissible returns on investment in cooperatives, the fixed value of the securities and the seasonal hazards of farming operations have had no appeal to growth minded investors. Hence farmers have found that the only sound and practical way to finance their off-the-farm businesses is to reinvest monies otherwise payable to them from their self-help business enterprises to provide the capital required for facilities, operations and as a basis for credit.

Some of the larger, older and stronger cooperatives could perhaps survive with a 15 year requirement for retirement of their membership equity capital. Many however would suffer a continuing strangulation, become ineffective and finally collapse.

4. While Section 531 is not estimated to yield any revenue gain or loss to the federal government, it will actually result in the loss of revenue.

Under many sections of H.R. 13270, the Report of the Ways and Means Committee gives the "Revenue Effect", estimating the revenue gain or loss which would result from the adoption and application of the proposed changes. The report is entirely silent as to any "Revenue Effect" estimated to result from the adoption of the proposed changes pertaining to "Cooperatives."

In theory, and in theory only, it is estimated that these proposed changes would not have any significant effect on tax revenue. This is because the imposition of a requirement for a larger current cash payment and of a specified time for retirement of the equity capital would not change the amount of the current or ultimate tax liability thereon.

However, in actual practice it is inevitable that the damage that would be done to the operations of cooperatives through the undermining of their capital structures would gradually retard and impede their operations with decreasing earnings subject to tax either to the cooperative or its members and patrons. This is the practical and predictable consequence of the application of the proposed new rules. While some of the larger and older cooperatives might be able to weather the storm, at least for awhile, the ones which would suffer the most are those operating at the local level serving the small and medium size family farmers who need their services most. Many of these would gradually disappear and be liquidated through the undermining of their capital structures.

In at least one area, the proposed requirement that membership capital be changed from equity to debt would definitely cause the loss of some tax revenue to the government. In some instances non-exempt cooperatives pay limited dividends on the stock or other certificates issued to evidence invested patronage refunds by members and patrons. These dividends are paid out of net earnings *after* payment of taxes. Through the conversion of these investments from equity capital to debis by the proposal in Section 531, the payments thereon would be *interest* and deductible in determining the net taxable income of the cooperative. Hence the taxes payable by the cooperative in such cases would be correspondingly reduced.

5. The required conversion under Section 531 of Membership capital from equity to debt would seriously and immediately impair and ultimately destroy the borrowing ability of cooperatives to soundly finance growing farmer demand for services and facilities.

There are several sources from which farmer cooperatives borrow capital to finance their operations. While some cooperatives can obtain limited financing through commercial banks and other sources the major source of credit is the Banks for Cooperatives of the Farm Credit Administration which were established in 1933 to provide a specialized credit service to farmers' marketing, supply and service cooperatives.

There are no recent statistics on the amount of total borrowed capital by the farmer cooperatives in the United States from sources other than the Banks for Cooperatives. The latest study by the Farmer Cooperative Service of the United States Department of Agriculture indicated that almost 58 percent of the outstanding borrowed capital of farmer cooperatives was supplied by the Banks for Cooperatives.

According to the latest information from the Farm Credit Administration, the Banks for Cooperatives had loans outstanding as of June 30, 1969, in the aggregate amount of $1,594,400,000 to 2,955 cooperative associations. Of this total, $649,200,000 (40.7%) was in "Seasonal" loans and $945,200,000 (59.3%) in "Term" loans. The number of cooperative associations with *term* loans outstanding as of June 30, 1969 was 2,705 or 91.5% of the borrowing associations. Although a specific breakdown on the maturity periods of these outstanding loans is not available we understand from officials of the Farm Credit Administration that in some instances the maturities run up to 20 years, the range on the majority of these loans is from 4 to 12 years, a significant number mature within 12 to 15 years and a relatively small number mature within 15 to 20 years.

The latest information on the financial structure of the farmer cooperatives of the country is included in a study by the Farm Cooperative Service of the U.S. Department of Agriculture for the year *1962* which is expected to be published in the near future. Although this is not current information and its does not reflect the situation for a year after the new tax treatment for cooperatives and their patrons became effective in 1963, it is the most recent information which we have been able to obtain on a nation-wide basis. Pertinent information resulting from that study is as follows:

Total number of associations	8,522
Assets	$5,322,000,000
Liabilities and equity capital:	
Equity capital (60.4 percent)	$3,215,000,000
Borrowed capital (19.4 percent)	1,032,000,000
Other liabilities (20.2 percent)	1,075,000,000
Total	5,322,000,000

What do these figures show? They disclose the inescapable fact that the capital structure of farmer cooperatives would be immediately impaired and undermined and gradually destroyed through the imposition of a 15 year requirement for the retirement of their equity capital.

If the proposal for a due date within 15 years or any other fixed time on all membership capital should become effective, members' investments would cease to be equity and instead become debt capital. As the past investments of members in the equity capital of their associations are retired and with no new investments by current members in the equity capital, there would necessarily be a continued shrinkage and ultimate disappearance of their net worth. Obviously the sources of credit for financing their operations would gradually disappear.

The real victims of this arbitrary and discriminatory action by federal edict would not be the cooperative corporations but the farmers themselves who have built and are building these self-help business enterprises and would then be denied the services and facilities they have joined together to provide through their own investments and patronage.

It is beyond our comprehension that any committee of the Congress or any Administration would single out this one type of business—cooperatives—and dictate to their farmer members when their investments from their own tax paid dollars must be retired from the business. Certainly the federal government has not attempted to so regulate the investments of partners in partnerships or the investment of stockholders in their proprietary corporations. The 15-year proposal in no respect can be classified as a revenue measure or tax reform. It can properly be classed only as a regulatory measure which would bring about the ultimate destruction of farmers' self-help cooperative business enterprises and reverse the declared policy of Congress which states:

> "It is declared to be the policy of Congress to promote the effective merchandising of agricultural commodities in interstate and foreign commerce so that the industry of agriculture will be placed on a basis of economic equality with other industries, and to that end protect, control and stabilize the currents of interstate and foreign commerce in the marketing of agricultural commodities and their food products * * * (3) by encouraging the organization of producers into effective associations or corporations *under their own control for greater unity of effort* in marketing and by promoting *the establishment and financing of the farm marketing system of producer-owned and producer-controlled cooperative associations and other agencies.*" 12 U.S.C. 1141(a)(3) (Emphasis added)

6. Section 531 would produce grave and costly enforcement problems for the government and compliance problems for farmer cooperatives.

The Secretary of the Treasury in his testimony before your Committee on September 4, 1969, stated that "The additional 30 percent requirement is complex and creates serious administrative problems." He recommended "that the additional 30 percent pay-out rule be eliminated."

With this recognition on the part of the Treasury Department which would be responsible for administering such provision, we believe no more need be said to establish the complete lack of justification for such provision on the basis alone of the administrative problems that would be encountered in an attempt to administer it. Administration and compliance under present law is relatively simple compared to what it would be under the new proposals. We ask the members of your Committee to try to visualize the utter chaos and exorbitant expense in government auditing procedures and cooperative bookkeeping in attempts to respectively audit and maintain records on cash patronage refund payments *which vary percentage-wise each year over a ten-year period* and which might under the proposal be used *either as payments to current patrons or in retirement of allocations of past years*. It can properly be asked "For what purpose would this exercise in extravagance and futility be undertaken?" In many cases, the costs in record keeping would far exceed the amounts of the patronage refunds involved. This would be particularly true in the cases of cooperatives operating over a wide area with thousands of small farmers receiving patronage refunds in comparatively small amounts.

It is regrettable that the Secretary of the Treasury in his appearance before your Committee on September 4 did not point out the complex and serious problems that would be imposed on cooperatives by adoption of the 15-year cash payment rule and recommend that it too be eliminated. Let me point out just one example of the divisive effects upon many cooperatives that would be certain to result from the application of just one provision in Section 531 for implementing the 15-year rule.

Section 531 provides as one way to implement the 15-year rule, as follows:

> "At all times on and after the date of issuance of such written notice of allocation, the bylaws of the organization require the remainder of such patronage dividend, or such payment, to be paid in money within the 15-year period beginning with the close of the taxable year with respect to which such written notice of allocation is made, and the *bylaws provide that such requirement shall in no event be changed without the consent of those adversely affected,* . . ." (emphasis supplied)

What do the underlined words mean and how would the Internal Revenue Service interpret them if such provision should be enacted into law? Let's take the case of Cooperative A with 1,000 members. These 1,000 members receive for fiscal year 1970 patronage refund allocations averaging $80 each amounting to a total of $80,000. The By-Laws of Cooperative A contain the provisions in Section 531 of the bill as quoted above. The By-Laws also provide that amendments thereto may be made by the affirmative vote of 75 percent of the members present at a meeting, at which a quorum is present. In 1985, there is a severe drought. Cooperative A operates at a loss and is unable to retire the patronage refund allocations issued for fiscal 1970. A membership meeting is duly called. 800 members are present. 90 percent of the members present consent to extend the time for retirement of the 1970 patronage refund allocations and 10 percent of the members present do not consent. What happens then? What happens when the Board of Directors of a proprietary corporation votes not to declare a dividend to the stockholders by a vote of 90 percent because there have not been earings from which to pay a dividend? What happens when 90 percent of the members of the Senate vote for a bill and 10 percent vote against it?

The answer is obvious. All the members of a legally constituted body are bound by the decisions of the majority or other legally prescribed percentage. But Section 531 would as to cooperatives by federal law repudiate decisions by a majority in their application to a minority who do not consent.

This 15-year proposal in Section 531 when analyzed in its practical application would represent a flagrant abuse of federal power and unprecedented interference with private business. It would tend to divide rather than encourage farmers to cooperate to help themselves. At this period in our national life when so much is being done materially by the federal government to assist disadvantaged groups in our nation, it is beyond comprehension that the Congress would spend any time in even considering a proposal which could only add handicaps, burdens and problems for farmers who are trying to help themselves through their own efforts.

CONCLUSION

I appreciate the opportunity that has been given for me to present this statement on behalf of the Council.

For the reasons documented in the statement, we respectfully urge your Committee to eliminate Section 531 in its entirety from H.R. 13270. We also respectfully urge that the conferees from your Committee maintain this position without compromise when the bill may be considered and action taken in conference.

We recognize that there is a general disposition to seek compromise when controversial issues are at stake. We sincerely believe that there is no justification for any compromise with respect to Section 531 solely on the basis of the fact of *no* public hearings on this issue before the House Ways and Means Committee and *no* adequate time now for thorough analysis in public hearings before your Committee of any compromise which may be suggested.

The operations of many farmer cooperatives today are being disrupted because of difficulties in the interpretation of hastily drawn provisions inserted by the Senate in the Revenue Act of *1926* to amend what is now Section 521 of the Internal Revenue Code, authorizing specific deductions for farmer cooperatives which meet certain stringent requirements in that section. Since February, 1965—over 4 years ago—the Council has been trying to get the National Office of the Internal Revenue Service to publish an official interpretation of certain provisions of that section for compliance purposes. About five years ago Internal Revenue agents in their auditing functions began placing interpretations on certain provisions in that section different from the interpretations that had been followed since 1926. To date we have no answer from the Service because of differences in the National Office between the attorneys and administrative officials as to what the provisions in question were intended by Congress to mean. We urge your Committee in the interest of sound legislation and its subsequent proper interpretation not to compound the problems for government and farmer cooperatives that now exist through further hastily drawn legislation which characterizes Section 531 as referred to you from the House of Representatives.

There are defects and problems inherent in Section 531 in addition to those already covered in this statement. An appendix to this statement describes some of these defects and problems as additional evidence why Section 531 should be entirely striken from H.R. 13270. The appendix also gives factual information concerning certain opinions which have been rendered concerning the so-called constitutional question involved in the tax treatment of cooperatives and their patrons.

Appendix

A. SECTION 531 WOULD UNDERMINE THE "CAPITAL FUND METHOD OF FINANCING" WHICH HAS BEEN ADOPTED BY AN INCREASING NUMBER OF COOPERATIVES WITH APPROVAL OF THE INTERNAL REVENUE SERVICE

It has already been pointed out to members of the Senate Finance Committee that the provisions of the Tax Reform Act of 1969 adopted by the House of Representatives includes a section relating to taxation of cooperatives which was adopted without sufficient consideration of the impact of this proposal on government revenues or on operations of cooperatives. There is, however, one specific method of financing of cooperatives which was apparently not taken into consideration in any way by the House Ways and Means Committee at the time Section 531 of the bill was adopted. This is the "Capital Fund Method of Financing." We feel that exploration of the unanswered questions which are raised in connection with the capital fund approach by Section 531 of the bill will further demonstrate that the portion dealing with cooperative taxation should be removed from the bill by the Senate Finance Committee.

Description of "Capital Fund" Approach

A basic precept in a farmers' cooperative is that equity capital should be provided by the grower-members. The capital fund approach is deemed by many cooperatives to be the fairest and most equitable way to determine what share of capital needs should be borne by each of the grower-members. Under this plan, a grower's capital contributions are directly related to his use of the cooperative facilities.

The plan essentially works like this. A period of time is established for measurement of total crop deliveries by the cooperative's grower-members. This time period consists of a sufficient number of years to equalize the impact of varying external factors affecting crop deliveries, such as unusual weather conditions, pest damage, etc.

After each delivery season, a tabulation is made of total crop deliveries for the entire period, customarily dropping off amounts delivered in the oldest outstanding year of the period of measurement and adding deliveries for the current year. Then a calculation is made for each grower-member of his proportion of deliveries during this time period. Also, during each accounting period, the capital needs of the cooperative are determined. Each member is then responsible for a portion of the capital needs which is in direct ratio to his proportion of deliveries of product to the cooperative.

This is then translated into a dollar amount for each grower-member. If an individual's prior capital fund contributions equal his newly calculated requirements, there will be no retain or assessment for capital purposes and he will receive 100% of his proceeds in cash. However, because of the pattern of crop deliveries from year to year, it is likely there will be adjustments in each individual grower's account every year. For example, if in a particular year a grower has delivered a larger proportion of the total crop received by the cooperative than he has in prior years, his share of the capital needs (assuming a static capital structure) will tend to increase. Thus on a per-unit basis of calculation he will be assessed or will have withheld a dollar amount to bring him up to his equitable share of the capital needs. Conversely, if he has used the cooperative's facilities to a lesser extent, it will tend to reduce the amount of capital established as his proportionate share and he will be refunded the amount which represents an excess over his established level of capital contribution.

In the event a member withdraws from the organization or ceases to produce the crop handled by the cooperative he will have received his entire capital contribution at the end of the period used by the cooperative to calculate the individual's capital contributions. Thus, if the period of measurement of deliveries is six years, at the end of that time the individual grower who is no longer delivering to the cooperative will have received full repayment for capital contributions earlier made.

The basic question which is raised in conjunction with the Tax Reform Act of 1969 is how the 15-year limitation period involved in Section 531 of the bill affects this capital fund operation, particularly in the case of a new member or one who continues to use the cooperative facilities.

Full Disclosure and Approval by Internal Revenue Service

Prior to adopting the capital fund method of financing, the cooperatives which have gone to this approach have obtained rulings from the Internal Revenue Service. In all instances the rulings have indicated full approval of this approach. They further have indicated that there are no taxable consequences to the cooperative at the time of creation of Capital Fund credits so long as any amounts retained or assessed against the individual member are fully disclosed to him and the member includes these amounts in his income at the time the credits are created.

Applicability of Proposal to Capital Fund Credits

At the time of creation, then, the full tax is paid on these credits in accordance with existing provisions of the Internal Revenue Code and regulations issued thereunder. It should further be pointed out that a member who has withdrawn or ceased to deliver products to the cooperative will receive repayment of his capital contributions within the period of time established for measurement of the percentage of use of the cooperative's facilities by each individual grower-member.

A question which is totally unanswered and apparently received no consideration whatsoever from the House Ways and Means Committee is how the 15-year period for repayment of per unit retains will apply to a cooperative whose members have adopted the capital fund approach. Perhaps an illustration will be helpful.

Let us assume a member of a cooperative who has capital credits standing in his name in the amount of $2,000 as of the year 1970. As a result of the pattern of his crop deliveries and calculation of his equitable share of capital needs in 1971, he must contribute an additional $100 in capital. In 1972, again because of the factors noted above, his calculated share of capital contribution decreases by $100 and this amount is repaid to him in cash. Now let us assume a very hypothetical situation, namely that for the next 13 years no adjustments are required in his capital fund. Then in 1986, 15 years after creation of the credit in 1971, must the cooperative redeem the $100 which was created in 1971? Does the adjustment that was made in 1972 qualify as such a redemption? If the cooperative does not redeem the 1971 credit in 1986, what are the tax consequences to the member and the cooperative? Do we get a different result depending upon whether the capital fund credit is created as a result of a per-unit retain or as a retain from a patronage dividend or by assessment?

Conclusion

It is obvious that the House Ways and Means Committee gave no consideration at all to the complex problems and disruptive results that would flow from the application of a 15-year limitation period (or any other limitation period) on the capital fund method of financing which has been adopted and is now in operation with the approval of members of an increasing number of cooperatives.

This is an additional compelling reason why Section 531 should be deleted in its entirety by the Senate Finance Committee and no action be taken to change the present tax treatment of cooperatives unless and until there has been an adequate opportunity to consider the full impact of any changes proposed.

B. SECTION 531 WOULD IMPOSE HARDSHIPS AND INEQUITIES ON THE MEMBERS AND PATRONS OF MANY COOPERATIVES THROUGH THE PROPOSED LIMITATION OF THE APPLICATION OF CASH PAYMENTS IN EXCESS OF 20 PERCENT TO RETIREMENT OF "ANY QUALIFIED WRITTEN NOTICE OF ALLOCATION"

Section 531 would amend Section 1388(c)(1) of the Internal Revenue Code to provide in part that the additional three percent required to be paid in cash each year for ten years beginning in 1970, until an *additional* 30 percent is paid in cash in 1979 and subsequent years, is paid either:

> "(i) as a part of such patronage dividend, or such payment,
>
> "(ii) *or in redemption* (to the extent allocated by the payor to such patronage dividend for the purpose of meeting the requirements of this clause, if not previously allocated to any other patronage dividend) *of any qualified written notice allocation previously paid as a part of a patronage dividend*, or such payment, for any taxable year, and . . ." (Emphasis added)

The term "*qualified written notice of allocation*" was first introduced in the Internal Revenue Code in Subchapter T enacted by the Congress in the Revenue Act of 1962 to provide a new tax treatment of cooperatives and their patrons. Hence, "qualified written notices of allocation" exist to evidence the patronage refund investments of members and patrons in their cooperatives only for fiscal years of cooperatives beginning after December 31, 1962.

Many cooperatives have adopted systematic plans for redeeming or revolving their equity capital and these plans in large part provide for such retirement in the order of the years in which the equity capital was invested.

Application of the underlined provision in Section 531, quoted above, would mean that the current cash payments in 1970 and thereafter used in retirement of past patronage refund investments would have to be applied in retirement of such investments made for 1963 and thereafter even though some pre-1963 investments had not been retired.

The inequities that would thus be imposed as to the members and patrons of the pre-1963 years compared to the treatment of the members and partons in 1963 and thereafter are clear and could not, we believe, be intended or justified. This is another glaring example of the defects inherent in Section 531 and a further specific reason why Section 531 should be deleted from the bill.

OPINIONS ON THE CONSTITUTIONAL QUESTION

When Mortimer M. Caplin testified before your Committee on September 19, 1969, on behalf of the National Tax Equality Association, permission was given at the request of a member of your Committee for the inclusion in the record of the hearings of two opinions related to the taxation of cooperatives.

Although these opinions appear to have no pertinency to the policy question before your Committee, we deem it important that the members of your Committee have factual information as to the identity of those opinions and their basic conclusions. It is also important that your Committee be informed of another opinion that has been rendered on the same subject and its basic conclusion.

I. "The Power of Congress to Tax Cooperatives on Net Margins"

Prepared by the Staffs of the Treasury and the Joint Committee on Internal Revenue Taxation—April, 1951

This staff report prepared over 18 years ago was first released by the House Ways and Means Committee for publication in 1960.

The basic conclusion of the staff opinion implicit in its title is that Congress does have the *power* under the Constitution to tax cooperatives on net margins.

Two significant statements in that opinion supplementing the basic conclusion are as follows:

"Congress has an equally broad power to determine, on practical grounds to whom income should be taxed."

"This shows that Congress may use *any reasonable standard* in measuring the taxable income of a cooperative, and the mere fact that the corporation is a cooperative does not impose a constitutional restraint on Congress in the measurement of its taxable income." (Emphasis added)

II. "Taxing the Net Margins of Cooperatives: Application of Basic Tax Principles and Analysis of Constitutionality"

This is an opinion by Mortimer M. Caplin made for and published by his client, the National Tax Equality Association, on May 22, 1969. His basic conclusion to the 51-page opinion is that:

> "There can be no serious question that net margins constitute income to cooperatives under basic tax principles and that taxation of that income would violate no rule of constitutional law. Any discussion of the tax treatment of cooperatives must begin with these conclusions. Proceeding from that basis, the essential *policy issue at stake*—whether the income of today's large-scale cooperatives should continue to receive a special tax preference—must be subjected to careful and rigorous re-examination on its own merits." (Emphasis added)

III. "Constitutionality of Legislation Taxing to Patrons Income Equal to the Face Amount of Non-Cash Patronage Refunds Distributed to them by Cooperatives"

This opinion was prepared by Mac Asbill, Jr., a partner in the law firm of Sutherland, Asbill and Brennan, Washington, D.C., January 25, 1962 for the National Council of Farmer Cooperatives.

In his 18-page opinion Mr. Asbill reached the basic conclusion that:

"For the reasons set forth above, legislation requiring patrons to include in income the face amount of documents evidencing their share of current patronage income of the cooperative enterprise would clearly be constitutional."

Mr. Asbill testified before your Committee on April 16, 1962, at public hearings on the Revenue Act of 1962 and his opinion is included in the part 5 of the printed hearings on that bill at pages 1709–1728. We are attaching to this statement a copy of his opinion with the request that it, too, be included in the printed record of these hearings.

What is the unanimous single conclusion drawn from these opinions? It is simply that the issue before your Committee in 1969, as in 1951 and 1962 is not a constitutional question. It is solely a matter for basic policy determination.

In 1962, after extensive hearings your Committee and the Congress decided as a basic policy matter that net earnings generated through the operations of cooperatives should be taxed to the members and patrons to the extent that their individual patronage created such net earnings. You also decided that such net earnings not distributed in cash as patronage refunds on the basis of patronage should be taxable to the members and patrons currently only where there is individual *agreement* on the part of such members and patrons to invest the part of the patronage refund not paid in cash in the capital of their association. We believe that after careful consideration of all the facts before you, your Committee will reach the basic policy decision that the action taken by your Committee and the Congress in 1962 is fair to farmers, their cooperatives and in the public interest and should not be changed.

(The opinion of Mac Asbill, Jr., referred to above follows:)

Constitutionality of Legislation Taxing to Patrons Income Equal to the Face Amount of Non-Cash Patronage Refunds Distributed to Them by Cooperatives

(Prepared by Mac Asbill, Jr., Sutherland, Asbill & Brennan, Washington, D.C.—for National Council of Farmer Cooperatives, 1616 H St., N.W., Washington D.C.—January 25, 1962)

Permission to reproduce or distribute this memorandum must be obtained from the National Council of Farmer Cooperatives.

FOREWORD

It has been asserted by some interested persons, both in and out of Government, that under the decisions in the *Carpenter* and *Long Poultry Farms* cases by the Fifth and Fourth Circuit Courts of Appeals on March 2, 1955 and November 8, 1957, respectively, as well as other cases decided by the Supreme Court, Congress does not have the power under the Sixteenth Amendment to the Constitution to require patrons to include in their income amounts equal to the face amounts of non-cash patronage refunds distributed to them by cooperatives.

In view of the fact that this issue, which has never been presented to the Supreme Court, is involved in legislative proposals now under Congressional consideration, we have had Mac Asbill, Jr. a partner in the law firm of Sutherland, Asbill & Brennan, who as co-counsel successfully argued for the patrons before the Circuit Courts of Appeals in both the *Carpenter* and *Long Poultry Farms* cases, make a thorough and impartial study and prepare for us a memorandum on the constitutional question involved. Mr. Asbill's analysis and conclusions which follow should be of value in removing doubt, where any has existed, as to the constitutional aspects of the question and should be helpful to members of Congress in developing legislation which will be fair to farmers and their cooperatives.

HOMER L. BRINKLEY,
Executive Vice-President,
National Council of Farmer Cooperatives.

CONSTITUTIONALITY OF LEGISLATION TAXING TO PATRONS INCOME EQUAL TO THE FACE AMOUNT OF NON-CASH PATRONAGE REFUNDS DISTRIBUTED TO THEM BY COOPERATIVES

In 1951 the Congress enacted legislation limiting the exemption from corporate tax of farmer cooperatives which had theretofore been wholly exempt. This legislation provided that such cooperatives could reduce their gross income for tax purposes by patronage refunds, whether paid in cash or in revolving fund certificates, retain certificates, letters of advice or some other document that disclosed to the patron the dollar amount of the refund, in the same manner and to the same extent as their taxable counterparts had done for years. The amount by which gross income was reduced was the face amount of such document, regardless of its value. Congress had been told, and it thought, that the patron receiving such a document would be required under the then existing income tax laws to include in his income the face amount of the document. Thus it was thought that Congress had achieved its purpose of subjecting to a single tax, either at the level of the cooperative or at the level of the patron, all income resulting from operations of farmer cooperatives.

However, several court decisions (e.g., *Carpenter* v. *Commissioner*, 219 F. 2d 635 (CA 5, 1955), and *Long Poultry Farms* v. *Commissioner*, 249 F. 2d 726 (CA 4, 1957)) reached conclusions inconsistent with the representations that had been made in this regard to the Congress. These decisions held that the patron receiving such a document had income, under the then existing Internal Revenue Code, only to the extent of the fair market value of the document. Thus, since the cooperative could reduce gross income by the face amount of such a document, there was no current tax, on the cooperative or the patron, to the extent that the fair market value of the document was less than its face amount.

These cases, as indicated above, were decided under the Internal Revenue Code of 1939, which (as is true also of the 1954 Code) contained no provision specifically dealing with the taxation of patrons of cooperatives. The cases were decided on the ground that the generally applicable provisions of the Code did not impose a tax on such patrons except to the extent of the fair market value of documents received by them. The Courts were not presented with the issue whether Congress had the *power* under the Constitution to tax patrons on income equal to the face amount of such documents.

We have now been asked for our opinion on that issue—i.e., the constitutionality of legislation which would accomplish the intent of Congress as expressed in the legislative history of the 1951 Act. *We are referring in this memorandum to legislation which would provide specifically that patronage income resulting from the operations of a cooperative in any year is to be included in the income of the patrons of that year to the extent of the face amount of documents, issued to such patrons within the time required by law, apprising them of their share of such income, without regard to the terms of such documents or the consent of the patrons.* (Such legislation is hereinafter referred to as "the proposed legislation" or "the proposed tax treatment of patrons".)

We believe such legislation would clearly be constitutional.

I. THE POWER OF CONGRESS TO TAX INCOME

The power of Congress to tax *income* is derived from Art. I, sec. 8, cl. 1, of the Constitution, which grants Congress the power "to lay and collect taxes, duties, imposts and excises. . . ." The only pertinent constitutional limitations upon this general taxing power are set forth in Art. I, sec. 2, cl. 3, and Art. I, sec. 9, cl. 4, both of which provide that "direct" taxes must be apportioned among the several states according to population. In *Pollock* v. *Farmers Loan & Trust Co.*, 158 U.S. 601 (1895), the Supreme Court held that a tax upon the *income from property* was in effect a direct tax upon the property itself, and hence beyond the power of Congress to impose without apportionment. The sole purpose of the Sixteenth Amendment, adopted in 1913, was to overcome the limitations which the *Pollock* case had placed upon Congressional power to tax *income*. It provides that:

> "The Congress shall have the power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several states, and without regard to any census or enumeration."

Thus the Sixteenth Amendment was not designed to grant Congress any power which it did not already have. If the tax was truly a tax on "income," rather than a tax on property, the Sixteenth Amendment merely removed any possible basis for imposing the constitutional requirement of apportionment, whatever the source from which the "income" was derived. See *Brushaber* v. *Union Pacific R. Co.*, 240 U.S. 1, 16–20 (1916).

II. CONGRESS HAS THE POWER TO SELECT THE LEVEL AT WHICH CURRENT BUSINESS INCOME WILL BE TAXED

In any situation involving a group of individuals who join together in an entity to conduct a common business undertaking, the "income" which is earned as a result of the joint undertaking is subject to tax. Insofar as the Sixteenth Amendment is concerned, Congress has the power to tax such "income," as earned, either at the level of the entity or at the level of the individual participants. The only constitutional limitation on the power of Congress to select the level of taxation (i.e., the person or entity on whom the tax will be imposed) is the Fifth Amendment's prohibition against the taking of property without due process of law. This means merely that the relationship between the income and the person taxed must be sufficiently close to justify, in fairness the imposition of the tax on such person.[1] In the setting of an individual-entity business relationship, where the individual is the beneficial owner of any income produced, it is entirely clear that both the entity and the individual participants are so closely related to the income that this requirement is satisfied and that the selection of the level of taxation is merely a matter of legislative policy. The history of the taxes which have been imposed on "income" derived within the framework of an individual-entity relationship makes these points convincingly clear.

A. ILLUSTRATIONS OF THE EXERCISE OF SUCH POWER

1. Partnerships

In the case of a partnership, for example, Congress originally levied the tax on income against the partnership itself, but then shifted the tax directly to the individual partners, whether or not the income had been distributed to them. The power of Congress to tax partners directly on their undistributed shares of partnership income was expressly upheld in *Burnet* v. *Leininger*, 285 U.S. 136 (1932), where the Supreme Court stated:

> "The Congress, having the authority to tax the net income to partnerships, could impose the liability upon the partnership directly as it did under the Revenue Act of 1917 . . ., or upon the 'individuals carrying on business in partnership,' as in the statutes here involved." (p. 142)

A later case, *Heiner* v. *Mellon*, 304 U.S. 271 (1938) reached the same result although the partnership was prohibited by state law from making any distribution of partnership earnings during the year in question.[2]

[1] Compare, for example, *Hoeper* v. *Tax Commission*, 284 U.S. 206 (1931), holding that a husband cannot be taxed on his wife's income, with *Burnet* v. *Wells*, 289 U.S. 670 (1933), sustaining the taxation to the grantor of a trust of trust income used to pay premiums on insurance on the grantor's life, although others were named as beneficiaries of the insurance.

[2] Interestingly enough, the Court there cited with approval Section 220 of the Revenue Act of 1918, taxing directly to shareholders the income of a corporation improperly accumulating earnings.

2. Corporations

Under the Act of June 30, 1864, the annual undivided profits of a corporation were taxed directly to its shareholders. In *Collector* v. *Hubbard*, 12 Wall. 1 (1870) the Supreme Court upheld the power of Congress to provide such treatment.[3]

For many years Congress has followed the general policy, with various exceptions, of levying the tax on business income produced by a corporation upon the corporation itself, and has taxed the shareholders individually only upon dividends paid to them. This treatment has been applied, and its constitutionality upheld, even in situations involving unincorporated associations which were not treated as corporations under state law. The power of Congress to tax income earned through such associations at the entity level, rather than at the individual level, was upheld in *Burk-Waggoner Oil Asso.* v. *Hopkins*, 269 U.S. 110 (1925).

With respect to foreign personal holding companies, Congress has undertaken since the Revenue Act of 1937 to tax United States shareholders directly on current earnings, even though undistributed, and its power to tax such shareholders in this manner was expressly upheld in *Eder* v. *Commissioner*, 138 F. 2d 27 (CA 2, 1943). Although this issue has never been presented to the Supreme Court, in *Helvering* v. *National Grocery Co.*, 304 U.S. 282, 288 (1938), which upheld the constitutionality of the undistributed profits tax on corporations, the Supreme Court stated that Congress, if it had chosen to do so, could have taxed the shareholder directly on the year's undistributed profits of the corporation.

*   *   *   *   *   *   *

As the situations referred to above illustrate, in every instance in which the Courts have been called upon to review the action of Congress in selecting the level at which a tax on current business income will be imposed, the constitutionality of *whatever action* Congress has taken has *always* been upheld.[4] Moreover, whenever parties join together to create income, it is inconceivable that Congress, having complete power to tax the income, would be limited by the particular form of the organization in choosing whether to tax the income to the entity or to the individual. There is nothing in the Constitution which could, by any stretch of the imagination, be thought to have that effect.

B. APPLICABILITY OF THE FOREGOING PRINCIPLE TO PROPOSED TAX TREATMENT OF PATRONS

Against this background the pertinent questions involved in determining the constitutionality of the proposed tax treatment of patrons are clear. Does the statute impose a tax on "income"? If so, can this tax constitutionally be imposed at the patron level rather than at the cooperative level? We think the answer to both quesions is clearly "Yes."

There is no question but that the current net margins earned through the operation of a cooperative constitute ~~income which~~ is constitutionally subject to tax without apportionment. Nor is there any doubt, under the authorities referred to above, that the imposition of such a tax on each patron based on his share of total current net margins would be a constitutionally permissible exercise by Congress of its power to select the level at which such income should be taxed. This would be true even though—as in the case of a partnership—the patron received no document apprising him of the amount of his share and even though that share was not distributed to him. Since income can be taxed to the patron without the issuance of such a document, it is certainly constitutional, as the proposed legislation would contemplate, to limit the amount so taxed to that

[3] Later, in *Pollock* v. *Farmers Loan & Trust Co.*, 158 U.S. 601 (1895), the Court held that a tax on income from property was equivalent to a direct tax on the property and was therefore unconstitutional unless apportioned among the several states (the Sixteenth Amendment not yet having been adopted). Although the Court in *Eisner* v. *Macomber*, 252 U.S. 189 (1920) indicated that, even after the adoption of the Sixteenth Amendment the *Pollock* case must be considered as having overruled the *Hubbard* case with respect to the power of Congress to tax *accumulated* corporate earnings direct to stockholders (since such *accumulated* earnings constitute *property* and not *income* of the shareholder) there has never been any indication that, since the adoption of the Amendment, *Hubbard* is not still sound authority concerning the power of Congress to tax *current* earnings direct to stockholders. See discussion of *Macomber* case, below.

[4] As we shall demonstrate, *Eisner* v. *Macomber* is not authority to the contrary.

portion of the net margin with respect to which the patron is given notice in the form of a document.[5]

The actual issuance of a document is unnecessary, as a matter of constitutional law, to render valid a statute taxing to the patron his share of the net margins of a cooperative. The crucial points, in the constitutional sense, are that income has been earned through business activity of the patron and others associated with him in the cooperative enterprise, and that such income can be taxed at the level chosen by Congress.[6] However, it would seem desirable as an administrative matter to provide for the issuance of such documents, and, as the proposed legislation would contempiate, to make such issuance the event which entitles the cooperative to a reduction of its gross income and which requires the income represented by the documents to be included by the patrons. Under this procedure each patron is informed of the amount which he is required to report as income.[7]

Some have suggested that the analogies referred to above in the partnership and corporate areas do not support the conclusion that the proposed tax treatment of patrons would be constitutional. It has been claimed, for example, that in the case of a partnership, a small group of partners is normally in control and can force the distribution of partnership earnings, whereas in the cooperative situation the number of patrons is usually large and the element of control is lacking. Therefore, the argument goes, the fact that Congress can tax partnership income directly to the partners does not mean that it can tax cooperative income directly to patrons. This observation, we submit, will not stand analysis. Many partnerships—note, for example, the real estate syndicate currently in vogue—have a great many partners, no one of whom is in control. Moreover, in a limited partnership the limited partners are not even entitled to a voice in partnership management; and yet they are clearly taxable on their share of partnership earnings, whether or not distibuted.

It has been suggested that the pass-through of corporate income to shareholders of foreign personal holding companies is constitutional only because it is necessary to prevent evasion and avoidance. Although the prevention of tax avoidance was what motivated Congress to impose a tax on shareholders of foreign personal holding companies, we submit that the constitutional *power* to provide such treatment is no more dependent on such considerations of policy than is the power to tax partners on undistributed earnings of a partnership. It has also been pointed out that the foreign personal holding company situation is one

[5] Some of the witnesses before the Ways & Means Committee have contended that the *Carpenter* and *Long Poultry Farms* cases, although decided under present law, mean that a statute specifically taxing the patron on income equal to the face amount of a patronage refund certificate would be unconstitutional. They reason that the definition of income in the present Code is intended to be as broad as the Sixteenth Amendment permits and that, consequently, decisions to the effect that under present law a patron realizes no income except to the extent of the fair market value of the document are decisions that the patron could not constitutionally be taxed on any greater amount. Such reasoning is patently fallacious. Although the definition of gross income in the present statute is seemingly all-embracing, it is obviously not intended to tax every taxpayer on all income that constitutionally could be attributed to him. Thus a cash basis taxpayer is not taxed on accrued, but unreceived, income; nor is a corporate stockholder, as a rule, taxed on undistributed corporate income. This does not mean that a statute, specifically taxing certain undistributed corporate income to stockholders, such as the foreign personal holding company provision, is unconstitutional. Similarly the *Carpenter* and *Long Poultry Farms* cases have no bearing on the constitutionality of the proposed tax treatment of patrons. They merely hold that the present law contains nothing which authorizes such treatment.

[6] Those who have expressed doubt as to the constitutionality of the proposed legislation have not analyzed the problem correctly: they have erroneously looked to the document itself for the constitutional justification for taxing the patron. The writer of this memorandum, before he had given any study to the constitutional issue and before he had placed that issue in focus, also took this approach. See Asbill, "Cooperatives: Tax Treatment of Patronage Refunds", 42 Va. L. R. 1087, 1112 (1956), where the question was posed: "Does a worthless piece of paper represent 'income' within the meaning of the Sixteenth Amendment?" If one starts with the false premise that the document is the constitutional *sine qua non,* it is not surprising that one questions whether a patron can realize any income when the document he receives is without fair market value. The doubt disappears, however, when one realizes that the document is merely evidence of previously earned income which could be taxed to the patron regardless of the issuance of any document.

[7] For a similar notification requirement, see Subchapter M of the Internal Revenue Code, dealing with regulated investment companies, which provides for the taxation at the level of the individual stockholders of certain capital gains realized, but not distributed, by such companies. Sec. 852(b)(3)(D). This treatment applies to such amount of capital gain as the company shall designate in a written notice mailed to its shareholders within 30 days after the close of its taxable year. Section 852 provides for payment of the capital gains tax by the corporation and grants a credit to the shareholder for the amount paid. This provision is similar to the provision in the Discussion Draft of the Revenue Bill of 1961 for withholding on patronage refunds.

where a small group of shareholders controls the corporation, and it has been suggested that this fact has an important bearing on the constitutionality of the foreign personal holding company provisions of the statute. It is, of course, true that for a corporation to qualify as a foreign personal holding company, more than 50% of the stock must be owned directly or indirectly by not more than 5 persons who are citizens or residents of the United States. However, it may well be that no one member of this group can control the corporation. Moreover, the tax is imposed on shareholders whether or not they are members of this group, whether or not they have voting stock, and whether or not the corporation was a foreign personal holding company at the time they acquired their stock. Consequently, it can be imposed on a minority shareholder who has no voice in the management or control of the corporation, who acquired his stock before the corporation became a foreign personal holding company (by subsequent changes in the stock ownership of other stockholders), and who is not even aware that the corporation is a foreign personal holding company.

Thus, we submit, the above examples of the pass-through of income from the entity level to the individual level are square authority for the constitutionality of the proposed tax treatment of patrons.[8] They support conclusively the proposition that Congress' power to choose the level of taxation cannot be controlled or limited by the label given by state law to a particular form of business operation. It is inconceivable that Congress can tax the individual associates when the state denominates the entity a partnership, but cannot do so when the state calls the entity a corporation or a cooperative. As the Supreme Court, in *Burk-Waggoner Oil Asso.* v. *Hopkins, supra*, stated with respect to unincorporated associations:

> ". . . . Neither the conception of unincorporated associations prevailing under the local law, nor the relation under that law of the association to its shareholders, nor their relation to each other and to outsiders, is of legal significance as bearing upon the power of Congress to determine how and at what rate the income of the joint enterprise shall be taxed." (269 U.S. at 114)

This language is unquestionably applicable to any form of business organization.

These examples also make it clear that it is unnecessary as a constitutional matter, to require specific consent by the patron to the proposed tax treatment, just as it is unnecessary to require such consent in the partnership and foreign personal holding company areas.[9]

III. EISNER V. MACOMBER IS NOT AUTHORITY TO THE CONTRARY

The only case which has been viewed as casting any doubt upon the power of Congress, in a business situation like that here involved, to impose the tax on current income at whichever level it considers most appropriate is *Eisner* v. *Macomber*, 252 U.S. 189 (1920). This case, perhaps more than any other in the tax field, has been offered over and over again, without analysis, in support of propositions upon which it does not even bear. Upon analysis, it is clear that the case does not touch upon the question here involved.

The issue there before the Court was whether a stock dividend which made no change in the stockholders' interests in the corporation constituted income

[8] They are also authority, if any be needed, for the proposition that dominion and control over property is not essential to the realization of income. Cases such as *James* v. *U.S.*, 366 U.S. 213 (1961) (holding embezzled funds to be taxable income), which have been cited to the Ways & Means Committee as authority against the constitutionality of the proposed legislation, merely say that dominion and control may give rise to realization of income; they by no means hold, or say, that income cannot be realized without such dominion and control.

[9] It has been pointed out by others that several Code provisions taxing undistributed corporate profits to shareholders require the individual consent of the shareholder. See, for example, Section 565 (Consent Dividends) and Subchapter S. The existence, in these provisions, of the requirement of individual consent does not, of course, mean that such a requirement is demanded by the Constitution; it simply means that Congress, as a matter of legislative policy, has deemed it advisable in those situations to tax undistributed corporate earnings to shareholders only when such shareholders have consented to such treatment. These examples involve situations where the number of shareholders is usually relatively small and where their consent can be obtained by the corporation without great administrative difficulty. Entirely different questions of policy are involved in determining the desirability of imposing the individual consent requirement in the cooperative area, where the number of patrons is often extremely large, and where the administrative problems in obtaining consent may be very costly and disruptive of the cooperative's operation and financial structures.

within the meaning of the Sixteenth Amendment. The Court held that it did not. That holding—that the splitting of two certificates of stock into three does not generate income—does not even remotely touch the question here involved, namely, whether income flowing *currently* to a cooperative can be taxed directly to the patrons whose patronage resulted in the realization of the income.

It is true that in the *Macomber* opinion, the Court discussed the question whether earnings of a corporation could be taxed directly to its stockholders. Aside from the fact that the statute there involved did not present such a question, since it purported to tax only the stock dividends themselves,[10] a careful consideration of the language of the Court and of Justice Brandeis' dissent clearly reveals that the Court was referring only to the taxation of *accumulated* corporate earnings, and that it was not considering—nor was it expressing any opinion on—the question whether a stockholder may be taxed on income of the corporation *as it is currently earned.*

The Government had argued in the alternative that the constitutionality of the statute imposing a tax on stock dividends could be sustained on the theory that corporate earnings could be taxed directly to stockholders, irrespective of the power of Congress to tax a stock dividend as such. That this argument was directed toward the taxation of the earliest earnings *accumulated* after March 1, 1913, not *current* earnings, is clear from the record of the case[11] and from the following statement by the Court:

> "Upon the second argument, the government, recognizing the force of the decision in Towne v. Eisner, 245 U.S. 418, and virtually abandoning the contention that a stock dividend increases the interest of the stockholder or otherwise enriches him, insisted as an alternative that, by the true construction of the Act of 1916, the tax is imposed not upon the stock dividend, but rather upon the stockholder's share of the undivided profits *previously accumulated* by the corporation; the tax being levied as a matter of convenience at the time such profits become manifest through the stock dividend. If so construed, would the act be constitutional?" (p. 217) (Emphasis supplied.)

The majority expressed the view that a statute which purported to tax the *accumulated* earnings of a corporation directly to its shareholders would not be constitutional, for the reason that ". . . what is called the stockholder's share in the *accumulated* profits of the company is *capital,* not income." (p. 219) (Emphasis supplied.) The opinion concluded with the following paragraph:

> "Thus, from every point of view, we are brought irresistibly to the conclusion that neither under the 16th Amendment nor otherwise has Congress power to tax without apportionment a true stock dividend made lawfully and in good faith, or the *accumulated* profits behind it, as income of the stockholder. The Revenue Act of 1916, in so far as it imposes a tax upon the stockholder because of such dividend, contravenes the provisions of article 1, § 2, cl. 3, and article 1, § 9, cl. 4, of the Constitution, and to this extent is invalid notwithstanding the 16th Amendment." (Emphasis supplied.) (p. 219)

Nowhere in the course of its opinion did the Court consider—or have occasion to consider—the constitutionality of a statute which taxed the *current* earnings of a corporation directly to its stockholders.

When one considers the dissenting opinion of Mr. Justice Brandeis, it is entirely clear that he also recognized that the Government's alternative argument was based upon the theory that Congress had the power to tax to share-

[10] The Court stated, at pp. 199–200 that the statute "(notwithstanding a contention of the government that will be noticed) plainly evinces the purpose of Congress to tax stock dividends as income."

[11] The stock dividend was declared on January 1, 1916, in the amount of approximately $25 Million. Of this amount, $20 Million was a capitalization of pre-March 1, 1913 earnings, which the statute did not purport to reach. The remaining $5 Million was a capitalization of the *earliest* post-1913 earnings (total post-1913 earnings being about $25 Million). It was Mrs. Macomber's share of this $5 Million of *accumulated* earnings which the Government sought to tax. This is clear from the following statement in the Government's brief on reargument:

> ". . . If Congress had levied an annual tax on the stockholder's share of corporate profits *accruing during each year,* then, of course, no one would say that any part of the profits accruing during a particular year could be carried forward and treated as income of a succeeding year. But that is not this case. . . . The result is that instead of an *annual tax on accruing profits,* we have a *single tax on accumulated profits* levied when they are distributed." (pp. 25–26).

holders *accumulated earnings*, rather than *current* earnings, of their corporation. He stated (p. 232):

> ". . . serious question of the taxability of stock dividends would probably never have been made if Congress had undertaken to tax only those dividends which represented profits earned during the year in which the dividend was paid, or in the year preceding."

Thus, since the question presented by the alternative arguments in *Eisner* v. *Macomber* was not the power of Congress to tax *current* corporate earnings directly to shareholders but its power to tax *accumulated* earnings when represented by the declaration of a stock dividend, it would indeed be erroneous to accept the case as any authority whatever on the question of the constitutional power of Congress to tax directly to shareholders the earnings of a corporation (or to patrons the earnings of a cooperative) *as they arise.*

In view of the above, it seems unnecessary to discuss at any length the subsequent history of *Eisner* v. *Macomber.* Suffice it to say that, even with respect to the matters to which the Court was actually addressing itself—such as the taxability of stock dividends, and the definition of income—the decision has been limited by subsequent cases to such an extent that it now must be considered as encompassing very little, if any, more than its own precise factual situation.[12]

Thus, a stock dividend is taxable if there has been a segregation of assets at the corporate level (*U.S.* v. *Phellis*, 257 U.S. 156 (1921) and *Rockefeller* v. *U.S.*, 257 U.S. 176 (1921)), or if there has been any change in the stockholders' proportional interests in the corporation (*Marr* v. *U.S.*, 268 U.S. 536 (1925) and *Koshland* v. *Helvering*, 297 U.S. 441 (1935)), even though nothing has been "severed from capital" and distributed to the stockholder for his own "separate use and benefit." See *Helvering* v. *Bruun*, 309 U.S. 461 (1940).

IV. FACTORS PECULIAR TO COOPERATIVES

It is clear from the foregoing that, notwithstanding *Eisner* v. *Macomber*, Congress has the power to tax the shareholders of a regular business corporation on the undistributed *current* earnings of the corporation. It is equally clear, if not clearer, because of the closer business relationship of patron and cooperative, that Congress can tax the patron on his share of current net margins derived from patronage.

In the cooperative situation the patron is not merely a passive investor—he plays a leading role in the transactions producing the income; he furnishes the products or purchases the supplies or services from which the income is derived. The patron must take affirmative action (i.e., he must do business with the cooperative) in order to create any patronage income which is taxable to him. Under these circumstances his relation to net margins received at the cooperative level is closer than that of a stockholder to corporate earnings. Indeed, this relationship is closer, economically, than that of many partners—and certainly all limited partners—to the earnings of their partnership. Since partnership income can be taxed directly to the partners, there is no logical or legal basis whatever for concluding that patronage income cannot be taxed directly to patrons.

* * * * * * *

For the reasons set forth above, legislation requiring patrons to include in income the face amount of documents evidencing their share of current patronage income of the cooperative enterprise would clearly be constitutional.

SUTHERLAND, ASBILL & BRENNAN,
By MAC ASBILL, Jr.

Senator CURTIS. Thank you very much.

Mr. Patrick B. Healy.

You understand that dairymen are used to working from early to late, and so you probably don't mind.

[12] Indeed, if the continued validity of the *Macomber* decision on the exact issue there involved were squarely presented to the Court today, we believe the case would be overruled. In *Helvering* v. *Griffiths*, 318 U.S. 371 (1943) the Government urged that *Eisner* v. *Macomber* be overruled, but a majority of the Court refused to reach the Constitutional issue because it concluded that the statute there involved was not intended by Congress to encompass the type of stock dividend involved in the *Macomber* case. Three Justices dissented on the ground that the *Macomber* case should be overruled.

Erwin Griswold, Dean of Harvard Law School, in "Cases on Federal Taxation" (5th ed. 1960) stated: "The [majority] opinion [in *Griffiths*] left little room to doubt that a statute explicitly taxing all stock dividends would be upheld." (p. 710).

STATEMENT OF PATRICK B. HEALY, SECRETARY, NATIONAL MILK PRODUCERS FEDERATION

Mr. HEALY. We are very happy to be here.

Senator CURTIS. Mr. Healy, we are delighted to have you here. This tax bill probably to many people is just so many pages, but to a great segment of our economy it is very important, and we assure you that what you have to say will be followed through when the committee deliberates.

You may proceed.

Mr. HEALY. Thank you, Mr. Chairman.

In the interests of time, I will attempt to summarize the summary we prepared.

My name is Patrick B. Healy, and I am the secretary of the National Milk Producers Federation, with offices at No. 30 F Street NW in Washington, D.C.

The statement which I am going to present here accurately reflects the farmers' viewpoint, because 75 percent of our board of directors are required to be farmers, and therefore any policy position which we adopt at meetings is adopted by a preponderance of farmers.

Furthermore, the board of directors of cooperatives are all farmers. Therefore, farmers do in fact set the policies under which cooperatives operate.

Arguments to the effect that Congress must protect farmers from themselves, or from their own cooperatives, are unsound and are merely an excuse to undermine cooperatives so processors and middlemen can take greater profits at the farmers' expense.

Farmers must be permitted to operate their own organizations, financed with their own funds, in whatever manner they deem best.

Congress should not undertake to substitute its judgment in the operation of a farmers' cooperative for the sound judgment and experience of its farmer members, who have at stake not only their own capital, this is the farmers' money we are talking about, but also their own welfare and future as dairy farmers.

Business requirements change from time to time. An inflexible across-the-board rule prescribed by Congress would be impractical.

What are cooperatives?

Cooperatives are a basic form of a self-help program in which farmers acting together in the marketplace seek to solve their own problems, improve the quality and service of their produce, and try to obtain a more reasonable return for the labor and investment required to produce the Nation's food.

Congressional approval of cooperatives:

There is a long history in Congress of legislation to encourage farmers to improve their own position by organizing and operating their own cooperatives.

That cooperatives have justified the confidence placed in them by Congress is amply attested by the fact that this policy of encouragement has been maintained consistently for 50 years.

Not only in the interests of the cooperative and the farmer, but also in the interests of our Nation as a whole, in order to provide for a healthy agriculture, it must be everyone's duty to protect and develop farmers' cooperatives and see to it that these associations prosper.

Farmers use cooperatives to keep processing marketing margins in line and to keep the cost of farm supplies in line. They do this by setting up and operating their own businesses when margins charged farmers by others become excessive.

The reason cooperatives meet with strong opposition is because the opportunities for others to take large profits at the expense of farmers is greatest when farmers are disorganized, and when there is no yardstick in the marketplace against which these other organizations must measure themselves.

The tax treatment of farmer cooperatives is not unique. It is not unusual, and it is not applicable to cooperatives alone. It is followed by businesses operated by individuals, by partnerships, and by small corporations, in that only one level of tax is assessed against their profits.

Large corporations are in fact subject to a double tax. We think this is wrong. But certainly we don't think the way to correct it is to put a double tax on everyone else.

We do not believe that there is one valid tax objective, one valid revenue objective, to be achieved by the cooperative provisions of the bill which is before this committee.

All savings which are made by farmers, when they market their product on a cost basis through their own cooperatives' are taxed. They are taxed at full value to the members and the patrons of the cooperative. This was settled in 1962, when we passed the legislation concerning the patronage refunds of cooperatives.

The provisions of this bill which are now pending before the Congress are an unwarranted attack upon farmer cooperatives. They are designed to undermine the capital of cooperatives and their financial structure thus making it easier for others to operate in the market alongside these institutions and to take a better profit at the farmers' expense.

We therefore recommend that section 531 be stricken from the bill. We think it should be because, first, it serves no valid tax objective. There will not be one additional penny of revenue to the Government, if this thing is passed—none.

Secondly, we feel that it is destructive and discriminatory, and it is an attack upon cooperatives which are operated by farmers in their own behalf.

Third, we think its real effect, rather than to provide for Federal revenue, would be to undermine the capital and the financial structure of the cooperatives.

Fourth, it would be an attempt to interpose the judgment of Congress for that of the farmer boards of directors of each of these cooperatives.

It would do this by prescribing an across-the-board rule which would be inflexible and inadequate to meet the changing conditions with which these cooperatives are confronted, conditions which are different maybe for each cooperative which must make up its mind as to what it should do.

We believe that problems relating to the internal operations of cooperatives, and here we are talking about the accrual, use, and revolving of the capital structure of these cooperatives, should be left to the farmer cooperatives, because they are the people who have the problem.

Finally, we feel that as long as one full level of tax is paid currently in the year in which it is earned, as is now the case, that farmers should be free to managa their own cooperatives, and to finance them with their own money, in whatever manner they deem best.

That concludes our summary, Mr. Chairman.

Senator CURTIS. Thank you.

Mr. Miller?

Mr. Hansen?

Mr. Healey, do you have anything further to say?

Mr. HEALY. Yes. I had thought perhaps that Mr. Miller would pursue his question with me as he did heretofore.

In answer to that question, I would like to say that this is what farmers do every day. This is the decision that they make every day.

They decide who will sit on their board of directors. They assemble at annual meetings and elect officers and directors. In effect they decide each year whether the capital shall be revolved or whether it shall be retained.

Furthermore, in 1962, and again in 1964, we went to each cooperative in this country, not only we in the dairy field but all cooperatives, and we explained this tax bill to them.

They all amended their bylaws to conform to the 1962 act, and again in 1964 to conform to the act which related to per unit retained capital. All of them are directly and explicitly aware of how their capital is used and of how their cooperative is operated.

All of them, or at least the majority in each cooperative, have agreed that this is something that the cooperative must be left free to judge. It is something that they have just recently been confronted with; and we see absolutely no reason to impose this 15-year deadline on cooperative capital, thereby making it debt instead of capital, and subordinating all other debt to it.

It makes it difficult for them to serve farmers and meet expanding agricultural needs. I understand the governor of the Farm Credit Administration was here today. He probably said that it would make it more difficult for cooperatives to obtain loans from an organization put in business by Congress to lend money only to them. I see no reason to turn this capital, which farmers invest so they can run their own business, into debt so that it becomes more difficult for them to borrow money elsewhere.

They make this decision every year, and each year they decide, "We need this to promote our business," or "We can afford to return a portion of it to you and still have an ongoing business."

Senator MILLER. Who says that?

Mr. HEALY. The boards of these cooperatives; which are elected by the farmers, and which are farmers themselves.

Senator MILLER. Yes. That gets to my point. These other statements which you are making, I think all of us on the committee recognize.

I am getting at this matter of the members themselves on an annual decision basis, because it is annual income we are concerned with. I understand how they operate, and the thing that troubles me is that I can see where this idea of annual income and dominion over annual income might well be exercised by a majority of the members rather than by a board which might not be able to be ousted for some time.

Frankly, I have not in my area seen where any boards have been ousted. But at the same time when you are dealing with annual income, perhaps the annual meeting of the board, of the membership, is the place to merely put the stamp of approval of the majority of the members on the disposition of the annual income.

Mr. HEALY. I think, Senator Miller, that in effect, this is what we do. We go to the annual meeting and we continue the boards in office, the boards which have taken these decisions. Furthermore, I know of no other place where we require all the stockholders, and that is in substance what we are talking about, of organizations to decide how much of that stock shall be called each year. Therefore, I cannot see why, when we get a small group of farmers, as is the case in your State particularly, why we should not trust these men to decide for themselves how best they can operate their own business.

Senator MILLER. When you say, "decide for themselves," are you talking about the boards of directors?

Mr. HEALY. I am talking about the board of directors elected by farmers, and who are subject to the people who elect them.

Senator MILLER. What is the matter with the members themselves?

Mr. HEALY. We have just been to the membership in 1964 and in 1962, and explained this tax issue to them in the greatest detail. We got their individual consent in many cases. In many cases we got, under the requirements for amending bylaws, which are quite rigid in some organizations——

Senator MILLER. Right. That is exactly what I am getting at.

Mr. HEALY. We just went through that, Senator, and I see no reason to impose rules on cooperatives that we do not impose on any other business. I can see no objective in it, nothing that would be served by it, except to create a feeling that perhaps the Congress of the United States does not trust cooperatives.

You see, I know the dairy business quite well, and I know of no market in this country where a man has only one cooperative to which he can sell his milk. He has a choice, and if he does not like what one cooperative does, he can sell elsewhere. If he doesn't like what any cooperative does, he can ship as an individual shipper to some milk dealer, who is doggone glad to get him.

This competition keeps the decisions of the Board, and the revolving of money, at the very best pace that the cooperative can develop and still continue to operate a business.

Senator MILLER. I understand that a revision of the bylaws can be quite an undertaking sometimes. It might even take years. It depends a lot on what the membership wants to do. But I must say that a majority of the members would have to make a decision on this matter instead of the Board, I can't see how that would impede the cooperative at all.

Mr. HEALY. Well, if that were the case, and we are unalterably opposed to that, the farmers would approve the financing of their cooperatives. There is no question about that; but, it would be an unnecessary burden every year, and we just shouldn't have to do more than we are doing now.

Senator MILLER. Yes, but it might be good for the members to be a little more active sometimes. I know you have troubles, sometimes all managers, all cooperative managers, have on one occasion or another a little trouble getting the members out, like they should, or getting them to participate like they should.

They are generally pretty well satisfied. But this fits with the concept of the democracy of the cooperative, and all I am suggesting to you is that this might be something that will be taken up with the conferees on the other side.

Mr. HEALY. As regards the conferees, I would hope this bill would come out of the Senate without section 531. I would judge that by this time many individual Members of the House have talked to people on the Ways and Means Committee, and I would hope that the Senate would send such resolute men to the conference that they would get their way.

Senator MILLER. Of course, you never know what the House is going to do.

Senator CURTIS. Thank you, Mr. Healy.

(Patrick B. Healy's prepared statement follows:)

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STATEMENT OF PATRICK B. HEALY, SECRETARY, NATIONAL MILK PRODUCERS FEDERATION

SUMMARY

1.—The federation

There is no conflict of interest between farmers and their agricultural cooperatives.

The Federation's statement accurately reflects the farmers viewpoint, because 75 percent of our board of directors are required to be farmers and policy positions are adopted at meetings where farmers predominate.

2.—Farmers control cooperatives

The boards of directors of cooperatives are all farmers elected by farmers. Farmers set the policies of their own cooperatives by democratic process.

3.—The farmers freedom of choice

Arguments to the effect that Congress must protect farmers from themselves, or from their own cooperatives, are unsound and are merely an excuse to undermine cooperatives so processors and middlemen can take greater profits at the farmers' expense.

Farmers must be permitted to operate their own organizations, financed with their own funds, in whatever manner they deem best.

Congress should not undertake to substitute its judgment in the operation of a farmers' cooperative for the sound judgment and experience of its farmer members, who have at stake not only their own capital but also their own welfare and future as dairy farmers.

Business requirements change from time to time. An inflexible across-the-board rule prescribed by Congress would be impractical.

4.—What are cooperatives

Cooperatives are a basic form of a self-help program in which farmers acting together seek to solve their own problems, improve the quality and service of their produce, and try to obtain a more reasonable return for the labor and investment required to product the Nation's food.

5.—Congressional approval of cooperatives

There is a long history in Congress of legislation to encourage farmers to improve their own position by organizing and operating their own cooperatives.

That cooperatives have justified the confidence placed in them by Congress is amply attested by the fact that this policy of encouragement has been maintained consistently for 50 years.

6.—Cooperatives help farmers

Cooperatives provide services for farmers when needed services are not otherwise available.

Farmers keep processing and marketing margins in line, and also the cost of farm supplies, by setting up and operating their own cooperative businesses when margins charged by others are excessive.

Cooperatives check the weights and tests of their members milk to assure fair treatment in an area which otherwise is easily subject to mistreatment.

7.—Cooperatives are important to consumers

Cooperatives have not sought unduly high prices. They ask only for a price level which will reflect to the farmer a fair return for his labor, taking into account the investment and risk involved.

Hourly returns for the labor of dairy farm operators, as reported by the Department of Agriculture, range from $.91 to $1.08 in the three test areas reported.

Cooperatives keep middlemen's margins under reasonable control.

Cooperatives help provide the abundant supplies of high quality food which consumers enjoy.

8.—Opposition to cooperatives

Cooperatives meet with strong opposition because the opportunities for processors and middlemen to take large profits at the expense of the farmer is greatest when farmers are disorganized, when there are no checks on weights and tests, and when there is no regulating influence on processing and purchasing margins.

9.—Tax equality

Businesses operated by individuals, by partnerships, by cooperatives, and by small corporations are all taxed alike in that only one level of tax is imposed.

Large corporations are subject to a double tax. This is wrong. But extending the double tax to cooperatives and then, in turn, to small corporations, partnerships, and individual businesses is not the proper way to correct it.

Large corporations can use the tax advantages available to cooperatives if they choose to operate on a cost basis as cooperatives do.

10.—No tax issue in the present bill

There are no valid tax objectives to be achieved by the cooperative provisions of the pending bill.

All savings made by farmers when they market their produce, or purchase their farm supplies, on a cost basis, through their own cooperatives are taxed at full value to the members and patrons of the cooperatives. This is true, under the present law, regardless of what percentage is paid in cash or left in the cooperative as capital.

11.—Discriminatory and destructive legislation

The cooperative provisions of the pending bill are an unwarranted attack upon farmers cooperatives, and are designed to undermine their capital and financial structures, thus making it easier for processors and middlemen to reap a greater profit at the farmer's expense.

12.—The federation's position

We recommend that Section 531 be stricken from the bill for the following reasons:

(1) It serves no valid tax objective;

(2) It is a destructive and discriminatory attack upon farmers agricultural cooperatives;

(3) Its real effect would be to undermine the capital and financial structure of agricultural cooperatives;

(4) It would interpose the judgment of Congress for that of the farmer boards of directors of cooperatives;

(5) It would prescribe an across-the-board rule which would be inflexible and inadequate to meet changing requirements;

(6) It is an attempt by Congress to interfere in the internal affairs of farmers' organizations;

(7) Problems relating to the internal operation of cooperatives should be considered by the agriculture committees and not the tax committees;

(8) As long as one full level of tax is currently paid, as it now is, farmers should be free to manage their own cooperatives and to finance them with their own money in whatever manner they deem best.

THE FEDERATION

The National Milk Producers Federation is a national farm organization. It represents dairy farmers and the dairy cooperative associations which they own and operate.

The policies of the Federation accurately reflect the viewpoint of dairy farmers who are members of cooperatives as well as the viewpoint of cooperative associations which dairy farmers have organized and joined.

This is true, because our bylaws require that at least 75 percent of the Federation's board of directors must be active dairy farmers. Attendance at our annual meetings, where our basic policy resolutions are determined, is predominantly that of the active dairy farmer.

The men who serve on our board of directors, and those who serve as voting delegates when our policies are adopted, are all chosen, either directly or indirectly, by farmers and they must be responsive to the wishes and thinking of the dairy farmers they represent.

This is most important in this hearing, because it will be argued that Congress must protect farmers against their own cooperatives.

FARMERS CONTROL COOPERATIVES

The boards of directors of dairy cooperatives, in practically every case, are all active dairy farmers. The directors are elected by farmers, and they must be responsive to the welfare of the dairy farmers they represent and also to their own welfare as dairy farmers themselves.

The bylaws of the cooperatives require their boards of directors to be active farmers, thus assuring control of the cooperative by farmers. This further assures that the cooperative will be operated in the best interest of farmers and that its policies will reflect accurately the farmer viewpoint.

The principle of one-man one-vote is traditional with cooperatives, and democratic control by the farmers themselves is a fundamental concept in these organizations. We know of no situation among our members, over many years of experience, where a few large producers have dominated a cooperative to the detriment of smaller producers. The one-man one-vote principle precludes this; and, in any event, farmers just don't operate that way in cooperatives. The reason they have combined together in a cooperative is to promote the common good of all through their united efforts.

THE FARMERS FREEDOM OF CHOICE

The control which farmers exercise over the Federation and over their own cooperative associations, as we have pointed out, is most important to a proper evaluation of the issues presented in this hearing.

Some will argue that farmers must be protected against their own cooperatives and that, unless Congress intervenes, cooperatives will take unfair advantage of the farmers that own and control them.

This is the same as saying that farmers must be protected against themselves and that farmers must not be permitted to use their own best judgment in the management of their own affairs.

It will be our position, and that of the dairy farmers we represent, that farmers should be permitted to operate their own organizations, financed with their own funds, in whatever manner they deem best.

Congress should not undertake to substitute its judgment in the operation of a farmers' cooperative for the sound judgment and extensive knowledge and experience of its farmer members, who have at stake not only their own capital but also their own welfare and future as dairy farmers.

We are not impressed with the argument that Congress should protect the farmer against himself—by making him do what he does not want to do—and by making him handle his own business in his own organization in a manner which is contrary to his own best judgment and contrary to the wishes of a majority of his co-members.

An examination of the present proposal, along with similar proposals that have been made in the past, will disclose that the real objective of such legislation is not to help farmers but to undermine ~~the effectiveness~~ of agricultural cooperatives and thus enable nonfarmer enterprises to reap a greater profit at the expense of disorganized farmers.

This is particularly true of the pending legislation, because it serves no tax objective whatever. Its sole result would be to undermine the capital and financial structure of important agricultural cooperatives, thus leaving farmers at the mercy, if any such quality exists, of the purchasers and processors of their produce.

Farmers must be free to make their own decisions in their own cooperatives—and Congress must not attempt to make decisions for them by a general rule of law—because the facts are different in practically every case.

For example, in a new or expanding cooperative, or in one planning to set up a new plant, it might be most important to farmers to build up capital in substantial amounts and to leave capital funds in the cooperatives for a relatively long period of time. In a cooperative already fully financed, the farmers may prefer to withdraw a large percentage of their current savings in cash.

In one cooperative, farmers may prefer to take a large proportion of their current savings in cash and leave their invested capital in the cooperative for longer periods. In another, the farmers may prefer to leave their current savings on deposit in the capital of the cooperative in order to bring about a more rapid revolving of older capital certificates.

Business requirements change from year to year. The right to make business decisions must be flexible and not hampered by general across-the-board rules prescribed by Congress, which in many cases would be impractical to meet current problems.

As long as the current payment of one level of tax is adequately provided for, as it now is, we see no reason why farmers should not be permitted to make their own decisions concerning their own funds in their own organizations.

It is entirely out of order, and most inappropriate, in such cases, for Congress to substitute its judgment for the business decisions of the farmers and thus meddle in the internal affairs and operations of these important agricultural cooperatives.

WHAT ARE COOPERATIVES?

Agricultural cooperatives are organizations of farmers who have banded together in an effort to improve their own economic lot.

They are entirely voluntary; and no farmer needs to join one, or to remain a member, unless he wishes to do so. In practically all cases, membership is open and any farmer who wishes to avail himself of the services of the cooperative and to participate in it is welcome to do so.

Cooperatives are a basic form of a self-help program in which farmers acting together seek to solve their own problems, improve the quality and service of their produce, and try to obtain a reasonable return for the labor and investment required to produce the Nation's food.

Some cooperatives are bargaining associations through which farmers can bargain as a group for the sale of milk to processing and distributing plants. Without such associations, farmers have no group bargaining power and are in the position of having to take for their milk whatever price the dairy companies may choose to pay.

Cooperatives als. check weights and butterfat tests of the milk sold by their members, thus eliminating the possibility of false or inaccurate tests and weights.

Other dairy cooperatives are manufacturing units. These are simply groups of farmers who, instead of selling their milk as a raw agricultural product, have organized cooperatively to manufacture it, on a cost basis, in their own plants, built with their own capital, in order to obtain a better return by selling it in the form of finished dairy products.

Cooperatives also purchase for their members, on a cost basis, the supplies and equipment needed on their farms.

CONGRESSIONAL APPROVAL OF COOPERATIVES

There is a long history in Congress of legislation to encourage farmers to improve their own position by organizing and operating their own cooperatives. The policy of Congress in this respect is well established by many enactments. To mention just a few, the Capper-Volstead Act was passed in 1922, the Agricultural Marketing Act was passed in 1929, numerous provisions relating to cooperatives were enacted in the 1930's, and legislation relating to cooperatives and to the Farm Credit Administration has continued to the present time.

That cooperatives have justified the confidence placed in them by Congress is amply attested by the fact that this policy of encouragement has been maintained consistently for approximately 50 years.

COOPERATIVES HELP FARMERS

Cooperatives have rendered a tremendously valuable service for agriculture over many years. Through them, farmers have provided services for themselves where needed services were not otherwise available.

They have kept processing and marketing margins in line by processing and marketing their own produce in their own plants when the margins charged by others were excessive. In the same manner, when prices charged for feeds and fertilizer and farm equipment have been excessive, farmers have set up their own purchasing operations.

The savings farmers have made by performing their own marketing and purchasing service for themselves in their own cooperatives runs into many, many millions of dollars. This has benefited not only the agricultural economy of the Nation but the economy as a whole, because agriculture is an important part of the total economy.

Cooperatives provide a yardstick for measuring excessive processing margins and provide a brake on middlemen's excessive profits.

Even in areas where there are no cooperative plants, the fact that farmers can set up their own plant if processing margins become too excessive serves as a strong influence to keep the margins within reasonable bounds.

Farmers do not organize cooperatives for the fun of it. In most cases, they are driven to do so for their own protection, either because the services they need are not being provided or because excessive profits are being taken at their expense. Dissatisfaction with weights and tests is another factor. Unless there is a very real need for farmers to organize, the setting up of a new cooperative is quite likely to fail.

COOPERATIVES ARE IMPORTANT TO CONSUMERS

Although farmers' cooperatives have been reasonably successful in the agricultural field, as Congress intended them to be, they have neither achieved nor sought unreasonably high prices.

Controls against undue enhancement of prices are provided in Section 2 of the Capper-Volstead Act, but in actual practice it has never been necessary to use this section.

This country is so large, and its agricultural resources are so great, that cooperatives could not have unduly enhanced prices, even if they had desired to do so.

But cooperatives have not sought unduly high prices. Basically they have taken the position that prices should be at a level which would reflect to the farmer a fair return for his labor, taking into account the investment and risk involved.

Consumers have no right to enjoy food at prices which do not provide reasonable compensation to farmers any more than they have a right to enjoy industrial products made with sweatshop labor.

Hourly returns for the labor of dairy farm operators, as reported by the Department of Agriculture, have been far below $1.00 per hour in many of the past years. The most recent figures for the three test areas reported are $1.07, $1.08, and $.91 (Agriculture Information Bulletin No. 230, September 1968).

Actually cooperatives perform a valuable service to consumers by keeping middlemen's margins under reasonable control.

Furthermore, the cooperatives are an important and vital factor in the production of the abundant supplies of high quality foods which this country enjoys.

OPPOSITION TO COOPERATIVES

It is not difficult to see why farmers' cooperatives meet with strong opposition and why such determined efforts are made to hamper or destroy them.

As we have indicated above, the cooperatives provide a control on excessive processing margins and on excessive middlemen's profits, both with respect to farm marketing and the purchasing of farm supplies.

The opportunity for processors to take large profits is greatest when farmers are disorganized, when there are no checks on weights and tests, and when there is no regulating influence on processing and purchasing margins.

TAX EQUALITY

Businesses operated by individuals, by partnerships, by cooperatives, and by small corporations are taxed alike in that only one level of tax is imposed. This tax is paid by the individual, by the partners, by the members of cooperatives, and by the stockholder members of small corporations.

Businesses operated by large corporations are double taxed, because one level of tax is charged to the corporation and another to its stockholders.

The same tax treatment that is accorded to cooperatives is available to big corporations if they choose to operate on a cost basis, as cooperatives do, and return to their patrons gross receipts less operating costs. In such a case, no profit would accrue to the big corporation and there would be no corporate tax. Cooperatives must operate on a cost basis and no profit can accrue to the cooperative.

All of the savings made through the operation of a cooperative must be passed back to its patrons, and the patrons are taxed on all such savings currently and at the full amount.

The double tax on corporations is wrong, and it should be gradually eliminated. It would merely compound the wrong to extend a double tax to cooperatives and then, in turn, to small corporations, partnerships, and individual businesses.

NO TAX ISSUE IN THE PRESENT BILL

There is no tax issue in the present bill, insofar as it applies to farmer cooperatives.

All savings made by farmers when they market their produce, or purchase their farm supplies, on a cost basis, through their own cooperatives are fully taxed to the members and patrons of the cooperative.

This tax is charged currently, without deferment, and all such savings are taxed at full value. This is true whether the farmers elect to receive their savings in cash or to leave them invested in the cooperative as capital funds of the coopratlve.

The tax result is unchanged, whether the savings paid in cash is 20 percent or 50 percent, because the farmer pays taxes currently on the full value of his share of the savings made.

There is, therefore, no valid tax objective to be achieved by the cooperative provisions of the pending bill.

DISCRIMINATORY AND DESTRUCTIVE LEGISLATION

The cooperative provisions of the pending bill are highly discriminatory and destructive and serve no useful tax purpose.

They are an unwarranted attack upon farmers' cooperatives, and are designed to undermine their capital and financial structures.

As long as one full level of tax is being paid currently by farmers on the savings made through their cooperatives, there is no valid basis for Congress to meddle in the internal affairs of the cooperatives.

Neither is there any valid basis for Congress to substitute its judgment for the business judgment of the farmer boards of directors of agricultural cooperatives. These men are well informed and they are farmer oriented. They know what is best for themselves as farmers and for the successful operation of their cooperatives.

An across-the-board rule imposed by Congress without knowing the day-to-day and year-to-year needs of each individual cooperative would be dangerous and ill-advised.

There is no need to protect the farmer from his cooperative, because the farmer controls the cooperative and membership in it is voluntary. A cooperative whose capital and financing arrangements did not have the support of its membership could not possibly survive.

We are not impressed by those who profess to want to help the farmer by undermining one of his most effective tools, his own cooperative.

This legislation is a thinly disguised attempt to permit processors and middlemen to take unwarranted and excessive profits from the farmer by crippling the farmers ability to perform services for himself, when such margins get out of hand.

THE FEDERATION'S POSITION

The Federation, and the dairy farmers we represent, have consistently supported the principle that one level of tax should be paid currently by farmers on the savings they make when they process their own produce through their own cooperative plants on a cost basis.

We have vigorously opposed, and continue to oppose in this bill, attempts to undermine the capital and financial structure of cooperatives under the guise of tax legislation.

We recommend that all of Section 531 of H.R. 13270, relating to Agricultural Cooperatives, be stricken from the bill for the following reasons:

(1) It serves no valid tax objective, since it neither increases nor decreases the tax liability of cooperatives or farmers or in any way changes the tax revenue as a whole;

(2) It is a destructive and discriminatory attack upon farmers agricultural cooperatives, wholly unwarranted by any valid tax objective;

(3) It is designed to undermine agricultural cooperatives by impairing their capital and financial structure in a manner not necessary to any revenue purposes;

(4) It undertakes to impose the judgment of Congress for that of the farmer boards of directors of cooperatives;

(5) It prescribes an across-the-board rule which does not take into consideration the fact that the capital requirements of cooperatives vary as between cooperatives and also vary from time to time in the same cooperative, depending upon its expansion and building programs;

(6) It is an attempt by Congress to interfere, unnecessarily, in the internal affairs of farmers' organizations;

(7) If there were any problems relating to the internal operation and financing of cooperatives, this would be a matter for the consideration of the agriculture committees and not the tax committees of Congress;

(8) As long as one full level of tax is being paid currently, as it now is, farmers should be free to manage their own cooperatives and to finance them with their own money in whatever manner the farmers prefer and in whatever manner the farmers themselves, in their own sound judgment, deem best for themselves as farmers and best for their cooperatives, which are so very important to them.

Senator CURTIS. Mr. Irving Clark.

STATEMENT OF IRVING CLARK, ON BEHALF OF THE FARMERS UNION CENTRAL EXCHANGE, INC., FARMERS UNION GRAIN TERMINAL ASSOCIATION, GREAT PLAINS SUPPLY CO., LAND O'LAKES CREAMERIES, INC., LIDLAND COOPERATIVES, INC., NORTHERN COOPERATIVES, INC., NORTH STAR DAIRY, TWIN CITY MILK PRODUCERS ASSOCIATION, AND THE MINNESOTA ASSOCIATION OF COOPERATIVES; ACCOMPANIED BY THOMAS STEICHEN, GENERAL MANAGER, FARMERS UNION CENTRAL EXCHANGE; AND RICHARD MAGNUSON, COUNSEL, FARMERS UNION CENTRAL EXCHANGE

Mr. CLARK. I have with me Thomas Steichen, the general manager of the Farmers Union Central Exchange, and Mr. Richard Magnuson, the counsel of the Farmers Union Central Exchange. I had with me earlier in the day a number of general managers of the other companies who are listed as being represented here with me, but they had to leave. Notwithstanding the lateness of the hour, we appreciate the opportunity to be here and to speak our piece.

I was prepared to raise a remark with the chairman a little while ago that not every person can be the first witness, and I realize that not every one can be the last witness, so I have that privilege.

Senator CURTIS. Some people turn to the last page of the book to see how it comes out, so maybe in these hearings you might not have such a bad spot.

Mr. CLARK. Thank you, Mr. Chairman. I hope the book comes out well.

In the interests of brevity, and out of respect and appreciation for your coming back and taking this additional time, I am not even going to summarize my summary, but I do wish to say four or five of our positions on the subject, which have been presented in great detail in my statement, and the statement of witnesses who immediately preceded me.

It seems to us—and of course it is in an oversimplified way—that you can say section 531 of the bill is a non-revenue-producing bill or section.

It seems to us that section 531 will destroy cooperatives, not merely prevent their growth. It will destroy them by eliminating their capital, as is clearly demonstrated in the rather objective statement of Mr. Jaenke of the Farm Credit Administration, as well as I think in our statements on file.

It will eliminate their ability to borrow, as Mr. Jaenke also pointed out, and in tables in his prepared statement, it shows that in 5 years it will be down to a nonborrowing posture.

The patrons of the cooperatives do have dominion and control over the affairs of the cooperative, including the matter of what portion of their earnings they shall distribute in cash, either as a straight patronage refund or recommendations of prior patronage refunds. The patrons, as Mr. Healy was just mentioning, have consented to take these distributions into their income.

They can withdraw their consent. They can cease to do business with the cooperative. They can amend the bylaws. They can come to the annual meeting, and I have attended a few, perhaps not as many as Senator Miller, and I have seen patrons not hesitate to get up on the floor and ask why a larger cash amount could not be distributed, and it was the job of management and the directors to satisfy those patrons, and they did so by showing them the facts of life relating to the financial statements and abilities of that organization.

As someone said earlier in the testimony today, the farm economy is at the bottom of the economy, and if a change of policy is to be made, policy adopted over many years by the Congress in many respects assisting cooperatives as a tool for the farmers, that change of policy we feel should come only after very careful and thorough study and consideration and testimony by a committee such as this or the Committee on Agriculture, as a policy matter, not as a decision on one page in this 360-page bill.

We urge respectfully that section 531 should be stricken from the bill by this committee and brought to conference in that way, and as the last witness said, we hope that the Senate conferees can stand firm on that proposition.

Thank you, Mr. Chairman.

Senator MILLER. Thank you.

Your entire statement, of course, will be in the record.

Mr. Hansen, do you have any questions?

Senator HANSEN. I have no questions.

Senator CURTIS. We thank you for your contribution to this testimony, and your associates.

(Mr. Clark's prepared statement follows:)

STATEMENT OF IRVING CLARK

I am Irving Clark of the law firm of Doherty, Rumble & Butler of Saint Paul, Minnesota. This statement is made on behalf of Farmers Union Central Exchange Inc., Farmers Union Grain Terminal Association, Great Plains Supply Company, Land O'Lakes Creameries, Inc., Midland Cooperatives, Inc., Northern Cooperatives, Inc., North Star Dairy, Twin City Milk Producers Association, and the Minnesota Association of Cooperatives. Those organizations conduct marketing and farm supply activities for farmers primarily in Wisconsin, Minnesota, Iowa, North Dakota, South Dakota, Montana, Washington, and Idaho. They are owned by approximately 2800 local cooperatives and approximately 800,000 individual rural patrons.

My firm is also General Counsel for National Federation of Grain Cooperatives, a federation of 20 regional grain marketing cooperatives which are farmers' marketing organizations serving approximately 2,800 local grain marketing associations. You have already heard testimony on behalf of that organization and its members. I am authorized to say that it also concurs in the opinions I am about to express.

After a thorough and careful consideration by Committees and the Congress, the Revenue Act of 1962 established a fair and workable basis for taxation of cooperative earnings. It accepted the principle that earnings of cooperatives should be taxed either to the cooperative or the patron, but not both. It required that the cooperative pay at least 20 percent of its patronage distributions in cash, and obtain the consent of the recipients to treat the entire dividend as income—or else the cooperative would pay tax on its entire earnings.

Following enactment of the 1962 Act, tens of thousands of cooperatives amended their by-laws and took other steps to comply with the Act. Their patrons have been paying the income taxes on patronage dividends contemplated by the Act.

In other words, the 1962 Act is working. Now Section 531 of the Tax Reform Bill would add new and impossible burdens to those placed on the cooperatives by the 1962 Act.

If the purpose of this legislation is to *destroy* cooperatives, it will succeed in its purpose.

If the purpose is to *help* the American farmer, it will fail miserably.

The Congress has repeatedly established that farm cooperatives are essential to American agriculture. Those experienced in the cooperative movement are now using that experience to assist *urban* cooperatives—in the ghettos of our big cities and wherever the problems of the poor can be aided by the American principles of self-help.

This bill would bring about the liquidation of that essential tool needed for both agricultural and urban workers—the cooperatives.

It must be, we conclude, that those who voted for the insertion in the Bill of Section 531 thought they were "helping the patron."

It is our purpose to show you in what respects they were mistaken.

Section 531 is not a revenue-producing measure. The objective was stated to be to put a bigger portion of the earnings of the cooperatives into the hands of the patrons, in cash. The Report of the Committee on Ways and Means says in part:

"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."

This rests upon the illusion that the patrons want the cash, but their cooperatives are withholding it—as though by a small group of willful directors. But there is no such situation in the cooperatives. Unlike the case of a business corporation, each stockholder or member of the cooperative typically has one vote, regardless of the number of shares held. They elect directors personally known to them, who share their views. They attend the annual meetings. If a majority of them insist upon a large proportion of earnings being paid in cash, they have the power.

So—the patrons control the cooperative. They have power to decide how much of its earnings the cooperative shall pay in cash. Legislation to compel an increase will simply bust the cooperatives. Some will go broke sooner than others, but it is only a question of time for all of them—if this provision is enacted.

In the guise of helping the patron, it will force liquidation of a tool he needs—now more than ever.

How is this so? It is a matter of cash requirements—of pressing needs for capital.

Of the approximately 2800 local cooperatives which are the owners and patrons of the groups for which I appear, two-thirds have earnings of $25,000 or less. As with all small businesses, annual earnings do not come in the form of cash. They are soaked up in increased accounts receivable, in increased costs of facilities, and in increased investment in the regional cooperatives.

Traditionally, the capital for these requirements has been provided by patrons agreeing to reinvest their patronage dividends in the cooperative. The patrons have not had spare cash. But they have been willing to let the cooperative treat their patronage earnings as a reinvestment, after paying 20 percent in cash to the patrons to enable them to pay their income taxes. This is because the cooperatives have been a needed source—in many places, the only source—of supplies, of marketing services, and of other services.

The cooperatives need to retain the largest part of their earnings, as they are not able to attract cash investments in the way a business with profit potential for investors, can. In other words, they are a service, a tool, not a profit venture.

Two-thirds of our local cooperatives have net earnings of $25,000 a year, or less. A sample of 400 of the stronger ones showed that their net earnings had increased very slightly during the last five years. Many of the 2800 cooperatives have been barely able to survive, using 80 percent of their earnings during the last five years for capital needs and redemption of older outstanding equities. The Bill would permit them to retain only 50 percent. Yet an ordinary business corporation earning $25,000 or less can retain 78 percent of its earnings, and usually does.

The problem is compounded by the provision that the cooperative must obligate itself to redeem all non-cash dividends within 15 years from date of issue. Our typical local cooperative has *more than* ten years' past equities outstanding. In order to be in position to redeem in 15 years those equities issued hereafter, many of them must first redeem all of their present equities during the next 15 years. They are required to by their by-laws, and by simple principles of fairness. That requirement, plus the 20 percent cash payout, will require a total cash payout of 85 percent of average earnings. That is *impossible.*

It is impossible for the local cooperative because it is necessary to plow back somewhere between 50 and 80 percent of earnings into inventories, receivables, and facilities just to keep even.

This brings us to the regional cooperatives. It is charged that these organizations are giants, expanding into manufacturing, oil refining, and other enterprises and competing unfairly with private business. The fact is that the "regional" or "federated" cooperative is made up of local cooperatives which own it and control it. They have banded together to extend their purchasing power, or marketing power. To allow farmers to join together in the ownership of a petroleum storage tank and a delivery truck while denying them the right to join together in the ownership of an oil refinery is to deny both history and the facts of modern economic life. Local farmers' cooperatives have always been provided services and supplies through regional coöperatives. Nearly all business organizations have had to grow larger in recent years in order to be competitive, and farmers' regional cooperatives have had to grow with them in order to survive. The regionals' cash tied up in receivables, inventories, and facilities has also increased, and the amount of their cash has correspondingly declined. Most important, any regional cooperative, no matter how well managed, can have a loss year. That means that they will be unable to redeem patronage refunds previously issued, which cuts down still further the flow of cash to the local cooperatives.

All this comes down to the proposition that Section 531 of the Bill is based on a series of fallacies:

The fallacy that earnings are cash.

The fallacy that there are no prior claims on that cash which is in fact realized—such as outstanding debt, or equities which the cooperative is obligated to redeem ahead of the new ones.

The fallacy that cooperatives don't have to acquire new facilities and equipment in order to provide services to keep their members alive.

The *basic* fallacy that Congress will help the patrons by putting their cooperatives in a straitjacket. We urge that Section 531 should be stricken from the Bill.

APPENDIX TO STATEMENT OF IRVING CLARK

ANALYSIS OF COOPERATIVE PROVISION (SECTION 531) OF TAX REFORM BILL OF 1969

This analysis has been prepared on behalf of the following cooperatives, their 2800 local cooperatives, and their over 800,000 individual rural patrons:

Farmers Union Central Exchange, Inc.
Farmers Union Grain Terminal Association
Great Plains Supply Company
Land O'Lakes Creameries, Inc.
Midland Cooperatives, Inc.
Northern Cooperatives, Inc.
North Star Dairy
Twin City Milk Producers Association
and the Minnesota Association of Cooperatives.

This statement is intended to give factual information regarding the effect of the provisions of Section 531 of the Tax Reform Bill of 1969, H.R. 13270, and to show the fatal damage it will do to many cooperatives.

1. What the bill provides

The entire proposed change of law as it relates to cooperatives is contained in one Section of the Bill—Section 531. It would amend only one section of the Internal Revenue Code, Section 1388. The present Section 1388 contains various definitions of terms used in Sections 1381 through 1388, IRC, which with Section 521 set forth the tax status of cooperatives. One of those definitions is a complex one, defining the term "qualified written notices of allocation." A portion of the definition, subsection (c)(1) of Section 1388, now provides that at least 20 percent of the amount of the patronage dividend distributions of a cooperative must be paid to the patrons in cash, and certain other requirements must be met, or the document representing the balance of the patronage dividend (sometimes called the "non-cash portion") will not be a "*qualified* written notice."

The Bill would amend that definition by adding two requirements:

New Requirement One. The amount paid out in cash must increase at the rate of 3 percent a year until 50 percent is reached. This amount of increase is called in the Bill "the applicable percentage," and it is stated at 3 percent for taxable years beginning in 1970, 6 percent for those beginning in 1971, etc., until it reaches 30 percent for years beginning in 1979 or any subsequent year. Together with the existing 20 percent, the applicable percentage makes a total of 50 percent of current earnings which must be paid out in cash for years beginning in 1979, and thereafter.

While the present 20 percent in cash now required must be paid out as part of the *current* patronage dividend, that is not true of the "applicable percentages," or increased amounts. They may either be paid out in cash as part of the current patronage dividend, or be paid out in cash "in redemption . . . of any qualified written notice of allocation" previously issued.

Comment. We are informed that this may not have been the intent of the framers, but the provision as now drawn has the effect of limiting redemptions which would be credited against the "applicable percentages" to redemptions of documents issued in 1964 or later. Older documents which may have been distributed prior to 1964 are not "qualified written notices of allocation" within the present Code definitions nor in the Bill. This would mean that although a cooperative may have older evidences of patronage distributions outstanding, and may be obligated by law or by its by-laws or other contractual arrangement to redeem them before it can redeem the 1964 and later documents, such redemptions would not "count" toward the "applicable percentage." This disadvantage, which perhaps could be corrected by a change of wording, is pointed out here as a matter of construction or interpretation of the language of the Bill. Correction of it by altering the language would *not* correct the drastic hardships imposed by the Bill—see below.

New Requirement Two. The Bill also adds to the definition of "qualified written notice of allocation" a requirement that the issuing cooperative must be obligated to redeem the "written notice" in cash within 15 years. The *obligation* may be created in either of two ways:

(a) The cooperative may adopt a by-law so providing, with a further provision that this obligation cannot be changed "without the consent of those adversely affected;" or

(b) The written notice may be in the form of "an unconditional written evidence of indebtedness . . . which matures within such 15-year period."

The Bill also requires that "qualified per-unit retains" issued by a cooperative include the same obligation of redemption within 15 years, either by by-law or by being in the form of an evidence of indebtedness which matures within 15 years. Thus, those cooperatives which use the method of distribution of earnings called "retains," or "capital retains," or "per-unit retains" would be subject to the same new requirements as those cooperatives which use the patronage dividend method alone—namely, the required increase in the percentage of earnings paid out in cash, until it reaches 50 percent (see below as to the true effect of this), and also issuance of obligations with fixed maturities of 15 years or less.

2. The provisions of the section would not work

Many of the illustrations in this analysis are based upon published summarized data covering 400 farm supply cooperatives. These cooperatives are not typical, but are among the strongest of the 2,800 cooperatives in the upper Midwest. The harsh impact of the provisions of Section 531 would apply with even greater force to the 2,400 cooperatives not covered by the published data. The data covering these 400 cooperatives is set forth at the end of this analysis as Exhibit A.

A. Most of the 2,800 local cooperatives in the upper Midwest have annual earnings of less than $25,900. Such organizations cannot be expected to survive under a 50 percent cash distribution requirement.

Available information on these upper Midwest local cooperatives indicates that 65 percent of them had annual net earnings of less than $25,000 each. The vast majority of them are small businesses operating in small rural communities. They were organized by their patrons, and perform a vital function as a source of supplies, of marketing services, and of other services at reasonable prices.

Like all small business organizations, nearly all of their relatively small annual earnings may be required in a given year for the repayment of loans or for the replacement of facilities and equipment. Inflationary pressures alone result in the necessity for additional working capital to finance larger dollar amounts of receivables and inventories.

The Congress has long recognized the economic necessity for small businesses to retain a major portion of their earnings, by the smaller corporate tax rate of 22 percent on the first $25,000 of net income. This is especially true in the case of cooperatives, which cannot attract equity investments motivated by profit potential.

The effect of the proposed 50 percent cash requirement on a cooperative with annual earnings of $20,000 would be as follows:

	Annual earnings	Income tax	Cash distributions	Retained earnings
Current rules:				
Ordinary corporation	$20,000	$4,400		$15,600
Cooperative	20,000		$4,000	16,000
Proposed rules:				
Ordinary corporation	20,000	4,400		15,600
Cooperative	20,000		10,000	10,000

Thus this provision of the Bill would allow the small cooperative to "plow back" into its operations *less* of its earnings than an ordinary business of the same size. This is not good economics, good tax policy, nor good farm policy, as well as being obviously unfair to the cooperative.

B. *Section 531 of the Bill appears to be based on the erroneous assumption that, in the case of cooperatives, "Annual earnings" are somehow equivalent to "additional cash."*

Section 531 imposes arbitrary cash distribution requirements on cooperatives based upon patronage dividends which are annual earnings. These cash requirements are stated at 50 percent, but together with the 15-year revolving requirement, they may easily amount to 100 percent, as will be illustrated later.

Nearly all cooperatives in our area are business organizations handling inventories of farm produce or of supplies. Under the provisions of the Internal Revenue Code they are required to compute earnings on the "accrual" basis. They are not on the cash basis of accounting.

There is no necessary correlation between accrued earnings and cash. In individual cases 100 percent of accrued earnings may be represented by a combination of increased inventories, increased accounts receivable, additional facilities, or reduced debt.

Nevertheless, under Section 531, they would be required to make cash distributions of from 50 percent to 100 percent of annual earnings regardless of the amount of available cash.

The data on 400 local cooperatives illustrates a 52 percent increase in earnings tied up in non-cash forms, in a period of five years. These increased items were accounts receivable, inventories, facilities, and investments in their regional cooperatives.

Portions of the above increases were financed by increased liabilities. However, the example illustrates the dramatic changes that can occur in any business organization, with substantial amounts of earnings reflected in a non-cash form.

These changes are compelled by necessity. Technological changes in farming, such as increased numbers of classes of fuel, increased kinds and mixes of fertilizer, chemicals and other supplies have compelled local cooperative associations to put additional money into facilities.

The Regulations under Section 537 of the Code give full recognition to all of the above factors for accumulation of earnings to meet the reasonable needs of the business, in the case of an ordinary business corporation, in the following words:

"(b) *Reasonable accumulation of earnings and profits.* Although the following grounds are not exclusive, one or more of such grounds, if supported by sufficient facts, may indicate that the earnings and profits of a corporation are being accumulated for the reasonable ends of the business provided the general requirements under §§ 1.537-1 and 1.537-3 are satisfied:

"(1) To provide for bona fide expansion of business or replacement of plant;

"(2) To acquire a business enterprise through purchasing stock or assets;

"(3) To provide for the retirement of bona fide indebtedness created in connection with the trade or business, such as the establishment of a sinking fund for the purpose of retiring bonds issued by the corporation in accordance with contract obligations incurred on issue;

"(4) To provide necessary working capital for the business, such as, for the procurement of inventories; or

"(5) To provide for investments or loans to suppliers or customers if necessary in order to maintain the business of the corporation." (Reg. § 1.537-2(b)).

Section 531 of the Bill, contrary to this Regulation and to all business experience, equates annual earnings with ability to make cash distributions.

C. *In the case of the fairly level earnings experienced by most cooperatives in recent years, the 15-year redemption provision amounts to an impossible requirement of annual cash distributions of up to 100 percent, which is a great many cases will begin at once, rather than in 15 years.*

Despite substantial increases in sales volume, the published data on 400 strong local supply cooperatives shows relatively level average earnings during the past 10 years:

[Dollar amounts in thousands]

Operations (averaged)	1958	1963	1968
Sales to patrons (400 local cooperatives)	$243	$308	$445
Local operating earnings	14	13	13
Regional patronage dividends	14	19	22
Net earnings (averaged)	27	33	35
Percent to sales	11.2	10.7	7.9

During 1968 the above cooperatives issued patrontage dividends of approximately 20 percent in cash and 80 percent in qualified notices. Assuming continuation of the trends of the past 10 years from 1970 through 1985, these cooperatives would face a *100 percent cash* distribution requirement in 1985:

Assumed net earnings in 1985	$35,241
Cash di tribution requirements:	
20 percent of 1985 net earnings in cash	7,048
Qualified notices of,1970 (80 percent of $35,241)	28,192
Total (100 percent)	35,240

The necessary cash would simply not be available unless all of the following impossible assumptions were made for 1985 and all subsequent years:

100 percent of the dividends received from regional cooperatives were in cash; accounts receivable did not increase; inventories did not increase; no replacements or additions were required for facilities and equipment; all patrons' equities issued prior to 1970 had already been redeemed.

Local cooperatives are owned and controlled by their patrons. In general, they have followed the equitable procedure of retiring patronage equities in the order of their issuance—oldest first. It can be fairly assumed that they would desire to continue this procedure. Many of them are obligated to do so by provisions in their by-laws. To do so (in order to retire such presently-outstanding equities before the *compulsory* redemptions called for by the 15-year requirement of the Bill), the 400 cooperatives covered by the data would somehow have to make average annual redemptions of the following dimensions beginning in 1969:

Assumed net earnings for 1969	$35,241
20 percent of 1969 net earnings, in cash	7,048
1/15 of presently outstanding patronage equities of $344,925 ,in cash	22,995
Total	30,043
Percentage of 1969 earnings	85

An 85 percent cash distribution can *not* be made because none of the necessary assumptions are true for 1969. In other words, it is simply *not true* that the dividends from the regional cooperative are all in cash. It is *not true* that accounts receivable, inventories and facilities investments fail to increase. On the other hand, they must inevitably increase.

In at least one state (Wisconsin), a dairy marketing cooperative is required by law to maintain a ratio of current assets to current liabilities of 1.25. The issuance of notices of allocation with a fixed maturity will alter that ratio adversely, putting the cooperatives subject to that law into receivership within the first few years.

Thus, the 15-year requirement has *immediate* impact on the many cooperatives of our area which are already obligated to retire their oldest outstanding equities first. It will force them to strive to retire those existing equities at a pace they cannot achieve or maintain, with many inevitable failures far sooner than 15 years.

D. *Recent business trends have diminished the ability of increasing numbers of cooperatives to revolve patrons' capital on any sort of predetermined basis.*

The ability of any business organization to make cash distributions is not determined by either net earnings or by cash on hand. Assuming no plans for facility additions and no shortages of working capital, it is determined by the "acid test" ratio: The ratio of the total of cash and accounts receivable to current liabilities.

This concept applies in the case of cooperatives and of ordinary business organizations. The factors involved are ignored by Section 531 of the Bill, even though they are given full recognition in the Regulations under the present Section 537 of the Internal Revenue Code, determining whether accumulations of earnings by ordinary corporations are reasonable or unreasonable.

As indicated previously, the data on the sample of 400 strong local cooperatives reveals increasing amounts of capital tied up in receivables, inventories, facilities and investments in regional cooperatives during the past 10 years. During the past 10 years these strong cooperatives have, on the average, been able to make cash distributions and redemptions averaging 50 percent of their total earnings, but the ability to continue such payments has been markedly diminished, as these figures show:

Acid test ratio (averaged)	1958	1963	1968
400 local cooperatives:			
Cash and receivables	$49,989	$69,915	$83,284
Less current liabilities	13,435	26,524	74,197
Available for cash redemptions, investments, and facility additions	31,554	43,391	9,087

Average 1968 earnings were $35,241 and non-cash patronage dividends distributed averaged $28,192.

Further analysis shows that 155 of the 400 "strong" cooperatives had *no* excess cash and receivables, and would be *unable* to make any cash redemptions without further increasing their present financial difficulties.

By disregarding such changes in overall business trends and changes in financial ability of individual cooperatives, the requirements of Section 531 would *render insolvent* the majority of the 400 strong local cooperatives covered by the summarized data, and even more certainly, the majority of the 2400 cooperatives not covered by the data.

E. *The Bill ignores the fact that as a matter of economic necessity substantial portions of the annual earnings of individual cooperatives are represented by increased investments in regional organizations.*

Local farmers' cooperatives have banded together to form regional organizations to provide them with marketing services or a source of farm supplies at reasonable prices. The regional organizations are a necessary extension of the operations of the local cooperatives.

In the case of the 400 farm supply cooperatives, earnings developed through their regional organizations have increased to over 60 percent of their total average earnings. To develop their sources of supply at reasonable costs the patrons, who first joined together in the ownership of petroleum storage tanks and delivery trucks, have had to join together in the ownership of interests in oil refineries and pipelines.

The maintenance of these regional organizations is essential to the operation of the local cooperatives. The necessary investments to finance these organizations have increased substantially in recent years to finance increased working capital needs and more complex and costly facilities and equipment. Regional cooperative investments account for approximately half of the capital investments required of the patrons of local cooperatives.

The regional organizations have obtained the cash needed for their facilities investments, receivables, etc., by retaining a portion of the cash and distributing the equivalent in "qualified written notices of allocation." To require the regionals to increase their distributions to an ultimate 100 percent cash would result in their *insolvency* and the loss of both the regional investments and the necessary part they play in the operation of the local cooperatives.

Changing economic conditions of recent years (higher volume, lower margins, increasing costs of facilities) have seriously reduced the ability of the regionals to make cash distributions of as much as 50 percent. Consequently, a major part of the total earnings of each local cooperative has been in the form of non-cash earnings, which diminishes its own ability to make cash distributions of a major part of its own total earnings.

Furthermore, any regional cooperative, no matter how well managed, can have a loss year. Two of the regionals in our Midwestern group have had loss years within the last five years, and it can happen again. That means that they will be *unable* to redeem patronage refunds previously issued, even though they may have a "due date" under the provision of Section 531 of the Bill.

F. *The arbitrary cash distribution provisions of Section 531 ignore the business needs of individual cooperatives to repay necessary loans, replace facilities and equipment, build up working capital, or to meet unforeseen financial problems.*

The ability of any business organization to make substantial cash distributions is determined by its financial position and not by its annual earnings. By ignoring this fact, Section 531 of the Bill becomes a possible source of eventual insolvency to all cooperatives under certain circumstances. The following table shows that even the healthiest of the three cooperatives, Cooperative A, will be trapped by the obligations imposed by the Bill, and will be unable to meet those obligations in spite of an increase in annual earnings. Cooperative B, having level earnings, will be even farther behind. Cooperative C, whose earnings have dropped, will fail that much sooner:

	Co-op A	Co-op B	Co-op C
Aenual earnings:			
1970	$10,000	$10,000	$10,003
1985	20,000	10,000	5,000
1985 earnings represented by increased accounts receivable, increased inventories, investmemts in regionals, replacements of equipment, payments on long-term debt	12,000	12,000	12,000
Cash available for distributions and redemptions	8,000	(2,000)	(7,000)
Sec. 531 requirements:			
(a) At least 50 percent in total, or	10,000	5,000	2,500
(b) 20 percent of total 1985 earnings	4,000	2,000	1,000
Plus redemption of 1970 noncash distribution	8,000	8,000	8,000
Subtotal	12,000	10,000	9,000
Total cash shortage in 1985	(4,000)	(12,000)	(16,000)

While these particular cases are hypothetical, the factors which cause the failures are *not* hypothetical. The data on the 400 strong local cooperatives shows that average financial positions of such organizations have been seriously weakened in recent years.

As a group, they face increasingly severe financial problems under present conditions. This is clearly shown by the data for the 400 strong local cooperatives and applies with even more force to the 2400 weaker local cooperatives not covered by the data. For example, the 400 cooperatives are strong supply cooperatives. A sample of grain marketing local elevators showed a *decline* of 31 percent in local earnings in the five years 1963 to 1968. At the same time the regional to which they belong suffered a *decline* in earnings of 40 percent. A similar sampling of dairy cooperatives showed a *decline* of 11 percent in combined local and regional earnings in the same period This is a highly critical period of time in the financial affairs of cooperatives and their patrons.

It would be indeed ironic if Section 531, in the name of aid to the patrons, is allowed to wreck financial havoc upon such cooperatives resulting in the loss to patrons of the necessary service they require together with their accumulated investments in these organizations.

G. *The arguments advanced in favor of the provision are mistaken.*

The Staff Report of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, dated August 18, 1969, attempted to summarize "Arguments For" and "Arguments Against" Section 531 of the Bill (page 93).

The first "Argument For" reads:

"(1) By requiring the cooperative to pay to the patron all of the patronage dividends within fifteen years, the Bill assures the patron that he will eventually receive the patronage income on which he has been taxed.

In fact, the Bill assures the patron nothing of the sort.

Instead, it requires that all patronage dividends not paid in cash shall be in the form of fixed obligations due within fifteen years or sooner. Since the effect of this provision must be the eventual replacement of all of the equity capital of each cooperative with a form of long-term debt with a fixed due date, the more probable result is to assure the patron that he will lose both the services of his cooperative and all of his accumulated investments in it in some future year when it has low earnings or a loss, causing its insolvency and forced liquidation. The report recognizes this to a degree in its "Arguments Against," saying:

"(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."

The second "Argument For" reads:

"(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."

This is simply not so. The patrons *do* have control, unlike the situation in an ordinary business corporation.

Dominion over treatment of patronage dividends is vested in Boards of Directors of members elected by members at annual meetings with one vote per stockholder. Most local cooperatives have less than 500 members. Their directors are neighbors who share their viewpoints and are personally known to most of them. Their control and voice in the affairs of their cooperative is real, unlike that of stockholders of large business corporations.

Patrons of a local cooperative who pay the tax on their share of the earnings of the cooperative do so voluntarily under the 1962 Act. They have consented to this tax treatment voluntarily. Under the 1962 Act they may withdraw their consent if they are not a member, or revoke their membership if they are a member, and the cooperative will pay the tax on their share of the earnings. They are aware of this right but, except for a very small number of cases, have not withdrawn their consents.

Through their elected Directors, the members of each cooperative currently do have full control of the patronage dividends taxed to them The Directors are able to determine the amount of cash that needs to be retained to meet the needs of the business and the amount available for payment to farmer patrons in the form of distributions and redemptions. This is reported to the members at well-attended annual meetings, and the members accept the decision because it is based on the facts.

The third "Argument For" reads:

"(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."

This is mistaken policy, and unfairly discriminatory. Ordinary corporations, under current law, are required to pay income taxes at the rate of 22 percent of the first $25,000 of taxable income and at the rate of 48 precent of their taxable income in excess of $25,000. Ordinary corporations are not required to make any payments to stockholders of earnings required in the operation of their business.

Two-thirds of our local cooperatives have earnings of less than $25,000 per year. They are now required to pay out 20 percent of the amount of their patronage dividends in the form of cash. Under the proposed Bill they would be required to pay out 50 percent of their earnings in the form of cash. The result of this is that the cooperatives will be able to retain a maximum of 50 percent of their earnings for the needs of the business—and often less. Ordinary business corporations of comparable earnings will, on the other hand, be able to retain 78 percent.

That this discriminatory policy is a mistaken one is well stated in the "Arguments Against" as follows:

"(2) The Bill ignores the roll 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."

It is a myth that cooperatives and regular businesses are "in balance"; cooperatives are, in fact, losing ground. While active business corporations as a whole gained 52.4 prcent in sales in the period 1960 to 1966, farmer cooperatives gained 29.6 percent. Statistical Abstract of the United States, 1969, Tables 694 and 903.

3. SUMMARY

a. The Bill requires a "phased" step-up in percentage of earnings paid out in cash from 20 percent to 50 percent in ten years. It also requires that the cooperative issue non-cash patronage dividends in a form which it is obligated to redeem within 15 years.

b. These provisions would not work:

A. Most of the local cooperatives have annual earnings of $25,000 or less. Their cash requirements are in excess of 50 percent of their earnings. A business corporation having earnings of the same level is permitted to retain 78 percent of the earnings.

B. It is erroneous to treat "annual earnings" as equivalent to "cash." They come to the enterprise tied up in the form of assets, and remain tied up in such form.

C. In the case of fairly level earnings, the requirement for redemption in 15 years has the effect of forcing annual cash distributions in excess of 50 percent, often 100 percent of earnings. This will begin in the near future, not in 15 years.

D. The ability of cooperatives to revolve patrons' capital on any "due date" basis is diminishing, rather than increasing. The legislation would put them in a straitjacket.

E. The investments in regional organizations are a matter of economic necessity for the local cooperatives.

F. The cash distribution requirements of the provision ignores existing debt and other business needs.

G. The arguments advanced in favor of the provision are mistaken and illusory.

SUMMARIZED DATA ON 400 LOCAL SUPPLY COOPERATIVES

				5-year increases	
	1968	1963	1958	1964-68	1959-63
Financial position (averaged):					
Current assets:					
Cash	$28,149	$33,963	$28,918	($5,814)	$5,045
Receivables	55,135	35,952	21,071	19,183	14,881
Inventories	89,693	49,671	38,508	40,022	11,163
Prepaid expense	1,643	1,040	754	603	286
Subtotal	174,620	120,626	89,251	53,994	31,375
Less current liabilities	74,197	26,524	18,435	47,673	8,089
Net working capital	100,423	94,102	70,816	6,321	23,286
Investments, primarily regional cooperatives	171,812	134,996	86,499	36,825	48,497
Facilities and equipment	98,386	52,353	33,612	46,033	18,741
Less long-term debt	(25,705)	(9,481)	(4,890)	(16,224)	(4,591)
Patron equities (owned by patrons)	344,925	271,970	186,037	72,955	85,933
Operations (averaged):					
Sales to patrons	445,797	308,371	243,525	137,426	64,846
Gross margins	103,996	69,594	52,633	34,402	16,961
Operating expenses	90,641	56,221	39,039	34,420	17,182
Local operating margins	13,355	13,373	13,594	(18)	(221)
Patronage dividends from regional cooperatives	21,886	19,478	13,672	2,408	5,806
Net earnings	35,241	32,851	27,266	2,390	5,585
Percent to sales	7.9	10.7	11.2	(2.8)	(0.5)

Senator Curtis. The committee will stand adjourned until 9:30 tomorrow morning.

(Whereupon, at 7:05 p.m., the committee adjourned, to reconvene at 9:30 a.m., Tuesday, September 23, 1969.)

TAX REFORM ACT OF 1969

TUESDAY, SEPTEMBER 23, 1969

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

The committee met, pursuant to recess, at 9:25 a.m., in room G-308, New Senate Office Building, Senator Russell B. Long (chairman) presiding.

Present: Senators Long, Anderson, Talmadge, Byrd, Jr., of Virginia, Williams of Delaware, Bennett, Curtis, Jordan of Idaho, Fannin, and Hansen.

The CHAIRMAN. The hearing will come to order.

This morning the Committee on Finance takes up the difficult question concerning the tax treatment of income earned on obligations of State and municipal governments. Heretofore, the Federal Government has refrained from taxing this interest income. The House tax reform bill does not attack the exemption for this interest in any direct manner. Rather, it includes State and local government bond interest in the so-called minimum income tax provision and also in the allocation of deductions provision.

In addition, there is another amendment in the House bill which would extend Federal subsidies to State governments to help them pay the higher interest costs which would be needed if they should choose to issue their bonds on a taxable basis.

In testimony before this committee on September 3, the Secretary of the Treasury recommended that this subsidy feature be deleted. He also recommended that State and municipal bond interest not be included in the minimum income tax provision.

However, he did recommend that this bond interest be continued in the allocation of deduction rules, advising the committee that the Supreme Court had already decided in litigation involving a similar allocation rule in the Life Insurance Income Tax Act of 1959 that this sort of allocation would not involve the imposition of a tax on this bond interest.

More than 250 witnesses requested to be heard on these features of the House tax reform bill. Unfortunately, time did not permit the committee to hear all of them. However, I do want to include in the record the names of many of those who felt this matter was important enough that they should seek to testify on it. This list is not complete. Many other witnesses who decided to testify on different aspects of the bill, as well, were also concerned about these provisions.

In addition, let me include in the record an enumeration of the many petitions submitted to the Senate by State, county, and local governmental units all across the country, expressing their objection to any Federal tax on State and local bond interest.

(The list of witnesses referred to and the list of governmental units submitting petitions to the Senate follow:)

Listing of Persons Requesting Opportunity To Be Heard at Tax Reform Hearings on the Subject of Bonds Who Were Not Scheduled

Bernard J. Ach, Attorney for School District 68, Friend, Nebraska
Joseph P. Adams, Port of Seattle, % Suite 242, Wyatt Building, Washington, D.C.
Honorable Ernest L. Albertsen, Mayor, City of South Sioux City, Nebraska
Honorable Harry P. Andersen, Mayor, City of Millard, Nebraska
Richard H. Austin, Wayne County Auditor, 1220 City County Building, Detroit, Michigan
Honorable Phil J. Bagley, Jr., Mayor of Richmond, Virginia
Gil Barrett, County Commissioner, Dougherty County, Albany, Georgia
William H. Beasley, Rankin-Beasley, Inc., Suite 220, Healey Building, Atlanta, Georgia
Bill B. Betz, Enright, Elliott and Betz, Suite 703, 606 S. Hill Street, Los Angeles, California
Herbert J. Binham, Executive Secretary, Tennessee Municipal League, Nashville, Tennessee
Honorable G. T. Blankenship, Attorney General, State of Oklahoma, Oklahoma City, Oklahoma
Johnny Bowman, Chairman, Eddy County Commissioners of New Mexico, Carlsbad, New Mexico
Henry L. Bridges, Auditor, State of North Carolina, Raleigh, North Carolina.
Honorable Chauncey H. Browning, Jr., Attorney General, State of West Virginia, Charleston, West Virginia
Cecil S. Brubaker, General Counsel, Metropolitan Utilities District, 1723 Harney Street, Omaha, Nebraska
Honorable Eugene W. Buch, Mayor, City of Fremont, Fremont, Nebraska
Honorable Francis B. Burch, Attorney General, State of Maryland, Annapolis, Maryland
Jack S. Burk, President, Barnard and Burk, Inc., Baton Rouge, Louisiana
William Carey, Chairman, Delegation Board of Sarasota County Commissioners, Sarasota, Florida
Richard Carpenter, Executive Director and General Counsel, League of California Cities, 1108 O Street, Sacramnto, California
Stanley R. Cowle, Administrator, County of Hennepin, 136 Court House, Minneapolis, Minnesota
Robert Q. Crane, Treasurer and Receiver General, State of Massachusetts, Boston, Massachusetts
Judge Charles E. Curry, Jackson County Court, Jackson County, Missouri
E. B. Davis, Auditor, State of Georgia, Atlanta, Georgia
Honorable Frank H. Davis, Treasurer, State of Vermont, Montpelier, Vermont
Honorable Don Deboodt, Mayor, City of Kimball, Kimball, Nebraska
Fred Denton, Jr., 114 St. Louis Street, Baton Rouge, Louisiana
Honorable John Ditter, Mayor, Grand Island, Nebraska
C. O. Donahue, Hawkins, Delafield and Wood, 67 Wall Street, New York, NY
Honorable Joseph A. Doorley, Jr., Mayor, City of Providence, Providence, Rhode Island
Robert L. Ehlers, Ehlers and Associates, Inc., Municipal Finance Consultants, 507 Marquette, Minneapolis, Minnesota
Marvin Ellis, President, Board of Education, Bellevue Public School, 2009 Franklin, Bellevue, Nebraska
Joseph O. Evans, Suite 707, 1028 Connecticut Avenue, Washington, D. C.
Honorable Earl Faircloth, Attorney General, State of Florida, Tallahassee, Florida
Houston I. Flornoy, Controller, State of California, Sacramento, California
R. D. Ford, Legal Officer, Port of Seattle, Seattle, Washington
Harold Fouts, Chairman, Board of Public Works, Nebraska City, Nebraska
Honorable William B. French, Mayor, City of Ord, Grand Island, Nebraska
Arnold E. Furlding, Auditor and Director of Budget, City of Waterbury, Waterbury, Connecticut

S. P. Gaillard, Jr., Gaillard, Wilkins and Smith, PO Box 164, Mobile, Alabama

Miss Evelyn Gandy, Treasurer and Member, Bond Commission, State of Mississippi, Jackson, Mississippi

Honorable W. F. Gettman, Mayor, City of Hastings, Hastings, Nebraska

Joseph E. Gibson, Supervisor, Albemarle County, Charlottesville, Virginia

Robert D. Gilberts, Superintendent of Schools, School District No. 1, City and County of Denver, Colorado

William G. Berge, President of Board of Education, School District No. 1, City and County of Denver, Colorado

Edwin Gill, Treasurer, State of North Carolina, Raleigh, North Carolina

Honorable Louis L. Goldstein, Comptroller of the Treasury, State of Maryland, Annapolis, Maryland

Cornelius W. Grafton, Attorney at Law, 310 West Liberty Street, Louisville, Kentucky

Honorable Milton H. Graham, Mayor, City of Phoenix, Arizona

William Greene, CPA, 300 Central Park Avenue, Hartsdale, New York

Thomas P. Guerin, General Manager, Commission of Public Docks, 370 N.W. Front, Portland, Oregon

William Hackman, President, Board of Education, Gering, Nebraska

William T. Hackett, Jr., Executive Director, Louisiana State Department of Commerce and Industry, Baton Rouge, Louisiana

E. R. Hafner, Executive Secretary, Association of County Commissioners of Florida, Tallahassee, Florida

Raymond H. Hawksley, General Treasurer, State of Rhode Island, Providence, Rhode Island

Honorable Robert M. Haworth, Mayor, City of Bellevue, Nebraska

Douglas M. Head, Attorney General, State of Minnesota, St. Paul, Minnesota

Honorable Norman E. Heine, Mayor, City of Baker, Baker, Louisiana

Lewis R. Holcomb, Executive Secretary, Washington Public Ports Association, 210 East Union Avenue, Olympia, Washington

Joseph F. Hughes, Director of Finance, Municipal Building, Edison, New Jersey

Robert Hutches, Chairman, Manatee County Port Authority, Court House, Bradenton, Florida

Orvil J. Johnson, City Manager, City of West St. Paul, Minnesota

Ralph T. Keyes, Executive Secretary, Association of Minnesota Counties, St. Paul, Minnesota

Paul G. Kinkelspiel, Stone and Younger, 1314 Russ Building, San Francisco, California

David E. Hartley, Stone and Younger, 1314 Russ Building, San Francisco, California

Honorable Carl T. Langford, Mayor, City of Orlando, Florida

Gordon L. Larson, Mayor, City of Chadron, Nebraska

Honorable Arthur Levitt, Comptroller, State of New York, Albany, New York

Otto H. Loser, City Comptroller, Room 504, City Hall, Chicago, Illinois

Dean A. Lund, Assistant Executive Secretary, League of Minnesota Municipalities, 314 Social Sciences Building, Minneapolis, Minnesota

A. Barry McGuire, Executive Director, Michigan Association of Counties, 319 W. Lenawee, Lansing, Michigan

Robert B. McLeaish, Jr., County Auditor, County of Hidalgo, Edinburg, Texas

Russ Marchner, Executive Director, Dade County League of Municipality, Miami, Florida

Honorable Crawford C. Martin, Attorney General, State of Texas, Austin

Edward J. Martin, Director of Finance, City of Philadelphia, Pennsylvania

Carlton C. Massey, County Executive, County of Fairfax, Fairfax, Virginia

George Mathews, General Counsel, Greater Baton Rouge Port Commission, Baton Rouge, Louisiana

Carl Meissner, Cottage Grove Village Administrator, 7201 14th Avenue, Cottage Grove, Minnesota

Honorable Floyd C. Miller, Mayor, City of Seattle, Washington

Richard E. Moore, Certified Public Accountant, 1615 Bonanza Street, Walnut Creek, California

G. A. Morrison, Commissioner of Revenue, Juneau, Alaska

Nebraska State School Boards, 1320 J Street, Lincoln, Nebraska

Hon. Gary K. Nelson, Attorney General, State of Arizona, Phoenix, Arizona

Honorable James H. Norick, Mayor, City of Oklahoma City, Oklahoma

William J. O'Brien, Auditor, State of Minnesota, St. Paul, Minnesota

Peck, Shaffer and Williams, Cincinnati, Ohio

Fioravante G. Perrotta, New York City Finance Administrator, New York

Mario A. Procaccino, Comptroller, City of New York, New York

Donald J. Reeb, State University of New York, Graduate School of Public Affairs, Sayles Hall, 179 Partridge Street, Albany, New York

James G. Richardson, Secretary, Community Affairs, State of Florida, 2200 N.W. 9 Place, Gainesville, Florida

Osee R. Fagan, City Attorney, City of Gainesville, 212 S.E. 1 Street, Gainesville, Florida

Robert C. Riehle, President, Wainwright and Ramsey, Inc., 70 Pine Street, New York, New York

Honorable David H. Rodgers, Mayor, City of Spokane, Washington

Jack Rogers, Executive Secretary, Washington State Association of County Commissioners, 106 Maple Park, Olympia, Washington

Marvin Rohrer, President, Arizona Supervisors and Clerks Associated, Court House, Prescott, Arizona

Fred W. Rosenfield, Phoenix, Arizona

Daniel F. Ruge, Director, Washington Office. State of New York, 1200 Eighteenth Street, N.W., Washington, D.C.

Honorable Sam Schwartzkopf, Mayor, City of Lincoln, Nebraska

Duane N. Scott, Director, Ohio Municipal Advisory Council, 508 Terminal Tower, Cleveland, Ohio.

Honorable Edward Sedlock, Mayor, City of Woodhaven, 21869 West Road, Woodhaven, Michigan

Vincent M. Simko, Treasurer, City of Bridgeport, Connecticut

Herbert H. Smith, Executive Director, County Officers Association of the State of New York, 248 State Street, Albany, New York

Richard L. Stoddard, Director, Division of Investment, Trenton, New Jersey

O. N. Strobel, Deputy City Controller, City of Milwaukee, Wisconsin

Honorable James E. Sudduth, Mayor, City of Lake Charles, Louisiana

A. F. Summer, Attorney General, State of Mississippi, Jackson, Mississippi

N. Maxson Terry, Jr., Terry and Terry, 48 The Green, Dover, Delaware

James Tipton, Executive Director, Tennessee County Services Association, Nashville, Tennessee

Joe E. Torrence, 308 Metro Courthouse, Nashville, Tennessee

Richard VanHoose, Superintendent, Jefferson County Public Schools, 3332 Newburg Road, Louisville, Kentucky

Honorable Edward I. Vrzal, Mayor, City of Norfolk, Nebraska

William F. Wallace, Jr., Box 1820, 500 Vaughn Plaza, Corpus Christi, Texas

Honorable Roy L. Webber, Mayor, City of Roanoke, Virginia

Honorable Kevin H. White, Mayor, City of Boston, Massachusetts

Robert P. Will, Legislative Representative, The Metropolitan Water District of Southern California, 1111 Sunset Boulevard, Los Angeles, Calif.

Thornley Wills, Chairman, Clay County Board of Commissioners, Clay County Court House, Moorhead, Minnesota

Hon. Leo. Winters, State Treasurer, Oklahoma City, Oklahoma

Judge L. D. Word, County Judge, Courthouse, Knoxville, Tennessee

Ralph Wulz, City Manager, 204 South Main Street, Wichita, Kansas

Albert Alfred, Chairman, Board of Brown County Commissioners, New Ulm, Minnesota

John E. Egan, President, Metropolitan Sanitary District of Greater Chicago, Chicago, Illinois

Honorable Albert P. Brewer, Governor of Alabama, Montgomery, Alabama.

Herbert W. Lehfeldt, Administrative Assistant, Office of the Governor, Juneau, Alaska

Honorable John Dempsey, Governor of Connecticut, Hartford, Connecticut

Honorable Russell W. Peterson, Governor of Delaware, Dover, Delaware

Honorable John A. Burns, Governor of Hawaii, Honolulu, Hawaii

Honorable Donald Samuelson, Governor of Idaho, Boise, Idaho

Honorable Edgar D. Whitcomb, Governor of Indiana, Indianapolis, Indiana

Honorable Robert D. Ray, Governor of Iowa, Des Moines, Iowa

Honorable Louie B. Nunn, Governor of Kentucky, Frankfort, Kentucky

John A. Jackson, Office of the Governor of Massachusetts, Boston, Mass.

Honorable Walter Peterson, Governor of New Hampshire, Concord, N.H.

Honorable William L. Guy, Governor of North Dakota, Bismark, N.D.

Honorable Dewey F. Bartlett, Governor of Oklahoma, Oklahoma City, Okla.

Honorable Raymond P. Shafer, Governor of Pennsylvania, Harrisburg, Pa.

Honorable Buford Ellington, Governor, State of Tennessee, Nashville, Tenn.
Honorable Calvin L. Rampton, Governor of Utah, Salt Lake City, Utah.
Honorable Mills E. Godwin, Jr., Governor of Virginia, Richmond, Virginia
Honorable Arch A. Moore, Jr., Governor of West Virginia, Charleston, W. Va.
Honorable Warren P, Knowles, Governor of Wisconsin, Madison, Wisconsin
Honorable Stan Hathaway, Governor of Wyoming, Cheyenne, Wyoming.

Executive Communications Regarding Bonds Referred to Committee on Finance

91st Congress

California

1. A resolution by the board of supervisors of the county of Los Angeles, California
2. A resolution by the City Council of San Fernando, California
3. A resolution by the City Council of the city of South San Francisco, California
4. A resolution by the Board of Supervisors of the County of Santa Cruz, California
5. A resolution by the Association of County Treasurers of California
6. A resolution by the Board of Trustees of the Reed Union School District of Belvedere-Tiburon, California
7. A resolution by the city of Watsonville, Calif.
8. A resolution of the city council of Madera, Calif.
9. Assembly Joint Resolution 40 of the California Legislature

Colorado

10. A resolution by the city Council of the city of Trinidad, Colorado

Indiana

11. A resolution by the Association of Indiana Counties

Iowa

12. A resolution by the city council of Storm Lake, Iowa

Kansas

13. House Concurrent Resolution 1051 of the Legislature of the State of Kansas

Kentucky

14. A resolution by the Board of Commissioners of Lexington, Kentucky

Louisiana

15. Senate Concurrent Resolution No. 14 of the Legislature of the State of Louisiana
16. A resolution by the Council of the City of New Orleans, Louisiana

Maine

17. A joint resolution of the Legislature of the State of Maine

Maryland

18. A resolution by the Baltimore, Maryland, City Council

Michigan

19. A resolution by the City Council of Holland, Michigan

Minnesota

20. A resolution by the Village Council of Minnetonka, Minnesota
21. A resolution by the city council of St. James, Minnesota

New Jersey

22. S. Con. Res. 55 of the legislature of the State of New Jersey
23. A resolution by the township of Morris, New Jersey
24. A resolution by the city of Elizabeth, New Jersey
25. A resolution by the city council of the city of Elizabeth, New Jersey

New York

26. A resolution by the Franklin County Board of Supervisors, Malone, New York
27. A resolution by the Board of Supervisors of Sullivan County, New York
28. A resolution by the Chatuaga County Board of Supervisors, New York
29. A resolution by the Board of Supervisors of Cayuga County, New York
30. A resolution by the Board of Supervisors of Steuben County, New York
31. A resolution by the Greene County, N.Y. County Legislature
32. A resolution by the Rockland County School Board of Supervisors, NYC
33. A resolution by the Niagara County Legislature, Lockport, New York
34. A resolution by the Rockland County Board of Supervisors, New City, New York
35. A resolution by the Town Board of Orangetown, Rockland County, New York
36. A resolution by the County of Westchester Board of Supervisors, White Plains, New York
37. A resolution by the Duchess County Board of Representatives, State of New York

Ohio

38. A resolution by the Ashtabula County, Ohio Commissioners
39. A resolution by the city of Eastlake, Ohio
40. A resolution by the Board of County Commissioners, Lake County, Ohio

South Carolina

41. A resolution by the Greenville County Council, Greenville, South Carolina
42. A resolution by the County Board of Directors, Beaufort, South Carolina

Texas

43. House Concurrent Resolution 173 of the Legislature of the State of Texas

Virginia

44. A resolution by the City of Franklin, Virginia

Wisconsin

45. A resolution by the city of Appleton, Wisconsin

EXECUTIVE COMMUNICATIONS REGARDING BONDS REFERRED TO COMMITTEE ON FINANCE AFTER SEPTEMBER 23, 1969

Connecticut

1. A commentary by the city of Waterbury, Conn.

Illinois

2. A resolution by the Executive Committee of the Council of Governments of Cook County, Chicago, Ill.
3. A resolution by the village of Arlington Heights, Ill.
4. A resolution by the Northwest Municipal Conference (Illinois)

Michigan

5. A resolution by the city of Grandville, Mich.
6. A resolution by the city of Albion, Mich.
7. A resolution by the city of Clawson, Mich.
8. A resolution by the Macomb County, Mich., Board of Supervisors.
9. A resolution by the city commission of Jackson, Mich.
10. A resolution by the City Council of Wayland, Mich.
11. A resolution by the city commissioners of Flint, Mich.
12. A resolution by the City Council of Livonia, Mich.
13. A resolution by the county of Gogebic, Bessemer, Mich.
14. A resolution by Iron County, Crystal Falls, Mich.
15. A resolution adopted by the Genesee County Board of Supervisors, Flint, Mich., re provide that counties are included within definition of local governments.

New Jersey

16. A resolution by the board of commissioners of the city of Millville, N.J.

Ohio

17. A resolution by the Mentor City Council, Mentor City, Ohio.

Washington

18. A memorial by the King County Council, State of Washington.

STATEMENT OF HON. W. W. DUMAS, MAYOR-PRESIDENT, PARISH OF EAST BATON ROUGE, CITY OF BATON ROUGE

The CHAIRMAN. Woodrow Dumas, the mayor of Baton Rouge. We are waiting for the other people to arrive, Mayor. You served as the president of the Council of State Governments and County Governments, I believe.

Mayor DUMAS. National Association of Counties. If you are ready, sir?

The CHAIRMAN. Go right ahead. Go ahead, Mr. Mayor.

Senator Long, Honorable Chairman of the Senate Finance Committee, I am Mayor W. W. Dumas, mayor-president of Parish of East Baton Rouge, city of Baton Rouge, La.

The Senate of the United States, represented by this committee deserves an expression of appreciation for its patience and adherence to democratic principles in affording the present public hearing—a procedure not allowed by the House Ways and Means Committee. If such a hearing had been conducted and more time taken in the study of H.R. 13270, the shattering damage to the ability of local governments to finance capital improvements which has occurred since the middle of August of this year might have been avoided.

As a consequence of the precipitous and extremely ill-advised action of attempting to impose taxation indirectly on municipal bonds, irreparable harm has already occurred to an increasing number of municipalities in the State of Louisiana. Passage of H.R. 13270 by the House of Representatives has compounded the difficulties in the Louisiana bond market. Within the past few days in order to sell a 20-year "A" rated bond it has been necessary for the governing authority to accept a requirement that the bond proceeds be deposited for a period of time of from 6 to 18 months before the bond proceeds may be expended. Such deposits are interest free to the issuing authority, and the investment of the idle funds inures to the benefit of the initial bond buyers.

The chaos and confusion generated by H.R. 13270 in the bond market has prevented many cities, including Baton Rouge, from proceeding with vital works of public improvement. For example, street paving certificates, secured by local or special assessments and additionally by a pledge of the full faith and credit of the parish of East Baton Rouge, have not been successfully sold within the maximum 6 percent interest limit since public advertisement several weeks ago. As a matter of fact, for the past 6 or 7 weeks we have been unable to do any kind of construction of this sort because of the unavailability of someone to buy the bonds.

Having a maturity of only 10 years, this short-term debt would ordinarily bring in the bond market prior to H.R. 13270 a sale price within 6 percent per annum. The delay in this particular project prevents the paving of a section of a graveled dirt street running between a large, new motel complex near the LSU campus known as the "Prince Murat House" and a large public housing project recently completed. Blowing dust from the traffic makes life almost unbearable in that portion of the public housing and motel properties facing the street. The public health, welfare, and safety is directly and adversely affected.

For an example, Senator, which I am sure you would be interested in the East Cameron Harbor and Terminal District offered its 20-year full faith and credit secured bonds for sale on November 1, 1969, and a copy of the official prospectus is offered for filing in the minutes of the hearing. The purpose of the project is to dig a barge canal from the navigable portions of the Mermentau River to a navigable depth in the Gulf of Mexico to permit shrimp and other fishing boats and offshore oil boats to utilize the natural harbor facilities of the Mermentau River. The mouth of the river has never been navigable, and the opening up of this new territory holds untold potential for the development of natural and human resources. This project, like many others in Louisiana, is denied to the people because bonds cannot be sold within the lawful rate of interest of 6 percent per annum, and the bond market of the United States will not purchase any more so-called tax-exempt bonds until the Congress has made it very plain that such bonds are, in fact, tax exempt for all times.

The government of the parish of East Baton Rouge which I represent has in progress large building programs costing many millions of dollars requiring the continued borrowing of money. On an open and free market, this could be accomplished. On a Government-controlled market, functioning through an urban development bank or some other similar scheme, it is not at all certain what could be accomplished.

The ability of East Baton Rouge Parish to borrow money is predicated on years of good fiscal management, development of an excellent credit reputation, the winning of outstanding ratings by national bond rating firms, prompt payment of debts when due. The advantage of such hard-earned good rating and the consequent ability to borrow money at advantageous interest rates in a private market should not be taken away by Government planners who seek to substitute or superimpose the judgment of an all-central agency or bank to determine priorities between States and local issuing authorities.

The elimination of the tax-exempt status in whole or in part, directly or indirectly, immediately or step by step, is nothing more or less than an attempt by the planners to destroy the ability of local government as we know it today to finance improvement and thereby render such government substantially impotent. Such an impotent government would then be replaced by the central planning and financing agency.

Local government officials thoroughout Louisiana are of the opinion that the blatant grab for power, disguised under the cover of "tax reform," is really an attempt to finally, once and for all, establish the central government as supreme, even on the level of local government. The effort should be turned back here in the Senate Finance Committee, Mr. Chairman, and by the thinking Members of both Houses of Congress. The damage—already done—irreparable in some places—can only be stopped by the strongest possible pronouncement by this committee and by your Senate colleagues that any attempt to tax municipal bonds to any degree will not be allowed now or at any other time in the future. The loss and chaos generated by the precipitous action of H.R. 13270 can be repaired only if all bond buyers for all time are given unconditional and unqualified assurance that the promise of the United States that such obligations are tax exempt will be honored, and that future years will not see a repetition of the debacle of 1969.

The officials in Louisiana are not confused as to who really benefits from the tax exemption advantages afforded local government. The real benefit is not to the few millionaires held up as the target. The real beneficiary is the little man, the poor man, the middle class, the average American taxpayer who carries the primary burden for essential cost of improvement. For example, in Baton Rouge we passed a $53 million, the school board has just passed a $63 million bond issue. That means we have gone to work and told the people of our community that it is going to take this number of dollars to do the work that we think ought to be done. Well, with the tax exemption taken off these bonds that means instead of $53 million it may take $63 million and then we have got to go and pass another $10 million bond issue which bond issues are not easily passed, they are not too well liked by the people in the community anyway. So it only puts another burden on the people.

The thinking citizens and public officials of Louisiana are not confused by the suggestion that a Federal subsidy plan will be more efficient than the present free and open market system. The volume of activity necessary to support the demands of modern innovative and creative local government would require the development of a Federal agency so large as would absorb any theoretical increase in Federal income tax savings. The cumbersome effort of the central bureau proposed to be created could not possibly match the private money market in its ability to promptly and efficiently meet almost any demand, as is judged on the basis of the honest law of supply and demand in a free enterprise system. There is nothing that cannot be accomplished in such a free society. There is much that cannot be accomplished in the controlled central government bureau.

Many projects in the State of Louisiana would simply not be subject to financing if it were not for the advantage of tax exemption. If these projects were required to compete on the open market without the tax exempt advantage, the burden of increased interest rates would be so great as to delay financing for years or perhaps prevent it forever. The States of the Deep South, including Louisiana and other lower population areas, would not fare well in competition for the interest of the central bureau planners.

The Government which I represent has issued and has outstanding millions of dollars of bonds represented to be "tax exempt." The "tax exempt" representations were printed in newspapers, in official documents, in contracts including the bonds and coupons. The representation of tax exemption was predicated on the fundamental concept of the inviolability of contract—on the historic constitutions principle of full faith and credit to the sanctity of contract.

Purchasers throughout the United States have acquired obligations of this local government in reliance upon such representations. At the time of their respective purchases, there was a sharp disadvantage between the interest rates offered on one hand for the "A" rated bonds of my local government and the much higher interest rates available otherwise in the open market. To suggest now that these obligations are taxable is to violate every concept of the obligations of contract which, in the Civil Law State of Louisiana, is an unconscionable and an indefensible act.

The breach of good faith with the holders of these obligations presents such an outrageous departure from the practice of civilized western man in adhering to the law of written contract, that the local government which I represent would feel constrained, if not legally obligated, to bring suit resisting in every possible lawful manner the unconscionable and unconstitutional encroachment here.

Litigation of this type by many parties in interest and the consequent publicity will have the effect of destroying the reputation—reliability of the tax exempt promise for a long period of time, if not permanently. In the meantime, chaos will result in unheard of high interest rates and discounts, as is now occurring in Louisiana.

If the historic concept of intergovernmental immunity is violated by H.R. 13270, it logically and ethically follows that the obligations of the U.S. Government should similarly be subject to tax and assessment by State and local government. In examples too numerous to enunciate, local government does not collect from the United States local or special assessments for street paving and other improvements levied on an abuting property front foot or square foot basis. Street paving or other local improvements directly benefiting U.S. property is simply donated, in deference to the long-standing and supposedly immutable doctrine of intergovernmental immunity.

This committee is urged to complete these hearings at the earliest possible time and to recommend to the Senate that conclusive action be taken to defeat the entire package of H.R. 13270; that the Congress undertake and adopt at the earliest possible date a reaffirmation and confirmation of the doctrine of intergovernmental immunity, of the inviolate status of the tax exemption on State and local bonds, and that such action be couched in such terms as shall stand out as an unconditional assurance and guarantee that the fiasco of 1969 will not be repeated at any time in the future. And, Mr. Chairman and gentlemen of the committee, as the mayor of Baton Rouge I tell you we are in dire trouble in making our budgets. We are up very shortly—our few finances are down, our construction is down, our sales tax revenue is down, and I don't think, I see hardly any way that we can meet our 1970 budget, and if we are going to be continued to be harrassed in such ways as this, why the construction in our community, and the sales tax, are tremendous; 45 percent of our revenues in our Government come from the sales tax, and if we continue to drop as we are right now that not only Baton Rouge but every city in the United States which is vital to the continuance of this great Nation we are going to be in one, I would say hell but I am before the committee here, but I won't say that, but in a heck of a fix.

So, gentlemen, all I can ask you for is not only the city of Baton Rouge, the city of New Orleans, Shreveport, Monroe, Jackson, Mississippi, Pittsburgh, Philadelphia, New York it doesn't make any difference our cities are in trouble. As a matter of fact, if I had my way about it I would recommend to you instead of an 8½ percent interest we go back to 2½ percent because the cities need the money.

Gentlemen, we are in trouble, that is all I can tell you. I appreciate you, Senator Long, for giving me this opportuntiy to come this far to tell you about our problems. I do keep you pretty well informed on Louisiana and you are certainly, to me, one of the finest representatives we have ever had, and we have been friends a long time and I have never lied to you and I don't intend to start now. But I will tell you this, if you really want to hurt the cities and to destroy government, then I am sure that if you let this tax pass then you are making a big mistake. Thank you very much, sir.

The CHAIRMAN. Mr. Mayor, what is your reaction to the provision in the House bill where they would make up the difference—in effect subsidize the difference—in interest rates. What you would have to pay and what a taxable bond would pay.

Mayor DUMAS. I have spoken with both county and municipal officials, and they are opposed to it. They don't believe it can work. I would like it to remain as it is in the event that the Federal Government would be short on funds, then why should they give us in Baton Rouge or anywhere else more consideration in Louisiana than they would their own bonds. I don't think it is good. The only thing that this committee and the Senate can do is just completely kill this provision and let it remain as is. The cities are already in acute financial difficulty and we feel that this is going to compound the problems rather than alleviate them.

The CHAIRMAN. The thought that occurs to me is that as soon as the Federal Government starts subsidizing the subsidies there will be a temptation to look at a State like Alaska. We passed a Federal law that caused them to get 90 percent of the resources. With a $9 billion windfall, why should we subsidize Alaska and give them the subsidy. Someone would then say, why must you have a multibillion-dollar subsidy for these cities. Here is where we could save some money. It seems to me that once the principle is established from that time forward it is always subjected to a motion to cut it in half or reduce it. On the floor yesterday Senator Williams made a strong and determined effort to cut the maritime subsidy bill which I was managing. Fortunately we beat him. It would seem to me that once you put the States and cities on a subsidy basis, then it could not be taken away.

Mayor DUMAS. I think the best example is that for over 10 or 12 years, now, the U.S. Senate and Congress voted to give a gasoline tax to construct the Interstate Highway System throughout the Nation. Now we learn as of April 1, 1970, that the President is going to curtail all construction work. If they can take something like that away from us, you can imagine what that will do to the subsidization of the bonds. We feel that the only answer to it is to completely kill this bill and get back where the bond buyers will give consideration to the purchase of municipal bonds so that we can continue the improvements of our cities and counties that are so badly needed.

The CHAIRMAN. You were an officer of the National Association of Counties—former president, I believe. You then became president of the National Association of Counties.

Mayor DUMAS. I am mayor-president of East Baton Rouge Parish, former president of the National Association of Counties, and am presently serving as a member of the board of directors of the National Association of Counties. I met with Bernie Hillenbrand, executive director of the National Association of Counties and John Gunther, executive director of the U.S. Conference of Mayors, and Pat Healey, executive director of the National League of Cities and other distinguished mayors and officials throughout the United States, and they all opposed any tampering with the tax-exempt bonds and appeal to the Senate Finance Committee and Members of Congress to kill this measure once and for all.

I will be sending you a copy of our 1970 budget. It will show the problems we are having. Baton Rouge has enjoyed the construction era—the reason why the construction has dropped is because of high interest rates and the continuance of the surcharge tax, and the possibility of the tax-free bonds being tampered with. We just cannot make it.

The CHAIRMAN. You recently tried to issue tax-exempt bonds——

Mayor DUMAS. I have a list of bonds we have not been able to sell. (He mentions the situation with gravel.) We have not authorized the parish attorney to negotiate. We can't even negotiate for them at a 6 percent interest rate. At that interest rate, we just cannot move them. People are going to be affected by it. People who ordinarily would be working, the laborers, contractors, and so forth, are going to be retarded. Construction work can't go on. I just hope that your wisdom and the Finance Committee's wisdom would see that this thing is killed once and for all, as it did in 1933 when it came up.

The CHAIRMAN. Please introduce the distinguished citizens accompanying you.

Mayor DUMAS. I would like to introduce Joseph Keogh, parish attorney, Ernest Eldred, assistant parish attorney, E. O. Bauer, chief of police, Capt. Robert Temple, captain of the city police.

The CHAIRMAN. I am proud that you have these fine citizens of Baton Rouge here today. I hope you can keep Baton Rouge in fine shape.

Mayor DUMAS. Senator I appreciate your giving us this consideration and we are all for you.

The CHAIRMAN. So far as I know, Mayor Dumas is the only person who can beat me in a swimming contest.

Thank you, sir.

Mayor DUMAS. Thank you, Mr. Chairman.

(The committee subsequently received the following letter, relevant to Mayor Dumas' testimony:)

STATEMENT OF FRED BENTON, JR, BENTON & MOSLEY BOND COUNSEL. BATON ROUGE, LA.

The written statement for the appearance of W. W. Dumas, Mayor-President, Parish of East Baton Rouge, City of Baton Rouge, filed with the Senate Finance Committee has been reviewed and the statements of fact therein contained in respect to impairment of the bond market in Louisiana are true and correct and adopted for the purposes of this statement as if set out in full herein.

Respectifully submitted.

FRED BENTON, JR.

Senator ANDERSON (now presiding). Governor Love.

STATEMENT OF HON. JOHN A. LOVE, GOVERNOR OF COLORADO; ACCOMPANIED BY CHARLES F. SCHWAN, JR., CONSULTANT FOR GOVERNORS' CONFERENCE

Governor LOVE. Senator Anderson, distinguished members of the committee, I am joined today by Governor Tiemann of Nebraska on my right, Governor Kirk of Florida, and Governor Evans of Washington and Governor McKeithen of Louisiana will soon be here.

We also have Mr. Charles F. Schwan, Jr., at the table, who is a consultant to the National Governors' Conference, and the Council of State Governments.

I will attempt, of course, to make my testimony as brief as possible.

Senator CURTIS. Mr. Chairman, I would like to welcome these Governors here, all of them, and particularly I am happy that on this panel is the Governor of Nebraska, who serves us well, the Honorable Norbert Tiemann. While I have the mike, I want to remind these witnesses as well as all others who appear on this municipal bond issue that this committee didn't originate that idea.

I do not know what the others think but as for myself I am opposed to the House bill. I am opposed to what the Treasury recommends. What they recommend would bring in $49 million, that is 25 cents for every individual here, in order to mess-up, and I can't think of any other word, the traditional situation where the Federal Government has kept hands off of the interest on State and municipal bonds.

Governor LOVE. Mr. Chairman, I am delighted to hear the statement of the Senator, and I hope it is shared by other members of this committee and by the entire Senate when the appropriate time comes.

It is almost inevitable that part of our testimony is going to be repetitious but we all feel so strongly about it that we want to be sure it becomes a part of the record.

Our concern is with each of the several provisions to which your committee is devoting its attention today—the proposed minimum income tax, allocation of deductions, and Federal subsidization of interest payments if State and local bonds are isued as taxable obligations. My remarks will be limited, in the main, to the tax and fiscal consequences if these provisions are enacted.

We appreciate your problem, we think we do. To reform the Federal income tax laws is a very difficult task. In so doing, however, we hope you will avoid disturbing the market for State and local bonds.

As you know, the pressure is enormous on State and local governments to furnish more and better services and facilities. Our capital requirements continue to grow at a rapid rate. Only 13 years ago, in 1956, total State and local bonds outstanding totaled less than $50 billion. Today that total has reached $140 billion—an increase of 180 percent. A Federal Reserve Board estimate is that it will approximate $210 billion in 1975. In other words, in 20 years the total of State and local bonds outstanding is estimated to increase by 320 percent. These figures should impress anyone who has doubts about the overwhelming capital needs of States and localities.

H.R. 13270 would enact a "limit on tax preferences," a form of minimum income tax for individuals, in the base of which would be State and local bond interest.

Treasury witnesses testified against the inclusion of State and local bond interest in the minimum tax. They did so for two reasons. Inclusion, they said would: (1) raise a constitutional issue and (2) have an adverse effect on the municipal bond market.

Both H.R. 13270 and the Treasury would require that individuals allocate deductions between taxable income and tax preference amounts. Both would include State and local bond interest. In the House bill this provision would apply to future bond issues only, and be phased in over a 10-year period, as I understand it. The Treasury, on the other hand, would have this requirement cover outstanding as well as future issues and make it fully effective immediately.

H.R. 13270 contains a plan for a Federal subsidy of a portion of State and local government interest costs if they chose—and the plan is optional with them—to issue taxable obligations. The Treasury promised to submit a substitute proposal for the House-approved plan.

Mr. Chairman, the revenue yield from inclusion of municipal bonds in the House LTP provision, according to the Treasury's estimate, would be $35 million, and that is a little less even than Senator Curtis was mentioning, and for its own allocation of deductions proposal, $45 million. These are not, as the Senator has said, comparatively large sums, but the impact on the market of these provisions would be disastrous.

Attached to my statement are certain exhibits. Most of them indicate what has happened as a result of the threat of taxation. Should the threat prove real, we may expect an even more severe impact.

Historically the yield relationship of comparable municipal and corporate bonds has been in the vicinity of 70 percent. In other words, if a corporate bond were sold at 8 percent, one would expect a comparable municipal to yield 5.6 percent.

Graphs Nos. 1 and 2, employing different indexes, illustrate the municipal-corporate bond yield relationship over the past 2 years. Please note that they show a yield relationship of about 80 percent, today. In other words, if a corporate bond were to be sold at 8 percent, a comparable municipal might be expected to bear an interest rate of 6.4 percent. As a matter of fact, that is slightly out of date. The relationship, instead of 80, was 84 percent as of yesterday.

Graphs Nos. 3 and 4 show the yields of tax-exempt and taxable bonds over the past 2 years as indicated by representative indexes. Again the closing of the gap can be seen.

Tables No. 1–3 show in tabular form the same data as graphs 1–4. Please note on table No. 1 the interest spread, 1.77 percent. By July 1969, the gap had shrunk to 1.39 percent. On table No. 2 a similar change can be seen. The respective interest rate differences were 1.80, 1.87, and 1.51. Table No. 4 shows that the yield relationship between municipal and U.S. Government 20-year bonds has been altered drastically, too. The interest rate differences were 0.93, 0.95, and 0.19, respectively.

Mr. Chairman, tight money presumably caused all these interest rates to climb. But the much more rapid climb in municipal bond interest rates can only be ascribed to the threat of taxation.

Also attached to my statement are two schedules. Turning first to schedule II, it shows in columns 1–4 the issuance of tax-exempt municipal securities for the years 1965–68 on a State-by-State basis as reported in the IBA Statistical Bulletin. The figures shown include issuances by local units of government as well as the State.

Columns 5 and 6 represent projections of bond sales by State for 1969 and 1970. They assume what I think is a conservative 10 percent per year increase over 1968 in the amount, that is, 5 percent probably due to inflation and 5 percent due to a real increase in outlays. To put it more accurately, they represent reasonable estimates of need. Based on first quarter statistics, bond sales in 1969 on an annual basis will be less than $11 billion, 40 percent below what might have been expected, reflecting what other witnesses have mentioned, I am sure, the difficulty of marketing these bonds now.

Turning now to schedule I, it shows estimates of interest costs increases that would be incurred if the provisions of H.R. 13270 relating to municipal bonds were enacted. Two estimates are made—one based on actual volume for 1968, the other on projected volume for 1970.

Column 2 represents calculations of the annual debt service on bonds issued in 1968. The interest rate used—4.5 percent—approximates the average of the Bond Buyers' Index for 1968. As can be seen, debt service totaled $1.24 billion for all States.

Column 3 shows debt service on a taxable basis. Columns 4 and 5 show additional interest costs by year and over the assumed 20-year life of the bonds. The interest rate increase assumed for purpose of computation is 2 percent. I think that is a reasonable assumption. Given these assumptions, the additional interest costs for 1 year would be $22 million, and over the life of the bonds the interest, the increased payment, would be $4.45 billion.

Columns 6 through 10 contain information similar to that of columns 1–5, but based on projected issuances for 1970. Please note the total of column 9, the assumed interest cost increase, approximately $270 million. If the same total were issued in 1971, the increase would be $540 million. By the 10th year, increased interest costs would add up to $2.7 billion, assuming no year-by-year increase in State and local financing.

Mr. Chairman, members of the committee, some may feel we have overestimated the increase in interest costs that would result from enactment of H.R. 13270. Some may feel that the Treasury proposals would result in a smaller increase. But if one reduces the estimated increase by one-half or even more, what remains is an undeniably heavier debt service burden that must be borne by State and local governments and by their taxpayers, and in most instances predominantly by their property taxpayers.

Secretary Kennedy testified that the impact on the market of the Treasury allocations of deductions proposal would be minimal. I submit that neither he nor we know if his opinion is valid. We know he estimated the revenue yield to be $45 million. Presumably that would be based on total bonds outstanding in 1969 of $154 billion, $140 billion in 1968 plus 10 percent. Assuming an additional 10-percent increase in bonds outstanding at the end of 1970 would mean a total of $170 billion. On such amount, revenue accruing to the Treasury would increase by 10 percent, also, to $49.5 million.

Look now at what the increased State and local debt service cost would be for 1970. Would it be 1 percent, $135 million or one-half of 1 percent, $67 million? That additional cost, whatever it might be, and I think undoubtedly it would be far above 1 percent, would continue over the life of the bonds.

No one can know until after the fact what the actual debt service cost increase would be. It would be in any case greater—and probably much greater—than the revenue yield.

Let me state at this point that the Treasury allocations of deductions proposal would have a very damaging effect. For one thing, allocation of deductions affects many more people than the House minimum tax. The latter is applicable only when total income from tax preference items exceeds $10,000 and regularly taxable income. The former is applicable to any amount of tax preference income in excess of $10,000. Moreover, allocation of deductions has particular relevance to banks—much the largest customers for State and local bonds. A banker might reasonably calculate if allocation of deductions is required of life insurance companies and of individuals and if the requirement with respect to banks were in the all-but-final House bill, can banks be far behind?

Mr. Chairman, those who purchase State and local bonds, in a sense, pay a tax. It is not paid to the United States, but it is paid to State and local governments in the form of lower interest rates. True, investors may hope to gain more in Federal income tax savings than in interest forgone. But have we not shown that the principal beneficiaries of low State and local bond interest rates are the issuing government? Have we not shown that to correct an alleged inequity in Federal income tax laws will cost State and local governments far more than the Treasury will realize in revenue? Immediately there would ensue postponement, cancellation, or reduction in scope of many public building projects—schools, hospitals, highways, water and sewer facilities, and other vitally needed items. Eventually, of course, these projects would be built. They would be paid for, however, largely out of increased sales and property taxes and utility fees. These are regressive in nature, but they would have to be relied on even more heavily than at present to supply the funds State and local governments could not afford to borrow.

Other witnesses who appear for the States will cover other aspects. I have tried to show, and I believe I have shown, certain of the dire results that Federal taxation would achieve. I do not believe that this committee, its parent body, or the Congress itself wishes to accomplish such results.

I appreciate, Mr. Chairman and members of the committee, your giving me this time and attention.

Thank you.

(Hon. John A. Love's prepared statement follows:)

Statement of the Honorable John A. Love, Governor of Colorado, Chairman, National Governors' Conference

SUMMARY

Mr. Chairman, Members of the Committee: Our concern is with each of the several provisions to which your Committee is devoting its attention today—the proposed minimum income tax, allocation of deductions and federal subsidization of interest payments if state and local bonds are issued as taxable obligations. My remarks will be limited, in the main, to the tax and fiscal consequences if these provisions are enacted.

We appreciate your problem. To reform the federal income tax laws is a very difficult task. In so doing, however, we hope you will avoid disturbing the market for state and local bonds.

As you know, the pressure is enormous on state and local governments to furnish more and better services and facilities. Our capital requirements continue to grow at a rapid rate. Only 13 years ago, in 1956, total state and local bonds outstanding totaled less than $50 billion. Today that total has reached $140 billion, an increase of 180 percent. A Federal Reserve Board estimate is that it will approximate $210 billion in 1975. In other words, in 20 years the total of state and local bonds outstanding is estimated to increase by 320 percent. These figures should impress anyone who has doubts about the overwhelming capital needs of states and localities.

H.R. 13270 would enact a "limit on tax preferences," a form of minimum income tax for individuals in the base of which would be state and local bond interest.

Treasury witnesses testified against the inclusion of state and local bond interest in the minimum tax. They did so for two reasons. Inclusion, they said would: (1) raise a constitutional issue, and (2) have an adverse effect on the municipal bond market.

Both H.R. 13270 and the Treasury would require that individuals allocate deductions between taxable income and tax preference amounts. Both would include state and local bond interest. In the House bill this provision would apply to future bond issues only, and be phased in over a 10-year period. The Treasury would have this requirement cover outstanding as well as future issues, and make it fully effective immediately.

H.R. 13270 contains a plan for a federal subsidy of a portion of state and local government interest costs if they chose—and the plan is optional with them—to issue taxable obligations. The Treasury promised to submit a substitute proposal for the House-approved plan.

Mr. Chairman, the revenue yield from inclusion of municipal bonds in the House LTP provision, according to the Treasury's estimate would be $35 million and for its own allocation of deductions proposal, $45 million. These are not large sums, but the impact on the market of these provisions would be far greater.

Attached to my statement are certain exhibits. Most of them indicate what has happened as a result of the threat of taxation. Should the threat prove real, we may expect an even more severe impact.

Historically the yield relationship of comparable municipal and corporate bonds has been in the vicinity of 70 percent. In other words, if a corporate bond were sold at 8 percent, one would expect a comparable municipal to yield 5.6 percent.

Graphs No. 1 and 2, employing different indices, illustrate the municipal-corporate bond yield relationship over the past two years. Please note that they show a yield relationship of about 80 percent. Today, if a corporate bond were to be sold at 8 percent, a comparable municipal might be expected to bear an interest rate of 6.4 percent. Note, too, that virtually all the change in relationship has occurred in 1969—the period during which this legislation has been under consideration.

Graphs Nos. 3 and 4 show the yields of tax exempt and taxable bonds over the past two years as indicated by representative indices. Again the closing of the gap can be seen.

Tables No. 1–3 show in tabular form the same data as Graphs 1–4. Please note on Table No. 1 the interest spread of 1.78 percent in August 1967. In January 1969, tıere was about the same spread, 1.77 percent. By July 1969, the gap had shrank to 1.39 percent. On Table No. 2 a similar change can be seen. The respective interest rate differences were 1.80, 1.87 and 1.51. Table No. 4 shows that the yield relationship between municipals and U.S. Government 20-year bonds has been altered drastically, too. The interest rate differences were 0.93, 0.95 and 0.19 respectively.

Mr. Chairman, tight money caused all these interest rates to climb. The much more rapid climb in municipal bond interest rates can only be ascribed to the threat of taxation.

Also attached to my statement are two schedules. Turning first to Schedule II, it shows in columns 1–4 the issuances of tax exempt municipal securities for the years 1965–1968 on a state-by-state basis as reported in the *IBA Statistical Bulletin*. The figures shown include issuances by local units of government as well as the state.

Columns 5 and 6 represent projections of bond sales by state for 1969 and 1970. They assume a conservative 10 percent per year increase over 1968, 5 percent due to inflation and 5 percent to a real increase in outlays. To put it more accurately, they represent reasonable estimates of need. Based on first quarter statistics, bond sales in 1969 on an annual basis will be less than $11 billion, 40 percent below what might have been expected.

Turning now to Schedule I, it shows estimates of interest costs increases that would be incurred if the provisions of H.R. 13270 relating to municipal bonds were enacted. Two estimates are made—one based on actual volume for 1968, the other on projected volume for 1970.

Column 2 represents calculations of the annual debt service on bonds issued in 1968. The interest rate used—4.5 percent—approximates the average of the *Bond Buyer's Index* for 1968. As can be seen, debt service totaled $1.24 billion for all states.

Column 3 shows debt service on a taxable basis. Columns 4 and 5 show additional interest costs by year and over the assumed 20 year life of the bonds. The interest rate increase assumed for purpose of computation is 2 percent.

Given these assumptions, the additional interest costs for one year would be $222 million, and over the life of the bonds $4.45 billion.

Columns 6–10 contain information similar to that of columns 1–5, but based on projected issuances for 1970. Please note the total of column 9, the assumed interest cost increase, approximately $270 million. If the same total were issued in 1971, the increase would be $540 million. By the tenth year increased interest costs would add up to $2.7 billion, assuming no year-by-year increase in state and local financing.

Mr. Chairman, Members of the Committee, some may feel we have overestimated the increase in interest costs that would result from enactment of H.R. 13270. Some may feel that the Treasury proposals would result in a smaller increase. If one reduces the estimated increase by one-half or even more, what remains is an undeniably heavier debt service burden that must be borne by state and local governments and their tax payers.

Secretary Kennedy testified that the impact on the market of the Treasury allocations of deductions proposal would be minimal. Neither he nor we know if his opinion is valid. We know he estimated the revenue yield to be $45 million. Presumably that was based on a total of bonds outstanding in 1969 of $154 billion ($140 billion in 1968 plus 10 percent). Assuming an additional 10 percent increase in bonds outstanding at the end of 1970 would mean a total of $170 billion. On such amount, revenue accruing to the Treasury would increase by 10 percent, also, to $49.5 million.

Look now at what the increased state and local debt service cost would be for 1970. Would it be one percent, $135 million or one-half of one percent, $67 million? That additional cost, whatever it might be, would continue over the life of the bonds.

No one can know until after the fact what the actual debt service cost increase would be. It would be in any case greater—and probably much greater—than the revenue yield.

Let me state at this point that the Treasury allocations of deductions proposal would have a very damaging effect. For one thing, allocation of deductions affects many more people than the House minimum tax. The latter is applicable only when total income from tax preference items exceeds $10,000 and regularly taxable income. The former is applicable to any amount of tax preference income in excess of $10,000. Moreover, allocation of deductions has particular relevance to banks—much the larger customers for state and local bonds. A banker might reason, if allocation of deductions is required of life insurance companies and of individuals and if the requirement with respect to banks were in the all-but-final House bill, can banks be far behind?

Mr. Chairman, those who purchase state and local bonds pay a "tax." It is not paid to the United States, but it is paid to state and local governments in the form of lower interest rates. True, investors may hope to gain more in federal income tax savings than in interest foregone. But have we not shown that the principal beneficiaries of low state and local bond interest rates are the issuing governments? Have we not shown that to correct on alleged inequity in federal income tax laws will cost state and local governments far more than the Treasury will realize in revenue? Should direct or indirect taxation be voted, what would be the result? Immediately there would ensue postponement, cancellation or reduction in scope of many public building projects—schools, hospitals, highways, water and sewer facilities and others vitally needed. Eventually, of course, these projects would be built. They would have to be paid for, however, out of increased sales and property taxes and utility fees. These are regressive in nature, but they would have to be relied on even more heavily than at present to supply the funds state and local governments could not afford to borrow or to pay the increased debt carrying costs on what they would have to borrow.

Other witnesses who appear for the States will cover aspects of taxation of State and local obligations that I have not covered. I have tried to show, and I believe I have shown, certain of the dire results that Federal taxation would achieve. I do not believe that this committee, its parent body or the Congress wishes to accomplish such results.

Mr. Chairman, members of the committee, I appreciate your giving me your time and attention. Thank you.

STATEMENT

Mr. Chairman, members of the committee, I am John A. Love, Governor of Colorado and Chairman of the National Governors' Conference. I am pleased to have this opportunity to appear before you on behalf of the State of Colorado and the National Governors' Conference to testify on H.R. 13270, the Tax Reform Act of 1969. Appearing with me as representatives of the states are my colleagues, Governor Richard J. Hughes of New Jersey, Governor Daniel J. Evans of Washington, Governor Claude R. Kirk of Florida, Governor Norbert T. Tiemann of Nebraska, and Governor John J. McKeithen of Louisiana.

Mr. Chairman, it is no secret that we are seriously concerned about several sections of H.R. 13270, and substitute provisions for them suggested by the administration. At the most recent National Governors' Conference, 51 of the 52 Governors attending the Conference—all who were present at the time—sent a wire to the President expressing our concern. Copy of the telegram is attached, but I should like to quote part of it at this time.

We wired the President:

One crucial matter which we did not have an opportunity to discuss with you is the taxation of state and municipal bonds. The infringement upon what we consider the constitutional prerogatives of state and local government would be a setback of major proportions to our mutual goal of governmental balance in the "Spirit of '76".

The staggering blow of increased costs for all public construction would either add to the tax burden of the people or stop construction of much needed public facilities.

Very simply, Mr. President, if the ability to market state and municipal bonds is jeopardized in any way, it will be a setback that for years to come will overshadow any positive proposals.

As citizens and taxpayers, we welcome the effort to reform our tax laws in which this Committee and the Congress are engaged. Inequities and imperfections that have grown up over the years should be corrected. The task you have set for yourselves is a difficult and complex one. We are here to urge that in its accomplishment, however, you do nothing to disturb the market for state and local government bonds.

I am referring, of course, to the provisions of H.R. 13270 relating to a limit on tax preferences, allocation of deductions and the subsidization of interest payments if state and local bonds are issued as taxable obligations, Sections 301, 302 and 601 and 602 respectively. I should like also to refer to the administration proposals on these subjects.

In the main, I shall limit my remarks to the tax and fiscal consequences of what is proposed. Other aspects will be discussed by those appearing with me.

Mr. Chairman, as I know you know, the pressure is enormous on state and local governments to furnish more and better services and facilities. Our population and our expectations continue to grow. To build the schools, highways, hospitals, water and sewer facilities and all the other projects we want and need means that state and local governments must have a healthy, readily available capital market. We are a Nation that builds on credit, and few, if any, of our public or private institutions are more dependent on credit than states and localities. At the end of 1956—only 13 years ago—state and local securities outstanding totaled less than $50 billion, according to Federal Reserve Board data. Today that total has reached $140 billion—an increase of 180 percent. The Federal Reserve Board estimates that the total outstanding in 1970 will be about $147 billion, and nearly $210 billion in 1975. Parenthetically, I assume that these estimates are based on there being no damage done to the market. In any event, the Federal Reserve Board estimate is that in 20 years—1956 to 1975—state and local government bonds outstanding would increase by about 320 percent. If there were any question concerning the need of state and local governments for capital funds, these data should put it to rest.

H.R. 13270 proposes enactment of a minimum tax on individuals, a "limit on tax preferences", in the base of which would be state and local bond interest. Witnesses for the Department of the Treasury testified that it would produce $85 million a year when fully effective. Of that amount, revenue from taxation of state and local bonds was estimated to produce $35 million. Application of LTP to bonds would be at a gradual rate of 10 percent per year over 10 years.

The Treasury witnesses urged this Committee that it not include state and local bond interest in this minimum tax. They cited two reasons for not doing so: (1) it would raise a constitutional question, and (2) it would have an adverse effect on the market for such bonds.

With respect to allocation of deductions, the House bill would require that individuals allocate deductions between taxable income and tax preference amounts, including in the latter state and local bond interest. The provision would apply to bonds issued after July 12, 1969, and be phased in over a 10-year period.

The Administration similarly would include municipal bond interest in the allocation of deductions requirement, but would extend it to cover interest on outstanding issues as well as future issues, and make it fully effective immediately.

The House included in its bill a plan to provide a subsidy to state and local governments—exercisable at their option—if they chose to issue taxable bonds. The Treasury opposed this plan, promising to submit a substitute proposal.

Mr. Chairman, although the revenues that the proposed inclusion of state and local bond interest in the limit on tax preferences—$35 million the Treasury estimated—and allocation of deductions—$45 million for the Treasury plan—would be small, the market impact of these provisions would be great.

Attached to my statement are certain graphs and tables. They illustrate the impact on the market that the *threat* of taxation has had. I wish to emphasize what they represent is the market reaction to the possibility of taxation. Should that possibility be realized, the impact could be expected to be even more severe.

Historically, comparable municipal and corporate bonds have been considered to have a relationship as to yield in the vicinity of 70 percent. This is to say, municipal yields have run at about 70 percent of those on comparable corporates. To put it another way, if a corporate bond were to be sold at 8 percent, one would expect a comparable municipal to yield 5.6 percent.

Graph No. 1 illustrates the relationship over the past two years. Please note that the latest data indicate a yield relationship of 80 percent. Today, if a corporate bond were to be sold at 8 percent, a comparable municipal would bear an interest rate of 6.4 percent—not 5.6 percent. Note also the extent of the change in the relationship that occurred in 1969.

Graph No. 2 illustrates the same basic change. It is based on different indices.

Graphs No. 3 and 4 show the yields of tax exempt and taxable bonds over the past two years as indicated by representative indices. Again the closing of the gap can be seen.

Tables No. 1–3 show in tabular form the data shown on the several graphs. Please note on Table No. 1 the difference of 1.78 percent in August 1967 (4.06 and 5.84 percent), which remained about the same, 1.77 percent, in January 1969, had by July shrunk to 1.39 percent. On Table No. 2, a similar change can be seen. The respective differences are 1.80, 1.87 and 1.51. Both Table No. 3 and Graph No. 4 indicate the yield relationship of one representative municipal bond index and U.S. Government 20-year bonds. Just to round out the story, a difference in interest rate of 0.93 percent in August 1967 (0.95 percent in January 1969) had shrunk in July 1969 to 0.19.

These data indicate a general increase in interest rates which may be ascribed to the tight money market. The time during which most of the change in yield relationship took place, i.e. when this bill was before the other body, make it abundantly clear that the threat of taxation of municipal bonds was the cause for that change.

Also attached to my statement are two schedules. If we may turn first to Schedule II, columns 1–4 reflect the issuances of tax exempt municipal securities for the years 1965–1968 on a state by state basis as reported in the *IBA Statistical Bulletin*. The figures shown for each state include issuances by local governmental units as well as those of the state itself.

The figures shown in columns 5 and 6 are projections of bond sales by state for 1969 and 1970. They assume a 10 percent per year increase over 1968, 5 percent due to inflation and 5 percent in real governmental outlays. They assume further that nothing in the tax situation would disrupt the issuance of municipal securities.

I should observe that the latter assumption is unwarranted. The ominous tax situation and attendant high interest rates—interest rates in some instances high enough to exceed legal interest ceilings and in others to force issuers out of the market—reduced the annual rate of issuances to less than $11 billion based on first quarter statistics. That is a level 40 percent below what might reasonably have been expected for this year. The figures in columns 5 and 6, in other words, represent reasonable estimates of need for state and local government capital financing.

If we may turn back to Schedule I now, it shows estimates of the additional interest costs that would be incurred by state and local governments were the provisions relating to municipal bonds of H.R. 13270 enacted. Two estimates are made—one based on actual volume for 1968, the other on projected volume reasonably have been expected for this year. The figures in columns 5 and 6, in for 1970. Inclusion of the 1968 figures and estimates is justified on the grounds that they represent a year unaffected by the current market uncertainties due to the threat of taxation and, therefore, represent an actual expression of state and local financing needs. As discussed above, the volume for 1970 undoubtedly is over-stated because of the taxation threat.

Column 2 of Schedule I represents calculations of the annual debt service on bonds issued in 1968. Inasmuch as it would be impossible to calculate the actual debt service on each of the over 5,400 separate issuances, a 20-year bond with equal annual payments of principal and interest was used for these computations. The interest rate used—4.5 percent—was the approximate average of the *Bond Buyer's Index* for 1968. This well-known index consists of 20 municipal bonds picked for their representativeness of the overall market. As can be seen, debt service was $1.24 billion for the entire 50 states.

For purposes of computation, an increase of two percentage points of interest has been employed. If this appears to be too large an increase, please remember that the January through July 1969 increase based on the threat of taxation only was 0.96 or 0.85 percent, depending upon which index is used. In any case, a two percent increase would have resulted in an annual debt service of $1.46 billion (column 4) or an increase of $222 million over the tax exempt cost. The figures in column 5 show that for debt issued in 1968 the additional interest cost over the life of the bonds would have amounted to the staggering sum of $4.45 billion. As appalling as these figures are, they relate to issuance of a single year.

Columns 6–10 contain information similar to that of columns 1–5, but based on projected issuances for 1970. Please note the assumed interest cost increase, approximately $270 million. If the same total in bonds were issued in 1971, the increase would be $540 million. By the tenth year, and making the unrealistic assumption that state and local financing would not grow from year to year, an additional $2.7 billion in interest costs would have to be paid that year from state and local government budgets.

Mr. Chairman, Members of the Committee, some may feel that we have over-estimated the increase in interest costs that would result from enactment of H.R. 13270 as it came to you. Some may feel that the Treasury proposals would result in a smaller increase. If one reduces the estimated increase by one-half or even more, what remains is an undeniably additional heavy debt service burden that must be borne by state and local governments and their taxpayers.

Mr. Chairman, neither Governors nor their fiscal officers nor Members of Congress make the market. Investors do. In their wisdom or unwisdom they determine what interest rates will be. The Treasury estimates of the actual revenue impact of the limit on tax preferences provision of H.R. 13270 as only $35 million, and its own allocation of deductions proposal as $45 million are not controlling. Investors decide for themselves. They can decide that if Congress breaches the tax exemption dike or reduces the value to them of their deductions, they will bid on bonds at sharply increased interest rates. They can and they do as we have seen from studying what happened to state and local bond interest rates while the Ways and Means Committee and the House were considering H.R. 13270.

Secretary Kennedy testified that the market impact of the Treasury allocation of deductions proposal would be minimal. Neither he nor we know if his opinion is valid. We do know, however, that the Treasury estimates the revenue yield in the first full year of operation of the proposal to be $45 million. We know too that this estimate is based on a requirement that deductions be allocated with respect to all bonds, outstanding as well as prospective. We may assume for present purposes that it was based on the total of bonds outstanding at the end of 1969—$140 billion at the end of 1968 plus our assumed 10 percent increase for 1969 or $154 billion. Let us then assume an additional 10 percent increase in bonds outstanding at the end of 1970, or approximately $170 billion. The revenue accruing to the Treasury would then amount to $49.5 million.

Let us now look at what the increased debt service cost would be to states and localities for just one year, 1970. Assume the increase to be—not two—but one percent. That would be $135 million. Assume it would be one-half percent. That would be $67 million. And remember, that is for that year only. The additional debt service cost would continue for the life of the bonds.

No one can know until after the fact what the actual debt service cost increase would be. There is reason to believe, however, that it would be much greater than the increase in federal revenue would be. As we have pointed out, the threat of enactment of H.R. 13270 with its phasing in of both LTP and allocation of deductions and its application of the latter only to future issues pushed interest rates up nearly one percent. The Treasury proposal, if enacted, would have nearly the same—possibly an even greater—damaging impact. For one thing, allocation of deductions affects many more people than the minimum tax. The latter is operative only when the total income from tax preference items exceeds both $10,000 and regularly taxable income. The former is applicable with respect to any amount of tax preference income in excess of $10,000. Moreover, and this seems to have been overlooked by both the House of Representatives and the Treasury, allocation of deductions can easily be made to apply to banks, by far the largest buyers of state and local bonds. As a matter of fact, in the all-but final House bill, banks were required to allocate deductions. If life insurance companies can be made to allocate, as Treasury witnesses pointed out the Supreme Court has held, and Congress chooses to require individuals to allocate, would bankers feel that they would be forever immune?

Mr. Chairman, another point overlooked or ignored is that those who buy state and local bonds pay a "tax" as long as they hold the securities. True, they do not pay it in the form of income tax to the United States, but they pay it to state and local governments by accepting a lower rate of interest than they would receive if they bought taxable securities. True, also, they expect to gain more in federal income taxes not paid than in interest foregone in many if not most instances.

But, have we not shown that the principal beneficiaries of low state and local government bond interest rates are the issuing governments? Have we not shown that to correct an alleged inequity in federal income tax laws will cost state and local governments in interest costs far more than the Treasury will realize in revenue?

If the Congress does not heed our warning, what will be the result? The immediate result will be the postponement, cancellation or reduction in scope of many public building projects—schools, hospitals, highways, water and sewer facilities and others vitally needed. Eventually, of course, these projects will be built. They will have to be paid for, however, out of increased sales and property taxes and utility fees. These taxes and fees—regressive though they may be—will have to be relied on even more heavily than at present to supply the funds state and local governments could not afford to borrow or to pay the increased debt carrying costs on what they would have to borrow.

Mr. Chairman, in my statement I have chosen not to speak on a number of aspects of what is involved in the direct or indirect taxation of state and local obligations by the Federal Government. Other witnesses appearing for the states will cover them. I have tried to show, and I believe I have shown, certain of the calamitous results that federal taxation would achieve. I do not believe that this Committee, its parent body or the Congress wishes to accomplish such results.

Mr. Chairman, Members of the Committee, I appreciate your giving me your time and attention. Thank you.

[Telegram]

SEPTEMBER 2, 1969.

Hon. RICHARD NIXON,
President of the United States,
The White House, Washington, D.C.

DEAR MR. PRESIDENT: Your presentation to the Nation's governors Monday night was a tremendous contribution to the meaningful establishment of the "new federalism." We are convinced, Mr. President, that we have before us the opportunity for a monumental breakthough to a positive partnership in government. You very ably outlined the paramount issues which are challenging our system of government, and laid the groundwork upon which all elected officials can join together in a common cause. That cause is, of course, a governmental system that can effectively deliver services to our people.

You can be assured of the complete cooperation of the Nation's governors in these vital issues.

One crucial matter which we did not have an opportunity to discuss with you is the taxation of State and municipal bonds. The infringement upon what we consider the constitutional prerogatives of State and local government would be a setback of major proportions to our mutual goal of governmental balance in the "Spirit of '76."

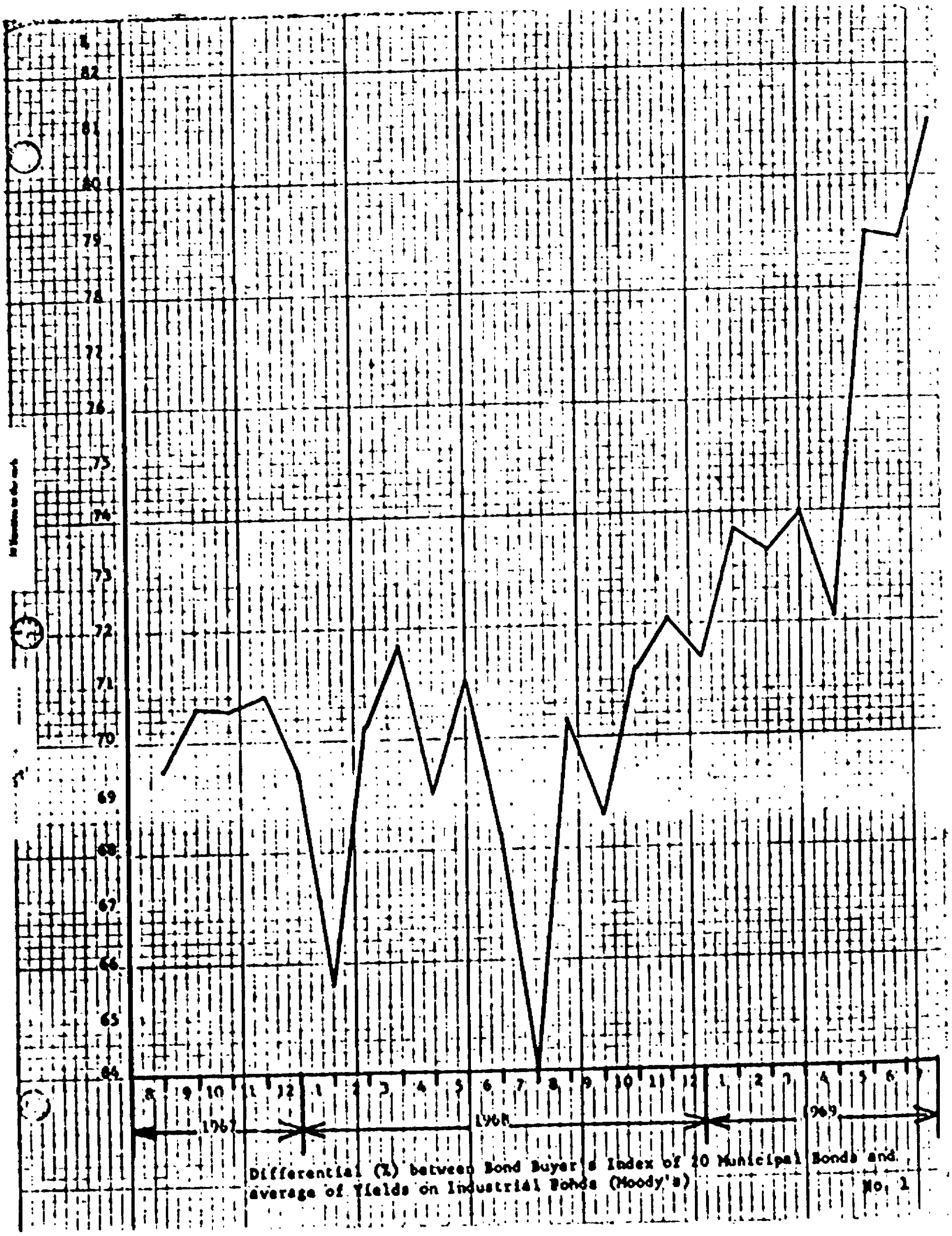
The staggering blow of increased costs for all public construction would either add to the tax burden of the people or stop construction of much needed public facilities.

Very simply, Mr. President, if the ability to market State and municipal bonds is jeopardized in any way, it will be a setback that for years to come will overshadow any positive proposals.

We urge your careful consideration of this vital matter, and by copy of this telegram call on the congressional leadership for their cooperation and support.

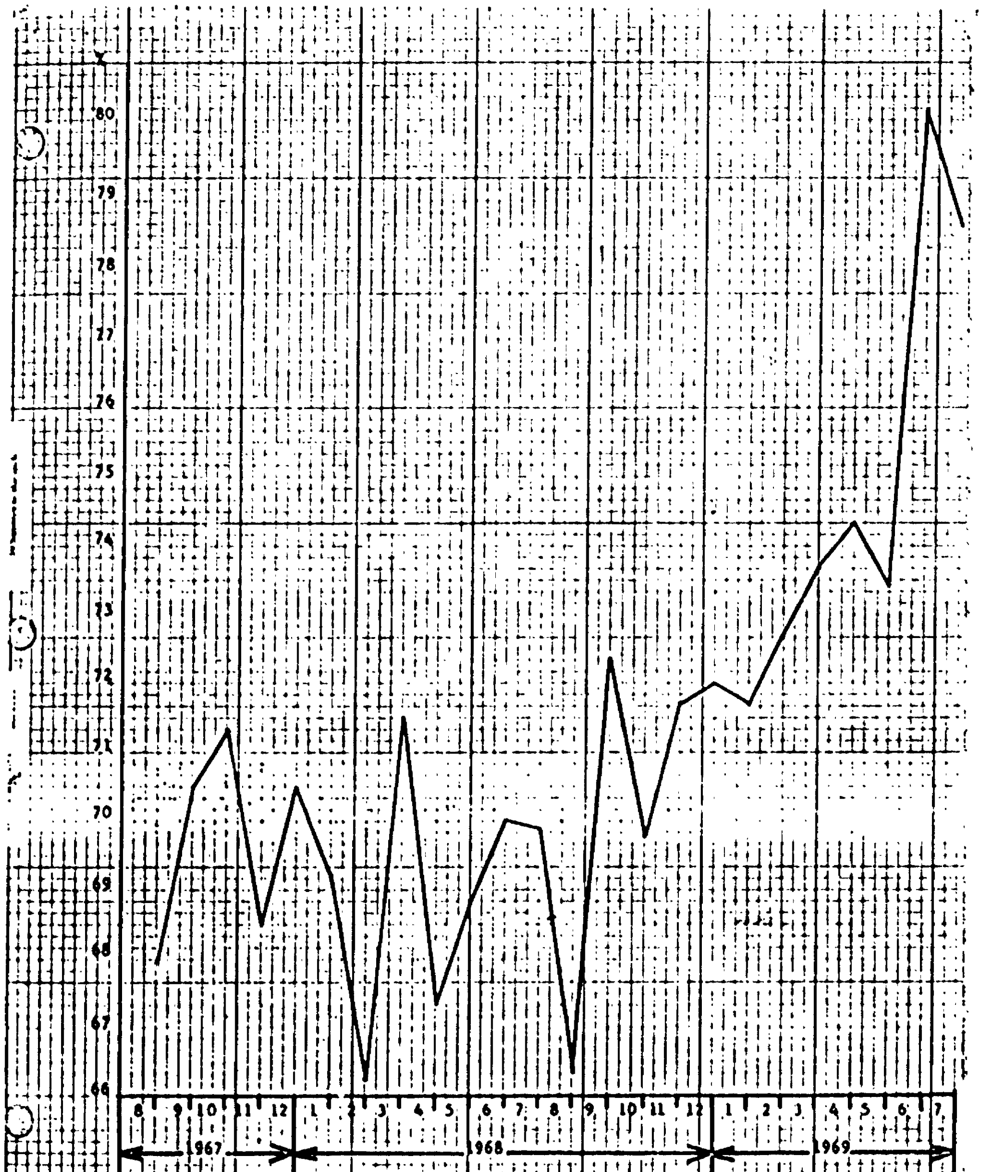
Again, we appreciate so much your presence at our conference, and the tremendous contributions you are making to provide order and balance in our federal system.

/s/ Gov. Buford Ellington, Tennessee, chairman of the National Governors' Conference, joined by all other governors present at today's business session: Gov. Albert P. Brewer, Alabama; Gov. Keith H. Miller, Alaska; Gov. John M. Haydon, American Samoa; Gov. Jack Williams, Arizona; Gov. Winthrop Rockefeller, Arkansas; Gov. Ronald Reagon, California; Gov. John A. Love, Colorado; Gov. John Dempsey, Connecticut; Gov. Russell W. Peterson, Delaware; Gov. Claude R. Kirk, Jr., Florida; Gov. Lester G. Maddox, Georgia; Gov. Carlos G. Camacho, Guam; Gov. John A. Burns, Hawaii; Gov. Don Samuelson, Idaho; Gov. Richard B. Ogilvie, Illinois; Gov. Edgar D. Whitcomb, Indiana; Gov. Robert D. Ray, Iowa; Gov. Robert Docking, Kansas; Gov. Louie B. Nunn, Kentucky; Gov. Kenneth M. Curtis, Maine; Gov. Marvin Mandel. Maryland; Gov. Francis W. Sargent, Massachusetts; Gov. William G. Milliken, Michigan; Gov. Harold Levander, Minnesota; Gov. Warren E. Hearnes, Missouri; Gov. Forrest H. Anderson, Montana; Gov. Norbert T. Tiemann, Nebraska; Gov. Paul Laxalt, Nevada; Gov. Walter Peterson, New Hampshire; Gov. Richard J. Hughes, New Jersey; Gov. David F. Cargo, New Mexico; Gov. Nelson A. Rockefeller, New York; Gov. Robert W. Scott, North Carolina; Gov. William L. Guy, North Dakota; Gov. James A. Rhodes, Ohio; Gov. Dewey F. Bartlett, Oklahoma; Gov. Tom McCall, Oregon; Gov. Raymond P. Shafer, Pennsylvania; Gov. Luis A. Ferre, Puerto Rico; Gov. Frank Licht, Rhode Island; Gov. Robert E. McNair, South Carolina; Gov. Frank L. Farrar, South Dakota; Gov. Calvin L. Rampton, Utah; Gov. Deane C. Davis, Vermont; Gov. Mills E. Godwin, Jr., Virginia; Gov. Melvin H. Evans, Virgin Islands; Gov. Daniel J. Evans, Washington; Gov. Arch A. Moore, Jr., West Virginia; Gov. Warren P. Knowles, Wisconsin; Gov. Stanley K. Hathaway, Wyoming; *and further joined by:* Conrad Fowler, president, National Association of Counties; Jack D. Maltester, president, U.S. Conference of Mayors; and Beverly Briley, President, National League of Cities.



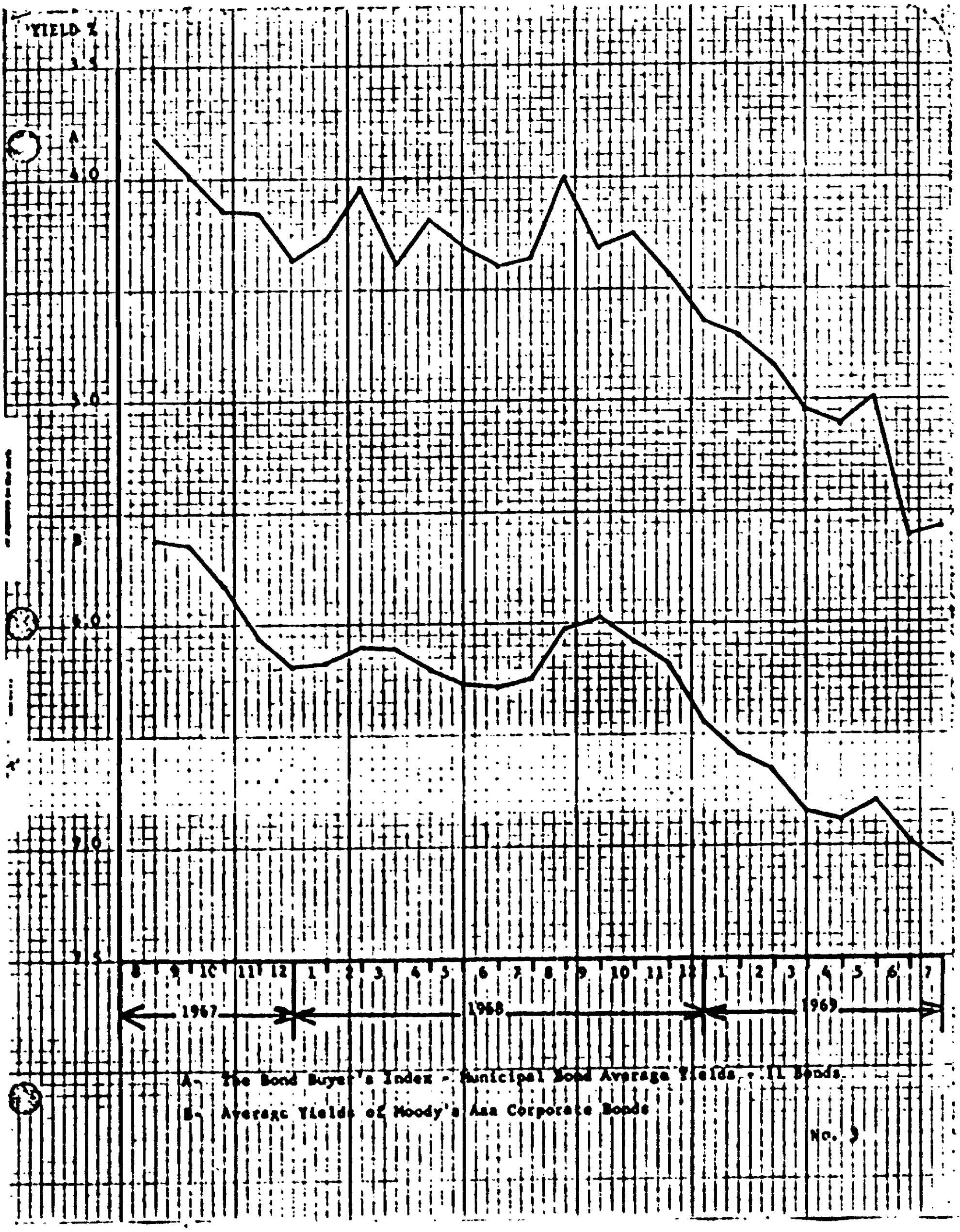
Differential (%) between Bond Buyer's Index of 20 Municipal Bonds and average of Yields on Industrial Bonds (Moody's)

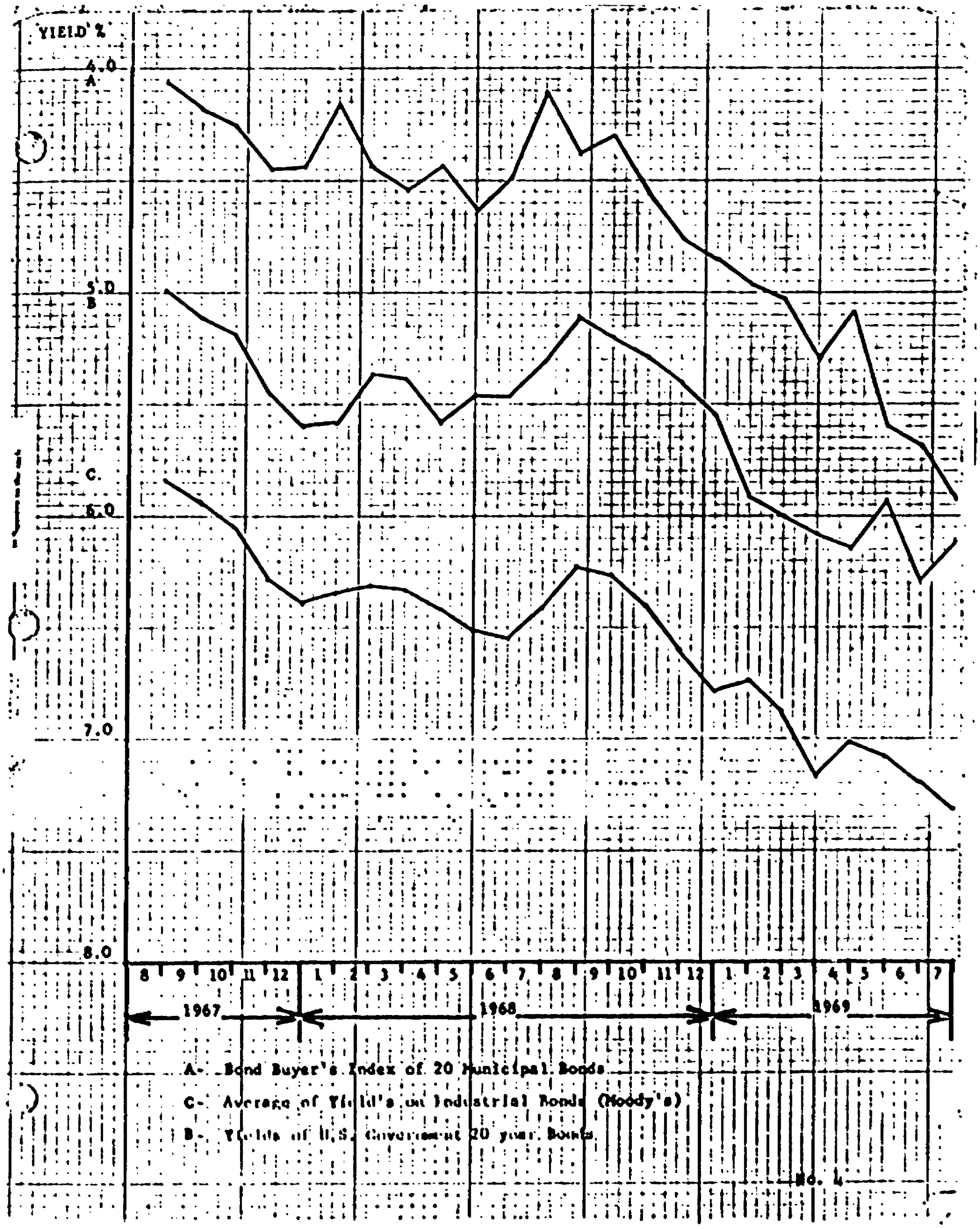
No. 1



Differential (%) between Moody's Average of Yields on Aaa Corporate Bonds and Bond Buyer's Index - 11 Bonds.

No. 2


YIELD %
3.5
A
4.0
5.0
B
6.0
7.0
7.5
8
9
10
11
12
1
2
3
4
5
6
7
8
9
10
11
12
1
2
3
4
5
6
7
1967
1968
1969
A. The Bond Buyer's Index - Municipal Bond Average Yields - 11 Bonds
B. Average Yields of Moody's Aaa Corporate Bonds
No. 3


YIELD %
4.0
A
5.0
B
C.
6.0
7.0
8.0
8
9
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11
12
1
2
3
4
5
6
7
8
9
10
11
12
1
2
3
4
5
6
7
1967
1968
1969
A- Bond Buyer's Index of 20 Municipal Bonds
C- Average of Yield's on Industrial Bonds (Moody's)
B- Yields of U.S. Government 20 year Bonds
No. 4

COMPARISON OF YIELDS, MUNICIPAL (BOND BUYER 20) AND INDUSTRIAL (MOODY'S AVERAGE)

[In percent]

	Bond Buyer's index of 20 municipal bonds	Average of yields on industrial bonds (Moody's)	Differential
1967:			
August	4.06	5.84	69.5
September	4.19	5.93	70.6
October	4.27	6.05	70.5
November	4.45	6.28	70.8
December	4.44	6.39	69.4
1968:			
January	4.16	6.34	65.6
February	4.44	6.31	70.3
March	4.54	6.33	71.7
April	4.43	6.42	69.0
May	4.64	6.52	71.1
June	4.48	6.55	68.3
July	4.11	6.42	64.0
August	4.38	6.32	70.3
September	4.30	6.26	68.6
October	4.56	6.40	71.2
November	4.76	6.60	72.1
December	4.85	6.79	71.4
1969:			
January	4.97	6.74	73.7
February	5.04	6.87	73.3
March	5.30	7.16	74.0
April	5.09	7.02	72.5
May	5.60	7.08	79.0
June	5.68	7.20	78.8
July	5.93	7.32	81.0

COMPARISON OF YIELDS

MUNICIPAL (BOND BUYER (11)) AND INDUSTRIAL (MOODY'S AVERAGE)

[In percent]

	Bond buyer's index, 11 bonds	Moody's average of yields on AAA corporate bonds	Differential
1967—August	3.82	5.62	67.9
September	3.99	5.65	70.6
October	4.15	5.82	71.3
November	4.16	6.07	68.5
December	4.37	6.19	70.5
1968—January	4.27	6.17	69.2
February	4.04	6.10	66.2
March	4.38	6.11	71.6
April	4.19	6.21	67.4
May	4.32	6.27	68.8
June	4.40	6.28	70.0
July	4.36	6.24	69.8
August	4.00	6.02	66.4
September	4.32	5.97	72.3
October	4.25	6.09	69.7
November	4.44	6.19	71.7
December	4.65	6.45	72.0
1969—January	4.72	6.59	71.6
February	4.84	6.66	72.6
March	5.05	6.85	73.7
April	5.12	6.89	74.3
May	4.99	6.79	73.4
June	5.61	6.98	80.3
July	5.57	7.08	78.6

COMPARISON OF YIELDS, MUNICIPAL (BOND BUYER 20), INDUSTRIAL (MOODY'S AVERAGE, AND U.S. GOVERNMENTS (20 YEARS)

In percent]

	Bond buyer's index of 20 municipal bonds	Average yields on industrial bonds (Moody's)	Yields of U.S. Government's (20)
1967			
August	4.06	5.84	4.99
September	4.19	5.93	5.12
October	4.27	6.05	5.18
November	4.45	6.28	5.46
December	4.44	6.39	5.60
1968			
January	4.16	6.34	5.57
February	4.44	6.31	5.37
March	4.54	6.33	5.39
April	4.43	6.42	5.59
May	4.64	6.52	5.47
June	4.48	6.55	5.47
July	4.11	6.42	5.31
August	4.38	6.23	5.12
September	4.30	6.26	5.20
October	4.56	6.40	5.29
November	4.76	6.60	5.40
December	4.85	6.79	5.55
1969			
January	4.97	6.74	5.92
February	5.04	6.87	6.00
March	5.30	7.16	6.08
April	5.09	7.02	6.20
May	5.60	7.08	5.92
June	5.68	7.20	6.29
July	5.93	7.32	6.12

ANALYSIS OF POTENTIAL COST TO STATE AND LOCAL GOVERNMENT
H. R. 13270
MUNICIPAL BOND ISSUANCES BY STATE AND ESTIMATED DEBT SERVICE THROUGH
TAX EXEMPT VS. TAXABLE
(MILLIONS)

SCHEDULE I

State	(1) Issuances 1968 (Actual)	(2) Debt Service Tax Exempt Basis	(3) Debt Service Taxable Basis	(4) Additional Due To Tax Each Year	(5) Interest Cost Due To Tax Life of Bond	(6) Issuances 1970 (Projected)	(7) Debt Service Tax Exempt Basis	(8) Debt Service Taxable Basis	(9) Additional Due To Tax Each Year	(10) Interest Cost Due To Tax Life of Bond
Alabama	$ 299.0	$ 23.0	$ 27.1	$ 4.1	$ 82.0	$ 363.0	$ 27.9	$ 32.9	$ 5.0	$ 100.0
Alaska	60.0	5.3	6.3	1.0	20.0	86.0	6.5	7.6	1.1	22.0
Arizona	90.0	6.9	8.2	1.3	26.0	109.0	8.4	9.9	1.5	30.0
Arkansas	36.0	2.8	3.3	.5	10.0	44.0	3.4	4.0	.6	12.0
California	1,976.0	151.9	179.3	27.4	548.0	2,391.0	183.8	217.0	33.2	664.0
Colorado	72.0	5.5	6.5	1.0	20.0	87.0	6.7	7.9	1.2	24.0
Connecticut	266.0	20.4	24.1	3.7	74.0	322.0	24.8	29.2	4.4	88.0
Delaware	62.0	4.7	5.5	.8	16.0	74.0	5.7	6.7	1.0	20.0
Florida	583.0	45.0	53.0	8.0	160.0	708.0	54.4	64.3	9.9	198.0
Georgia	222.0	17.0	20.0	3.0	60.0	267.0	20.5	24.2	3.7	74.0
Hawaii	90.0	6.9	8.2	1.3	26.0	109.0	8.4	9.9	1.5	30.0
Idaho	15.0	1.2	1.4	.2	4.0	19.0	1.5	1.7	.2	4.0
Illinois	553.0	42.5	50.1	7.6	152.0	669.0	51.4	60.7	9.3	186.0
Indiana	216.0	16.6	19.6	3.0	60.0	262.0	20.1	23.8	3.7	74.0
Iowa	165.0	12.9	14.9	2.0	40.0	200.0	15.4	18.2	2.8	56.0
Kansas	108.0	8.3	9.8	1.5	30.0	131.0	10.1	11.9	1.8	36.0
Kentucky	367.0	28.2	33.3	5.1	102.0	444.0	34.1	40.3	6.2	124.0
Louisiana	531.0	40.8	48.2	7.4	148.0	642.0	49.4	58.3	8.9	178.0
Maine	64.0	4.9	5.8	.9	18.0	77.0	5.9	7.0	1.1	22.0
Maryland	512.0	39.4	46.4	7.0	140.0	619.0	47.6	56.2	8.6	172.0
Massachusetts	369.0	28.4	33.4	5.0	100.0	447.0	34.4	40.6	6.2	124.0
Michigan	694.0	53.3	62.3	9.0	180.0	839.0	64.5	76.1	11.6	232.0
Minnesota	299.0	23.0	27.1	4.1	82.0	362.0	27.8	32.3	4.5	90.0
Mississippi	141.0	10.8	12.8	2.0	40.0	171.0	13.1	15.5	2.4	48.0
Missouri	452.0	34.7	41.0	6.3	126.0	547.0	42.1	49.6	7.5	150.0
Montana	12.0	.9	1.1	.2	4.0	14.0	1.1	1.3	.2	4.0
Nebraska	372.0	28.6	33.8	5.2	104.0	450.0	34.6	40.8	6.2	124.0
Nevada	22.0	1.7	2.0	.3	6.0	26.0	2.0	2.4	.4	8.0
New Hampshire	34.0	2.6	3.1	.5	10.0	41.0	3.2	3.7	.5	10.0
New Jersey	472.0	36.3	42.8	6.5	130.0	571.0	43.9	51.8	7.9	158.0
New Mexico	50.0	3.8	4.5	.7	14.0	61.0	4.7	5.5	.8	16.0
New York	2,197.0	168.9	199.3	30.4	608.0	2,659.0	204.4	241.3	36.9	738.0
North Carolina	223.0	17.1	20.2	3.1	62.0	270.0	20.8	24.5	3.7	74.0
North Dakota	9.0	.7	.8	.1	2.0	11.0	.8	1.0	.2	4.0
Ohio	700.0	53.8	63.5	9.7	194.0	847.0	65.1	76.9	11.8	236.0
Oklahoma	212.0	16.3	19.2	2.9	58.0	256.0	19.7	23.2	3.5	70.0
Oregon	219.0	16.8	19.9	3.1	62.0	265.0	20.4	24.0	3.6	72.0
Pennsylvania	1,187.0	91.2	107.7	16.5	330.0	1,437.0	110.5	130.4	19.9	398.0
Rhode Island	95.0	7.3	8.6	1.3	25.0	116.0	8.9	10.5	1.6	32.0
South Carolina	146.0	11.2	13.3	2.1	42.0	177.0	13.6	16.1	2.5	50.0
South Dakota	13.0	1.0	1.2	.2	4.0	15.0	1.2	1.4	.2	4.0
Tennessee	212.0	16.3	19.2	2.9	58.0	256.0	19.7	23.2	3.5	70.0
Texas	773.0	59.6	70.3	10.7	214.0	928.0	72.1	85.1	13.0	260.0
Utah	22.0	1.7	2.0	.3	6.0	26.0	2.0	2.4	.4	8.0
Vermont	54.0	4.2	4.9	.7	14.0	65.0	5.0	5.9	.9	18.0
Virginia	202.0	15.5	18.3	2.8	56.0	244.0	18.8	22.1	3.3	66.0
Washington	320.0	24.6	29.0	4.4	88.0	387.0	29.8	35.1	5.3	106.0
West Virginia	52.0	4.0	4.7	.7	14.0	63.0	4.8	5.7	.9	18.0
Wisconsin	237.0	18.2	21.5	3.3	66.0	287.0	22.1	26.0	3.9	78.0
Wyoming	37.0	2.8	3.4	.6	12.0	45.0	3.5	4.1	.6	12.0
TOTALS	$16,125.0	$1,238.8	$1,461.2	$222.4	$4,448.0	$19,514.0	$1,500.6	$1,770.2	$269.6	$5,392.0

ANALYSIS OF POTENTIAL COST TO STATE AND LOCAL GOVERNMENT
H. R. 13270
Municipal Bond Issuances By State
(Millions)

SCHEDULE II

State	(1)	(2)	(3)	(4)	(5)	(6)
	Amount of Issuances				1969	1970
	1965	1966	1967	1968	(Projected)	(Projected)
Alabama	$ 362	$ 261	$ 390	$ 299	$ 330	$ 343
Alaska	12	11	78	69	76	84
Arizona	103	93	49	90	99	109
Arkansas	49	79	147	36	40	44
California	1,642	1,584	1,719	1,976	2,174	2,391
Colorado	131	106	85	72	79	87
Connecticut	189	117	314	266	293	322
Delaware	59	96	68	61	67	74
Florida	364	274	219	585	644	708
Georgia	204	272	346	221.	243	267
Hawaii	58	24	89	90	99	109
Idaho	11	11	7	15	17	19
Illinois	353	422	606	553	608	669
Indiana	186	209	193	216	238	262
Iowa	53	144	175	165	182	200
Kansas	103	70	113	108	119	131
Kentucky	153	414	351	367	404	444
Louisiana	299	246	442	531	584	642
Maine	16	22	40	64	70	77
Maryland	227	270	386	512	563	619
Massachusetts	250	262	446	369	406	447
Michigan	379	466	586	694	763	839
Minnesota	282	203	296	299	329	362
Mississippi	120	99	217	141	155	171
Missouri	136	146	270	452	497	547
Montana	22	24	21	12	13	14
Nebraska	45	100	55	372	409	450
Nevada	47	51	50	22	24	26
New Hampshire	55	22	52	34	37	41
New Jersey	265	343	348	472	519	571
New Mexico	81	73	36	50	55	61
New York	1,416	1,457	1,554	2,197	2,417	2,659
North Carolina	143	130	294	223	245	270
North Dakota	17	19	7	9	10	11
Ohio	414	332	608	700	770	847
Oklahoma	149	309	86	212	233	256
Oregon	56	141	122	219	241	265
Pennsylvania	673	639	998	1,187	1,306	1,437
Rhode Island	84	40	106	95	105	116
South Carolina	63	44	165	146	161	177
South Dakota	12	15	8	13	14	15
Tennessee	149	207	396	212	233	256
Texas	657	543	662	775	853	938
Utah	102	15	23	22	24	26
Vermont	22	39	5	54	59	65
Virginia	166	105	243	202	222	244
Washington	267	85	301	320	352	387
West Virginia	84	80	71	52	57	63
Wisconsin	222	202	225	237	261	287
Wyoming	16	10	51	37	41	45
TOTALS	$10,9[illegible]	$10,924	$14,119	$16,125	$17,740	$19,514

Senator ANDERSON. I will next call Gov. Dan Evans of the State of Washington, who I believe is next in line.

STATEMENT OF HON. DANIEL J. EVANS, GOVERNOR OF THE STATE OF WASHINGTON

Governor EVANS. Mr. Chairman, and members of the committee. I will just add briefly to the remarks of Governor Love.

I serve or rather have just finished serving as chairman of the National Governors' Conference Committee on Fiscal Affairs and Executive Management. We have dealt with this problem of taxation of municipal bonds, and the Governors' Conference expressed their opinions in opposition to taxation, as I am sure the chairman of the conference, Governor Love, has pointed out.

Let me not reiterate testimony he has given or testimony that I am sure my colleagues will give but rather describe to you a most recent and very important thing that has happend in our own State of Washington that, I think, will drive home the point. We have had authorized by the legislature in January of 1969 a series of bond issues, and we are in the process now of trying to sell them. One of them deals with the very necessary construction of community colleges, in our State. Those bonds came to the market just a couple of weeks ago.

For the first time in our State's history we were forced to reject bids on tax-exempt bonds because of the rate. These were well protected bonds. They had a good rating. They were tax-exempt, and the low bid was 7.4 percent. We were incapable of issuing those bonds, and we will have to do one of two things in the near future—either rebid and hope that the rate somehow is lower or fail to construct necessary community college facilities for our students.

Now, the pay-off, if we ultimately have to go to that kind of rate, is from the tuition paid by community college students. I think this just reemphasizes what Governor Love has pointed out that the extra costs to State and local governments are not just costs of those governments themselves, but costs to property taxpayers, to youngsters who are going to community colleges and paying the higher tuition. To those who pay sales tax and other rather regressive forms of taxation, this is where the burden is going to fall, and it is our considered opinion that the extra costs to the taxpayers of this country, particularly the low-income taxpayers on whom this burden falls, will be far, far greater than any benefit to be gained by the Federal Government in terms of this portion, at least, of tax reform.

Governor LOVE. Thank you very much, Governor.

(Hon. Daniel J. Evans' prepared statement follows:)

STATEMENT OF GOV. DANIEL J. EVANS, CHAIRMAN, NATIONAL GOVERNORS' CONFERENCE ON EXECUTIVE MANAGEMENT AND FISCAL AFFAIRS

SUMMARY

1. The provisions of H.R. 13270 dealing with taxation of state and local bonds will result in a basic change in our governmental structure arising from immediate economic pressure.

2. The provisions insure a narrowing of the difference between the cost of taxable and non-taxable issues. The current chaotic condition of the market can, in specific part, be attributed to the proposed provisions, and has already resulted in serious financial problems in construction programs in the State of Washington and substantial increased cost of borrowing throughout the country.

3. The provisions do not represent tax reform, but shift to more regressive state and local tax burdens and utility charges.

4. The basis of exemption is constitutional, and enactment will result in legal challenge, with continuing chaos in the bond market and severe intergovernmental conflict.

5. The purchaser of municipal bonds now pays a minimum tax by accepting a lower interest rate.

6. There is no indication that tax exemption of municipal bonds was a significant factor in the failure by wealthly individuals cited by the Treasury Department to pay income taxes.

7. Further study needs to be undertaken on the role of tax exempt securities in the tax system and on ways to broaden the market for municipal bonds before changes in the tax exempt status of municipal bonds should be considered. ACIR has suggested such a study in which the National Governors' Conference would be desirous of participating.

Statement of Governor Daniel J. Evans

I sincerely appreciate the decision of this Committee to hold public hearings on the provisions of H.R. 13270 which deal with taxation of state and local bonds. Seldom has an issue of such intergovernmental importance and sensitivity been before you. The decision by the House of Representatives without any public opportunity for Governors and local officials to express themselves is an unfortunate chapter in the history of the federal system.

Others who will appear before you in future hearings will deal with the technical features of the optional issuance of exempt or non exempt bonds, the allocation of deductions and the minimum tax provisions of H.R. 13270. I believe that taken separately or together, their result will be a change in the basic structure of government resulting from immediate economic pressure and demagogic appeals. Therefore, I urge the members of this Committee to weigh most carefully the effect of this issue.

The effect of the provisions of H.R. 13270 is, by gradual stages, to tax the interest on state and local bonds. The much discussed local choice to issue either tax exempt bonds or taxable bonds with an interest subsidy is an illusory choice. The requirement that the Secretary of the Treasury fix the interest subsidy for fully taxable bonds each quarter on the basis of the difference between the interest yield on such fully taxable bonds and the yield on "tax exempt" bonds as determined by the market at that time, makes it apparent that this difference would gradually decline and the cost of borrowing to state and local governments *even under the subsidy option* would substantially increase.

The effect on the municipal bond market of this legislation can be viewed dramatically today by each of us and can be separated from the general financial market instability. The Dow Jones municipal bond index rose from 6.02% to a record 6.23% in one week in September. Within the past month in the State of Washington we have increased the burden to our present taxpayers by markedly shortening the maturity period on one issue of bonds which *must* be sold by December 31 and has an interest rate limitation, and the timely construction of vitally needed vocational education and general educational facilities in our community colleges has been placed in jeopardy by rejecting all bids on a $22 million issue because they were based upon interest rates which the state could not accept. We can only hope that when we reissue a call for bids on this issue, some order will have returned to the market.

Financial experts in my state have stated that the interest rate differential between taxable and non taxable bonds has narrowed from 30% to 20% since this legislation came under consideration. Based on the supportable assumption of the issuance of $10 billion in state and local bonds throughout the country during the year, the portion of the increase in cost attributable to the potential effect of this legislation will cost local taxpayers of the nation more than $1 billion over an average 25 year life of the bonds issued in one year alone. This cost will be compounded each year in which additional bonds must be issued under the present market conditions.

The net effect of the enactment of these provisions will be to increase slightly the tax yield to the federal government at the expense of substantially increasing the cost of borrowing by state and local government. It will increase the federal *income* tax yield at the expense of higher *property* taxes and higher *utility charges* for the local residents who pay the cost of municipal and state borrowings. It is not overall tax reform, but enforced local tax regression. It is a *shift* of the tax burden to the advantage of the federal treasury but the disadvantage of renters, home-owners, and utility users, regardless of their ability to pay. I cannot too strongly express my view that the result of these provisions are inimical both to the concepts of federal-state relations expressed by Presidents Nixon and Johnson, and to the views of those who most urgently desire real tax reform. The Federal Treasury cannot be viewed as the single entity in the nation's tax structure. When the entire tax system is viewed, these provisions will prove regressive in effect.

Tax deductions are generally permitted as a matter of Federal policy to encourage charity and investment and stimulate discovery of natural resources or similar worthwhile activities. But exemption of state and local bond interest does not derive from such Federal policy. It stems from the constitutionally mandated doctrine of inter-governmental immunity which is designed to permit the continued functioning of States and their political subdivisions. There is no doubt that litigation will ensue if this bill is enacted. By making this litigation inevitable, the Congress will doom the municipal bond market to several years of chaos which can only result in costing the public taxpayer hundreds of millions of dollars in additional interest cost. At a time when close intergovernmental relationships are being encouraged, a bitter and divisive battle will ensue, causing possibly irreparable harm to the Federal system.

It should be pointed out that the House of Representatives did not take cognizance of the fact that the buyer of State and local government bonds is now paying a "minimum tax" (in effect) to local government bonds by accepting a lower interest rate than he would demand if the bonds were taxable. Individuals with incomes in excess of $200,000 per year who pay no taxes are cited by the U.S. Treasury Department as examples of the need for reform. However, in the vast majority of cases cited by the Treasury Department this non-taxpaying status was achieved through depreciation, charitable contributions and other deductions and *not* through municipal bond holdings. The only study which has been conducted of which I am aware supports the conclusion that a minor portion of the income of most persons with large incomes is derived from this source. Action should be taken by this Committee to have timely information on this subject before it should consider accepting the provisions of H.R. 13270. The Advisory Commission on Intergovernmental relations has expressed interest in dealing with the subject of taxation of municipal bonds and I urge the Committee to utilize this prestigious body on which all levels of government are represented to bring more realistic recommendations before us. I assure you that the Nation's Governors will participate constructively in such a study. Given the crippling condition of today's bond market, this Committee and the Treasury Department, in conjunction with ACIR and the National Governor's Conference Committee on Executive Management and Fiscal Affairs should be reviewing ways to broaden the market for municipal bonds. The use of urban development bonds and the authority for investment of unemployment compensation trust funds in municipal bonds are among suggestions which deserve further study.

The recent National Governors' Conference unanimously adopted a policy statement originating in the Committee of which I was Chairman, affirming its support of the constitutional freedom from taxation of municipal bonds by the Federal Government and affirming its opposition to the provisions of H.R. 13270 which so obviously affect the marketability of state and local securities, and thereby the provision of needed public services and facilities. I appreciate the opportunity to share with you this view on behalf of the nation's Governors.

Governor Love. Next on the schedule is Governor Norbert T. Tiemann of Nebraska.

STATEMENT OF HON. NORBERT T. TIEMANN, GOVERNOR OF NEBRASKA

Governor Tiemann. Mr. Chairman and members of the committee, thank you very much for allowing me to speak on behalf of tax treatment of State and local bonds.

On very few issues would there be found possible a greater degree of agreeement among representatives of State and local governments than the one we are considering today. We are firmly opposed to any proposal to tax our bonds, be it a minimum tax, allocation of taxes or some other scheme. I should be less than candid if I did not report that we are divided in our views on the efficacy or desirability of a plan embodying a Federal subsidy of one kind or another in exchange for the issuance of municipal bonds on a taxable basis. About this I will have more to say in just a moment. I am not here to argue the legal case for tax exemption of securities. But I do wish to emphasize that we believe strongly that any Federal tax on the bond interest of a State or its local governments without the State's consent, is unconstitutional, and clearly so.

The doctrine of reciprocal immunity from taxation was enunciated by the Supreme Court almost as many years ago as the Republic is old. In the intervening century and one-half, it has resisted successfully many assaults.

The Congress has complete discretion in determining what the tax treatment shall be for capital gains, charitable deductions, depletion allowances and other items. The tax immunity of State and local governments, however, is part of the warp and woof of our federal system.

Be that as it may, my reasons for urging the continuing inviolability of reciprocal immunity will be cast solely in policy terms.

On March 11 of this year, I was afforded the opportunity to appear before the Ways and Means Committee on the subject of tax reform. As the representative of the National Governors' Conference, I urged strongly that the committee not include in its bill provisions to tax State and local bonds. Other witnesses and I warned that the inevitable result of such provisions would be an escalation in bond interest rates. Unfortunately, we have been proved to be excellent prophets.

In February, before we testified, the Bond Buyers' Index of 20 representative municipal bonds was 5.04 percent. On August 21, the index breached 6 percent to reach 6.02. The Bond Buyers' Index of 11 bonds—more highly rated issues—showed yields in February to be 4.84 percent. On August 21, it hit 5.92. These are increases of 0.98 and 1.08 in the short space of 6 months. In the period February–July, corporate issues and 20-year U.S. Government bonds experienced interest rate increases of 0.44 and 0.12 respectively.

I am not here to assert a claim to be regarded as a seer. I am not here to argue that tight money has not caused interest rates to rise. But I do assert, however, that the only thing that could have caused State and local bond interest rates to increase so much more greatly than those of these other long-term securities is the consideration the House gave to taxation of State and local bonds. I'll make one more prophecy. Should the Senate and then the entire Congress decide to tax our bonds—be the form minimum tax, allocation of deductions or some other—our interest rates will continue their climb both absolutely and relatively.

You have heard, Mr. Chairman, testimony that the House provisions on a "limit on tax preferences" and allocation of deductions and the Treasury scheme with respect to the latter will have only minimal revenue consequence. We do not quarrel with this view. What we fear is that the market will react—as it has already—to a much greater degree than the revenue consequences would appear to justify.

One of the Treasury witnesses referred to the market reaction as being primarily psychological. Well, of course it is psychological. So labeling it does not make it any less severe, however. Whether the Congress, Governors, mayors, the Treasury or anyone else feels the actual and potential reaction to be justified is beside the point. Investors make their own decisions. And their decisions determine what the State and local bonds interest rate will be.

They might decide that a minimum tax rate established, and I am talking about the investors now, might decide that a minimum tax rate established by this Congress could be increased by a subsequent Congress. They might decide that an allocation of deductions requirement for individuals applicable only to future issues of bonds and phased in over 10 years, as provided by H.R. 13270 enacted by this Congress, might be changed to be effective immediately with respect to both outstanding and future issues at the behest of a future Secretary of the Treasury. They might decide that once absolute immunity is abridged they must fear later additional abridgements.

Their fears might prove to be groundless, ' ut personally I find it hard to criticize investors for entertaining suc fears when they contemplate investing their money for 10 or 20 or up to 50 years.

Mr. Chairman, if ultimately Congress decides not to include State and local bond interest in a minmum tax or an allocation of deductions requirement, the mere considerations of these items has already cost State and local governments and their taxpayers $13.8 million annually. This can be shown very clearly.

Assume, if you will, that the yield relationship that existed last February between the Bond Buyers' Index and the Average of Yields on Industrial Bonds were to obtain today. The yield relationship then was (73.3). Today it is (81.0). Assume that municipals issued in the intervening period had an average date of maturity of 20 years.

The difference between what might have been and what will be—what will be, members of the committee—is $276 million.

That difference allows for the general increase in interest rates. It can be ascribed only to the consideration that the Congress has given to taxation of State and local bond interest. It represents the "hedge" that those who bought the bonds decided they needed to guard against the possibility of taxation.

Were the investors overcautious? Well, each one of can judge for himself.

Commercial banks constitute the largest category of investors in State and local bonds, as I am sure you have been told many times. A banker confronted with a choice among investments might conclude that he needed such a "hedge." His reasoning might be that since the Supreme Court has held that life insurance companies must allocate deductions, as Assistant Secretary Cohen testified, since the House determined that individuals must do so, and since the House Ways and Means Committee anounced shortly before it reported the tax reform measure a "tentative decision" to require banks to allocate, Congress might decide that banks must allocate deductions long before the bonds he bought would mature.

Mr. Chairman, in testifying before the Ways and Means Committee, I said:

> In approaching this issue we do not intend to be merely negative or to defend the status quo simply because it is the status quo. Rather we seek—with you—a reexamination of the common objective and possible alternatives open to us * * *.

This was my attitude at that time and it still is.

Following the hearing, I was given an opportunity to submit a supplementary statement. In it, I outlined my views on what possible means might be found to satisfy the objective of the committee while protecting the State and local bond market. With your permission, Mr. Chairman, I shall indicate briefly what the statement contained and file with you its complete text.

First, I urged that, since the matter was both of enormous complexity and of vital concern to State and local governments, it be given sufficient study. I suggested that the Advisory Commission on Intergovernmental Relations might be asked to make the study. Incidentally, I understand it is doing so. I pledged the complete cooperation of State and local governments in such a study.

Second, I suggested that if the committee felt impelled to act without further study, it consider:

(1) A system employing a Federal-State agreement in which the Federal Government would agree to pay a percentage of the interest cost of future issues of State and local securities if they were issued as taxable obligations, and waive immunity from State and local taxation of income from future issues of its own securities. A State, in turn, would agree to waive tax immunity for its obligations and those of its political subdivisions if it or they chose to issue taxable securities; or

(2) A Federal system of urbanks. This would be a variation of the urban development bank proposal introduced by a number of Members of Congress.

In the statement, I listed four specific criteria that I felt any plan must contain. They were:

(1) State and local governments must be able to determine all policy questions relative to bonding free of Federal control.

(2) State and local governments must have the opportunity to choose between the alternative plan, whatever it might be, and reliance on the private market.

(3) Reliability must be assured. If inaugurated, the scheme must be continued unless 3 years' notice of its intended termination were given.

(4) The plan must provide for a minimum processing time.

With your further permission, I am attaching to my statement an amplification of the proposal for Federal-State agreements.

It seems ironic to me that we give serious consideration now at this time to revenue sharing, a mass transit fund, reformation of our welfare system, and other proposals that indicate an appreciation of the serious financial plight of State and local governments—and to taxing State and local bond interest. The last could cost us most or all of what we hope to receive from the others.

At the State and local level, we are aware of the difficult decisions you must make in order to reform our tax laws. We wish you well. Our only additional desire is that you understand that we are pleading the case for State and local governments—not industry, not banks, not individuals, not any class of investors. The beneficiaries of the continued tax exemption of State and local bonds will be State and local government. Only marginal benefits will accrue to investors as testimony by witnesses for the Treasury has indicated.

Mr. Chairman and members of the committee, thank you very much.

(Hon. Norbert T. Tiemann's prepared statement follows:)

STATEMENT OF HON. NORBERT T. TIEMANN, GOVERNOR OF NEBRASKA

SUMMARY

Mr. Chairman, Members of the Committee, my name is Norbert T. Tiemann. I am Governor of Nebraska. I appreciate your permitting me to speak on the tax treatment of state and local bonds.

On March 11 of this year, I was afforded the opportunity to appear before the Ways and Means Committee on the subject of tax reform. As the representative of the National Governors' Conference, I urged strongly that the Committee not include in its bill provisions to tax state and local bonds. Other witnesses and I warned that the inevitable result of such provisions would be an escalation in bond interest rates. Unfortunately, we have been proved to be excellent prophets.

In February, before we testified, the *Bond Buyers' Index* of 20 representative municipal bonds was 5.04 percent. On August 21, the index breached 6 percent to reach 6.02. The *Bond Buyers' Index* of 11 bonds—more highly rated issues—showed yields in February to be 4.84 percent. On August 21, it hit 5.92. These are increases of 0.98 and 1.08 in the short space of six months. In the period, February-July, corporate issues (Moody's Average of Yields on Corporate Bonds) and 20-year U.S. Government bonds experienced interest rate increases of 0.44 and 0.12 respectively.

I am not here to assert a claim to be regarded as a seer. I am not here to argue that tight money has not caused interest rates to rise. I do assert, however, that the only thing that could have caused state and local bond interest rates to increase so much more greatly than those of these other long-term securities is the consideration the House gave to taxation of state and local bonds. I'll make one more prophecy. Should the Senate and then the entire Congress decide to tax our bonds—be the form minimum tax, allocation of deductions or some other—our interest rates will continue their climb both absolutely and relatively.

You have heard, Mr. Chairman, testimony that the House provisions on a "limit on tax preferences" and allocation of deductions and the Treasury scheme with respect to the latter will have only minimal revenue consequences. We do not quarrel with this view. What we fear is that the market will react—as it has already—to a much greater degree than the revenue consequences would appear to justify.

One of the Treasury witnesses referred to the market reaction as being primarily "psychological." Of course it is. So labeling it does not make it any less severe, however. Whether the Congress, Governors, Mayors, the Treasury or anyone else feels the actual and potential reaction to be justified is beside the point. Investors make their own decisions. And their decisions determine what the state and local bonds interest rate will be.

They might decide that a minimum tax rate established by this Congress could be increased by a subsequent Congress. They might decide that an allocation of deductions requirement for individuals applicable only to future issues of bonds and phased in over 10 years, as provided by H.R. 13270, enacted by this Congress might be changed to be effective immediately with respect to both outstanding and future issues at the behest of a future Secretary of the Treasury. They might decide that once absolute immunity is abridged they must fear later additional abridgements.

Their fears might prove to be groundless, but personally I find it hard to criticize investors for entertaining such fears when they contemplate investing their money for 10 or 20 or up to 50 years.

Mr. Chairman, if ultimately Congress decides not to include state and local bond interest in a minimum tax or an allocation of deductions requirement, the mere considerations of these items has already cost state and local governments and their taxpayers $13.8 million annually. This can be shown very easily.

Assume, if you will, that the yield relationship that existed last February between the *Bond Buyers' Index* and the Average Yields on Industrial Bonds (Moody's) were to obtain today. The yield relationship then was (73.3). Today it is (81.0). Assume that municipals "issued in the intervening period had an average date of maturity of 20 years.

The difference between what might have been and what will be—*what will be*, Members of the Committee—is $276 million.

That difference allows for the general increase in interest rates. It can be ascribed only to the consideration that the Congress has given to taxation of state and local bond interest. It represents the "hedge" that those who bought the bonds decided they needed to guard against the possibility of taxation.

Were the investors overcautious? Each one of us can judge for himself.

Commercial banks constitute the largest category of investors in state and local bonds, as I am sure you have been told repeatedly. A banker confronted with a choice among investments might conclude that he needed such a "hedge." His reasoning might be that since the Supreme Court has held that life insurance companies must allocate deductions, as Assistant Secretary Cohen testified, since the House determined that individuals must do so, and since the House Ways and Means Committee announced shortly before it reported the tax reform meassure a "tentative decision" to require banks to allocate, Congress might decide that banks must allocate deductions long before the bonds he bought would mature.

Mr. Chairman, in testifying before the Ways and Means Committee, I said. "In approaching this issue we do not intend to be merely negative or to defend the status quo simply because it is the status quo. Rather we seek—with you—a reexamination of the common objective and possible alternatives open to us . . ."

That was my attitude. That continues to be my attitude.

Following the hearing, I was given an opportunity to submit a supplementary statement. In it I outlined my views on what possible means might be found to satisfy the objective of the Committee while protecting the state and local bond market. With your permission, I shall file with you its complete text, and a memorandum outlining an alternative subsidy plan.

Mr. Chairman, Members of the Committee, to me it is ironic that serious consideration is being given to revenue sharing, a mass transit fund, reformation of our welfare system and other proposals that indicate an appreciation of the serious financial plight of state and local governments—and to taxing state and local bond interest. The last could cost us most or all of what we hope to receive from the others.

At the state and local level, we are aware of the difficult decisions you must make in order to reform our tax laws. We wish you well. Our only additional desire is that you understand that we are pleading the case for state and local governments—not industry, not banks, not individuals, not any class of investors. The beneficiaries of the continued tax exemption of state and local bonds will be state and local government. Only marginal benefits will accrue to investors as testimony by witnesses for the Treasury has indicated.

Thank you, Mr. Chairman, Members of the Committee, for permitting me to testify.

Statement of Hon. Norbert T. Tiemann

Mr. Chairman, members of the committee, my name is Norbert T. Tiemann. I am Governor of Nebraska. I appreciate your permitting me to speak on the tax treatment of state and local bonds.

On very few issues, Mr. Chairman, would it be possible to find a greater measure of agreement among representatives of state and local governments than the one we are considering today. We are firmly opposed to any proposal to tax our bonds, be it minimum tax, allocation of deductions or some other scheme. I should be less than candid if I did not report that we are divided in our views on the efficacy or desirability of a plan embodying a federal subsidy of one kind or another in exchange for issuance of municipal bonds on a taxable basis. About that I shall have more to say later.

I am not here to argue the legal case for tax exemption of our securities, but I do wish to emphasize that we believe strongly that any federal tax on the bond interest of a state or its local governments without the state's consent is unconstitutional. The doctrine of reciprocal immunity from taxation was enunciated by the Supreme Court almost as many years ago as the Republic is old. In the intervening century and one-half, it has resisted successfully many assaults.

The Congress has complete discretion in determining what the tax treatment shall be for capital gains, charitable deductions, depletion allowances and other items. The tax immunity of state and local governments, however, is part of the warp and woof of our federal system. Be that as it may, my reasons for urging the continuing inviolability of reciprocal immunity will be cast solely in policy term.

On March 11 of this year I was afforded the opportunity to appear before the Ways and Means Committee on the subject of tax reform. As the representative of the National Governors' Conference, I urged strongly that the Committee not include in its bill provisions to tax state and local bonds. Other witnesses and I warned that the inevitable result of such provisions would be an escalation in bond interest rates. Unfortunately, we have been proved to be excellent prophets.

In February, before we testified, the *Bond Buyers' Index* of 20 representative municipal bonds was 5.04 percent. On August 21, the index breached 6 percent to reach 6.02. *The Bond Buyers' Index* of 11 bonds—more highly rated issues—showed yields in February to be 4.84 percent. On August 21, it hit 5.92. These are increases of 0.98 and 1.08 in the short space of six months. In the period February–July, corporate issues (Moody's Average of Yields on Corporate Bonds) and 20-year U.S. Government bonds experienced interest rate increases of 0.44 and 0.12 respectively.

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Mr. Chairman, in testifying before the Ways and Means Committee, I said, "In approaching this issue we do not intend to be merely negative or to defend the status quo simply because it is the status quo. Rather we seek—with you—a reexamination of the common objectives and possible alternatives open to us. . . ."

That was my attitude. That continues to be my attitude.

Following the hearing, I was given an opportunity to submit a supplementary statement. In it I outlined my views on what possible means might be found to satisfy the objectives of the Committee while protecting the state and local bond market. With your permission, I shall indicate briefly what the statement contained and file with you its complete text.

First, I urged that, since the matter was both of enormous complexity and of vital concern to state and local governments, it be given sufficient study. I suggested that the Advisory Commission on Intergovernmental Relations might be asked to make the study. Incidentally, I understand it is doing so. I pledged the complete cooperation of state and local governments in such a study.

Second, I suggested that if the Committee felt impelled to act without further study, it consider:

1. A system employing a federal-state agreement in which the Federal Government would agree to pay a percentage of the interest cost of future issues of state and local securities if they were issued as taxable obligations, and waive immunity from state and local taxation of income from future issues of its own securities. A state, in turn, would agree to waive tax immunity for its obligations and those of its political subdivisions if it or they chose to issue taxable securities; or

2. A Federal System of Urbanks. This would be a variation of the Urban Development Bank proposal introduced by a number of Members of Congress.

In the statement, I listed four specific criteria that I felt any plan must contain. They were:

1. State and local governments must be able to determine all policy questions relative to bon'ing free of federal control.

2. State and local governments must have the opportunity to choose between the alternative plan, whatever it might be, and reliance on the private market.

3. Reliability must be assured. If inaugurated, the scheme must be continued unless three years notice of its intended termination were given.

4. The plan must provide for a minimum processing time.

With your further permission, I am attaching to my statement an amplification of the proposal for federal-state agreements.

Mr. Chairman, Members of the Committee, to me it is ironic that serious consideration is being given to revenue sharing, a mass transit fund, reformation of our welfare system, and other proposals that indicate an appreciation of the serious financial plight of state and local governments—and to taxing state and local bond interest. The last could cost us most or all of what we hope to receive from the others.

At the state and local level, we are aware of the difficult decisions you must make in order to reform our tax laws. We wish you well. Our only additional desire is that you understand that we are pleading the case for state and local governments—not industry, not banks, not individuals, not any class of investors. The beneficiaries of the continued tax exemption of state and local bonds will be state and local government. Only marginal benefits will accrue to investors as testimony by witnesses for the Treasury has indicated.

Thank you, Mr. Chairman, Members of the Committee, for permitting me to testify.

SUPPLEMENTARY STATEMENT OF HON. NORBERT T. TIEMANN, GOVERNOR OF NEBRASKA

This is a supplementary statement to that which I presented to the Committee on Ways and Means, March 11, 1969, on behalf of the National Governors' Conference. I thank the Chairman for giving me the opportunity to submit this more detailed statement.

Since March 11 representatives of State and local governments have met frequently to discuss ideas and proposals to further the objectives of the Committee on Ways and Means while protecting the market for municipal securities. I believe that several exciting proposals have been formulated that warrant further examination and refinement. These proposals are outlined later in this statement.

It is not necessary to enlarge on our belief that any Federal tax on the bond interest of a State or its local governments without that State's consent is unconsitutional. The doctrine of reciprocal immunity from taxation was enunciated by the Supreme Court almost as many years ago as the Republic is old. In the intervening century and one-half it has resisted successfully many assaults. It goes without saying that we could support no proposal that raises this constitutional issue.

We are convinced that the doctrine of reciprocal immunity extends to the inclusion of the interest paid on State and local obligations in the calculation of a minimum tax, allocation of deductions to such tax exampt income or any similar proposal the effect of which would be to levy a tax on such securities.

Eschewing the constitutional argument except to point out that tax treatment of capital gains, charitable deductions and depletion allowances are matters over which the Congress has complete discretion while the tax immunity of State and local governments is part of the warp and woof of our federal system, we shall state our reasons for the continuing inviolability of reciprocal immunity solely in policy terms.

Our reasons have to do largely with the marketability of State and local securities and consequences flowing therefrom. Investors in securities are sophisticated. They would not be confident that a minimum tax rate, for example, would not be increased or, if the interest paid on State and local securities were taxed as income to individuals, it would not be taxed as income to banks, other financial institutions and corporations. Not being confident, they would not buy or would buy only if interest rates were boosted sufficiently to safeguard their investment.

As a consequence, interest rates would have to be raised appreciably. Some capital improvements would be postponed, others limited in scope, still others abandoned. To take up some of the slack, State and local taxes—particularly sales and property taxes, both regressive in nature—would have to be raised. Additional pressure would be brought on the Congress to increase the range of programs supported by grants-in-aid, to raise authorizations for current grant-in-aid programs and to appropriate sums more nearly comparable in size to authorized amounts. Nor would there be much benefit to the United States Treasury from the much higher interest rates. As individuals and entities subject to tax moved out of the municipal bond market, tax exempt pension and welfare funds, foundations and other tax exempt institutions would move in.

It is particularly ironic that, at a time when State and local governments are under such intense financial pressure, the integrity of their securities—the means by which they finance most of their capital expenditures—should be threatened. The "urban crisis" is not an invention of city hall publicists. The urgings of some that the Federal government assume entire responsibility for welfare costs or States assume entire responsibility for elementary and secondary education costs are prompted by an awareness of the serious nature of the fiscal crisis faced by States and localities. In Congress similar recognition is represented by the many bills to share Federal revenues with the States and local governments. We believe that the Committee on Ways and Means does not wish to bring about a marked increase in interest costs for State and local capital expenditures, to cause an increase in regressive taxes, and to benefit the United States Treasury only marginally—all to tax more heavily an uncertain number of millionaire tax evaders. The proposals described below would avoid such dire consequences.

PROPOSALS UNDER CONSIDERATION

Study of Proposed Methods of Taxation.—The matter of taxation of State and local obligations is a complex one as the Committee on Ways and Means is aware. Equity is not to be achieved by the simple expedient of providing for taxation of such securities as if they were private obligations. Vying with this objective are constitutional and policy issues that must be resolved satisfactorily. Obviouly this matter is of great interest to the Congress. Even more obvious is its interest to State and local governments. It is their capital improvements that would be jeopardized were an unwise Federal policy to be elected. The Federal interest is represented by an undetermined amount that may run into millions of dollars annually. To State and local governments, the annual stake is literally billions of dollars worth of capital improvements.

For these reasons, if it is not possible within a relatively brief period to find a satisfactory way to safeguard the integrity of State and local securities within a Federal tax system that is equitable to the generality of taxpayers, we believe that it would be wise to refer this matter to a study group. Should this prove necessary, we pledge our entire cooperation in the study.

We propose that such a study be concerned with devising alternative methods of financing capital needs of State and local governments which will expand available capital and reduce reliance on tax exempt bonds, but not imperil the Federal tax immunity of State and local bonds when their use is necessary. Possible expansion could include the purchase of State and local obligations by the Federal Reserve Board and the Unemployment Compensation Fund.

To make such a study we suggest the Advisory Commission on Intergovernmental Relations. It is unique in having as members representatives of Federal, State and local governments from both the Legislative and Executive Branches.

With respect to specific proposals below, obviously much work must be done if they are to be perfected. Others equally worthy or better might be developed. To this end, we shall devote as much time and energy as may be needed, and will be available for consultation with the Committee on Ways and Means or its staff.

Federal-State Agreements.—One proposal that is being considered would provide for a Federal-State agreement. The Federal government would agree to pay a percentage of the interest cost of future issues of State and local securities, if they were issued as taxable obligations, and waive immunity from State and local taxation of income from future issues of its own securities. A State, in turn, would agree to waive tax immunity for its obligations and those of its political subdivisions if it or they chose to issue taxable securities. The Federal percentage might be 50 percent. Since in effect corporate interests costs are subsidized by the Federal government in the amount of 50 percent, Federal participation in the interest rate costs of State and local government bonds at this level appears not to be unreasonable.

The method of issuance would involve a dual set of coupons for each State-issued bond. The investor would clip the Federal coupon and present it for payment as if the bond were an issuance of the United States. The other coupon would be presented for payment to the disbursing agent of the State or political subdivision.

This proposal appears to offer several advantages. Since immunity would be waived, a confrontation would be avoided on the issue of the constitutional basis for immunity of Federal obligations from taxation by States and State obligations from taxation by the Federal government. Since there would be taxation of future issuances only, there would be no question of equity to purchasers of earlier issues who assumed in good faith that income from Federal, State and local obligations was not subject to taxation. Finally, were such securities made taxable, the allegation of tax avoidance could not be raised.

Federal System of Urbanks.—Another suggestion that has been advanced involves the establishment of a Federal System of Urban Development Banks. As the name implies, this is a variation of the Urban Development Bank proposal that has been introduced in the Congress. It would require each State to establish a bank to purchase obligations issued by the State and its political subdivisions. Obligations of the State Urbanks would be sold to private purchasers as taxable securities with a Federal coupon as proposed above or as tax exempt securities. If the demand on a given State Urbank were too great, it could call on a Federal Development Bank to serve as a secondary market. An additional responsibility of the Federal Urbank would be to act as the insuring agent for local bonds in return for a premium to be paid on each issue.

Possible advantages of this suggested arrangement are several. First, in having a series of 50 State Urbanks, as opposed to only one Federal institution, there would be a minimum of delay in a bank's determining that the credit of the issuing government was adequate to support the issue of the securities in question. Second, by providing that the obligations would be insured, there would be no need for a Federal "guarantee" of payment with the consequent possible exposure of the Federal government to make good on its warranty. Third, by assigning to the several Urbanks responsibilities of banker and, in the case of the Federal Urbank, insurer, there would be no need or occasion for interference with the policy decisions of the issuing unit.

ELEMENTS OF A PROPOSAL

Any proposal that is adopted must meet constitutional limitations and provide for equity among taxpayers. In addition to these obvious requirements in our view it should meet certain other specifications. Some of them have been suggested or implied above. However, at the risk of repetition, we believe they should be stated explicitly.

Freedom from Federal Control.—It is a mark of our system of government that power is widely dispersed. Decisions with respect to public policy are made at each of the several levels of government. Means to insure that the electorate is heard are familiar at all levels. By such means we insure both an optimum measure of popular participation and an optimum responsibility to popular control. Both are impossible of realization, however, if decisions which should be made at the State or local level are made at the Federal level. The decision to build a court house or a school, where to build it, what size it should be and how to raise the money for its construction are not questions that can be answered properly by a Federal official. Any scheme that may be developed must permit such basic policy decisions to be made by responsible State or local officials and legislators.

Alternative Markets.—To this point in time State and local governments have been able to borrow from the private bond market the funds they need for capital expenditure requirements. Of late interest rates on municipal securities have risen markedly, but so have they for housing mortgages, corporate bonds and United States Government bonds. Assuming that the credit "squeeze" does not become appreciably tighter, there is no reason to suppose that State and local governments will not be able to continue to place their primary reliance on the private bond market.

On the other hand, an alternative market, particularly one that might offer preferential rates, would be a welcome additional source to satisfy the continually growing State and local capital needs. It must be an alternative, however. State and local governments must retain the option to go to the private market if they choose.

Reliability.—Assuming a method can be devised that meets other expectations, it also must be reliable. Credit cannot be turned on and off like a faucet. Any scheme that depends for its funds on annual appropriations cannot be relied upon. If the Congress proposes to make a commitment, it must be met in full and it must be continued for at least three years after notice of termination is given. Should a satisfactory alternative capital market plan be developed State and local governments will expect to utilize it. They would be unable to do so—or would do so at their peril—if they could not anticipate that money would be available when they needed it. If the alternative were to be established and then abruptly discontinued or radically reduced in scope, the effect would be disastrous. Private markets would have to be reestablished—a process that would require time. State and local governments would have lost valuable time at a minimum and possibly all chance to sell their securities.

Freedom from Delay.—The next requirement is one which more properly might be addressed to the agency made responsible for administering any of the alternative plans. Nevertheless, it is an important element in the successful operation of any plan that might be adopted. Provision must be made for a minimum processing time. Delay can add to interest costs at a time when rates are climbing. Inevitably it adds to building, land acquisition and other costs. Even at favorable interest rates an appreciable delay in processing could offset completely any savings in interest rate reduction.

CONCLUSION

In discussing our position regarding taxation of state and local bonds I mentioned—and I now underscore—the irony of proposals to subvert the tax exempt status of said bonds while at the same time the recognition of State and local fiscal crises is being expressed in proposals and actual legislation to provide for block grants, revenue sharing, and grant consolidation. The National Governors' Conference has stated its firm support of these varying means of relieving the fiscal crises, as I indicated in answer to questions from Committee members at the hearings of March 11. At that time Chairman Mills inquired whether the States would exchange the tax-exempt status of their bonds in return for some form of revenue sharing and block grants. In reply I indicated that I would submit this question to the Executive Committee of the National Governors' Conference. This matter will be on the Executive Committee's agenda when it meets in mid-May. But I do not anticipate any specific action by the Executive Committee at its forthcoming meeting. It should be noted that the National Governors' Conference has a Standing Committee on Executive Management and Fiscal Affairs. That Committee is now at work on revenue sharing, block grants, grant consolidation and related matters. Specifically that Committee is gathering data from the states regarding their capital improvement programs and the effect of the tight money market on the marketing of State bonds and State programs. The survey results will be made known to the House Committee. Thus it is my view that the Executive Committee will request that the Committee on Executive Management and Fiscal Affairs give careful attention to this important question raised by the distinguished Chairman of the Committee on Ways and Means.

FEDERAL-STATE AGREEMENTS

The Problem.—To avoid inequities from the exemption of state and local government bond interest in a manner which is constitutional, fair and not harmful to state and local governments and local taxpayers.

The Solution.—An optional double coupon plan, can accomplish a voluntary termination of the issuance of exempt bonds. With such termination the inequities would become impossible for future issues and would come to an end as outstanding issues are paid off. Elements of amplification are set forth below.

A WORKABLE DOUBLE COUPON PLAN

(a) To be constitutional the plan must be completely optional with the affected states. Therefore the technique of a federal-state agreement is recommended, authorized by legislation of both the Congress and the affected state legislature. The agreement should prohibit withdrawal by either the federal government or the state except on five years notice.

(b) In the agreement the state would authorize its local governments to elect to issue taxable bonds and would also authorize taxable bonds at the state level. The United States would authorize each such issuer of taxable bonds to attach coupons for the federal share of the interest.

(c) The United States coupons would be the direct obligation of the United States and not of the issuer. This is necessary because:

(i) It avoids conflict with innumerable constitutional and statutory limits on the interest rate a local government can pay.

(ii) It avoids the problems of local government having to pay more interest and waiting to get the excess back from Washington.

(iii) It will give investors in a new kind of security, more confidence.

(d) The United States coupons would be for half the interest payable. Fifty percent is fully justified because:

(i) A private corporation can cost the United States 52.8 percent of the interest paid on private bonds. This results from the deductibility of the interest payments from the base for corporate income tax at the present 52.8 percent rate.

(ii) The Treasury estimates the United States will recover 42 percent of the interest payment on taxable state and municipal bonds. Since the purpose is reform, all this should be returned to the issuers. The additional 8 percent is well justified as a needed contribution to the local government crisis.

(iii) Since the plan must be optional to be constitutional, the federal percentage should be large enough to make sure that all issuers will opt for taxability to assure that the reform will be accomplished.

The cost to the local issuers in recent years has been around 33 percent. A substantial increment above the figure is required for the option to work.

(iv) Adding municipal bonds to the taxable market will probably raise all taxable interest rates, so that just to break even requires more than the present 33⅓ percent.

(e) The Federal Goverment would reaffirm that state and local issuance would be subjected to no controls. The federal coupon authorization would not be withheld from any true state or municipal bond regardless of the purpose of issuance, interest rate or any other factor.

Industrial development bonds, properly defined, and arbitrage bonds are not true exercises of the state or municipal borrowing power and would be ineligible for the federal coupon.

Governor LOVE. Mr. Chairman, we would next like to have Gov. McKeithen of Louisiana testify.

STATEMENT OF HON. JOHN J. McKEITHEN, GOVERNOR OF LOUISIANA

Governor MCKEITHEN. Mr. Chairman, and members of the committee, I am John McKeithen of Louisiana.

I have come here today to convey to you the deep concern of the State of Louisiana and its political subdivisions on the proposed change in the tax-exempt status of State and municipal bonds.

At the outset, let me again reiterate that it is the State and its political subdivisions which are charged with the duty to furnish schools, streets, roads, water supply, sewerage disposal, and hospital facilities, as well as many other services and facilities, all of which, of course, require capital outlays. One can only expect that the demand on the State and local governments to supply such facilities is going to continue to increase, and that the need for capital facilities will likewise increase. Given this situation, there seems to be no justification for the Federal Government to take action which will only serve to increase the cost of supplying these services. Let me cite you three examples to illustrate the difficulties inherent for the State of Louisiana in the impairment of the tax exemption on its bonds.

In 1968, the Legislature of Louisiana authorized a $300 million general obligation bond issue to finance an extensive highway capital improvement program for the State. In order to provide the funds to service these bonds, the legislature authorized an increase in the gasoline tax of 1 cent per gallon. It was awfully hard to get it passed. It requires a two-thirds vote in our State, a monstrosity that just stifles in Louisiana. We are hoping to do something about that with the help of the Federal courts. Obviously any increase in the interest rate which the State of Louisiana must pay will result in an impairing of the State's ability to service this bond issue out of the gasoline tax. The alternatives will be either to reduce the construction program and the amount of the bonds issued, thereby keeping within the funds earmarked to service the bonds, or to proceed with the program, issue the full amount of bonds, and obtain the additional funds required to service the bonds from other existing sources of revenue which are very small in our State, with a consequent reduction in other much needed programs or to go back and ask for additional taxes. For the last, I have just about lost my nerve.

By any alternative the citizens of Louisiana are bound to suffer. The last session of the legislature concluded in June of this year. A bond issue of over $100 million was provided to finance a capital outlay program primarily for port and harbor development. Senator Long, I found in our State it is much easier to have bond issues than it is for the money to pay for them. We want to improve our ports. The great Port of New Orleans, the second largest port of the United States, is suffering for lack of funds. If we pass the bond issue we hope we will sell the bonds to improve that port, and we want to help our State universities. Part of that bond issue will be for State universities, for hospitals, and our schools for exceptional children.

Our State badly needs this program, particularly for our harbor and port facilities, and I cannot overemphasize the fact that the passage of this bill will make the program more expensive to the State to the detriment of other vitally needed services since debt service on bonds has a first lien on the general fund in Louisiana.

As an additional consideration, the Constitution of Louisiana imposes an interest rate limitation of 6 percent on many of the political subdivisions. This limitation and current bond market conditions have prevented many political subdivisions from embarking on any capital outlay programs. And certainly, the fear of loss of tax exemption on municipal bonds will not improve the marketability of these bonds. Thus, the outlook is for an additional postponement of the day upon which these municipalities can hope to finance their much needed capital improvement programs.

Those knowledgeable in this field have informed me that there are over 81,000 State and local governmental units in the United States. It has been estimated that the number of State and local issuers who might be expected to be able to compete with the bonds of private corporations is probably less than 500, and certainly not more than 1,000. Is it the intent of this bill to deny over 80,000 State and local government units the ability to finance their capital outlay programs through the issuance of bonds?

Some of those with whom I have conferred about this bill refer to the provision which seeks to eliminate the injury which will be done to State and local governments by offering to States and municipalities the right to issue fully taxable bonds in return for an interest subsidy. One interesting point is that this provision seems to place no limits upon the amount which may be paid out by the U.S. Treasury, nor does it establish any conditions for qualification for such subsidy. It would not seem possible that such an uncontrolled drain upon the U.S. Treasury could be permitted to continue very long, and we think sooner or later, the Congress, you distinguished Members of the Congress and of the U.S. Senate, would have to place some limit upon the amount of funds which could be withdrawn from the Treasury through this interest subsidy. Once Congress recognized the need for limiting expenditures in this area, it would necessarily establish conditions and limitations and restrictions upon eligibility for such funds.

Inevitably, some Federal agency would make the determination of the nature and location of such projects for which a subsidy would be paid. At that point, effective control over most capital construction by State and local governments will have been transferred to the Federal Government. It seems incredible to me that this proposal, raising as it does the very real possibility of Federal control over each and every construction program of every State and every local governmental unit throughout the country, should come at a time when the need for local control, more flexible and more responsible to those most immediately affected, is becoming increasingly more evident.

As an incidental matter, it should be pointed out that this interest subsidy would be of no assistance at all to any municipality unable to borrow money, or for that matter the State, because of constitutional or statutory limitations on the interest rate, or because of the disappearance of a market for the bonds themselves.

Let's look at the effect of this bill from a practical standpoint. As a result of the tax exempt status of State and local bonds, lower interest rates are obtained, and therefore, the taxpayers benefit by having less taxes needed to service the bonds. If the tax exempt status is removed, interest rates will increase and additional taxes will be required to service the bonds. Even if the interest subsidy will substitute for the increased taxes, why tamper with a system that has worked so well in this country for 150 years merely for the purpose of substituting a different method of tax savings for public improvement projects?

In conclusion, let me say that the best legal minds in our State have serious reservations about the constitutionality of the interest subsidy.

Thank you very much, Mr. Chairman, and members of the committee.

Governor Love. Thank you, Governor.

(Hon. John J. McKeithen's prepared statement follows:)

Statement of Hon. John J. McKeithen, Governor of Louisiana

Summary

Mr. Chairman, Members of the Committee, I am John J. McKeithen, Governor of Louisiana. I appreciate your hearing me on the subject of the tax treatment of state and local bonds—a subject of intense interest and concern to our state and its local governments.

We appreciate the difficulty and complexity of what you are trying to accomplish. As taxpayers and citizens, we wish you well in this undertaking.

Mr. Chairman, state and local governments from their own resources support services in such areas as education, highways and highway safety, crime prevention and control, health, water and natural resources, and a host of others. In all these program areas, they receive federal grants-in-aid. Major federal construction grants include those for highways, airports, hospitals, water pollution abatement, urban renewal and others. They represent national policy decisions relative to national goals. Total grants-in-aid approximate $25 billion. Grants for capital purposes total $6.457 billion (estimated) for fiscal year 1970.

These grants must be matched by state and local governments. If capital expenditure is involved, almost always bond financing is used.

Many bills have been introduced providing for sharing federal revenue with states and localities. The administration is about ready to offer its plan. Other aid programs have been proposed. Their proponents are undoubtedly sincere in arguing that they are necessary to ease the severe financial pressure on state and local governments.

You may imagine then how astonished we were when H.R. 13270 included state and local bond interest in its provisions for a limit on tax preferences and allocation of deductions. Our wonderment was increased by the administration's "instant" allocation of deduction plan, and its proposal that it be applied to both future and outstanding issues.

Are you surprised that we rub our eyes or shake our heads in wonder?

On the one hand, we see national policies to give aid to state and local governments to achieve national goals. Additional programs are proposed—some with the avowed purpose of relieving the fiscal crisis of these governments. On the other hand, we see provisions in the House bill that would impair the ability of state and local governments to raise needed capital. Then the administration proposes an even harsher allocation of deductions plan.

Mr. Chairman, there are many reasons to oppose these provisions, but I shall limit my remarks to policy considerations.

The genius of the federal system lies in its mutual forebearance from taxation of instrumentalities, property, revenue or income derived from securities. We have a system of parallel governments. It is no more right that the Federal Government interfere with or impede the states in the performance of their governmental functions than it is for a state to interfere with or impede the Federal Government in the attainment of its governmental aims.

Governments raise money by various means. Taxation is the largest revenue producer, but borrowing is of great significance. In 1968, state and local governments issued more than $16 billion in debt instruments. Such a sum supports the assertion that the power to borrow is as essential to government as the power to tax.

If the Congress takes action to impair state and local capacity to borrow, how shall we raise capital funds, including those required to match federal grants? Shall we raise taxes to build schools and hospitals? Shall we accommodate to increased debt service costs by reducing our contributions toward the building of highways and airports?

If it is felt that these questions represent an overreaction, I should like to call your attention to certain information from the tables presented by Governor Love.

INTEREST RATES, SEVERAL INDICES, SELECTED DATES

[In percent]

	20 municipals		Industrials		11 bonds		AAA corporates		U.S. government 20	
August 1967	4.06		5.84		3.82		5.62		4.99	
January 1969	4.97	(0.91)	6.74	(0.90)	4.72	(0.90)	5.59	(0.97)	5.92	(0.93)
July 1969	5.93	(.96)	7.32	(.58)	5.57	(.85)	6.08	(.49)	6.12	(.20)
Aug. 21, 1969	6.02		....		5.92		....		....	

Please note that between August 1967 and January 1969, figures in parentheses indicate the range of rate increases was very narrow—.90 to .97. Note, however, that from January to July this year, the municipal bond indices rose by .96 and .85. Private issues rose .58 and .49, U.S. Government obligations .20. Note, too, from the August 21 date that municipal bond interest rates continue to rise.

The change in market behavior can be explained only by the consideration that has been given to taxing state and local obligations. If the decision to tax is affirmed, even higher rates will result.

Necessarily taxes ultimately will be relied upon to pay these increased rates. Who are the taxpayers? They are those who pay federal taxes—those who anticipate relief from enactment of the tax reform bill.

Does that sound like we are chasing our tail? We are.

We are, that is, except for two reasons.

One reason is that the cost to state and local taxpayers will be far greater than will be realized in revenue if these provisions are enacted.

The second is that the bill would reduce income tax rates—a progressive tax. By far the largest part of local government revenue comes from real property taxes. States rely primarily on sales taxes. Both are regressive taxes.

To enact these provisions would achieve a modest increase in federal revenue. This would be achieved at the expense of higher state and local taxes—taxes far larger in total than the revenue realized. Enactment may help to reduce a progressive tax—but would raise regressive taxes.

Mr. Chairman, tampering with the tax exempt status of state and local bonds is justified on the grounds that wealthy persons escape their fair burden of taxation by their owning municipal bonds. Sometimes it is stated that the revenue loss exceeds state and local savings.

As to the former, this has not been proven. Possibly wealthy persons have large holdings. Neither they nor other taxpayers report income derived from such ownership. As a matter of fact, one might wonder why they should. The Ways and Means Committee reported that the 154 individuals with adjusted gross incomes of $200,000 or more in 1966 did very well under other provisions. They claimed as deductions, the Committee showed, large charitable deductions, interest payments, real estate depreciation and farm losses. That half of capital gains not taxed was another bonanza. Why should these people invest heavily in what were until recently low-yield securities?

Gentlemen, do those who buy state and local bonds realize savings in taxes? One may assume some do. Is the aim to make a profitable investment different from that of other investors? Or are they attracted to our bonds because they are a safe investment? Some do. State and local governments honor their obligations. Who knows why investors pick particular securities? Some local banks buy their local government bonds from a sense of civic duty.

Mr. Chairman, the so-called "taxpayers' revolt" is not confined to the national level. Despite it, however, reasonably and logically, we must point out that tax dollars are required to rebuild our cities, protect our environment, improve our transportation system, and assure our people adequate diets, health care and educational opportunities. These and other domestic programs are supported primarily by state and local governments. To endanger them by endangering our capacity to borrow would be folly. We need your help—help you have already determined is in the national interest. We trust you will serve your real, long-term interests and ours by rejecting these proposals.

Mr. Chairman, Members of the Committee, I thank you.

Statement

Mr. Chairman, Members of the Committee, I am John J. McKeithen, Governor of Louisiana. I appreciate your hearing me on the subject of the tax treatment of state and local bonds—a subject of intense interest and concern to our state and its local governments.

We appreciate that the Committee on Finance in considering means to reform our tax laws is endeavoring to accomplish a difficult and tremendously complex assignment. We are aware that current national policy may dictate your recommending certain changes. We understand your desire to remove or minimize certain inequities. As taxpayers and citizens, we wish you well in this undertaking.

What you decide—what the Congress decides—will have very far-reaching effects. Among those that will be affected will be state and local governments.

Mr. Chairman, state and local governments from their own revenues support services in such areas as education, highways and highway safety, crime prevention and control, health, water and natural resources and a host of others. In all these broad categories they administer programs for which they receive federal grants-in-aid. Major federal construction grant programs include those for highways, airports, hospitals, water pollution abatement, urban renewal and others. These programs represent policy decisions by the National Government in the attainment of national goals. Total grants-in-aid approximate $25 billion. Grants for capital purposes total $6.457 billion (estimated) for fiscal year 1970.

Formulas vary, but these grants must be matched by the recipient state and local governments. If capital expenditure is involved, almost always bonds are issued to raise the necessary funds.

Many Members of Congress have introduced bills to share federal income tax revenue with state and local governments. The administration is about ready to offer its plan, we are told. Proposals have been made for a mass transit fund. The President has asked that welfare laws be reformed to increase aid to the states. Many other financial assistance schemes have been advanced. Their proponents are obviously sincere in their support of these measures as being necessary to ease the severe financial pressure on states and localities.

Perhaps you can imagine our astonishment when the Ways and Means Committee and then the House of Representatives approved the inclusion of state and local bond interest in the limit on tax preference and allocation of deductions provisions of H.R. 13270. Those feelings were compounded when the administration unveiled its "instant" allocation of deductions plan and proposed it be applied to both future and outstanding issues.

Are you surprised that we rub our eyes or shake our heads in wonder?

On the one hand, we view declared national policies to give aid to state and local governments to achieve national goals. In addition, other aid programs are urged—some with the avowed purpose of relieving the fiscal crisis of these governments. On the other hand, we are witness to House passage of LTP and allocation of deductions formulas that would impair the ability of state and local governments to raise needed capital. Then the administration proposes an even harsher allocation of deductions plan.

The situation appears to be another illustration of the left hand's not knowing what the right hand is doing.

Mr. Chairman, I do not propose to argue that the consideration of these provisions has had a severe impact on municipal bond interest rates. If the material submitted by Governor Love does not prove that point, no words of mine will do so. Nor shall I show that the administration's allocation of deductions formula will be even more damaging than the one in H. R. 13270. Its specifications make that clear. It is not my intention to argue the constitutional issue. Presumably that will be done by others. I shall limit my remarks to policy matters.

The genius of the Federal system is in its mutual forbearance from taxation of instrumentalities, property revenue or income derived from securities. No specific provision in the Constitution forbids such taxation. It is inherent in the concept of federalism. We have a system of parallel governments in other words. It is no more right or appropriate that the Federal Government interfere with or impede the states in the performance of their governmental functions than it is for a state to interfere with or impede the Federal Government in the attainment of its governmental aims.

Governments raise money by various means—taxes, borrowing, fees for services, licenses, various enterprises, and others. Taxation is the largest revenue producer, but borrowing is of great significance. As has been pointed out, in 1968 state and local governments issued more than $16 billion in debt instruments. This is no small sum. It supports the assertion that the power to borrow is as essential to government as the power to tax.

It the Congress takes action to impair the capacity to borrow of state and localities, how shall we secure the capital funds we need, including what is required to match federal grants? Shall we raise taxes to build schools and hospitals? Shall we accommodate to increased debt service costs by reducing our contributions toward the building of highways and airports?

If it is felt that these questions represent an overreaction, I should like to call your attention to certain information from the tables presented by Governor Love.

INTEREST RATES, SEVERAL INDICES, SELECTED DATES

[In percent]

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July 1969	5.93 (.96)	7.32 (.58)	5.57 (.85)	7.08 (.49)	6.12 (.20)
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Please note that in the period August 1967–January 1969, the range in interest rate increases was very narrow—.90 to .97, the figures shown in parentheses. Note, on the other hand, that between January and July of this year, the municipal bond indices rose by .96 and .85. The indices showed that rates for private issues rose .58 and .49, for U.S. Government obligations .20. I have added the reports on municipal bond interest rates for August 21, 1969, to show that they are continuing to rise.

The change in the behavior of the market must be ascribed to the consideration that has been given to taxing state and local obligations. Should the decision the House has made be affirmed by the entire Congress, even higher rates must be expected.

How will state and local governments secure the revenue to pay these increased rates? Ultimately, it would be raised by taxes.

Who are the taxpayers? They are those who pay federal taxes—those who anticipate relief from the enactment of the tax reform bill.

Does that sound like we are chasing our tail? We are.

That is, we are except for two reasons.

One reason is that the cost to state and local governments and their taxpayers will be far greater than the Federal Government will realize in revenue if the provisions you are considering are enacted.

The second is that you are contemplating rate reductions in the income tax—a progressive tax. By far the greatest portion of local government revenue is raised by taxes on real property. States rely primarily on sales taxes. These are regressive taxes.

To enact these provisions would achieve a modest increase in federal revenue. This achievement would be at the expense of higher state and local taxes—taxes far larger in total than the revenue realized. In other words, enactment may help to reduce a progressive tax—but raise regressive taxes.

Is this achievement in line with what most people regard as wise tax policy? Do we feel that to cause regressive taxes to be raised by a reduction in a progressive tax serves our social purposes?

Criticism may be leveled at state and local governments because their tax structures are not more progressive. Even so, they cannot be changed overnight. Nor will the situation be improved by their being forced to bear the burden of increased bond interest rates.

Mr. Chairman, tampering with the tax exempt status of state and local bonds is justified on the grounds that wealthy persons escape taxation by having large investments in such bonds. Sometimes it is stated that the cost to the Treasury from income not taxed is greater than the savings realized by state and local governments in the lower interest rates they pay.

As to the former—large municipal bond holdings by the wealthy—this has not been proven. (Possibly they have such holdings, but we just don't know.) Neither they nor other taxpayers report income derived from such ownership. As a matter of fact, from the information contained in the Report of the Ways and Means Committee, one might wonder why they should. The 154 individuals with adjusted gross incomes of $200,000 or more who paid no federal income tax in 1966 seem to have done all right by claiming as deductions large charitable contributions, interest payments, real estate depreciation and farm losses. The excluded half of capital gains was another bonanza, the Committee stated. Why should those so skilled in minimizing their taxes invest heavily in what were until recently investments with low yields?

Incidentally, the Ways and Means Committee in justifying the bill made its first reference to municipals on page 9 of the Report. It stated, "It is believed that still other high-income individuals paid no tax and did not even file tax returns since virtually their entire income was from tax-exempt State and municipal bonds."

By page 11, what the Committee "believed" had become a "fact." There it said, "Also, despite the fact that tax-exempt State and municipal bond interest is a prime way for well-to-do individuals to escape the burdens of taxation, . . ."

What the Committee "believed" had become a "fact" and a "prime way"—in the short space of two pages.

In fairness, I should point out that thereafter the actions and statements of the Committee were consistent. It acted and justified its actions on the basis of the "facts."

Gentlemen, is it true that those who buy state and local obligations realize or hope to realize, savings in taxes? One may assume some do. Is their aim to make a profitable investment different from that of any investor? Or are they attracted to our bonds because they are a safe investment? Again one may assume this to be a motivating factor. The record of state and local governments is that they honor their obligations. Who knows why investors pick particular securities? Some local banks, for example, buy the bonds of their city or county—or in Louisiana, parish—out of a sense of civic duty.

Members of the Committee, you have heard much about the "taxpayers' revolt." No doubt your correspondence has been heavy on this subject. Let me assure you that it is not confined to the national level. State and local tax rates have been rising. Except for the surtax, Congress has been able to reduce tax rates several times in the past 15 years. We have not been so fortunate. We have been increasing rates and instituting new taxes.

We may deplore the restiveness of the taxpayer. We may be aware that governmental expenditure can be supported only by comparable taxation. We may agree with Justice Holmes that taxes are the price we pay for civilization. Reason and logic may sustain our position. Unfortunately, taxpayers in revolt have little time for reason and logic.

About a year ago, Governor Rockefeller of New York said that states and localities supported from their own revenues 64 per cent of the governmental expenditures for domestic programs. It is these expenditures that we need to make to rebuild our cities, protect our environment, improve our transportation system and assure that our people have adequate diets, health care and educational opportunities.

Gentlemen, to endanger even to a minor degree our capacity to sustain these programs is folly. To do so to raise the paltry sums—$35 million from LTP and $45 million from allocation of deductions—would compound the folly. We need your help—help you have already determined is in the national interest. We trust yours will serve your real, long-term interests and ours by rejecting these proposals.

Mr. Chairman, Members of the Committee, I thank you.

The Chairman. We will next hear from Governor Kirk of Florida.

STATEMENT OF HON. CLAUDE R. KIRK, JR., GOVERNOR OF FLORIDA

Governor Kirk. Thank you.

Mr. Chairman, I would like to appear here not only as a Governor, but perhaps as an insurance executive and financial analyst and investment banker in case I have to go back to that. [Laughter.]

I would like to point out that perhaps what I am going to say may be redundant, but it is for emphasis and I think the closing part of my talk may have some novelty within it that I hope you hear it clearly when I arrive at that point.

I think what the House has done is much like your hospitality here. You have extended us water without glasses. [Laughter.]

Gentlemen, we are all here today to consider a matter far more basic than the details of a proposed tax bill. Changing the historic tax-exempt status of municipal bonds would have a deep and penetrating consequence which we should recognize, and that is loss of faith in the integrity of our government.

Even while Congress has been discussing the enactment of a law to tax interest on State and local security, we have seen the steady deterioration of the investing public's confidence in their value.

It is time, once and for all, to lay this matter to rest, by deciding to abide by the assurances given all States over 50 years ago when the income tax constitutional amendment was admitted to the States. That assurance was that the Federal Government could not and would not directly or indirectly tax this income source——

The Chairman. If I might just interrupt you for a moment, some of our committee is already suffering sunburn from these lights and I am going to ask the TV to take the lights off the committee. You gentlemen might not have had quite that much exposure to the sunny climate of Louisiana and Florida but inside this room we have just about had all the bright lights our eyes can take and I would like to urge that this light over here be turned off and any other light in the eyes of the committee members. We are perfectly happy to have you gentlemen on television, but we have had enough of it ourselves. I would like to ask these lights be turned off for the committee members. Thank you very much. Go ahead Governor Kirk.

Governor KIRK. That assurance was that the Federal Government could not and would not directly or indirectly tax this income source, and we now find ourselves faced with the very thing the States were assured would never happen.

This is a breach of faith which, if permitted, would destroy the very foundation of our federal system; that is, sovereign status but mutual trust in each other.

Another trust which is even more important than that between governments is the trust of the people in their government at all levels, Federal, State and local. All too frequently this trust has been violated and this proposal flies in the face of assurance, given time and time again, that the Federal Government will not tax the interest on local and State bonds. The credibility of the Federal Government has too frequently been successfully attacked, and I am sure you do not want to add to this credibility gap.

If you now take the back door approach by indirectly taxing State and local bonds, the investing public will be forewarned that the fiscal integrity of the States no longer exists. The results will be chaotic.

The proposal to subsidize a portion of the interest costs accruing to the States and local governments, if they agree to issue taxable bonds, would give the Federal Government in Washington control over all such State and local borrowing for capital outlay programs. The effect of this proposal would be increased Federal control rather than increased Federal revenues, although offered under the guise of tax equity. Federal regulations and the necessity for prior Federal approval will inevitably result.

President Nixon has emphasized the importance of the "New Federalism" under which the States will be called upon to assume an increasing share of the responsibility for providing the public services citizens have come to expect from their Government. These tax proposals, by shifting authority and control of capital outlay borrowing to Washington, and by making it more difficult and costly for State and local governments to do their job of building needed public facilities, are in conflict with the goal of decentralizing authority and responsibility as urged by the President.

The minimum income tax and the allocation of deduction proposals, as they relate to the interest on State and municipal bonds, would increase the cost of borrowing for the needed improvements for which State and local governments are responsible and would, therefore, necessarily increase State and local taxes. These higher taxes would have to be paid by the same taxpayers supposedly being benefited by the so-called tax reform package. Every taxpayer in America would have to pay more taxes to his State, county, school district, and city if these proposals become law, thus increasing tax inequity in the name of tax equity. The increased cost which would have to be paid by the taxpayers under these proposals would be in excess of the amount of additional revenue to be collected by the Federal Government under these indirect forms of taxation of presently tax-exempt bonds. The total cost of government to the taxpayer would thereby be increased.

The effect upon growth States, such as Florida, would be particularly harmful, because of the great need for financing education, antipollution, transportation, health, and rehabilitative facilities for which

State and local governments are responsible. Such growth States have critical needs for such facilities and would, therefore, suffer disproportionately the consequences of the increased cost of borrowing. These needs cannot be ignored if the States are to assume their proper responsibilities. These proposals would impose unfair burdens upon those States which have the greatest needs and make the greatest efforts to solve them. The impact of this burden would be even greater as the local level with smaller communities whose credit ratings are not as well established in the bond market. Every local taxpayer in States with rapidly growing populations would pay the price of these attempts at tax reform in increased property and excise taxes.

There is one other inevitable consequence of the proposed legislation about which you should be forewarned. The constitutional doctrine of reciprocal immunity from taxes has been held sacred by both the States and the Federal Government since the drafting of our Constitution. If the Federal Government chooses to unilaterally circumvent or abort this doctrine by legislation such as this, so then should the States be free and anxious to tax the instruments of the Federal Government. This would open a Pandora's box of incalculable proportions. The negative effect on the desirability of U.S. Treasury obligations would impose the same burden on the Federal Government which this legislation would place on the States. Let us not break this delicate balance of powers which has been so wisely cherished and maintained by our forefathers.

Thank you.

The CHAIRMAN. Thank you very much.

Now, gentlemen, perhaps you didn't all hear this, but let me explain our problem to you. We have had requests by more than 700 witnesses, including some very fine and distinguished Governors who are not here today but whom you are representing, to testify before this committee with regard to things that are in this House bill.

Out of 700 witnesses we tried to limit our witness list to 300, and we have printed here every prepared statement of every witness who appears so we have each of your statements already in print and if we haven't read it we should; I have. Now, in order that these witnesses might have an opportunity to appear in a morning session while the news media are present rather than testifying sometime after 6 or 7 o'clock this evening when most of the press and television have gone home, I am trying today to have the statements-in-chief presented in this room, and the interrogation in our regular committee room, that is 2221.

Now, I should think that quite a number of the Senators here are going to want to ask questions of this panel of Governors who are representing, as I understand it, 50 Governors of all 50 States of this Union. I see you are nodding.

Governor LOVE. That is true, Mr. Chairman.

The CHAIRMAN. You are not only speaking for your five States, but you are speaking for 50 States, and that being the situation those who would like to interrogate the panel of witnesses, I am going to request to move to our regular committee room and the television and press will be represented there and then we will proceed to hear the other witnesses. But with regard to the Governors, if we don't get through with interrogation of the Governors this morning I would like to ask if you gentlemen can be available at 2 o'clock this afternoon in this room?

Senator WILLIAMS. Mr. Chairman, the Governors have been very cooperative here, their statements have been short and they are presenting a statement which is of vital importance to the States. I am just wondering, we have completed seven witnesses here this morning, and on a matter of this importance, I think that all of the members would be interested in asking questions and I think we could make better time if we proceed with a brief interrogation of these Governors right here in which we can all participate. This is of vital importance to the States.

The CHAIRMAN. I will make this proposition to you, Senator Williams, I will let each Senator ask one question and let any Governor respond to it and then we will come back at 2 o'clock or else move the interrogation over to our committee room.

Senator WILLIAMS. I have no questions myself but I thought this would be the more orderly procedure because the Governors would be interested in the comments of each of the members of the committee.

The CHAIRMAN. One of the most severe limitations put on Senators is 10 minutes on each round of interrogation, 17 Senators by 10 is 170 minutes. That would put us to about 1 or 2 o'clock in the afternoon. I would like to ask my own Governor a few questions in this matter. I have a great admiration for him. He is the first Governor in our century to be reelected, may I say. We had to change the constitution to allow it. If that is acceptable I would let each Senator ask one question.

Senator WILLIAMS. Whatever you say. I have no questions. I might say to the Governors that this is the first time our committee has ever operated under a restriction directed from the policy committee as to how much time was can have and how we can conduct committees.

The CHAIRMAN. I don't like that, but I am bound by it, and——

Senator WILLIAMS. We are not bound on this side.

The CHAIRMAN. I understand that, but we are in the majority.

Senator Byrd, do you have any questions?

Senator WILLIAMS. I just wanted the Governors to know why this is being throttled.

Senator BYRD. Thank you, Mr. Chairman.

May I put this question, which I put to the Secretary of the Treasury when he appeared before the committee? First, let me preface it in this way: This committee is faced with a dilemma, as I see it. It is important, I think, that all individuals who earn a substantial income should pay some tax to the Government. Now the problem the committee faces, as I see it, do we—well, let me say this first, if the present status of tax-exempt State and municipal bonds is changed, I believe you will agree that that will increase the cost of State and local government. Now, if that is correct, do we gain enough either in dollars or in principal to change the present status of tax-exempt bonds. I would be pleased if one or more of the Governors would respond to that.

Governor LOVE. Senator, we, I am sure I speak for not only all of the Governors here but all 50 Governors in saying, no, we don't think in balancing those kinds of equities and looking at those alternatives that it is anywhere near equal.

We have in our statements and in the printed portion here some of the specific numbers. I think that the revenues forecast from the proposed action under the House and/or Treasury approach is in the $30, $40, $50 million area, and we have many graphs, statistics that indicate that the offsetting liabilities which would fall on the taxpayers of the States and localities, primarily the property taxpayers and the sales taxpayers and so on, would exceed those numbers by great amounts, tens of times. We recognize there seems to be a surface inequity for a person to have a large income all of which is tax exempt. In order to get at that seeming inequity, to penalize the States and localities and create the chaos that is already beginning to occur in the municipal bonds market, is clearly not worth it.

Senator BYRD. You feel that it would definitely increase the costs of State and local government?

Governor LOVE. It already has. Simply the threat of taxation has increased it very materially. We have looked, for example, at the percentage of interest that has historically been paid by the tax free municipal bonds compared to a comparably rated industrial, historically it has been about 70 percent. It is now 80 and above. It is an increase not only that can be attributable to the growing increase in interest rates but also an increase that reflects the threat of taxation, the uncertainty. If taxation really did occur, we would be confident it would go up more.

Senator BYRD. Do you feel too, that it raises a serious constitutional question?

Governor LOVE. Very definitely. We haven't devoted any major portion of our testimony today to the constitutional question. We understand that you will be hearing from our attorneys general at some portion of these hearings. Nevertheless, we have each of us, I think, mentioned that there is no doubt that there is, at the very least, a serious question. I think all of us here feel that it is unconstitutional.

Senator BYRD. This matter is a very complex one for me, at least, and I want to try to plug the so-called tax loophole, but I certainly am not anxious to increase the tax burden on the average citizen throughout our Nation, in every State and county and city in the country, so I am glad today to get your appraisal and your feeling, and the feeling of the five Governors representing the 50 Governors.

As I understand, you feel it would seriously increase the cost of government in the localities and thus would work a hardship on the individual taxpayer?

Governor LOVE. Governor Evans.

Governor EVANS. Just two very brief points: One, in going back to the particular bond issue I mentioned, which is a very clear case in our own State of the problems this proposal has caused, we estimate that that one bond issue alone, which is by no means a major share of our own State's borrowing, will over the life of the issue cost the people of the State of Washington, basically the youngsters who are paying tuition or the general taxpayers if we have to go beyond tuition, some $20 million.

I think that is a very significant element and when multiplied by all of the taxing units in the country far outweighs any benefits to the Treasury.

I think the other point that is so important is that none of us, and as far as I can tell, no experts from the Treasury or from any Federal agency, really knows whether there are significant tax dodgers in terms of tax-exempt bonds because they are not reported on income tax returns.

Now, there is some conjecture that this is the case but I think very little knowledge. Those who do invest in tax-exempt bonds are in effect paying the tax of lower interest. Certainly there are better investments for them to make than tax-exempt bonds. I suspect that a large share of the income to those who have very high incomes and low taxes come from other sources rather than tax-exempt bonds.

Governor KIRK. I think by definition, Senator, if I may add, the only description you can make of this is regressive taxation. I am dead serious about ability of the States to tax income from Treasury obligations. We have our people working on that now, and that will run the costs up.

Senator BYRD. Thank you.

The CHAIRMAN. Thank you.

Working from the end of the table in this direction, I think you will have the opportunity of getting about four former Governors in succession. Senator Hansen, the newest member of our committee, is a former Governor, and I am sure he will find some sympathy with your position.

Senator HANSEN. Thank you very much, Mr. Chairman. I am very pleased to greet former colleagues of mine and for whom I have the highest regard.

I read the statements of each of you and I am very much impressed with the points you make.

I would like to ask Governor Love a question. Two of the proposals that have been made propose that the limit on tax preferences apply to State and local bond interest as well as the allocation of deductions requirements.

Now, in your judgment, does not each of these proposals make it more difficult to finance the proper operations of State government in all of the ramifications, including junior colleges, to which Governor Evans referred?

Governor LOVE. I don't think there is any doubt that that is true, Senator. I am confident, too, that we are speaking for all 50 Governors when we say that we are opposed not only to the House measure, but we are opposed to the Treasury provisions or suggestions, too.

We feel that it is vitally important that it be made clear soon, as a matter of fact, that we are not going to change the rules in midstream on the taxation of State and local bonds, because there is chaos in the market to a certain extent already. Governor Evans indicated the difficulty in the sale of that issue.

We have in the State of Colorado, I think, something like $40 to $50 million now in authorized school bond issues which are not salable, in part because again of a limitation on interest that the State has set. We are going to have things come to a grinding halt unless this issue can be made clear quickly, I believe.

Senator HANSEN. Would it be indicated, if this committee felt so disposed, to spell out clearly and unequivocally its conviction that insofar as municipal bonds are concerned, none of these provisions which tend to depress the market for this type of State financing, would be applicable.

Governor LOVE. I am sure that would be most helpful, Senator Hansen, if that can be done.

Governor TIEMANN. Mr. Chairman, may I interject a comment here. Nebraska in her 102-year history now for the first time is able to issue revenue bonds for road construction. We have now in Omaha the most beautiful ski jump in the Missouri River Valley, and we are trying to complete this thing by using revenue bonds. Suddenly we run into this buzz saw of a depressed market. Bonds for various States, subdivisions outside the State of Nebraska can't be sold.

I would surely think that a clear-cut, forceful statement from this committee would bring some semblance of order out of the chaos we have presently. I think it is an excellent suggestion.

Senator HANSEN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Fannin.

Senator FANNIN. We are pleased to have you all here this morning. You have made some very impressive statements and vital statements, I believe.

I know you are vitally concerned about the impact on the present and future issues. I am also advised we have had quite an effect from the House bill on the bonds outstanding. I wonder if you would have any specific examples in your own State as to what has happened regarding the salability of the bonds that are outstanding. Here we have $140 billion of bonds outstanding, and I have been really frightened by some of the reports that have come forth as to the salability of those bonds at the present time.

Governor LOVE. Do we have any specifics on that?

I don't think we have the specifics at this moment, Senator. But obviously the change in the interest rate on new issues is going to be reflected in those outstanding; we are not going to be——

The CHAIRMAN. I would suggest you provide that for the record? I am sure you will have no difficulty when you discuss it.

Governor LOVE. We will be delighted to do it.

Senator FANNIN. Thank you.

(Information supplied for the record follows:)

Since it is a highly technical and difficult problem to determine the loss in our market value of outstanding State and local bonds which has been occasioned by the various tax reform proposals, we have consulted the Investment Bankers Association. They inform us that, during the period from 1 January to 1 October, 1969, the total market value of such securities declined about $17.6 billion of which between $5.9 billion and $8.8 billion was conservatively estimated to be attributable to tax reform proposals. This constituted between 5.8% and 8.7% of the market value in early January, 1969. We understand that, in their supplemental testimony to be submitted to the Committee, the Investment Bankers Association will present such an estimate in detail.

The CHAIRMAN. Senator Jordan.

Senator JORDAN. Thank you.

Gentlemen, yesterday, we had testimony yesterday, from one witness, Mr. Meany, suggesting that in order to make certain that bonds would be marketable at State and local levels that the Federal Government guarantee payment of future issues of State and municipal bonds. He further recommended that the Government subsidize State and local governments for the difference in the interest rate between municipal bond rates and investors. Which of you would like to comment on that suggestion?

Governor Love. I am sure each of us would. If I can very briefly speak to the two points. The guarantee of the bond issued by the State or the local government, it seems to me, clearly would affect very little to the interest rate at which it would be sold. I simply point to the interest rate currently being paid by Government bills. I think it is about 7 at the present time. So the guarantee would add little, in my opinion. It is not the credit of the local government that is the problem, it is the interest rate.

Now, the subsidy provision, I think each of us has devoted a little time to that, pointing out among other things that it would put the State and local governments completely at the mercy of the continuing appropriations. It is my understanding that this body can't bind future Congresses, and there would be no certainty in our mind, no legal guarantee, that the amounts, and they would be very large amounts, would be forthcoming, and the marketability would therefore be hurt.

I also would suggest that the amount of such a subsidy would be large enough that you would find it difficult to fit within what I believe, I have been informed, is a rather tight and stringent budget situation.

Senator Jordan. What do you calculate the difference between municipals and industrials of the same grade to be now on the market, Governor?

Governor Love. As of yesterday, I think, the Bond Buyers' Index as of the 18th, you correct me here Charlie, shows an interest rate of 6¼ percent. As of the 22d, 7.44, on Moody's.

Mr. Schwan. The first of course is municipals, the second is the industrials, and the difference is what you are asking.

Governor Love. The difference, then we are talking about, is a 6¼ on a municipal, and a 7.44 on a comparably rated industrial bond. This indicates about, contrary to the roughly 70-percent relationship that has existed, the municipal rate is 84 percent of the industrial.

Senator Jordan. And you ascribe that sudden increase in the cost of financing municipals partly to the activities of the Congress in treating this subject.

Governor Love. Yes, indeed. I think there is no other way to account for it, that the investor in making his decision about whether he will buy a 20-year bond has a certain justified concern that perhaps that interest will no longer be tax free and he, therefore, cranks that into his decision about what he is willing to pay.

Senator Jordan. Thank you.

Thank you, Mr. Chairman.

The Chairman. Senator Talmadge.

Senator Talmadge. Mr. Chairman, I have no questions. I do want to congratulate each of you distinguished Governors on your statements. I think you made very impressive statements.

The Chairman. Senator Curtis.

Senator Curtis. Mr. Chairman, I just want to thank these busy Governors for appearing here in behalf of all their constituents and I will waive questions.

The CHAIRMAN. Senator Anderson.

Senator WILLIAMS. No questions, except to thank the Governors for being here, and concurring in what Senator Talmadge said in saying that you made an excellent case.

The CHAIRMAN. I just want to ask one question which didn't occur to me until we met today. Governor McKeithen can comment on it if he wants to. The best I can make of it is that in the effort to make up about $80 million over a long period of time that the provisions would phase in, actually means in effect that every State in this Union will be required either to raise taxes or to reduce services.

Governor MCKEITHEN. Senator Long, it will wreck us in Louisiana if this bill is enacted. It will wreck us in our State. For all of our construction, we will have to come back and ask for additional sales taxes and gasoline taxes. The very people I think this committee would like to help are going to end up picking up the tab.

The CHAIRMAN. Now, let me ask this further question. Do any of you Governors know any source of Federal revenue that is being directed toward you at the present time that doesn't have some kind of Federal strings attacked to it?

Governor MCKEITHEN. That is another point I made, Senator Long. We feel if the Congress adopts the subsidy plan we think clearly we will be told where we can spend, where we must spend every dollar, how it must be spent. We would like to avoid that if we possibly can.

The CHAIRMAN. I know President Nixon has suggested that we should start sharing some revenue with the States, no strings attached. I am also aware of the fact every time somebody becomes a great enthusiast for his particular program he wants to put a condition on it that no money will go to any State government unless the State does what the Federal Government thinks what it ought to do. Whether we can ever have a Federal aid program with no strings attached remains to be seen. We might try it but I for one think it will have to be tried and proved before we can believe it.

If I were the Governor, I would take the view that, "Thanks just the same for your offer of a subsidy but we would just as soon that you let the whole matter drop."

Governor MCKEITHEN. That is our position, I think, Senator Long.

Governor EVANS. Mr. Chairman, one other point that has not been brought up. We happen to have in the State of Washington an exceptionally high amount of investments already, we have very high unemployment compensation reserve funds, we have very large teachers' retirement funds and State employees' retirement funds and we have over a billion dollars of securities we own as a State in trust for these various funds.

The wreckage of the municipal market has sent down the value of those investments we now hold in trust. Because we have the authority to invest in municipals ,we hold a great many of them of other States, other municipalities. The decline in their value is something else that has happened without even the passage of this act, but with merely the threat of it. The passage, I am sure, would hamper us on a very long-term basis in that very important field.

The CHAIRMAN. Do any of you gentlemen know——

Governor KIRK. Following Governor Evans' answer, I wonder if I might ask the committee a question myself since as a financial analyst I can tell you the minute you get a positive statement out of this committee the market will turn and we will be happy and joyous again, how early might we get an early positive statement from this committee? [Laughter.]

Because every day is costing Florida money.

Governor EVANS. We have got some bonds to sell.

The CHAIRMAN. It will be right soon.

Governor KIRK. How about now? [Applause.]

The CHAIRMAN. I can only speak for myself. Stanley Surrey is the initiator of this scheme and he is supposed to be here to testify for it tomorrow, and so far as I am concerned tomorrow will be soon enough.

Senator CURTIS. Mr. Chairman, we might call attention to the fact we cannot bind the Senate.

Governor KIRK. I understand that, Senator.

Senator CURTIS. Nor can we bind the conferees.

Governor KIRK. But I will tell you the team speaks strongly now.

The CHAIRMAN. I want to ask you one question. You gentlemen represent the Governors in the Governors' conferenc [illegible] you know of any Governor who favors this deal where we put t [illegible] on and then proceed to subsidize it?

Governor LOVE. No.

The CHAIRMAN. In other words, your reaction is that you are not asking for the subsidy and you would appreciate being left alone on the tax, I take it that is your attitude?

Governor LOVE. Yes.

The CHAIRMAN. That is true.

Senator Miller is recognized for 5 minutes.

Senator MILLER. Thank you very much, Mr. Chairman. I appreciate the fine statements we have had from the panel, and I would just add this as a point, that I assume the panel would instead of merely a statement out of the committee indicating its position, infinitely rather have action by the Congress as a whole on the tax bill which would put Congress on record on this point.

Governor KIRK. No question about it.

Senator MILLER. The sooner the better.

Governor KIRK. But the market would turn tomorrow just by a positive statement of this committee.

Senator MILLER. Now, we received testimony from the Treasury representatives indicating that if tax-exempt municipal bond interest was included in this so-called limit on tax preference approach, which would enable us to assure the taxpayers of this country that nobody could invest all of their money in tax-exempt bond interest and receive a large amount of income without having to pay some Federal tax, that if we did this, this would amount to a tax of about $35 million, and that the total interest take by individuals would amount to about $2 billion, so that we would have an impact of $35 million of tax on a $2 billion annual payout. Now I can well understand the uncertainty of the market and I can well understand the concern of the

Governors with respect to this tax and subsidy approach about which Governor McKeithen was most persuasive.

I can understand the uncertainty and concern if we tax the securities purchased by banks. But if you look at only the limit on tax preference item and realize this is a $35 million impact out of a $2 billion payout, if there is nothing more to it than that, I am wondering how severe this impact really would be. I am wondering how uncertain the market would be if that is all there is to it.

Now, I will grant you, you add up all of the provisions of the House, and I can well understand the market situation and I can well understand the concern that you have and I have, too, with respect to the Federal Government getting into a position of eventual control, but if we are only going to talk about the limit on tax preferences which would enable the Congress to go before the people and to say to the general taxpayers, "No longer are you going to pick up stories in the newspapers indicating that somebody has $200,000 of income and hasn't paid 1 red cent to the Federal Government for all of the services that the Federal Government is supplying that person." I am wondering if we are talking about a very serious problem. I am wondering if that was all there was to it, and you were able to forget about all these other little goodies in the tax bill of the House, if we wouldn't come out to a fairly good balance on this preserving the interests of the States.

Governor KIRK. No one has ever proven your statement, though. No one has even proven your statement, Senator, that there are those who are making this horrendous profit and that their entire portfolio is made up of municipals.

Senator MILLER. I must tell you that we have testimony of the Treasury officials on this.

Governor LOVE. Even assuming this is true, I think I can safely speak for all the Governors in saying we would still be opposed. Even if you say it is going to have a limited effect and will only generate some 35 million, it nevertheless throws, it may be psychological to a certain extent, whatever it is it throws, a cloud upon the tax-free status of the bonds. I think that the most persuasive thing is even without anything being done now that already the thought that bonds could be taxed has made a great difference in the market.

Governor KIRK. We could take the same theory in Florida and say why don't we tax income on Federal paper, and that is exactly what we will have to do and that is what we are preparing to do now.

Senator TALMADGE. Mr. Chairman, if the Senator will yield at this point. There is one point which has not been made. While people who have a portfolio of municipals and nothing else may avoid the Federal income tax it has not been pointed out last year, the rate of inflation was 5 percent, this year the rate of inflation is 7 percent. While they may avoid income taxes to the Federal Government they are losing the corpus of their investments.

Governor LOVE. That is right.

Governor KIRK. Further than that there is the estate tax which they pay ultimately.

Governor MCKEITHEN. I think, Senator, you ought to remember who is going to pick up that tab, who is going to pay that additional high interest. It will be the man who paid the sales tax, the man who paid the gasoline tax.

Senator MILLER. The point I am making is that I can't see that there is going to be much, if any additional tax if you only got a $35 million impact on a $2 billion annual payout.

Now, the point the Senator from Georgia has made to me is perhaps the most important factor in the uncertainty of the municipal bond market, but I am trying to get this down to a matter of perspective, and I must tell you one reason we have this before us is because there is substantial sentiment, as you well know, certainly not from this source, but they are on the Hill and elsewhere, to make these bonds wholly taxable. When you have the president of the AFL-CIO coming before this committee and advocating that and when you have other Members of Congress advocating complete taxation of this interest, this is something I think is very serious, and I would like to see some way of getting this problem resolved, once and for all.

Governor KIRK. No one has ever accused Mr. Meany of being a financial analyst and I am quite serious about this thing. The way it is being proposed, you have a regressive tax facing the poor people of Florida and they are really poor.

Senator MILLER. We don't say Mr. Meany is a financial analyst.

Governor KIRK. He is part of the problem.

Senator MILLER. But they have a lot of political power and I can't take the——

Governor KIRK. We can. We are working for the people.

Senator MILLER. I am saying for the sake of getting this problem off the books, a $35 million bite out of $2 billion annually.

Governor KIRK. Senator, Mr. Meany doesn't worry us.

Governor LOVE. If that is all, Senator, that it did accomplish was to provide in that great grouping $35 million in tax it is not worth any substantial risk in upsetting what has worked well and what we need to continue to have working well as far as the financing of our State and local governments.

The CHAIRMAN. May I just put one question here that is of concern to me? During this generation we have seen a great deal of powers and functions of State governments stripped away by Federal control. Now in some States there has been a lot of complaint about that. I know it is true in Louisiana, and I am sure it is true in some others. But most of that had been done without asserting the taxing power to do it, and most of it has been done by court decisions and things of that sort, in some cases asserting the regulatory power by the Government. We are well aware the power to tax is the power to destroy.

Do you five Governors, speaking for 50 Governors, see in this proposal for the Federal Government to tax State and local bonds, and instrumentalities of State and local governments, something of a threat to what little sovereignty still resides in the 50 States of this Union?

Governor MCKEITHEN. No question about that, Senator. I had "sovereign" in my statement and I struck it out because of my being from the Deep South. Yet we come up here with sovereign rights again. There is no question about that, particularly if you start subsidizing us and paying the interest for us you know we will be told then how to spend the money.

Governor EVANS. I think whether it is allocation of deductions or limitation on tax preference or subsidy, any of those, or all of them, and even the portion of it that Senator Miller mentioned, it is a breaching of the gap. We can lay out, and the Treasury can lay out, all of the nice figures they want to; they can't change the psychology of the bonds market. It is going to cost the citizens of the States, the little guy, a lot more money than he is paying now. As far as I am concerned, in direct answer to your question, I will testify tomorrow on revenue sharing, and I think I speak for all the Governors in being in favor of revenue sharing, but if it ever came to the point of trading, I think we would be buying a bum deal to get revenue sharing even on a very extensive basis in trade for any portion of taxation of municipal bonds.

The CHAIRMAN. Senator Hansen.

Senator HANSEN. Mr. Chairman, it seems to me that the central question we ought to be asking ourselves is simply this: How can we assure the 200 million people in this country that every person is paying some tax? We are talking amont 154 persons who are very wealthy and who reportedly paid no income tax last year. Bnt, in order to gain the slight advantage that we would seemingly gain by imposing this limit on tax preferences and the allocation of deductions, we are jeopardizing $140 billion worth of revenue that goes to all of the 50 States. I think we just have things completely out of perspective.

I don't agree at all that it makes sense to impose these extra limitations on municipal bonds and have all citizens suffer in order to gain the satisfaction of telling a few individuals they are going to have to pay a lot more taxes. [Applause.]

The CHAIRMAN. I regret it but we are not permitted to have demonstrations in this committee room. [Laughter.].

If we were I would be applauding myself. Go ahead.

Senator HANSEN. I was just going to conclude by saying that I don't think we ought to make such a foolish move in order to gain the slight advantage that seemingly would have accrued to us by jeopardizing this very vital function of the financing of all of the 50 States.

Governor KIRK. I point out too that the States can retaliate and if you want to finance New York State you are in trouble.

The CHAIRMAN. As a practical matter if we start doing this to the States don't you have the right to start taxing our bonds?

Governor KIRK. That is what I am telling you they haven't said that before and if you want to finance New York State you are wrong.

Senator WILLIAMS. Is it not true, it is not so much the $35 million tax that would be imposed that is creating this problem, as it is the uncertainty in the minds of investors as to what this Congress or some future Congress would do once we take the step in that direction?

Governor LOVE. I think that is absolutely right. Once the wall is breached, once we violate this immunity from taxation of the two sides of our federal system, I think it opens a Pandora's box and undoubtedly leads to uncertainty in the investors' minds.

Governor TIEMANN. These 154 people who have these great holdings of municipals, or the banks that hold so many municipals, are trying their hardest to get rid of them and they can't find the market for them. The secondary market in municipals, when everything is good, is bad, and now it is completely demoralized. I think, to sum up what has been said here and the sentiments of, I think, everyone, once you breach or violate reciprocal immunity then you have sold part of your soul and it is not worth it.

The CHAIRMAN. I want to indicate this, the 50 Governors indicated their willingness to testify here on this matter but agreed to let your testimony speak for them. You have presented a magnificent case and I think that would be the judgment of every member of this committee. I would say to the other 45 Governors who were not present here that they had been represented by the utmost of logic and dignity and I do think that in view of the threat that exists to State governments in this bill you have been most restrained in the way you have presented your case. As chairman I appreciate it very much and I am sure I speak for the entire committee.

Governor LOVE. Mr. Chairman, we are most appreciative of the time you have given. We appreciate the stringencies of your time and we appreciate the fact you have heard us out with patience and courtesy.

Thank you very much.

The CHAIRMAN. Thank you very much.

(Prepared statement of Hon. Claude R. Kirk, Jr., follows:)

STATEMENT OF HON. CLAUDE KIRK, JR., GOVERNOR, STATE OF FLORIDA

SUMMARY

Changing the historic tax exempt status of municipal bonds will reflect on the integrity of our government.

Proposal to subsidize a portion of interest costs would lead to Federal control over state and local borrowing and would be in conflict with President Nixon's goal of decentralizing authority and responsibility.

Proposals would increase the cost of borrowing to communities and would result in increased taxes at state and local levels.

The effect on growth states would be particularly harmful due to their critical need for financing.

If doctrine of reciprocal immunity from taxes is violated by Federal Government, it will lead to similar action by states to tax United States Treasury obligations.

STATEMENT

Gentlemen, we are all here today to consider a matter far more basic than the details of a proposed tax bill. Changing the historic tax exempt status of municipal bonds would have a deep and penetrating consequence which we should recognize, and that is loss of faith in the integrity of our government.

Even while Congress has been discussing the enactment of a law to tax interest on state and local security, we have seen the steady deterioration of the investing public's confidence in their value.

It is time, once and for all, to lay this matter to rest, by deciding to abide by the assurances given all states over fifty years ago when the Income Tax Constitutional Amendment was submitted to the states. That assurance was that the Federal Government could not and would not directly or indirectly tax this income source, and we now find ourselves faced with the very thing the states were assured would never happen.

This is a breach of faith which, if permitted, would destroy the very foundation of our Federal system; that is, sovereign status but mutual trust in each other.

Another trust which is even more important than that between governments is the trust of the people in their government at all levels, Federal, state, and local. All too frequently this trust has been violated and this proposal flies in the face of assurances, given time and time again, that the Federal Government will not tax the interest on local and state bonds. Credibility of the Federal Government has too frequently been successfully attacked, and I am sure you do not want to add to this credibility gap.

If you now take the back door approach by indirectly taxing state and local bonds, the investing public will be forewarned that the fiscal integrity of the states no longer exists. The results will be chaotic.

The proposal to "subsidize" a portion of the interest costs accruing to the states and local governments, if they agree to issue taxable bonds, would give the Federal Government in Washington control over all such state and local borrowing for capital outlay programs. The effect of this proposal would be increased Federal control rather than increased Federal revenues, although offered under the guise of "tax equity." Federal regulations and the necessity for prior Federal approval will inevitably result.

President Nixon has emphasized the importance of the "New Federalism" under which the states will be called upon to assume an increasing share of the responsibility for providing the public services citizens have come to expect from their government. These tax proposals, by shifting authority and control of capital outlay borrowing to Washington, and by making it more difficult and costly for state and local governments to do their job of building needed public facilities, are in conflict with the goal of decentralizing authority and responsibilty as urged by the President.

The minimum income tax and the allocation of deduction proposals, as they relate to the interest on state and muncipal bonds, would increase the cost of borrowing for the needed improvements for which state and local governments are responsible and would, therefore, necessarily increase state and local taxes. These higher taxes would have to be paid by the same taxpayers supposedly being benefited by the so-called tax reform package. Every taxpayer in America would have to pay more taxes to his state, county, school district, and city if these proposals become law, thus increasing tax inequity in the name of tax equity. The increased cost which would have to be paid by the taxpayers under these proposals would be in excess of the amount of additonal revenue to be collected by the Federal Government under these indirect forms of taxation of presently tax exempt bonds. The total cost of government to the taxpayer would thereby be increased.

The effect upon growth states, such as Florida, would be particularly harmful, because of the great need for financing education, anti-pollution, transportation, health and rehabilitative facilities for which state and local governments are responsible. Such growth states have critical needs for such facilities and would therefore suffer disproportionately the consequences of the increased cost of borrowing. These needs cannot be ignored if the states are to assume their proper responsibilities. These proposals would impose unfair burdens upon those states which have the greatest needs and make the greatest efforts to solve them. The impact of this burden would be even greater at the local level with smaller communities which are not as well established as credits in the bond market. Every local taxpayer in states with rapidly growing populations would pay the price of these attempts at "tax reform" in increased property and excise taxes.

There is one other inevitable consequence of the proposed legislation about which you should be forewarned. The Constitutional doctrine of reciprocal immunity from taxes has been held sacred by both the states and the Federal Government since the drafting of our Constitution. If the Federal Government chooses to unilaterally circumvent or abort this doctrine by legislation such as this, so then should the states be free and anxious to tax the instruments of the Federal Government. This would open a Pandora's box of incalculable proportions. The negative effect on the desirabilty and marketability of United States Treasury obligations would impose the same burden on the Federal Government which this legislation would place on the states. Let us not break this delicate balance of powers which has been so wisely cherished and maintained by our forefathers.

The CHAIRMAN. Senator Baker?

We will next hear from Senator Howard Baker, a very busy man.

Senator, I know how it is to run for these party jobs and the tremendous time that is necessary. [Laughter.]

I can also tell you how it works out sometime, both ways.

STATEMENT OF HON. HOWARD H. BAKER, U.S. SENATOR FROM THE STATE OF TENNESSEE

Senator BAKER. Mr. Chairman, I will do my very best not to reply at all one way or the other in that respect.

Mr. Chairman, and members of the committee, thank you very much. I appreciate the opportunity to appear here today and to testify in connection with one of the most vital fiscal matters that will address itself to the nature of federalism in the next several years.

Another matter that is of almost equal importance will come up today with the introduction of the Administration's Federal revenue-sharing bill on the Floor of the Senate which I am sure this committee will delve into very deeply indeed as time goes by.

If I may, I will at this time continue with my statement, Mr. Chairman.

Mr. Chairman, the Tax Reform Act of 1969 contains three sections which, if enacted, may adversely affect the ability of State and local governments to meet their capital requirements. The first would impose a limitation on certain tax preferences, including among such preferences interest on state and local securities. The second would require that individuals allocate their deductions between taxable and tax-exempt income, including interest on municipal bonds. The third would permit State and local governments to issue at their option taxable bonds, a portion of the interest on which would be paid by the Federal Government. In my judgment, these three provisions should be deleted from the House-passed bill.

As I have stated on numerous occasions, I believe that the immunity of State and local governments in the exercise of their legitimate functions from Federal taxation is necessary for the preservation of our constitutionally delineated dual sovereignty form of government. I further believe that if the Congress undertakes to encroach upon the tax exemption of State and local securities, it inevitably has the power to control State and local financing and without self-control of its own financing, no government can continue as an independent and autonomous body.

The Tax Reform Act is designed to provide a more equitable distribution of our tax burden. I support this legitimate objective. However, in attempting to insure a more evenhanded distribution of the cost of supporting our Government, we must consider not only the fair distribution of the Federal income tax burden but also the fair distribution of the total tax burden—Federal, State, and local.

It is apparent that the limit on tax preferences and the allocation of deductions provisions will, if adopted as passed by the House, result in an increase in municipal interest rates to levels close to those of corporate bonds of similar credit quality. In fact, since the House Ways and Means Committee opened hearings on this question, investment yields on new issues of local government AA-rated bonds have risen 70 base points or from about 5.50 percent to 6.20 percent. If the tax exemption is breached, investors would have little confidence that the advantages to them of holding tax-exempt securities would not be whittled away further, and they would, of course, demand higher interest rates to compensate them for the higher risk in purchasing these securities. As the cost of borrowing increases, State and local taxes, primarily property and sales taxes, will also increase, and the burden of thee taxes falls disproportionately on those in the low- and middle-income groups. Therefore, if the objective is to provide a more equitable distribution of the total tax burden, as I believe it is and should be, then the Congress should not revoke or alter this tax exemption in such a way as to increase the cost of borrowing to State and local governments.

It would be particularly unfortunate to increase the cost of borrowing at this time when the current operating revenue needs of State and local governments are such that proposals for Federal revenue sharing are being seriously advocated and widely supported. I believe that the provisions presently in the bill adversely affecting municipal financing are inconsistent with the concept of revenue sharing and the objectives it is designed to achieve. Underlying my strong support for both retention of this tax exemption and the enactment of revenue sharing is the basic conviction that strong and financially viable State and local governments are essential both to a healthy federalism and to the best possible performance of Government services.

I would like to make one additional point. A considerable amount of the sentiment for tax reform stems from the testimony given by former Secretary of the Treasury Joseph Barr concerning 154 individuals who in the year 1967 had adjusted gross incomes in excess of $200,000 yet paid no Federal income taxes. Unfortunately, the impression was allowed to form that this was accomplished to a large measure through municipal bond ownership, even though the data submitted by former Secretary Barr did not include interest on State and local securities among the tax-reducing factors utilized by the 154 individuals. Interest on State and local securities is not included within gross income and consequently does not appear at all on the income tax return. For this reason it is most difficult to determine the degree of tax avoidance by individuals holding State and local bonds.

A possible solution to this lack of data might be to require individuals and corporations to disclose on their income tax returns the amount of interest received from tax-exempt securities. If this information were to indicate substantial abuse of this exemption, then I would support a reasonable legislative solution designed to alleviate the problem without adversely affecting the ability of State and local governments to meet their capital requirements.

Mr. Chairman, this point was made very strenuously by Governor Evans, by Senator Miller, and by others in previous testimony.

I would add one addendum that I believe was touched on by the Chairman and possibly by others, including Senator Williams, I believe. The uncertainty of the fate of tax-exempt bonds, State, county, and city, is such that at this moment there is virtually no municipal bond market, and the capital borrowing authority of local governments is practically nonexistent at this point, primarily because of uncertainty.

If there is continuing uncertainty by reason of an encroachment in the nature of a minimum income tax at this point, then I think the bond market will continue to suffer, and correspondingly the ability of State, county, and local governments to finance their needed capital improvements will also suffer.

I believe we must come to terms with this particular aspect of the problem but frankly I do not think we have the data at hand to make an intelligent judgment.

In conclusion, Mr. Chairman, I earnestly feel that we are dealing with the heart of the nature of federalism, and that if we can't devise a way to preserve the independent fiscal status of the now semiautonomous lesser units of government, then I think we have struck at the very basis of governmental balance in this country, and if we are not very careful we will create an unwanted and an unwarranted additional burden of taxation through regressive taxes, by and large, on that class of people least able to afford to pay it, the wage earner, the low-and middle-income groups of this country.

Thank you very much.

The CHAIRMAN. Thank you very much, Senator Baker.

Senator Miller?

Senator MILLER. I take it that the thrust of your comment with respect to this limited tax reference and allocation of deductions is that the $35 million of revenue, on the one hand, and the $45 million, on the other hand given us by the Treasury represents soft figures, and before we move on this we ought to have what we call hard evidence based upon accurate statistical surveys.

Senator BAKER. I think you are entirely right, Senator Miller. As long as there is no inclusion of tax-exempt securities in the gross taxable income or as a declaration of nontaxable income on corporate and individual tax returns, it is, it seems to me, impossible to make a fair judgment of where we stand in this respect.

That is now the law. I think it very possibly should be the law, and that income be included, although not taxable, so we later can make a judgment in a more dispassionate way.

The CHAIRMAN. Thank you very much, Senator. We will be discussing it with you further on the floor of the Senate if we ever get it out there.

Senator BAKER. Thank you.

The CHAIRMAN. Now, the next witness will be the Hon rable C. Beverly Briley, who is the mayor of Nashville, Tenn., and president of the National League of Cities. He was to be accompanied by Mayor Tate who at this moment is tied up in conference, and I believe it was suggested that Mayor Ilus W. Davis, mayor of Kansas City, should accompany him on this panel to discuss this same problem as it affects the cities.

STATEMENT OF HON. C. BEVERLY BRILEY, MAYOR OF NASHVILLE, TENN., AND PRESIDENT, NATIONAL LEAGUE OF CITIES; ACCOMPANIED BY PATRICK HEALY, EXECUTIVE DIRECTOR, NATIONAL LEAGUE OF CITIES

Mayor BRILEY. Mr. Chairman, and gentlemen, I am going to abbreviate my statement considerably because the Governors so adequately covered the subject as it applies to cities.

As you announced I am the president of the National League of Cities and the mayor of Nashville, Davidson County, Tenn., and I am representing more than 14,600 cities in this country.

The CHAIRMAN. Incidentally, Mayor, your entire statement will be printed and what you say in addition to your statement will also be in the record.

Mayor BRILEY. Thank you, sir. We have not a great many mayors here to testify, for brevity, but we could have most of the 14,600 come if it was desired because all of us recognize the terrific impact of H.R. 13270's provisions upon our fiscal activities.

The CHAIRMAN. Yes.

Mayor BRILEY. Principally, what gives us this great concern stems from the important role that cities have had in the federal system of government, a role designed by the patriotic forebears of our time, who preserved this for us. There is very good evidence of the wisdom of the system, and there is no question about it, we have had at least some semblance of an organization whereby we could independently finance our local affairs in a free marketplace. But if we take a look at the market conditions since it was first announced that taxation of State and local bond interest was going to be an open question in the House Ways and Means Committee last fall, you will observe that the bond market took a serious stumble and has gone completely since that period of time.

Tax exemption is very important for many reasons. First, as I have mentioned, it is important to preserve our federal system of government.

Second, the principle of tax exemption has created an independent source of capital upon which cities, counties, and, of course, the States can depend and successfully compete with the other elements of the capital market. It is the only way we can compete in that broader market.

And, third, it has kept the facilities that we have to provide for our citizens at the lowest possible financing cost.

We could not very well compete in the bond market against A.T. & T. and the other corporations because their revenues are a whole lot more certain than the revenues we have for a schoolhouse we build or a highway that we build.

The equity question bothers us particularly.

It has been estimated that there could be maybe even as much as $80 million of income to the Federal Treasury through the LTP and ADR. But our studies indicate that the costs that we would have to pass on to the property taxpayers will run better than $150 million annually if this bill should pass. So we have a great deal of concern as to whether or not we should upset a delicately complex market that we know has worked, and worked very well during all these years in order to try to reach a few rich people.

We are going to pass this tax on actually to the poorest people in the Nation, the property taxpayer, the water user, and others. Gentlemen, we are all faced with the inflationary costs of construction. We are faced with this tremendous costs of environmental pollution and the need to physically rejuvenate our cities. Must we also add to these costs, additional interest costs and pass them along to the water consumer, and the property taxpayer, in order to provide what some have falsely called equity? We are doing a complete disservice, and I do not believe that we are talking in terms of tax equities if this is going to be the inevitable result as is now very obvious.

So we, following what the Governors said, add our amen.

We are opposed to the idea of the Federal subsidy. I think there are two very good basic reasons for it. In the first place, I don't think that any of us could agree that the Federal Government should completely underwrite all the bonds that every State, city, and other community might want to issue.

This suggests there would have to be some regulations involved, and that means we would shift some control outside of the local citizenship and the citizens in determining local prioriteis and what facilities are truly needed.

Second, we also, of course, are concerned over the fact that there would not be anything binding about this program, and we would have to rely upon future Congresses to continue the program and fund it.

We also believe a large number of smaller communities will not be able to market their bonds at all under the provisions of the subsidy program and there will have to be billions of additional dollars in Federal grants to those communities.

Even when the market was a normal market, in a good many instances the local banks were the only purchasers of bonds of small communities although it was competitive it was really a negotiated basis in order to have the funds available in the community in order to maintain a viable economic climate. Anything that would upset this degree of balance would drastically upset the basis of our Government.

We think ultimately we would be calling upon the Federal Government to participate far more heavily than any of us are willing to accept.

I will now let my colleague from Kansas City speak and then be available for any questions that you may have.

The CHAIRMAN. Mr. Mayor, have you seen the summaries that have been prepared by our committee on the testimony which has been presented?

Mayor BRILEY. No, sir; I have not.

The CHAIRMAN. I want to send you a summary and let you take a look at the summary of your testimony.

Mayor BRILEY. Incidentally, I have an article written by our executive secretary, Mr. Patrick Healy, that has been reproduced in the Congressional Record. I do want to file that because it was not filed in my statement.

The CHAIRMAN. Without objection.

(The article and Beverly Briley's prepared statement follow:)

THE ASSAULT ON TAX-EXEMPT BONDS

(By Patrick Healy)

"Property taxes will be increased 6 per cent across the board; charges to water and sewer users will have to be raised 10 per cent."

This statement by the mayor of one large midwestern city indicates what would be the effect on his city of making municipal bond interest subject to federal taxation. Similar effects will be felt throughout the country. Thus, hundreds of thousands, perhaps millions of homeowners, water users, and other users of local government services would be taxed under the terms of the hasty, ill-considered, and fundamental changes to the whole federal system contained in the innocent-looking tax bill recently passed by the United States House of Representatives. We hope that the Senate will remove from the bill what could cause a true "taxpayer's revolt" of mammoth proportions.

How did this alarming prospect come about? Not by a frontal assault on the immunity of the state and local government bonds from taxation by the federal government, as has failed miserably in the past. Rather, this time, a more devious device has been used to include income from municipal bonds in calculation of a minimum income tax on individuals (but not as yet on corporations). This takes form in the so-called "limit on tax preferences" and in the "allocation of deductions"—very technical and difficult to explain to members of Congress, not to mention the great mass of homeowners and other voters.

But the result of causing higher municipal bond interest costs to local taxpayers is the same, whether using the frontal assault or the devious device. Indeed, the mere announcement of decisions by the House Ways and Means Committee caused a major upheaval in the municipal bond market as investors in municipal bonds lost their confidence in the durability of tax exemption. Bond yields, already pushed to record high rates by the present inflationary character of the economy, jumped an additional ½ of 1 percentage point in response to Ways and Means Committee decisions, quickly ratified by the whole House.

The tax exemption of state and local government bonds has never been under such sustained, heavy attack from so many quarters. By riding the crest of an unprecedented public demand for general reform of the federal tax structure, itself an unquestionably laudable objective, the opponents of the tax-exempt status of state and local bonds, or "municipal bonds" as they are commonly called, have made considerable headway toward overturning the traditional, in fact historical, tax-free status of these bonds. These opponents have based their attack principally on two arguments:

1. That the federal government loses more tax revenue through tax exemption of municipal bonds than states and localities gain in lower financing costs which result from the tax-exempt feature of the bonds, and,

2. That the tax-exempt feature is some kind of major "loophole" in the federal tax system, the closing of which will produce greater tax equity.

Much of the misunderstanding with regard to the loophole question has come about from lumping tax exemption together with such currently unpopular tax avoidance devices as unlimited charitable contributions, accelerated real estate depreciation, hobby farming, mineral depletion allowances, and the like. Municipal bond interest is distinct from these other tax benefits in that it relates not to economic policy but to a constitutionally delineated sysem of government operation.

Now comes a new approach in the form of concern for the ability of the state and local governments to find a large enough market for their tax-exempt bonds to meet rising capital needs.

In the May-June, 1969, issue of Tax Policy, Professor Stanley S. Surrey of the Harvard Law School argues that a probable high level of new tax-exempt bond issues over the next decade will raise serious problems for states and localities in reference to their ability to raise capital funds, and raises problems for the equity of our federal tax system. He goes on to state that this rapidly increasing volume based on the tax-exempt privilege creates a powerful buyer's market that works against states and localities as they realize less and less advantage from the tax-exempt privilege. He also states that as interest rates increase as a result of this phenomenon, bond buyers will get even greater tax savings from their investments. He then calls on those interested in the financing plight of state and local governments to consider whether new financing techniques are available and appropriate to the needs of bond issues.

This subject is of paramount importance to citizens and government officials alike, and I am delighted to be accorded the opportunity to respond to the case put forward by Mr. Surrey. He has been regarded by many as among the foremost opponents of the tax-exempt feature of state and local bond financing. He does not, however, understand the complexities of the market place for securities issued by the state and local governments, nor does he appreciate the intricacies of intergovernmental finance which so clearly underlie discussions of proposed alternative financing methods as well as the basic rationale for tax exemption

CAPITAL FINANCING NEEDS IN PERSPECTIVE

State an dlocal debt outstanding has increased by 89 per cent since 1960. Unquestionably the greatest need for public improvement expenditure has existed recently and will continue to exist at the state and especially at the local level. While there does loom ahead a substantial increase in state and local capital borrowing the identifiable trend in this area does not warrant alarm.

Mr. Surrey estimates that net additions to tax-exempt financing will, within ten years, total two to three times the present net level of approximately 10 billion per year. He does not mention, however, that the present volume of municipal finanicng is, if anything, lagging somewhat behind the level projected by the Joint Economic Committee of the Congress in 1966,[1] certainly the most comprehensive and most recent estimate available. Table 1 shows three sets of actual and projected underwriting figures for the period 1960–1975.

TABLE 1

[In millions]

	Growth at at 8.7 percent	Growth at 10 percent (Surrey)	Actual	Joint Economic Committee
1960	$7,230	$7,230	$7,230	
1961	7,859	7,953	8,360	
1962	8,543	8,748	8,558	
1963	9,286	9,623	10,107	
1964	10,094	10,585	10,544	
1965	10,972	11,644	11,084	
1966	11,927	12,808	[1] 10,589	$14,200
1967	12,965	14,089	[2] 12,988	14,900
1968	14,093	15,498	[3] 14,044	15,700
1969	15,319	17,048		16,600
1970	16 652	18,753		17,600
1971	18,101	20,628		18,600
1972	19,676	22,691		19,500
1973	21,388	24,960		20,800
1974	23,249	27,450		21,800
1975	25,272	30,202		22,700

[1] Excludes $500,000,000 industrial aid financing.

[2] Excludes $1,300,000,000 industrial aid financing.

[3] Excludes $1,600,000,000 industrial aid financing, and $730,000,000 anticipatory financing to avoid provision of Revenue and Expenditure Control Act of 1968, Watson amendment in California, and similar measure in Oregon.

As shown in Table 1, Mr. Surrey estimates a growth of new issues of 10 per cent during the most recent period when, in fact, excluding industrial aid financing which for all practical purposes has now been terminated by the Revenue Control and Expenditure Act of 1968, the true growth of the most recent period is approximately 8.7 per cent. That does not at first glance seem to be a major differential; but by 1975, assuming a base of $15.0 billion normal financing this year, underwriting volume would be overstated by 7.4 per cent. By 1980 underwriting volume would be overstated by 14 per cent.

The important point, as economist Sidney Homer has stated. is:

> A basic rule of economics is that that "human wants are infinite." Nobody thinks of estimating next year's Gross National Product by adding up everything that everybody will want. Similarly it can be said that "Capital requirements are infinite," or that "State and municipal requirements are infinite." The determining factor of the volume of new facilities that will be created is not need; the limiting factor always is somebody's ability and willingness to finance new facilities and somebody else's ability and willingness to service the debt. Facilities are very expensive. Taxes are already high. Construction on credit costs vastly more than pay-as-you-go construction. Therefore, in explaining the moderate volume of state and municipal financing in recent years and in estimating its future volume, a catalogue of needs or wants (while useful) is not as important as an estimate of the future taxability of the community and the cost and availability of credit.[2]

[1] *State and Local Public Facility Needs and Financing,* Study prepared for the Subcommittee on Economic Progress of the Joint Economic Committee, 89th Congress, 2d Session, Washington: Government Printing Office, 1966. The National League of Cities, in conjunction with the Urban Institute, is currently engaged in updating data on anticipated capital outlays of states and municipalities through 1975. Data from this study are not yet available.

[2] *Ibid.,* Volume 2, pp. 276–77.

Thus, capital expansion by states and localities is tempered by the law of supply and demand and by sound financial planning and establishment of priorities by public officials. The plain truth of the matter is that, as has been true in the past, the highest priority water pollution problem, school building problems, housing problems, and other public service demands will be taken care of first and the less vital projects will have to wait their turn. As we are learning to our dismay, no nation is rich enough to fulfill all of its aspirations as opposed to all of its necessities. Thus "*enormous increase*" in state and local capital needs, and "exploding replacement needs" in schools, for example, are phrases which avoid giving any weight to the substantial replacement which has already been part of the post-war boom in school construction.

Ironically, the chief tangible item which would support any drastic increase in state and local debt relates to federal assistance programs such as water pollution control, airport construction, and so forth. Pressures on the federal government, to quote Mr. Surrey, have recently "caused attention to be focused on the potentialities of debt service grants to state and local governments . . . rather than the lump-sum grants that have been more traditional." What this means is that the federal government, in order to make a semblance of meeting unfilled financial commitments to states and localities, is really attempting to alleviate its own budget problems and avoid increasing federal debt. This pushes an added capital burden on to state and local governments by forcing them to raise the federal share of program costs in addition to their own share. Such a drastic shift in the federal aid delivery system would indeed give those who wished, one an opportunity to conclude that the market would have an insuperable problem.

What we need above all is the careful and painstaking approach manifested in the 1968 Joint Economic Committee study, certainly a landmark in the field. True, some of the assumptions underlying that pioneering study may need to be re-examined and possibly revised in the light of recent inflationary economic experience. A diversity of views exists among economists as to whether a substantial increase in state and local government financing in the period ending in 1975 will be experienced and whether adequate investment funds will be available to meet these needs. Certainly the potential market behavior of the commercial banks during this period is of the utmost importance, since they are the major buyers of state and local government securities. But hard facts and sound economic theories based on those facts are the answer, not unsubstantiated guesswork.

PRESENT COSTS OF MUNICIPAL BONDS

In discussing the present market, Mr. Surrey points to the "inevitable" rise in tax-exempt interest vis-a-vis corporate bonds of comparable quality. This process is not proved by any statistical evidence. As he himself admits elsewhere in his discussion, municipal rates have held remarkably steady at approximately 70 per cent of comparable taxable interest rates for a considerable period. Even now, in the fourth year of unexampled high rates of interest and under the pressure of monetary restraint, the present ratio is only 75 per cent. If the inflationary economic situation cools and Congress stops tampering with the tax-exempt status of municipal bonds, this ratio should once again stabilize at about 70 per cent and continue to offer its usual economic advantage to public bond issuers.

Since preparation of this article, the ratio has narrowed to 81 percent, mostly in response to market uncertainty caused by passage of the Tax Reform Act by the House of Representatives.

THE EQUITY QUESTION

In the course of this discussion, Mr. Surrey says: "Tax-exempt interest ranks second after capital gains taxation—perhaps third if we knew more about the magnitude of accelerated depreciation on buildings—among the factors enabling high-income taxpayers to reduce their effective rate of tax." This comment gives an impression that tax-exempt interest is a much more important factor in tax reduction for high-income taxpayers than is actually the case. The table cited by Mr. Surrey as the basis for his statement is in a study prepared in the Treasury Department and covers aggregate figures for taxpayers with adjusted gross incomes of $100,000 or more, 1967 level.

TABLE 2

	(In millions)
Amended adjusted gross income	$16,720
Less—personal deductions (taxes, interest, charitable contributions, etc.) but not including the unlimited charitable contribution	2,350
Amended taxable income	14,370
Less:	
One-half of capital gains on assets actually sold	3,775
Exempt interest on State and local bonds	440
Deduction for unlimited charitable contribution	105
Farm "tax losses"	70
Excess percentage depletion	60
Taxable income	9,870
Tax	4,715
Tax as percent of taxable income	47.8
Tax as percent of amended taxable income	32.8
Tax as percent of total income	28.2

Source: Tax Reform Studies and Proposals, U.S. Treasury Department, Joint Publication, Committee on Ways and Means, U.S. House of Representatives, and Committee on Finance, U.S. Senate, Washington, Government Printing Office, 1969, p. 83.

It shows (a) "amended adjusted gross income," defined as adjusted gross income after deductions for "proper business expenses," and increased by "the exempt part of capital gain, exempt interest, and excess percentage depletion." then (b) "amended taxable income" after taking out personal deductions (taxes, interest paid, charitable contribution, etc.), and (c) taxable income. The small element of truth in his statement depends upon highly selective statistical definition of the phrase "effective rates of tax," the particular definition being the ratio of tax paid to "amended taxable income." The deductions are eliminated from the comparison although they, too, are "factors enabling high-income taxpayers to reduce their effective rate of tax." Deductions totaled $2,350 million, and even if one-quarter were attributed each to *contributions* and *interest paid*, this would be $580 million each, compared with the $440 million interest on state and local bonds. Looked at in this way, interest on state and local bonds is probably no higher than the fourth or fifth largest factor instead of second or third.

The tabulated figures, if accurate, do disclose the relative importance of state and local interest as a factor of tax reduction to the individuals with incomes of over $100,000 a year, and its importance may be honestly computed by its relation to the total aggregate reduction in tax base—all factors—of $6,850 million ($16,720 million "amended adjusted gross income" less $9,870 million taxable income). State and local bond interest of $440 million is only 6.6 per cent of the total for all factors, and less than 12 per cent of the most important item, i.e., capital gains. To bill this as the "second" or "perhaps third" largest factor is at best to exaggerate beyond the bounds of ardent advocacy, and at worst to falsify the record.

EQUITY ISN'T EVERYTHING

Going to the guts of the matter, we are dealing with an issue far more complex and important than the role tax-exempt bond interest plays in tax avoidance. Attempting to tax income from municipal bonds automatically raises the complexities of:

1. Structural problems of the federal system itself and the allocation of powers and duties among three levels of governments—federal, state and local;
2. Complicated economic market relationships which involve the proper functioning of both the public and private sectors of the entire capital market;
3. Important legal problems which certainly would lead to protracted litigation ending in the Supreme Court; and
4. The problems of making the total tax structure—federal, and particularly state and local—function as fairly and effectively as possible by not further depressing financial resources of states and localities.

It is on the latter point, especially, that the so-called quest for equity falls on its face. As Nashville Mayor and National League of Cities President C. Beverly Briley stated recently, "It is the height of irony that an effort to tax a very few individuals receiving income from municipal bonds will boomerang against hundreds of thousands of local property taxpayers and users of municipal services who will have to bear the burden of increased debt service costs." As investors lose confidence in the integrity of tax exemption and the good faith of the federal government, their waning confidence will be reflected in higher interest rates bid for new bond issues. Higher interest costs added to an already heavily strained property tax system, a system known to be regressive, will neither contribute to taxpayer equity nor help financially hard-pressed cities meet mounting capital and operating revenue needs. Even if interest rates rise only 1 percentage point, it would cost on the order of an additional $150 million annually for a single year's volume of $15 billion. Over a 14 year period, the average life of long-term general obligation bond issues, this comes to about $2 billion.

I shall not dwell on the constitutional issue involved in the taxation of interest from municipal bonds. This is an issue which, I am confident, will be forced into the courts if the legislation proposed by the House Ways and Means Committee is enacted. Regardless of the outcome, lengthy litigation will cost a further stigma on municipal bonds which could even halt investment until the issue is resolved.

Mr. Surrey, however, has referred in his article to a statement made in 1942 by the Department of Justice before the House Ways and Means Committee to the effect that a tax on state and local bond interest "would be constitutional" and then makes the categorical claim that "certainly nothing has happened in the intervening years to cause lawyers to believe that such a prediction would, to say the least, be any less valid today." Presumably, Mr. Surrey meant to say that the Department of Justice in 1942 took the view that the Supreme Court would uphold an attempt to subject the income from municipal bonds to taxation and that no decisions have been rendered in the intervening years to change this prediction. Obviously, since there has been no direct attack on the tax status of municipal bond interest which has been the subject of litigation, "nothing has happened," to use the author's own words, to change this. In short, Mr. Surrey is stating only that the Department's opinion of 1942 has not been tested in court. The statement is really meaningless, but it has the effect of giving the reader the impression that it is all over but the shouting. Mr. Surrey only cites a "contrary argument" of the Attorney General of Maryland in a footnote, and makes no further reference to comments by attorneys deeply involved in the municipal bond business holding similar views. Without better information, the reader must feel that the only valid viewpoint is that set forth in the main body of the article and that "contrary" arguments are not to be considered seriously.

The facts, of course, are different. There is a substantial body of respectable legal opinion holding that an attack on the concept of intergovernmental immunity would be defeated in the Supreme Court. In fact, the present Administration, in proposing its "limit on tax preferences" program, recommended that the interest from municipal bonds not be included because of the market impact and doubtful constitutionality of such a move.[4] An attempt to conceal or downgrade the existence of such a viewpoint is misleading, particularly when the issue has already been clouded with misinformation and emotional appeals to "tax equity."

The reciprocal immunity doctrine is derived from the constitutional foundations of our federal system of government. The federal system is a remarkably durable system because each level of government has exercised a degree of independence of action within the framework established by the United States Constitution and the constitutions of the various states. This does not mean the actions of one level are isolated from or unaffected by those of another. Nevertheless, integrity of local policymaking must be respected and maintained in order that state and local governments can fulfill their primary responsibilities to the needs and demands of local citizens. If the federal government interferes with local fiscal decisions through federal taxation or supervision of local debt management, it interferes with the independence of judgment that local agencies must exercise in determining their own policies and programs which are dependent upon capital financing. Officials of local government will zealously preserve and protect the independence of local policymaking.[5]

[4] See the statement of the Honorable Charls E. Walker, Under Secretary of the Treasury, before the Committee on Ways and Means, U.S. House of Representatives, April 22, 1969.

[5] For an excellent brief on the constitutional issue, see the Statement of Northcutt Ely, General Counsel, American Public Power Association, in Hearings on the subject of tax reform before the Committee on Ways and Means, U.S. House of Representatives, 91st Congress, 1st Session, Washington: Government Printing Office, 1969, Part 6, pp. 2195-202.

PROPOSE ALTERNATIVES FOR CAPITAL FINANCING

This brings us to the central objective of Mr. Surrey's article and of this article, the need, and, do we know enough about such alternatives to adopt one at the present time?

To simplify, while differing in mechanics, most of these proposals revolve basically around an offer of a federal government subsidy on municipal bond interest rates in return for a waiver of tax exemption by state and local bond issuers.

Alternatives for capital financing should be viewed constructively. States and localities have utilized a relatively stable source of capital funds in the past and will continue to depend upon the tax exempt bond market in the future for an adequate supply of capital funds. While evidence suggests that this source will continue to meet the foreseeable needs of states and localities, it is the only source of capital financing available aside from the luxurious pay-as-you-go method.

In my opinion, any proposed alternative system of capital financing would have to meet the following criteria:

1. First, it must preserve the present federal system and protect the state and local governments from federal domination.

2. The state and local governments must preserve their freedom to act, independent of federal control, on matters of purely state and local concern.

3. Any federal subsidy must be at least as generous as the present financing advantage which the states and municipalities enjoy by virtue of tax exemption.

4. The federal government's obligation to provide a subsidy in lieu of tax exemption must be automatic and irrevocable.

5. The states and municipalities must have unrestricted access, at their own option, to both tax-exempt and taxable markets.

6. Financing precedures must not be subject to delay by federal red tape which might make state and local governments miss their best markets or involve them in increased capital costs as construction costs keep rising.

REAL COSTS OF TAX EXEMPTION

Mr. Surrey states in his article: "Those interested in the federal tax structure deplore the method of achieving this effect because of both the tax favoritism and the inefficiency or wastage involved in resorting to the technique of favoritism, in that more federal tax revenue is lost than the local governments obtained in aid." Again he states: "That exemption is a way of supplying federal aid—presently amounting to about $1.2 billion annually (at a revenue cost of $1.8 billion—to those governments through the lower interest rates."

The facts are quite otherwise. According to the United States Department of Commerce, gross state and local debt outstanding in the three most recent years an interest paid on that debt are estimated as follows:

TABLE 3

	1966	1967	1968
Beginning	$104,700,000,000	$111,600,000,000	$122,000,000,000
End	111,600,000,000	122,000,000,000	132,300,000,000
Total	216,300,000,000	233,600,000,000	254,300,000,000
Outstanding debt	108,150,000,000	116,800,000,000	127,150,000,000
Interest paid	3,451,000,000	3,813,000,000	4,437,000,000
Interest cost (percent)	3.19	3.26	3.46

Let us make the simplistic assumption that the United States Treasury makes, which we believe to be partially in error, but which probably represents their best case. Briefly stated, it is that present holders of tax exempts have a weighted average marginal tax rate of 42 per cent and that the federal government, therefore, loses the amount of increased tax revenue it would derive from those holders, if they should be forced, or had been forced, to purchase taxable securities instead.

It is ridiculous to assume, as Mr. Surrey apparently does, that the states and municipalities would ever have surrendered the 30 per cent financing advantage derived from tax exemption in the past or would ever surrender it in the future unless they received in exchange an irrevocable subsidy at least equal to the advantage surrendered. This is recognized by the proposal of Senator William Proxmire (D. Wisc.) and Congressman Wright Patman (D. Tex.) for a Municipal Capital Market Expansion Corporation, and the Urban Development Bank proposal offered by former President Johnson, both of which offered a subsidy of 33⅓ per cent. From the point of view of the state and local governments, it would be foolish to yield a financing advantage of 30 per cent *without federal control* for a subsidy of 33⅓ per cent *with federal control* merely because they are told there may be some hypothetical advantage by way of increased tax revenues to the federal government.

Indeed there is little economic inducement under normal conditions for public issuers to shift markets and they are unlikely to do so unless they receive a better *quid pro quo* than a subsidy of 33⅓ per cent. This is recognized by the emergence from the National Governors Conference of the so-called double-coupon proposal which envisages an irrevocable open-end 50 per cent subsidy to be paid by the federal Treasury. Actually, a good case can be made for a 50 per cent subsidy on grounds of equity. As pointed out by Sidney Homer in the 1966 JEC study:

> The fact that the gross interest rate usually paid on tax exempts is well below other interest rates is often misinterpreted as an inducement to borrow large sums. However, when municipalities or states borrow they often have to find additional revenues to meet debt service—immediately, not 30 years hence. And they cannot deduct their interest payments as corporations can so that Uncle Sam pays half. They pay it all.[*]

In all fairness, it must be pointed out that from an economic point of view the state and local governments would benefit substantially from an automatic irrevocable 50 per cent federal subsidy. It could scarcely be otherwise since they would be trading a 30 per cent financing advantage for a 50 per cent federal subsidy.

Mr. Surrey's analysis leaves the impression that the Treasury would gain a substantial amount of revenue if the present tax exemption for municipal securities were terminated and the federal government subsidized states and localities for the higher interest payments that they would have to make. It is not at all clear, however, that when the dust settles, this would in fact be the result. For termination of the exemption would result in vast upheaval in present financial markets. Many investors now drawn to municipal securities would no longer be attracted to them. These would tend to be taxpayers with high marginal tax rates. Individuals, in particular, would desert the municipal market in favor of equities. That is, individuals who now find municipal securities attractive because of the tax exemption would seek out investments with the next best tax advantage. They would probably turn, therefore, to investments which offered capital gains.

Other investors would be drawn into the municipal market by the increased yields which would be available if the tax-exempt status were terminated. These investors would be the ones who are themselves exempt from federal taxation, such as pension funds, foundations, and university endowment funds. Because they are tax exempt, these institutions would purchase fixed income securities which had a high yield relative to other securities offered in the market.

As a result of these shifts, taxable municipal issues would not be taxed at an average rate as high as 42 per cent. The rate would be much lower, probably no higher than 25 per cent. It would be unrealistic to assume, in other words, that the composition of a taxable municipal market would be the same as that of the tax-exempt municipal market.

If the average tax rate applied to interest on state and local government securities were less than the rate of the subsidy—which we think is the only reasonable assumption—then the cost of the subsidy to the Treasury would exceed the increased revenues due to the termination of tax exemption.

Let us for a moment assume that the marginal tax rate is 42 per cent. Table 4 shows calculations which demonstrate that if the most realistic subsidy rate of 50 per cent were utilized, the federal government would carry a net revenue loss on its subsidy program. Table 4 also shows that the federal government would realize a very serious loss if, as our studies show, the marginal tax rate of investors was 25 per cent. Only in the one instance of a 33⅓ per cent subsidy based on the incorrect assumption of a 42 per cent marginal tax rate would there be any federal revenue gain. But such a small subsidy would not be attractive enough, in light of potential dangers of the plan, to attract bond issuers.

[*] *State and Local Facility Needs and Financing, op. cit.,* Volume 2, p. 275.

Table 4

Savings to State and local governments because of tax exemption:	
$127,150,000,000, at 5 percent (taxable)	$6, 357, 500, 000
$127,150,000,000 at 3½ percent (tax exempt)	4, 450, 250, 000
Savings to State and local governments	1, 907, 250, 000
Range of subsidies:	
33⅓ percent of $6,357,500,000	2, 119, 167, 000
50 percent of $6,357,500,000	3, 178, 750, 000
Federal revenue gains (no tax exemption—'ncreased tax revenues):	
Increased revenue, at 42 percent of $6,357,500,000	2, 670, 150, 000
Increased revenue, at 25 percent of $6,357,500,000	1, 589, 375, 000
Case 1:	
Increased revenue, at 42 percent	2, 670, 150, 000
Subsidy, at 33⅓ percent	2, 119, 157, 000
Federal gain	550, 983, 000
Case 2:	
Increased revenue, at 42 percent	2, 670, 150, 000
Subsidy, at 50 percent	3, 178, 750, 000
Federal loss	508, 600, 000

Estimated property, the so-called revenue loss to the federal government dwindles to a loss of $551 million, the amount of the federal government's net gain after taking into account the federal subsidies in lieu of tax exemption it would have been compelled to pay. That is the most favorable case for the federal government.

Assume that it has to pay instead a subsidy of 50 per cent. It is now benefiting from past tax-exempt financing to the tune of $509 million, or the net loss it would otherwise sustain after accounting for federal subsidy in lieu of taxation.

The basic principle is that even using the United States Treasury's assumptions, the federal government is bound to lose if the subsidy rate on the taxable obligations is above the marginal average tax rate of those who presumably would be forced into the taxable market.

Let us see how this works out with current financing as calculated in Table 5.

Table 5

Present annual savings to State and local governments because of tax exemption:	
$15,000,000,000, at 8 percent (taxable)	$1, 200, 000, 000
$15,000,000,000, at 5.6 percent (tax exempt)	840, 000, 000
State and local government savings	360, 000, 000
Range of subsidies:	
33⅓ percent of $1,200,000,000	400, 000, 000
50 percent of $1,200,000,000	600, 000, 000
Range of Federal revenue gains or losses assuming no tax exemption:	
Increased revenues, at 42 percent of $1,200,000,000	504, 000, 000
Increased revenues, at 25 percent of $1,200,000,000	300, 000, 000
Case 1:	
Increased revenue, at 42 percent	504, 000, 000
Subsidy, at 33⅓ percent	400, 000, 000
Annual Federal gain	104, 000, 000
Case 2:	
Increased revenue, at 42 percent	504, 000, 000
Subsidy, at 50 percent	600, 000, 000
Annual Federal loss	96, 000, 000
Case 3:	
Increased revenue, at 25 percent	300, 000, 000
Subsidy, at 33⅓ percent	400, 000, 000
Annual Federal loss	100, 000, 000
Case 4:	
Increased revenue, at 25 percent	300, 000, 000
Subsidy, at 50 percent	600, 000, 000
Annual Federal loss	300, 000, 000

Thus, the maximum benefit to the federal government on the most favorable assumption shows an annual gain of $104 million. If it pays a 50 percent subsidy, it will lose $96 million.

The following table shows the cumulative effect:

[In millions of dollars]

	Annual financing	Cumulative annual financing	Cumulative annual gains case 1	Cumulative annual losses cases 2
1970	16,652	16,652	115,400	106,600
1971	18,101	34,753	240,900	229,400
1972	19,676	54,429	377,300	348,300
1973	21,388	75,817	525,600	485,200
1974	23,249	99,066	686,800	634,000
1975	25,272	124,338	862,800	795,700

The point is that the federal government's subsidy plan may not be all that it is cracked up to be.

Furthermore, Treasury costs would be increased in another way. Termination of tax exemption for municipal securities would narrow the market for long-term issues in general. Thus interest rates on Treasury bonds would be higher than they otherwise would be. The general increase in Treasury borrowing costs might be as high as 50 basis points. Applied to the very large total of federal debt held, such an interest cost increase would clearly be very significant. This higher interest cost might be incurred only gradually as new issues of taxable municipals replace outstanding tax-exempt issues, but it would be important nonetheless.

A general increase in long-term borrowing costs would also affect corporate borrowing and individuals securing a home mortgage. A strict accounting would take these added costs into consideration.

Mr. Surrey's implication that termination of tax-exempt status for municipal securities would involve a net saving to the Treasury is, therefore, clearly unrealistic if we consider the shape of the world after an adjustment had been made by the new law. Furthermore, in the interim period in which this adjustment was being made, there would be heavy added costs as underwriters struggled to discover the new configuration of the financial markets.

A MORE CONSIDERED APPROACH NEEDED

We would have hoped that the idea proposed by Mr. Surrey and the legislation prepared by the Ways and Means Committee could have awaited the results of a study currently under way by the Advisory Commission on Intergovernmental Relations. This study is expected to be completed by December. It involves a detailed examination of all the proposed alternatives and their effect on traditional capital financing, their relationship to tax reform, and their possible benefits to states and localities. This Commision, composed of representatives from all three levels of government—federal, state, and municipal—as well as distinguished representatives from the private sector, could render an important public service by impartially investigating the problems in this area and providing a rational and enlightened basis for their solution.

It seems incredibly ill-considered and hasty to make fundamental changes, as the Ways and Means Committee has proposed, in a system that has endured since the beginning of the Republic and served states and local governments well through many difficult times, merely on the basis of one day's hearings, very nearly the total extent of the House Ways and Means Committee's public consideration of this vital problem. The Investment Bankers Association, in its testimony before the Ways and Means Committee on March 11, 1969, raised important economic and market questions to which, as it candidly admitted, there were as yet no satisfactory answers. Nevertheless, no further investigation by the committee of these questions has, to our knowledge, taken place, and virtually all consideration of proposed legislation has proceeded behind closed doors. Such a method of procedure does little to inspire confidence that legislation emerging from this committee is based on a deliberate and impartial weighing of all the factors involved. On the contrary, it seems to bespeak a panic haste to shoot first and ask questions later. We hope the Senate will move more carefully when it begins consideration of these matters.

If the issuance of taxable municipal bonds in significant amounts does eventually prove necessary and desirable, we believe it extremely unwise in the interim to throw sand in the gears of the present tax-exempt market through the introduction of either the "limit on tax preferences" or the "allocation of deductions" proposals until such time as the proper legislative bases have been established in the various states and the initial problems of marketing such taxable securities have been worked out. It is foolish to burn down the old house before the new one is ready to live in.

Furthermore, if such proposals are intended to render the functioning of the present tax-exempt market difficult or impossible in order to force a recourse to the taxable markets, this immediately raises grave doubts about the "voluntary" nature of the new taxable financing device and the credibility of those who say they have no wish to destroy the institution of tax exemption as such.

CONCLUSION

The financing needs which state and local governments will face in the years ahead are admittedly great. Let us have careful investigation of these needs, updated regularly if necessary, and the priorities they will command in the hierarchy of all our needs as a nation, and balance against them the not unbounded national economic strength that can be mobilized. We will then be operating rationally as to the need for a major new capital financing mechanism.

Certainly it is not all that clear that the subsidy plans proposed thus far are well enough understood to work as favorably as their proponents suggest. Most fail to account for the large and growing subsidies which the federal government must provide to make a system of taxable state and municipal bonds workable. Second, no weight is given to the "across-the-board" rise in interest rates in the taxable market which will result from the large-scale introduction of taxable municipal bonds into the taxable sector. This development, from the federal government's point of view, will be unfavorable since the increased tax revenues will not compensate for the added interest costs and the necessary federal subsidies in lieu of tax exemption. And last, much more must be known about the impact of such proposals on traditional intergovernmental fiscal relationships.

STATEMENT OF C. BEVERLY BRILEY, MAYOR OF NASHVILLE, TENNESSEE, PRESIDENT, NATIONAL LEAGUE OF CITIES

SUMMARY

The cities of the nation are vitally concerned with the provisions of H.R. 13270 which affect municipal bond interest because they would increase the cost of city government and threaten the physical rejuvenation of our cities. Tax exemption is important to cities because it protects the integrity and independence of fiscal policy-making by cities, it provides a stable, adequate independent source of capital and saves states and cities billions of dollars in interest costs and tax dollars.

The market impact of mere House passage of H.R. 13270 has been great: increasing interest costs an average of ½ to 1 percentage point which in turn has added millions of extra dollars to local debt service costs. The actual and the psychological impact of the ADR and LTP will very severely curtail the market for municipal bonds.

The large extra cost of this action to local taxpayers and the very small return to the Federal government, coupled with the fact that extra costs must be paid through regressive property taxes hardly is equitable. Congress must take full responsibility for any increase in local property taxes. This action would really cause a taxpayers revolt.

The interest subsidy provisions do not meet certain criteria of acceptability established by bond issuers and would pose critical problems for both the federal and the local governments.

The cities call upon this Senate Finance Committee to delete provisions which include bond interest in the Limit on Tax Preferences and the Allocation of Deductions rule. They urge deletion of the interest subsidy program from the bill for consideration at a future time.

Statement

I am C. Beverly Briley, Mayor of Nashville, Tennessee and President of the National League of Cities. I am speaking on behalf of more than 14,600 cities of all sizes throughout the nation.

Reason for concern

In early August, the House of Representatives passed H.R. 13270 which contained provisions to tax directly and indirectly the interest from municipal bonds. This action has increased interest rates significantly on all state and local government bonds and will cost state and local taxpayers millions of additional tax dollars over the next ten to twenty years. If the Senate concurs with the House action, the effect on municipal capital financing will be devastating.

Surely no other issue has concerned city officials over the past several months to the degree that this has. The reason is simple. This action strikes at the very fiscal stability of our cities. This an insidious threat because the provisions of H.R. 13270 could increase taxes and add additional strain to already tight budgets. It will delay or perhaps halt altogether public works projects which are vital to the physical rejuvenation of our cities—in fact our entire physical environment. We thus attach the greatest importance to these hearings for the Senate must undo the damage contained in H.R. 13270. The alternative is to face a taxpayers' revolt of mammouth proportions that would put the current "revolt" to shame.

Importance of tax exemption

Tax exemption of municipal bonds is important for these reasons. First, it represents a clear determination on the part of those who designed our federal system and of succeeding governmental officials to protect the fiscal policy integrity and independence of each level of government. It is a hands-off policy which enables local officials to be fully responsive to local conditions and needs, not to the policies of another level of government. Second, the principle of tax exemption has created a special, independent source of capital upon which cities can rely without concern for competitive capital demands from the private sector or from the federal government. Third, and perhaps most important, tax exemption has kept the cost of capital relatively low, saving states and local governments billions of dollars in interest costs and tax dollars. The legislation before you jeopardizes all of these benefits.

It is obvious that the actions of one level of government are not isolated from or unaffected by another in our "marble cake system." But the integrity of local policymaking must be respected and maintained in order that state and local governments can fulfill these primary responsibilities to the needs and demands of local citizens. Interjecting the Federal government into local fiscal decisions through Federal taxation or any other form of influence on local debt management, the both of which are almost answered by H.R. 13270, interferes with the independence of judgment that local officials now exercise in the important area of capital financing.

Abandoning or severely constricting the tax exempt money market as envisioned through the interest subsidy provisions of the bill suggest serious political implications. When we consider that taxable local government bonds would have to compete with corporate securities and securities of the Federal government for available funds, we must ask, under such conditions, would local government bonds be well received by the investor? The clear answer is that the private sector competition could well place the collective needs of our communities, as determined by governmental processes, secondary to the interest of a corporate board of directors or the motivation of economic gain of an individual investor.

The economic return from the construction of a school or sewer project may not be as great as that from a steel mill or automobile plant, but the social importance is another matter. To require needed public projects to compete for the investor's dollar on equal economic terms with say, General Motors and AT&T is fiscal folly.

Market impact

I will return to the interest subsidy plan later. What has been and will be the specific market impact of the inclusion of bond interest in the Limit on Tax Preferences and Allocation of Deduction rules?

The tax exempt bond market, like all other segments of the economy, has felt the effects of inflation and tight monetary policies applied by the Federal government to cool off inflation. Commercial banks, the largest single investor group in the market, have curbed their municipal bond investment programs and in fact have been liquidating portions of their bond holdings to maintain reserves and lending capacity. However, extrapolating the effects of tight monetary policy, based roughly on bond price trends in periods prior to the House action and comparison to the effects of the 1966 credit crunch on municipal bonds, shows that the prospective action of Congress has had a noticeable effect on interest rates. This effect has been estimated conservatively at least at an average ½ of one percent increase in bond yields and is more likely on the order of one percentage point. We can only conclude from this that the investors' faith in the traditional security of municipal bond tax exemption has been breached and he is reacting to it.

If Congress enacts the specific provisions of H.R. 13270 which affect bonds (i.e. inclusion of bond interest in the allocation of deductions and the limit on tax preferences) it would probably remove individual investors from the market for tax exempt bonds altogether. Moreover, this action could have an irreparable psychological effect on institutional investors, namely the banks and fire and casualty insurance companies. Once the principle of tax exemption is breached, these investors in making long term investments in municipal bonds, would have to anticipate the day when some future Congress might apply the rules of H.R. 13270 against the bond investment practices.

The situation is made more difficult by the threat of litigation to test the constitutionality of bond interest inclusion in the Limit on Tax Preferences. Lengthy litigation all the way through the Supreme Court, taking as much as three years, would leave the status of tax exemption in total doubt and could very well discourage investment in municipal bonds altogether.

Cost impact

In dollars, the cost of the House action is immense. Assuming that final action on this bill did not occur until next year and that the effect on interest rates of House passage of H.R. 13270 is indeed an average of one percentage point increase, the additional cost on an annual volume of $15 billion of bonds is $150 million. The effect of actual enactment over the life of future bonds would be more and of course, cumulative. These figures are particularly striking when one considers that the Treasury Department will receive less than $80 million a year in tax revenue as a result of applying "ADR" and "LTP" to municipal bond interest. This is indeed a sad price to have to pay for very little accomplishment in either tax revenue or making the Federal income tax system more "equitable."

Where is the real equity?

This equity question rises continuously. Our studies show that based on the best estimates, interest from municipal bonds rate a very poor fourth or fifth in terms of all factions contributing to tax avoidance. In percentage terms, based on Treasury Department figures, it accounts for only 6.6% of all such factors and only 12% of the largest factor—capital gains.

Moreover, we have found from conversations with market experts that those few individuals now buying municipal bonds (less than 2% of new bond issues have been bought by individuals in recent years) are more likely to be in lower tax brackets—older persons seeking retirement investments, school teachers and so forth—not high tax bracket individuals who are naturally more interested in growth for their investments. Thus, your action would tax "the forgotten American" as he has been called, who may own 5 or 10 bonds.

On the other hand, local agencies would have to increase already strained tax rates on the regressive property tax to meet the additional costs. The diversion of additional scarce local funds to debt service would further aggravate the shortage of funds needed to finance other essential local services. Moreover, further aggravating an already regressive tax system is hardly equitable.

To tax a very few rich individuals, móst of whom do not now view municipal bonds as good investments anyway.

—risks complicating the structural problems of the Federal system itself.

—risks unbalancing highly complex economic market relationships in the entire capital market,

—raises important legal and constitutional questions which would lead to protracted litigation,

—and makes more difficult the problems of making the total tax structure—federal, state and local—function equitably and effectively while not further depressing local resources.

To us, it is unthinkable to take these risks which will boomerang against hundreds of thousands of local property taxpayers and users of municipal services who will have to bear the burden of increased debt service costs and whose governments will have to suffer the other consequences. This is not equity and we who are the first to feel the taxpayers revolt will be hard put to explain why the Congress of the United States took action which causes us to increase taxes.

The interest subsidy plan

The House has proposed in H.R. 13270 that the Federal government undertake to subsidize municipal bond interest in turn for a waiver of tax exemption on the part of the local bond issuer.

Alternatives to capital financing need not be viewed unconstructively. States and localities have enjoyed a relatively stable source of capital funds in the past and will continue to depend upon the tax exempt bond market in the future for an adequate supply of capital funds. While strong evidence shows that this source will continue to meet the foreseeable needs of states and localities, it is the only source of capital financing available aside from the luxurious pay-as-you-go method and, of course, is dependent largely upon future activity of institutional investors and the expectation that Congress will not attempt to tamper with the principle of tax exemption. To this end, the "alternative" adopted by the House is not really an alternative in that the other applicable provisions of the bill do much to curtail the tax exempt status of bonds.

Criteria for alternatives

Any proposed alternative system of capital financing would have to meet the following criteria:

1. First, it must preserve the present Federal system and protect the state and local governments from Federal domination.
2. The state and local governments must preserve their freedom to act, independent of Federal control, on matters of purely state and local concern.
3. Any Federal subsidy must be at least as generous as the present financing advantage which the states and municipalities enjoy by virtue of tax-exemption.
4. The Federal government's obligation to provide a subsidy in lieu of tax-exemption must be automatic and irrevocable.
5. The states and municipalities must have unrestricted access, at their own option, to both tax-exempt and taxable markets.
6. Financing procedures must not be subject to delay by Federal red tape which might make state and local governments miss their best markets or involve them in increased capital costs as construction costs keep rising.

We feel the interest subsidy program falls short of meeting these criteria and agree with the Administration in recommending that it not be enacted. This provision of the bill, we believe, was hastily constructed without consultation with public issuers, bond attorneys and market experts and presents problems for both the Federal Government and states and localities. Among its more serious question marks are:

—strong evidence that the program will cost the Federal government substantial amounts of money rather than add any profit to the Treasury.
—the marketability of taxable municipal securities.
—the fact that taxable municipal bonds will be directly competitive with Federal securities and corporate securities and will not bear the guarantee of the Federal government or the magic name of a powerful corporation.
—an impact of a large volume of taxable securities on the taxable bond market in terms of interest costs.
—state legal barriers.

I include for the record at this point an article written by Patrick Healy, Executive Director of the National League of Cities, entitled "The Assault on Tax Exempt Bonds," appearing in the July/August issue of *Tax Policy*. The article deals extensively with the so-called capital financing alternatives and will serve as detailed explanation for our opposition.

Allow me to expand on a subject I also referred to earlier when I used the word "manipulation" in connection with the subsidy arrangement embodied in H.R. 13270. As stated in the bill, the purpose of the subsidy is ". . . to encourage states and their political subdivisions voluntarily to relinquish the privilege of tax exemption . . ." In other words, the Secretary of the Treasury is empowered to offer an interest subsidy great enough to entice municipal issuers to sell taxable securities. Obviously, if no, or very few, tax exempt bonds were issued—as would probably be the case in the event of a 40% subsidy—the tax exempt market would soon shrink and perhaps dry up completely. After that came to pass, would the Secretary of the Treasury still feel obliged to continue offering a 40% subsidy? Unlikely. If there were no genuine tax exempt market against which to gauge a true yield differential—and therefore the size of an equitable subsidy—it is unlikely that the Secretary would feel obliged to offer more than the minimum subsidy of 25%. Carrying this to the next logical step, a case could be made in some future Congress that there is no need for *any* subsidy, inasmuch as there would no longer be any *visible* difference in tax exempt and taxable yields. But, even if the present subsidy arrangement were left unchanged and the proposed minimum of 25% left in effect, state and local governments would still have lost a goodly portion of their present "market" subsidy of 30–35%. This seems ironic when one considers that the Federal government is talking about "revenue sharing" at this same time. Perhaps even more harmful than the economic penalty which can be perpetrated under the present bill, is the very real prospect that the Federal government, through its ability to set the subsidy rate and the power that any such discretion inherently carries with it, would be in a position to exert real influence over policy matters heretofore considered the domain of local government.

The answer to the problem lies not in dismissing the subject of alternatives outright but in postponing its consideration until this committee and its House counterpart can fully study and understand its ramifications.

Prior to closing, I should like to address myself briefly to the [illegible] of "arbitrage." The House bill contains a provision designed to bar state and local governments from issuing bonds and investing the proceeds in U.S. obligations. In those few cases where such investment was attempted for the purpose of obtaining revenue from the difference in interest cost between municipal and United States bonds, the legal officers of the states concerned have stepped in and halted the process. The provision is unnecessary and dangerous, particularly because it contains no definitions of or standards relating to arbitrage. Rather, it leaves this whole question to the discretion of the Secretary of the Treasury. We recommend its deletion.

To summarize, we are convinced that the inclusion of any of the provisions affecting municipal bond interest will have a disastrous effect on the fiscal well-being of our states and cities and will serve to seriously impair the physical development of our cities. It is truly incredible how much damage so little a stroke of the legislative pen will wrought. This must not come to pass. The interest from municipal bonds should be deleted from the Limit on Tax Preferences Rule and from the Allocation of Deductions Rule. The interest subsidy program should be deleted and deferred to future hearings.

The CHAIRMAN. Mayor Davis.

STATEMENT OF HON. ILUS W. DAVIS, MAYOR OF KANSAS CITY, MO.

Mayor DAVIS. I appear here today not only as mayor of Kansas City, Mo., but as president of the Missouri Municipal League. I have been authorized to appear here on behalf of the city of Kansas City by the city council, and on behalf of the Missouri Municipal League by the board of directors of that organization. I am here to register a strong protest to any effort by the Congress of the United States to levy a tax on the income of municipal bonds.

At a time when local government is confronted with its hour of greatest financial need to provide not only essential public services but capital needs for various essential areas of local government responsibility, we are confronted with this proposed legislation, which in our opinion could destroy our ability to proceed with and plan any bond financed capital programs. The people of our areas are looking to local government for the development of streets, sewers, and airports, the financing of urban renewal, development of pollution control facilities, as well as the construction of schools, hospitals, parks, waterworks, and other basic facilities for expanding urban areas.

There is no doubt, as has been indicated by the bond market for the past several weeks, that due to the threat of taxation of municipal bonds, coupled with high interest rates, and the uncertainty which surrounds the purchase of those securities, the capital market for municipal facilities has almost been destroyed. If the interest from municipal bonds becomes taxable, there must be a complete reappraisal of the municipal bond as an instrument of financing by the market. There is little question that municipal bonds would then be competing directly with the vast requirements of private enterprise in its financing of corporate expansion. In view of the small size of most municipalities in this country, there is little question that the cost of debt financing for city government would exceed the cost of debt financing of private corporations. This is especially true when we are in the period of history where the cities are confronted with monumental social, economic, and political problems. The best estimate we can get in this area is that municipal bonds of good quality would require roughly 2 percent more interest rate than is being paid now, which if extended over a period of time to include all debts of Kansas City, would bring about a real estate tax increase of 6 to 8 percent to finance the additional interest cost. In the field of revenue there would be little doubt the net interest increase would amount to about 2½ percent.

Over a period of time, if this increase were extended to the present debt of Kansas City for water and sewer facilities, the water and sewer rates of this city would need to be increased by 10 percent to accommodate additional interest costs. It is quite apparent that instead of putting the burden of taxation onto the rich—which is the appealing but unrealistic political basis for this change—the ultimate result would be that real estate taxes and water rates and sewer rates of the poor and rich alike would undergo a substantial increase. And I can't emphasize too much, gentlemen, that instead of taxing the rich in this proposal by one of the phenomena of financing in this country, if this proposal goes through you are ending up increasing real estate taxes and the water rates and the sewer rates of the poor and the rich of this whole country.

Now, we are aware that a proposal has been made to temper this result by giving a subsidy by the Federal Government for the additional interest costs which would result from the taxation of municipal bond interest. This proposal does not appear to be sound. We feel that if the Federal Government starts paying some substantial share of the interest on municipal debt that the next step would be for the Federal Government to exercise control over the issuance of that debt. History tells us that the man who pays the fiddler calls the tune, and certainly it should not be unexpected for the Federal Government to step in and attempt to exercise some control over the amount, the purpose, and the type of debt instrument that might be issued by local government if the Federal Government were paying part of the interest cost. In addition, there is a question as to what the financial market might think of a debt instrument which had an interest coupon that was payable by two governments. A division of responsibility for the payment of interest on a debt instrument could create much additional expense and confusion in the administration in the issuance of this debt instrument and could create market confusion concerning the value of that interest.

At a time when the Federal Government has announced publicly that it is going to pursue a policy of decentralization, as has been evidenced by its action in establishing regional centers in various areas; and at a time when the Federal Government has announced that it is going to rely more and more on our Federal policies of separating responsibility for various areas of Government action, it would appear that this proposal to bring all of the interest of local debt instruments into the purview of the Federal Government flies in the face of these policies. This country has enjoyed a long tradition of a division of labor and responsibility, as between the National Government and local government. This tradition has led to well-defined areas of responsibility in the construction of capital facilities and has promoted well the financial markets in the sale of debt instruments. This proposed legislation would immediately place the Federal Government in a stance to exercise control over the issuance of any local debt instrument in the United States and would reduce the capacity of local government to meet its obligations in the construction of capital facilities.

It is with considerable irony that I note that while the Federal Government is ready to step in and levy taxes on the income of the debt instruments of local government and thereby increase substantially the cost of local government, that the National Government has said nothing about letting local government levy real estate taxes on facilities of the Federal Government so that additional money could be raised to meet the additional financial burdens. If we are to abandon the principle of separation of responsibility in the field of taxation, I say that it should be done on both sides and that local government should be permitted to levy the ordinary real estate taxes on the market value of the Federal Government property that enjoys all of the services now provided by local government without making any contribution therefor. Indeed the Congress might well consider the net financial results of such a breakdown in the laws and traditions that now exist before it proceeds further with this proposal.

No one has questioned the fact that if such legislation, as is proposed, were to be adopted, it would be immediately challenged in the courts on the basis of the Constitution and the case law that now exists on the books. Certainly, such litigation would take time to be considered and resolved, and in the meantime, there is no question but that the municipal bond market would be in a state of limbo due to the uncertainty of both the legal and the financial aspects of the taxation of municipal bond interest. This litigation would continue for many months at a period when there has never been a greater need for municipal and school facilities than there is today.

It is incredible that local government work, which is suffering from lack of understanding and operational support at the State level, should now find itself battered by the National Government in the field of its capital financing, to the point where such financing is now almost impossible. Here at the peak of the urban crisis, when the major population centers of this country are seething with unrest, part of which can be attributed to a lack of facilities to meet the needs of the times, the Congress has stepped in with a proposal which has completely disrupted the capacity of local government to undertake capital financing. This lack of understanding by the National Government on the practical functioning of local government at a time of crisis reflects no credit on this proposal. The continuation of discussions and hearings on this proposal will effect a moratorium on the construction of badly needed capital facilities by local government across this country. An immediate decision should be made to abandon the efforts to levy Federal income taxes on the interest of local government debt instruments so that local government from coast to coast can continue to meet and carry out its obligations.

Gentlemen, we thank you very much for the opportunity to appear before you.

The CHAIRMAN. Mayor Davis, you used a word that appeals to me. You used the word "incredible." To me it is absolutely incredible that the House of Representatives would send us something that is opposed by 50 Governors in 50 States, by every State legislature, by every mayor, by every county commissioner, by every little board of education, by every governing body in the entire United States other than the Federal Government itself. That to me is utterly incredible.

I suppose this is as good a time as any to put in communications we have received from State legislatures, cities, county governments, all over the whole country, and I will ask those be provided for the record and printed. It costs money but while we are dealing with this thing it ought to be made available. I am also going to ask we print a list of outstanding people from the width and breadth of this country, Governors, mayors, legislators, outstanding lawyers, port authorities, about everybody you can think of throughout the entire country who asked to testify and we just can't hear because we don't have time, we just can't hear all these fine people, and every one of them had the right to be heard, at least have their views presented, and some of these are outstanding people. Just to pick out a few of them, for example, some people we just can't hear, here is the mayor of Albany, N.Y., or here is the city comptroller of Chicago, here is a man speaking for the Michigan Association of Counties, just to pick off three in alphabetical order. It is utterly fantastic to this Senator to think the House would send us something that.*

Mayor BRILEY. Mr. Chairman, we who have been dealing with this problem for many years recognize the great importance of this and we were really amazed that this did get into the House version.

The CHAIRMAN. To me it is utterly fantastic that it got this far.

As I say, I will never be surprised again at what can happen in Washington. [Laughter.]

Senator ANDERSON. Wasn't there quite a substantial vote in the House?

Mayor BRILEY. Yes, sir; it was under the closed rule, and this question itself was never really put to the House, this particular point of

*The Communications received by the Committee expressing an interest in the subject of municipal bonds appears as appendix C of this volume, p. 3597. The list of persons requesting to testify before the Committee on this matter appear at p. 3602.

the question, because the House considered the bill under the closed rule.

The CHAIRMAN. Senator Williams?

Senator Hansen.

Senator HANSEN. Mr. Chairman, I don't have a question but I would like to associate myself with the remarks you just made. I think you are absolutely right. I have had communications from the Wyoming Association of County Assessors, and the county commissioners. Yesterday there were three representatives of my State here, the president of the Wyoming Stockgrowers Association, the vice president, and a representative of the county commissioners association were all on hand, and they agree with exactly the sentiments you express.

If I may, I would like to have this telegram put in the record.

The CHAIRMAN. By all means.

Thank you very much, gentlemen. We appreciate your testimony here today. It is a very fine presentation on behalf of the mayors of this entire Nation.

(The telegram referred to by Senator Hansen, Mayor Ilus W. Davis' prepared statement, and a statement of Rollin F. Agard, Financial Consultant, Aviation Department, city of Kansas City, Mo., follows:)

[Telegram]

WORLAND, WYO., *September 22, 1969.*

Hon. CLIFFORD P. HANSEN,
Senate Office Building,
Washington, D.C.

Be alerted that Wyoming County Assessors' Association as a group and individually go on record as opposed to the exemption being removed on local bonds as pending in Senate hearings scheduled to begin September 23.

FORD M. WELCH,
President, Wyoming County Assessors Association.

STATEMENT OF MAYOR ILUS W. DAVIS, KANSAS CITY, MO.

SUMMARY

1. I appear in opposition to the levying of a tax on income of municipal bonds on behalf of the City Council and the Board of Directors of Missouri Municipal League.

2. In hour of greatest financial need, this legislation could destroy ability of local government to finance capital programs.

3. This proposed legislation has now almost destroyed the municipal bond market. If municipal bond interest becomes taxable, there must be a complete reappraisal of these bonds as an instrument of financing.

4. The cost of debt financing for city government would exceed the cost of debt financing of private corporations, municipal interest costs would increase roughly 2 to 2½% resulting in 6-8% increase in real estate taxes and about 10% increase in water and sewer rates.

5. Instead of putting taxation on the rich (an appealing but unrealistic political basis). it would substantially increase taxes and water and sewer rates of the poor and the rich.

6. The proposed federal subsidy of a portion of interest costs provides opportunity for Federal Government to exercise control over amount, purpose, and type of debt issued by local government.

7. The subsidy would provide division of responsibility for payment of interest on these bonds creating much additional expense in administration.

8. The Federal Government has in recent months pursued policy of decentralization. This legislation flies in the face of such a policy.

9. This legislation levies taxes on income of local government bonds at substantial cost to those governments but is silent about letting local government levy real estate taxes on facilities of Federal Government to meet local financial burdens.

10. This proposed legislation would be immediately challenged in the Courts constitutionally and on basis of case law now existing. This would take time, thus further contributing to the state of limbo in the municipal bond market.

11. At peak of urban crisis, the Federal Government proposes to step in and completely disrupt capacity for local government to undertake capital financing.

Statement

Gentlemen: I appear here today as Mayor of Kansas City, Missouri and as President of the Missouri Municipal League. I have been authorized to appear here on behalf of the City of Kansas City by the City Council, and on behalf of the Missouri Municipal League by the Board of Directors of that organization. I am here to register a strong protest to any effort by the Congress of the United States to levy a tax on the income of municipal bonds.

At a time when local government is confronted with its hour of greatest financial need to provide not only essential public services but capital needs for various essential areas of local government responsibility, we are confronted with this proposed legislation, which in our opinion could destroy our ability to proceed with and plan any bond financed capital programs. The people of our areas are looking to local government for the development of streets, sewers and airports, the financing of urban renewal, development of pollution control facilities, as well as the construction of schools, hospitals, parks, water works and other basic facilities for expanding urban areas.

There is no doubt, as has been indicated by the bond market for the past several weeks, that due to the threat of taxation of municipal bonds, coupled with high interest rates, and the uncertainty which surrounds the purchase of those securities, the capital market for municipal facilities has almost been destroyed. If the interest from municipal bonds becomes taxable, there must be a complete reappraisal of the municipal bond as an instrument of financing by the market. There is little question that municipal bonds would then be competing directly with the vast requirements of private enterprise in its financing of corporate expansion. In view of the small size of most municipalities of this country, here is litle question that the cost of debt financing for city government would exceed the cost of debt financing of private corporations. This is especially true when we are in the period of history where the cities are confronted with monumental social, economic and political problems. The best estimate we can get in this area is that municipal bonds of good quality would require roughly 2% more interest rate than is being paid now, which if extended over a period of time to include all debts of Kansas City, would bring about a real estate tax increase of six to eight percent to finance the additional interest cost. In the field of revenue bond financing, which is the basic means of financing water works and pollution control facilities, there would be little doubt the net interest increase would amount to about 2½%. Over a period of time, if this increase were extended to the present debt of Kansis City for water and sewer facilities, the water and sewer rates of this City would need to be increased by 10% to accommodate additional interest costs. It is quite apparent that instead of putting the burden of taxation onto the rich (which is the appealing but unrealistic political basis for this change) the ultimate result would be that real estate taxes and water rates and sewer rates of the poor and rich alike would undergo a substantial increase.

We are aware that a proposal has been made to temper this result by giving a subsidy by the federal government for the additional interest costs which would result from the taxation of municipal bond interest. This proposal does not appear to be sound. We feel that if the federal government starts paying some substantial share of the interest on municipal debt that the next step would be for the federal government to exercise control over the issuance of that debt. History tells us that the man who pays the fiddler calls the tune, and certainly it should not be unexpected for the federal government to step in and attempt to exercise some control over the amount, the purpose, and the type of debt instrument that might be issued by local government if the federal government were paying part of the interest cost. In addition, there is a question as to what the financial market might think of a debt instrument which had an interest coupon that was payable by two governments. A division of responsibility

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for the payment of interest on a debt instrument could create much additional expense in the administration in the issuance of the debt instrument and could create market confusion concerning the value of that interest.

At a time when the federal government has announced publicly that it is going to pursue a policy of decentralization, as has been evidenced by its action in establishing regional centers in various areas; and at a time when the federal government has announced that it is going to rely more and more on our federal policies of separating responsibility for various areas of governmental action, it would appear that this proposal to bring all of the interest of local debt instruments into the purview of the federal government flies in the face of these policies. This country has enjoyed a long tradition of a division of labor and responsibility, as between the national government and local government. This tradition has led to well-defined areas of responsibility in the construction of capital facilities and has promoted well the financial markets in the sale of debt instruments. This proposed legislation would immediately place the federal government in a stance to exercise control over the issuance of any local debt instrument in the United States and would reduce the capacity of local government to meet its obligations in the construction of capital facilities.

It is with considerable irony that I note that while the federal government is ready to step in and levy taxes on the income of the debt instruments of local government and thereby increase substantially the cost of local government, that the national government has said nothing about letting local government levy real estate taxes on facilities of the federal government so that additional money could be raised to meet the additional financial burdens. If we are to abandon the principal of separation of responsibility in the field of taxation, I say that it should be done on both sides and that local government should be permitted to levy the ordinary real estate taxes on the market value of the federal government property that enjoys all of the services now provided by local government without making any contribution therefor. Indeed the Congress might well consider the net financial results of such a breakdown in the laws and traditions that now exist before it proceeds further with this proposal.

No one has questioned the fact that if such legislation, as is proposed, were to be adopted, it would be immediately challenged in the Courts on the basis of the Constitution and the case law that now exists on the books. Certainly, such litigation would take time to be considered and resolved, and in the meantime, there is no question but that the municipal bond market would be in a state of limbo due to the uncertainty of both the legal and the financial aspects of the taxation of municipal bond interest. This litigation would continue for many months at a period when there has never been a greater need for municipal and school facilities than there is today. It is incredible that local government work which is suffering from lack of understanding and operational support at the State level, should now find itself battered by the national government in the field of its capital financing, to the point where such financing is now almost impossible. Here at the peak of the urban crisis, when the major population centers of this country are seething with unrest, part of which can be attributed to a lack of facilities to meet the needs of the times, the Congress has stepped in with a proposal which has completely disrupted the capacity of local government to undertake capital financing. This lack of understanding by the national government on the practical functioning of local government at a time of crisis reflects no credit on this proposal. The continuation of discussions and hearings on this proposal will effect a moratorium on the construction of badly needed capital facilities by local government across this country. An immediate decision should be made to abandon the efforts to levy federal income taxes on the interest of local government debt instruments so that local government from coast-to-coast can continue to meet and carry out its obligations.

Statement by Rollin F. Agard, Financial Consultant, Aviation Department, City of Kansas City, Mo.

SUMMARY

1. This legislation destroys the market for securities now tax-exempted.
2. Any subsidy granted by Federal Government must be tax supported from local residents and business.
3. Revenue derived from taxing this bond interest will not offset cost of subsidy and higher rate costs.

4. Raise serious question concerning claim that there will be no federal review of local projects financed by taxable bonds.

5. Subsidy could be, in effect, a blank check on U.S. Treasury and by controlling this, U.S. Government controls local financing.

6. Cost of administration federally and locally would be substantial.

7. Prospects of passage of this legislation has effectively destroyed the market, both primary and secondary.

8. Twenty-four states limit interest rates to 6% or below on General Obligation Bonds, six states limit interest to 7%, and twenty states limit interest to 6% on Revenue Bonds.

9. There is a question in some states whether taxable bonds can be legally issued.

10. No time to be tampering with the right of l :al government freedom to finance its needs.

Statement by Rollin F. Agard, Financial Consultant, Aviation Department, City of Kansas City, Mo.

While the bill before this committee permits states and municipalities to continue with the issuance of tax-exempt bonds, the same act practically destroys the market for a tax-exempt security. The alternative of a Federal interest subsidy holds no assurance that such a plan will continue to exist. It will only be a matter of time before the legislation is changed in the press of events that no further subsidies will be granted on future municipal issues.

I think it is well to point out that any subsidy granted by the Federal level for municipal bond interest must be supported from taxes which originate from local residents and business. I believe very strongly that the cost of financing under the proposed legislation will be substantially greater than before. The income to be derived by the Federal Government from the taxable securities will by no means offset the subsidy and the higher rates that the municipal portion of the bond package would require.

Proponents for this legislation have advocated that there would be no Federal review of local projects. I find it difficult to accept this viewpoint. This has the effect of writing a blank check on the Federal Treasury for the sum of the subsidy to be provided from that source. The Federal Treasury is not a bottomless pit, and each session of Congress must, if this legislation is passed, appropriate the needed sums for the subsidy payments. There is little question but that eventually all local initiative would be a thing of the past. The cost at the Federal level for administration of such a program will be substantial as well as less effective than now exists. Also, the administrative cost at the local level will be much greater.

Events of recent months reveal the seriousness of impairment of the municipal market resulting from congressional action to this date. Hundreds of municipal bond issues have been grounded because of interest rates which would exceed legal limits. For those issues which could be marketed, the cost to the taxpayers will run into many millions of additional dollars. Each week many bond isues have failed to obtain voter approval. Only recently the voters of Texas refused to approve an increase in the interest ceiling.

The August 25, 1969, issue of the Daily Bond Buyer published information showing that in twenty-four states, statutes set interest rate ceilings at 6% or below for general obligation bonds. Six other states have a limit of 7%. For revenue bonds twenty states have a 6% ceiling. Moreover, the charters of many cities establish interest rate ceilings as is the case in Kansas City. Ordinarily, charters can only be amended by a vote of the people.

The impact of this legislation has thrown the secondary market into a state of chaos. This phase of the municipal bond market has become increasingly important, with the municipal debt now at about $130 billion. Thousands of bond holders, many of whom do not fall in the wealthy levels of our society, are seeing their lifetime savings being depleted by as much as 25 to 30%. This is destroying the faith of investors for municipal bonds. It is one of the major factors that have caused the interest rates to spiral in recent months to levels never before experienced.

If this bill is approved in its present form the Federal Government may find itself in the bond business, thus destroying another phase of this nation's private enterprise system.

There could also be a question in some of the states as to whether any municipality has the authority under the constitution and laws of the state, to issue taxable bonds without an amendment of the state constitution and the bond laws of the state.

In light of the serious need for local improvements to provide essential facilities for an expanding nation, this should not be the time for tampering with the local financing systems. America is great because it has had local freedom. If this is traded for a powerful central government we are doomed for destruction. If the tax-exempt status of municipal bonds is removed, a long period of litigation is inevitable. This, too, will stifle progress at the local level and could endanger the National economy.

(The committee subsequently received the following telegram, re: Mayor Davis' statement:)

[Telegram]

LEES SUMMIT, MO., *September 19, 1969.*

Senator RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
U.S. Senate Building,
Washington, D.C.:

Please consider Mayor Davis as representing the city of Lees Summit, Mo., when he appears before your committee concerning the taxing of municipal bonds. Mayor Davis and I have discussed this matter at great length and I am in full concurrence with him.

ALFRED C. JOHNSON,
Mayor of the city of Lees Summit.

The CHAIRMAN. Now we will call the Honorable Ivy Baker Priest, if you please, California State treasurer, and I believe she will be accompanied by George Harrington, bond consultant.

VOICE. Mrs. Priest understood she was to be last. She has left her hotel but she is not in the room at the moment.

The CHAIRMAN. All right, we will call the next witness, the Honorable Louie Welch, mayor of Houston, Tex.

STATEMENT OF HON. LOUIE WELCH, MAYOR OF HOUSTON, TEX.

Mayor WELCH. Mr. Chairman and gentlemen, you have before you what we conceive to be a well-written statement in the hope that it could be well read but we find upon our appearance that most of it is repetitious of what already has gone before.

I would like to join, with the concurrence of Governor Preston Smith of Texas, those who have preceded me in the testimony in urging the earliest possible indication from this committee in an official way what has been stated here so beautifully unofficially.

I would like also to point out what we consider to be one of the extreme fallacies of the subsidy program for tax-exempt bonds. This merely tells the man who is not paying any tax, "We will pay you a higher interest with which to pay the tax." You are just giving him money out of the Federal Treasury to pay you back a lesser amount, and to me this is absolutely inconceivable.

I am concerned because 5 years ago when I first became mayor, people in good faith bought bonds of the city of Houston, that they cannot today recover $70 for each $100 investment, because of the impact of this House legislation.

Senator ANDERSON. Is that the quotation?

Mayor WELCH. Yes, sir; between 65 and 70 percent of face value is all the 20-year bonds we sold are selling at today. If they become taxable under any guise, limitation of tax preference, or ADR, any way, they won't be worth 50 cents on the dollar.

Now, this will not be because the people of Houston have breached the faith with the people who bought these bonds. It will be because of the acts of this Congress.

We believe that instead of looking to a limiting factor as this legislation would do, on State and local bonds, that this body should consider the broadening of the market. There is an exhibit that you have before you included in my testimony which shows that the allocation of deduction requirement, which is already applicable to life insurance companies, has since 1960 reduced their percentage of investment in State and local bonds from 5.2 percent of their total outstanding to only 2.3. You just put them completely out of the market. They no longer buy our bonds, which means that that removal alone gives us a much more limited market than we previously had because they were holding 5.2 percent of all of our outstanding bonds and they are not buying any more.

There is also, I think, the most substantive suggestion for subsidy that I have seen anywhere, which was prepared by the Urban Institution and it is incorporated as a part of my testimony. If a subsidy must be paid, we suggest that it be paid only to the pension funds of State and local governments, and that would take them out of the A.T. & T. market and let them buy the bonds of the States and the local units of government and would free another $5 million a year for the purchase of tax-exempt securities.

Gentlemen, I have a 10-minute speech but I will just let you have it there.

Thank you.

The CHAIRMAN. Mayor, you made a fine statement. Of course, your entire statement will appear in the record and your addendum will be added to it.

Senator ANDERSON. I just think your market prices is probably pretty low. I was in the House when we started World War II and were told by a man from Treasury who came down and testified that if we do this with a $109 billion budget we would close every bank, every insurance company, and all these other people, and I didn't see any one of them close. I can't believe that this bond of 50 percent is accurate.

The CHAIRMAN. Would you mind giving us those quotations and making them available?

Mayor WELCH. We sold bonds slightly in excess of 3 percent.

Senator WILLIAMS. I think part of it is attributed to this action by the Congress and part of it would be attributed to the fact that interest rates in the last few years, and particularly the last 3 months, have advanced so much and has affected the price of the bonds and many AAA bonds are selling at 20, 30-percent discounts, and I am sure the same thing is true of long-term State bonds and municipal bonds.

Mayor WELCH. That is correct, sold all over.

Senator WILLIAMS. Sold a few years ago at a coupon rate, probably attributable to both problems.

Mayor WELCH. That is right but the fact the municipals have advanced more rapidly than the industrials is attributed to the loss.

The CHAIRMAN. Any further questions?

Thank you.

Mayor WELCH. Thank you.

The CHAIRMAN. You might, if you would, document the statement what your bonds sold for and what they are selling for now.

Mayor WELCH. I would be happy to.

The CHAIRMAN. We will then add that to your statement at a proper place in the record.

(Hon. Louie Welch's prepared statement follows:)

STATEMENT OF HON. LOUIE WELCH, MAYOR, CITY OF HOUSTON, TEX.

Senator Long and gentlemen: Thank you for the opportunity to appear before your committee. I shall attempt to be as brief as possible here, taking the time which you have granted to emphasize the significance of the legislation which you are considering. For your later contemplation I also am providing copies of detailed statistical and analytical studies which support these points.

Gentlement, the proposals now before you will directly and seriously increase the cost of living of your constituents. They will do this by adding measurably to the cost of public education and every state. They will do this by increasing significantly the cost of local government in every community of every state. Furthermore, they will irreparably damage the traditions of state and local government independence from federal control.

These effects, lest you hear in your minds the cry of "Wolf" from the imaginative shepherd, already have been felt. They are demonstrated currently by the serious problems of the bond market under only the threat of this bill.

Now, we are referring here specifically to the provisions which include interest from state and local bonds in the limited tax preference and the allocation of deductions rule.

To the taxpayer, the costs of these proposals will add up to some $1.32 billion *per year*. Details on this staggering impact are shown in Exhibits A and B to this presentation. What is not shown in these figures are the unpleasant facts which this must involve, as these unnecessary costs are incurred by cities and school systems in every state.

Reflect for a moment, if you will, on the problem to be faced by mayors and school system leaders each time they place new bonds on the market under this proposed system. It will be incumbent upon them to explain to their constituents—who are your constituents, too—the reason why local government is costing more. And that reason, as the public will be told time and time again, will be because this Congress passed the law which costs them more to borrow money for their school buildings, for their sewers, for their water, for their streets . . . for every essential item of local government.

Make no mistake about it. There will be no choice for local officials, for they must tell the public the facts. And in this case, they will find it necessary to tell them the facts often, for when $1.32 billion dollars are incurred in extra costs *each year*, scarcely a day will go by that does not see some community being reminded of the cause for its rising cost of living.

I refer you again to Exhibits A and B, the sources of this estimate. You will see that it is a low estimate, not a high one. It is based on facts already established. In particular, Exhibit B shows that since this legislation was proposed, the interest rates on state and local bonds—which are the cost to the public—have increased more than one-half of one percent beyond increases on comparable, taxable bonds. This one-half percent, translated into the extra dollars which this is costing the public, amounts to $1.32 billion per year. And this, I remind you again, is the impact from the mere *threat* of the law. Passage undoubtedly would make it more severe.

The interest subsidy proposal would have further dire effects. The tradition of our nation since its founding has preserved for the people the right to determine their own destiny in local matters. Imposing this new thinking on local governments now would severely restrict the right of a community to meet its own challenges on such strictly local matters as construction of school buildings and paving of streets. This, with the cities of the nation so much larger and so much more complex, with the tremendous shift of population to urban centers, would be a crippling blow to the very system of life which has made the United States what it is today.

And for what? What will really have been accomplished by this measure, intended for the much-needed purpose of tax reform?

The Committee already has received testimony which shows the answer. From the office of the Secretary of the Treasury you have been given the facts and figures which show that, at best, this bill would recapture some $80 million annually. And that "best" will not be achieved for ten full years—years during which the cost to local government and to the taxpayer will be more than 16 times as much *each year.*

Of course, it also should be recognized that the buyers of municipal bonds, from whom this money is to be taken, already have paid their taxes when they buy the bonds. This, after all, is the simple effect of accepting a lower return on their investments than would be available in fully taxable securities. They are, in effect, to be penalized by this legislation for supporting their local governments, and the psychological impact of this punishment can only further damage the market for municipal bonds.

Local governments have been pleased at the concern of this Congress with the need for lower, not higher, costs for local government. Attachments 1, 2 and 3 to this testimony, which have been prepared by the Urban Institute, Washington, D.C., are submitted as a more effective and acceptable alternative to the interest subsidy proposals thus far put forth.

The proposals of the Urban Institute should prove most attractive to this Committee because they accomplish the desirable purpose of broadening the market for state and local bonds through inducing new types of investors to purchase these securities. This approach, by offering a subsidy to state and local retirement funds for example, would lower local government borrowing costs by opening the door to a substantial, new and rapidly increasing source of funds. It would preserve the integrity of tax exempt bonds and the independence of local governments to finance capital improvements.

I urge the Committee to examine the Urban Institute proposals thoroughly, for they provide a method which will not require federal permission for state and local borrowing and will thereby preserve rather than diminish local autonomy.

I further urge this Committee to provide itself with adequate time to examine other alternate proposals which you will receive. In particular, we are told that the Treasury Department during these hearings will present an alternative plan and I am sure that you will agree that there is not adequate time for you to make an informed judgment prior to the end of your hearings in October.

Gentlemen, the discussions now under way before you in regard to HR 13270 cover far-reaching and decisive matters. Your actions can permanently alter the traditional sovereignty of the states and their political subdivisions. Indeed, it is within your power in these measures to make virtually every local government dependent upon the federal government for its capital improvements programs and, thereby, for its economic health and its very future.

As the representative of the citizens of Houston, and with the concurrence of the Governor of Texas, the Honorable Preston Smith, we urge you on behalf of all citizens of our state to drop all references to state and local bonds from this legislation.

Specifically, we urge the following changes in HR 13270:

Deletion on income from state and local bonds in

Section 301—Limit on tax preferences for individuals, estates, and trusts;
Section 302—Allocation of Deduction;

Deletion in entirety:

Section 601—Interest on certain governmental obligations;
Section 602—United States to pay fixed percentage on yield on taxable issues.

We further urge you to permit this subject to receive the proper time, attention and consideration which it deservies. We pledge to you our cooperation in this essential study.

An Analysis of the Tax Reform Bill of 1969 (H.R. 13270) as Passed by the House of Representatives of the United States on August 8, 1969, as It Pertains to Local Government Financing

(By Louie Welch, Mayor, City of Houston, Texas)

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Tax reform is vital and badly needed in our Nation today. Many facets of this legislation are important and necessary to the equality of taxation in our system of government. Portions of this legislation deal with State and Local government financing of capital improvements through municipal bonds.

As the Mayor of Houston, I have examined these portions of the legislation which affect our city (and all local government throughout the United States) and find some of them to be so costly to the average taxpayer that I feel that I must speak out in an effort to warn members of Congress and the people themselves of the consequences of this little understood portion of this legislation.

The portions of the legislation to which this paper is addressed will be discussed as two separate matters:

FIRST DISCUSSION

Section 301—Limit on tax preferences for individuals, estates and trusts.

Section 302—Allocation of deductions.

It is the inclusion of interest from local government bonds in these two sections to which these comments are directed.

SECOND DISCUSSION

Section 601—Interest on certain governmental obligations.

Section 602—United States to pay fixed percentage of yield on taxable issues.

I advocate total elimination of these provisions as being costly to taxpayers of both the Federal government and local governments, and because it adversely changes the traditional relationships between Federal, State and Local governments.

FIRST DISCUSSION

Section 301—Limit on tax preferences for individuals, estates and trusts (hereafter referred to as LTP).

Section 302—Allocation of deductions.

Both of these sections place a tax on previously tax-exempt obligations of local governments.

The basis for the inclusion of interest from state and local bonds in LTP and allocation of deductions is set forth on page 9 of *The Report of the Committee on Ways and Means* dated August 2, 1969. The Committee reported that it had examined 154 tax returns from the year 1966 of individuals who had adjusted gross income in excess of $200,000 and who paid no income tax. It continued:

Your Committee examined these 154 returns (along with other tax cases involving low effective rates) in detail in order to find out the reasons for their nontaxtable status.

The analysis showed that in most cases the nontaxtable status arose from a combination of several factors. The most important single cause of nontaxability for this group was itemized deductions which totaled over $130 million or 116 percent of adjusted gross income. Another group of these taxpayers benefited most from the unlimited charitable contribution deduction (49 cases). In fact the single most important itemized deduction for the nontaxable group was the charitable contribution deduction, amounting to nearly $79 million, of which $55 million or 70 percent was property, the bulk of which represented untaxed appreciation. Another group benefited primarily from the deduction of interest paid (72 cases), which was the second most important itemized deduction for the group as a whole. Most of this interest paid was on loans which were presumably for the purpose of acquiring appreciating investment assets held for capital gain purposes and was frequently deducted from earned income. Others benefited from such items as real estate depreciation, the excess of percentage over cost depletion and intangible drilling and development expenses, and farm losses. Many were nontaxable because they were able to exclude one-half of capital gains from their income and offset all their itemized deduction against the remaining income subject to tax.

Your committee also examined the returns of taxpayers who were taxable but paid low effective rates of tax. The most important reason for the low effective tax rate paid by these taxpayers was the combination of the excluded half of capital gains and itemized deductions which were offset against their income subject to tax.

Note that no mention is made of interest from state and local government bonds. In fact, there would be no economic justification for ownership of tax-exempt securities by those taxpayers because tax-exempt income does not have maximum net after tax benefit when a taxpayer's tax rate is 0%.

The next paragraph of the report continues:

> It is believed that still other high-income individuals paid no tax and did not even file tax returns since virtually their entire income was from tax-exempt State and municipal bonds.

No evidence is found in the report to support this statement. In fact, the word "believed" seems to speak for itself. We would support legislation that would require the reporting of interest on state and local bonds on federal income tax returns so that the Congress could know whether or not his statement is correct.

WHAT WILL BE TAXED UNDER LTP AND ALLOCATION OF DEDUCTIONS?

The only municipal bonds to be taxed as a result of this legislation would be those held by individuals, estates and trusts. The distribution of ownership of state and local bonds is set forth below.

Ownership of municipal bonds

	Percent
Individuals, estates and trusts	32
Banks	38
Insurance companies	17
Pension funds, sinking funds, and all others	13

Further, only those obligations held by individuals whose tax preferences are an amount greater than one-half of their adjusted gross income would be taxed in any manner by LTP.

The allocation of deductions formulas apply only to interest on local government bonds issued after July 12, 1969.

Under the transition rule, only one-tenth of such interest would be taken into consideration for allocation purposes in the first year, two-tenths in the second year and so on, until after 10 years, 100% of the interest on only new issues of tax-exempt bonds would be included.

It must be apparent to even the casual observer that the federal government is not in a position to tax any more than a minimal percentage of outstanding bonds as a result of these proposals. Indeed, under the formula it will be many years before any significant percentage of bonds can be affected.

It is my opinion that much of the damage which has occurred to the market for municipal bonds over the past sixty days is a result of fear—the fear of a subsequent extension of this formula.

I understand the attitude of those Senators on this Committee who commented in these hearings on September 4, 1969 to the effect that the impact of this legislation on the market for tax-exempt bonds over recent weeks is difficult to understand.

EFFECT ON U.S. TREASURY AND LOCAL GOVERNMENT

The Assistant Secretary of the Treasury, the Honorable Edwin S. Cohen, testified on September 4, 1969, to the effect that the total annual tax collected after the 10-year phase-in period as a result of State and Local Bond interest would be only $80,000,000. He estimated revenue of only $45,000,000 as a result of the inclusion of municipal bond interest in the Allocations of Deductions rule and only $35,000,000 as a result of the inclusion of this interest in LTP.

Exhibit A at the conclusion of this report demonstrates the additional cost to state and local government as a result of higher interest rates on their securities. The study reflects that an increase in local government borrowing next year, 1970, in the amount of ½% would cost states and local governments $1.32 billion over the life of those bonds.

Since Secretary Cohen has testified that the return of taxes to the U.S. Treasury after 1979 would only be $80 million, the vast difference in these two figures is difficult to understand.

However, fear, sentiment, opinion and attitudes are all important factors in a free market. Although it seems to be far out of proportion to reality, the facts are that average yields on state and local bonds have risen in excess of ½% more than yields on comparable Government and Corporate Bonds during the past sixty days. Exhibit B demonstrates these facts.

Stated in another manner, if the increased yields on state and local bonds remain at the higher level (½%) that has recently been attained, and the ultimate (1979) tax return to the U.S. Treasury is considered as a constant figure, a significant net loss to all taxpayers is the result.

Cost to local governments of ½% higher interest rates	$1,320,000,000
Return to Treasury from LTP and Allocation of Deductions	80,000,000
Net annual loss to all taxpayers	1,240,000,000

It is apparent from these calculations that the taxpayers would still suffer even if the increase in interest rate to local governments was reduced to as little as 1/20 of 1%.

Cost to local governments of 1/20% higher interest rates	$132,000,000
Return to Treasury from LTP and Allocation of Deductions	80,000,000
Net annual loss to all taxpayers	52,000,000

EXHIBIT A

DOLLARS LOST TO STATE AND LOCAL GOVERNMENT AS A RESULT OF HIGHER INTEREST RATES ON MUNICIPAL BONDS

	Volume of new new debt issued [1]	½ percent increase results in loss of—	1 percent increase results in loss of—
1970	$17,600,000,000	$1,320,000,000	$2,640,000,000
1971	18,600,000,000	1,385,000,000	2,790,000,000
1972	19,500,000,000	1,462,500,000	2,925,000,000
1973	20,800,000,000	1,560,000,000	3,120,000,000

[1] Source: JEC study.
Average maturity: 15 years.

EXHIBIT B

RELATIVE CHANGES IN BOND MARKETS—YIELD COMPARISON (JULY 2, 1969, AS RELATED TO SEPT. 4, 1969)

[In percent]

	Moody's Corporate Bond Index	U.S. Treasury [1]	Bond Buyer averages State and local bonds [2]
Sept. 4, 1969	7.44	6.21	6.37
July 2, 1969	7.33	6.17	5.68
Net increase in yield	+.11	+.04	+.69

[1] 20-year maturity used for illustration.
[2] 20-bond average as compiled by the Daily Bond Buyer using representative yields on tax-exempt bonds of 20-year maturity.

Source: Daily Bond Buyer.

SECOND DISCUSSION

Section 601—Interest on certain governmental obligations.

Section 602—United States to pay fixed percentage of yield on taxable issues.

The Treasury Department in its testimony of September 4, 1969, before the Senate Finance Committee did not recommend the interest subsidy provisions set forth above and we presume that this decision was based upon an analysis of the cost of these provisions to the United States Treasury, and therefore, to all taxpayers. Several important considerations in this matter are discussed below.

The impact upon markets for taxable securities—The Investment Bankers Association reports that in 1968 their members underwrote and distributed approximately $33 billion in corporate, state and local bonds. Approximaely one-half or $16 billion was in tax-exempt state and local bonds. It would seem that any substantial infusion of more taxable securities into that market would trend interest rates on taxable securities higher thus increasing corporate and federal government interest rates on its direct borrowing as well as on Federal agency borrowing higher than those relative levels presently attained by taxable debt securities.

Changing ownership patterns of state and local bonds as a result of taxable interest rather than tax exempt interest—Taxable securities over the period 1966–67–68 (see Exhibits 3 and 4) were held by investors whose aggregate tax rate was only 13.4%. It is logical to conclude that this percentage would be reached on taxable federally subsidized local government bonds. In fact, purchase of their own securities by local governments at higher taxable yields would be a natural result and could easily cause the tax return to the federal government to drop below the 13.4% level which exists for other taxable securities.

Obviously, any federal interest subsidy of the magnitude of 30% to 40% would create a substantial drain on the United States Treasury and a heavier federal tax burden on all taxpayers.

STATISTICAL ANALYSIS OF OPTIONAL TAXABLE STATE AND LOCAL BONDS, 40-PERCENT INTEREST SUBSIDY

Annual increment	Interest rate	Annual interest cost in dollars
(A) $16,000,000,000	8 percent (taxable)	$1,280,000,000
(B) $16,000,000,000	3.2 percent (Federal subsidy)	512,000,000
(C) $16,000,000,000	4.8 percent (local participation)	768,000,000
(D) $16,000,000,000	5.6 percent (tax exempt)	896,000,000
Savings to local government (D)—(C)		128,000,000

Federal Government revenue gain (or loss):	
Taxable income (A)	$1,280,000,000
Tax recovery at 13.4 percent	171,520,000
Less Federal interest subsidy (B)	(512,000,000)
Loss to U.S. Treasury	(340,480,000)
Savings to local government	128,000,000
Annual net gain (loss) to all taxpayers	(212,480,000)

	30 percent interest subsidy		Annual interest cost
	Annual increment	Interest rate	
A	$16,000,000,000	8 percent (taxable)	$1,280,000,000
B	16,000,000,000	2.4 percent (Federal subsidy)	384,000,000
C	16,000,000,000	5.6 percent (local participation)	896,000,000
D	16,000,000,000	5.6 percent (tax exempt)	896,000,000

Note: Savings to local government (D) $896,000,000 minus (C) $896,000,000: None.

FEDERAL GOVERNMENT REVENUE GAIN (OR LOSS)

Taxable income (A)	$1,280,000,000
Tax recovery at 13.4 percent	171,520,000
Less federal interest (subsidy (B))	384,000,0000
Gain (loss) to U.S. Treasury	(212,480,000)
Savings to local government	
Annual net gain (loss) to all taxpayers	($212,480,000)

Keep in mind that these figures are for one year only. The average life of state and local bond issues approximates 15 years. The total cost on this basis for using this device, for just one year could thus approximate $3,187,200,000. In addition to the above figures one can mentally add the unestimated cost of administering such an undertaking. The basic principle underlying this discussion rests on the foundation that the Federal Government is likely to have a net drain on the Treasury as a result of this approach.

Since local citizens are also Federal Taxpayers it is the citizen who will suffer. The wealthy will merely seek another investment which will offer a better "after tax" return on investment dollars, than taxable state and local government securities.

EXHIBIT 3

Investor group	Net purchases of corporate and foreign bonds (in billions)				Percent contributions	Effective Federal tax rate	Effective taxable contributions
	1966	1967	1968 estimate	3-year total			
State and local government	$4.4	$6.7	$7.0	$18.1	44.7	0	0
Private pension funds	1.9	1.0	1.5	4.4	10.9	0	0
Subtotal No. 1				22.5	55.6	...	0
Mutual savings bank	.3	2.0	.2	2.5	6.2	18	1.1
Life insurance companies	2.2	3.7	3.2	9.1	22.5	20	4.5
Subtotal No. 2				11.6	28.7	...	5.6
Other insurance companies	.1	.8	.4	1.3	3.2	48	1.5
Commercial banks	.1	.8	0	.9	2.2	48	1.1
Other finance	.4	−.6	.3	.1	.2	48	.1
Households	1.2	1.8	−.9	2.1	5.2	50	2.6
Rest of world	1.2	.8	0	2.0	4.9	50	2.5
Subtotal No.3				6.4	15.7	...	7.8
Grand total	11.8	17.0	11.7	40.5	100.0	...	13.4

Source: 1966 and 1967 net purchases are from Board of Governors, Fedeı.ı Reserve System; "Flor-of-Funds" Jan. 31 1968, p. 16. 1968 estimate is SB & H projection.

NET FUNDS INVESTED IN CORPORATE AND FOREIGN BONDS BY INVESTOR GROUP ARRANGED BY TAX BRACKET

Dollar amounts in billions]

	Net volume of purchases of corporate and foreign bonds, 1966, 1967, and 1968	Percent contribution
Zero tax bracket:		
State and local governments	$18.1	...
Private pension funds	4.4	...
Total in zero tax bracket	22.5	56
1- to 20-percent tax bracket:		
Mutual savings banks	2.5	
Life insurance companies	9.1	
Total, 1- to 20-percent tax bracket	11.6	29
21- to 50-percent tax bracket:		
Other insurance companies	1.3	...
Commercial banks	.9	...
Other finance	.1	...
Households	2.1	...
Rest of world	2.0	...
Total, 21- to 50-percent tax bracket	6.4	16
Grand total	40.5	100

Note: Average tax bracket: 13.4 percent.

NOTES ON THE URBAN INSTITUTE MUNICIPAL MARKET EXPANSION PROPOSALS

Briefly stated, the Urban Institute plans to seek to expand the supply of funds available to municipal borrowers by opening up State and local savings to support that sector's investment programs. To do this, the proposals circumvent the obstacle of tax-exemption that makes these investments now unprofitable for state and local pension funds by paying them a subsidy to neutralize the pretax yield differential between taxable and nontaxable securities. In the case of the Unemployment Trust Fund, it is proposed that State and local securities be made legal investments and also that this fund be paid a subsidy. These subsidies should be largely self-supporting since the taxable security incomes given up by these non taxpaying investors will be held by taxpaying investors. That is, the diminished supply of tax-exempts to taxpaying investors will channel their holdings into taxable investments and the tax revenues from these would approximate the subsidy required to induce the State and local pension funds to hold tax-exempts.

Altogether, the State and local funds could supply from $4 to $8 billion a year to the municipal bond new issue market. Moreover, these inflows would be largest in times of stringent monetary conditions when municipal yields soar above their traditional relationship to those on taxable instruments. The cost of such a subsidy scheme would be, for $4 billion in State and local securities with 5 percent coupons, $80 million dollars with a 40 per cent coupon subsidy. This compares to the $7.5 billion that the Federal government dispenses in grants to State and local facilities alone.

Some specific notes on the proposals:

1. The UI proposals do no violence to the principle of tax-exemption. They rather expand the supply of funds in such a way as (1) to increase the efficiency of tax-exemption *qua*-subsidy to State and local borrowers and (2) to reduce the extent of tax shelter available to high income-tax bracket investors.

2. Communities and states would continue to issue bonds in the same manner. Underwriting would still be in the hands of private investment bankers. The Federal government or any agency of it would have no interest in a control over the amount or timing or nature of any state and local borrowing. The market mechanism would remain the same in all mechanical details.

3. But a new investor group, that of the State and Local Pension Funds, would now be purchasing State and local bond issues. For example, if the subsidy rate were 40 per cent, pension funds would acquire municipals on the basis of a 40 per cent markup on coupon yields to be covered by a Federal government subsidy. Thus, if municipal bonds were selling at 6 per cent, a pension fund buying this bond would receive a post-subsidy yield of 8.40 per cent. Today, that would be above the yield available on the highest grade corporate issue.

4. The pension fund would receive the subsidy routinely on the presentation of a copy of the coupon to the Treasury. Although there might need to be some provisions to protect the Treasury against intra-governmental transactions and to insure "arms length" transactions, there would be no restriction as to the nature or maturity or purpose of the municipal bond. The buying decision is left strictly up to the pension fund.

5. State and local pension funds are growing at a rate of about 10 per cent or $4 billion a year. Their total assets are $45 billion, the majority of which are invested in corporate bonds. Given that the average investment life of their fixed income securities (93 per cent of the total) is 10 years, they have a rollover of $4 billion as well as net new funds of $4 billion to invest each year. If roughly one half (or $4 billion) of this were to be invested in State and local securities, it would be sufficient to absorb about 40 per cent of the $10 billion annual net increase in State and local securities. A 40 per cent expansion in net available funds would not only allow for more borrowing but would lower the cost of the borrowing done. And the market would be greatly stabilized. Addition of just the net growth in the Unemployment Trust Fund would add another $1.0 billion of support to the market. The selection process of which bond to buy for the Federally administered fund could be solved by tying their purchases to Federally guaranteed tax-exempt notes and bonds such as those emitted by HAA and UAA.

6. How does the subsidy pay for itself? The subsidy pays for itself by (1) keeping tax-paying investors from holding tax-exempt securities, and (2) keeping non taxpaying investors from holding taxable securities. Of course, this rearrangement is not brought about by fiat or purposeful exclusion, but is an outcome of removing the barrier which tax-exemption forms to the investment flow of certain non-taxpaying institutions—in this case, the State and local pension funds—into the tax-exempt market.

While the final outcome is a complicated thing, the essential idea can be expressed as follows: Given a fixed supply of tax-exempt bonds and investor resources, the pension funds would absorb part of the supply of tax-exempt bonds. High taxable income investors, that now demand a high discount to hold municipals, would acquire taxable investments instead. (A simple way of looking at it is that they would purchase the corporate bonds that otherwise would have been held by the pension funds.) Taxable investors would pay taxes where now taxes are avoided—both by their holding of tax-exempts and by the pension funds holding potentially taxable securities. These taxes would probably cover most if not all of the subsidy since the average marginal rate on tax-exempt investors is approximately 40 per cent.

There are other costs and savings to consider. Federal government borrowing costs might go up somewhat, but it is primarily a short-term market and State and local pension funds make only a small contribution in support. On the other hand—and this is very important—the broadened municipal market would be able to absorb a greater volume of financing and at a lower cost. This type of support would cheapen the borrowing of governments, especially in times of tightness when the taxable to non-taxable yield ratio drops off precipitously.

A Proposal To Allow the Unemployment Trust Fund To Invest in State and Local Securities

Over the past 12 years, the total volume of state and local obligations outstanding has grown by over 250% (Table 1). Yet, despite the substantial growth in this source of financing capital outlays, our society has not been able to keep pace with the increasing needs for educational facilities, sewage disposal plants, hospitals, and the like so as to maintain, let alone improve, the quality of public services in these areas. Therefore, we may reasonably expect the demand for capital funds to continue to grow at least as rapidly over the next decade, and the question arises: Who will be the leaders of these funds?

To provide a perspective, Table 2 presents the stocks of state and local securities held by various institutions for the years 1960 and 1965–68 as well as the percentage distributions in those years. Several facts emerge from this table. First, over the 8-year period, commercial banks have become the mainstay of the state and local securities market and have increased their holdings of the total stock from 26% in 1960 to 45% in 1968. (As will be seen below, this proportion is projected to rise to over 50% in 1975.) This development has been accompanied by a decline in the proportion of municipals held by households, which in 1960 were the most important suppliers of funds to states and localities. Fire and casualty insurance companies classified in Table 2 as "other insurance" are the other major lenders to state and local governments. State and local government holdings of their own securities through pension funds have fallen both relatively and absolutely since 1960. The expanding role of commercial banks in the municipal market may be demonstrated by the fact that 68% of the change in stocks from 1960 to 1968 were absorbed by these institutions.

Table 1.—State and local securities outstanding

[Dollars in billions]

End of year:	*Stock outstanding*
1956	49.4
1960	68.7
1965	101.2
1966	107.2
1967	117.3
1968	128.5

TABLE 2.—HOLDERS OF STATE AND LOCAL SECURITIES

[In billions of dollars and percentage distributions]

	1960		1965		1966		1967		1968	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Total	68.7	100.0	101.2	100.0	107.2	100.0	117.3	100.0	128.5	100.0
State and local governments	7.2	10.5	4.8	4.8	4.5	4.2	4.0	3.4	3.6	2.8
Other	61.5	89.5	96.4	95.2	102.7	95.8	113.3	96.6	124.8	97.1
Households	28.7	41.8	38.4	37.9	40.6	37.9	40.6	34.6	42.0	32.7
Corporate business	2.4	3.5	3.6	3.6	4.4	4.1	5.1	4.3	5.2	4.0
Commercial banks	17.6	25.6	38.6	38.1	41.0	38.2	50.0	42.6	58.1	45.2
Mutual savings banks	.7	1.0	.3	.3	.3	.3	.3	.3	.4	.3
Life insurance	3.6	5.2	3.5	3.5	3.1	2.9	2.9	2.5	3.0	2.3
Other insurance	8.1	11.8	11.3	11.2	12.7	11.8	13.7	11.7	15.6	12.1
Other institutions	.4	.6	.5	.5	.5	.5	.6	.5	.6	.5

The dependence of municipalities upon commercial banks as a source of funds has at least two consequences. On the one hand, the considerable resources of commercial banks are increasingly available for financing much needed capital facilities in our urban areas. On the other hand, when financial markets tighten, commercial bank resources become severely squeezed, forcing states and municipalities either to look elsewhere for funds (usually to individual investors) at considerably higher interest rates or to revise their borrowing plans. Thus, commercial banks, while at times quite a large source of financing, are also an exceedingly volatile source. It is not coincidental that 1966 was both a year during which the net increase of municipals fell by about 20% relative to 1965, and also a year during which commercial banks absorbed only 40% of the net increase. We should be quite concerned, then, about the near-term outlook for the municipal market in view of the preliminary data for the first quarter of 1969 which shows commercial banks adding municipals to their portfolios at an annual rate of only $1.5 billion after averaging $8.5 billion the previous two years.

In terms of the longer-term prospects, unpublished financial forecasts at the Federal Reserve Board assume that commercial banks will be in a position to continue to absorb the bulk of future state and local borrowings. Table 3, which is based on these forecasts shows estimated holdings of the stocks of municipals and the percentage distributions for the years 1970 and 1975. The 1975 estimates of total stocks are quite close to those of Diamond in *State and Local Public Facility Needs and Financing* (U.S. Congress, Joint Economic Committee, 89th Cong., 2nd Sess., December 1966, p. 50). It should be noted that this is an equilibrium projection in the sense that the stocks represent a balancing of demands for and supplies of funds. The public facility needs of state and local government are not projected to be completely satisfied in this projection. Rather, the estimates represent what may be reasonably borrowed, given present institutions. In as much as the 70% growth in the outstanding stock over the 8-year period 1961–1968 failed to raise the quality of public services, it is unlikely that a 63% increase from 1968–1975 will do much more. Hence, it is desirable to broaden the market for state and local securities from two points of view:

(1) to develop new sources of financing beyond what present financial institutions can provide so as to allow a faster growth in the rate of public facility construction;

(2) to move away from the present heavy reliance on commercial bank resources which display a high volatility in response to changes in financial market conditions.

One possible source of additional financing has already been referred to—state and local pension funds—and they will be the subject of a later memorandum. Suffice it to say that the tax-exemption feature is of no value whatever to the pension funds, and the lower returns which result are the major reason for their declining role in the municipal market.

Our interest in this memorandum is in the federal trust funds of the original Social Security legislation, and specifically the Unemployment Trust Fund, which recommends itself as a possible source of state and local government financing on several grounds.

(1) The Unemployment Trust Fund (UTF) holds primarily the states' own funds. The federal government is merely the trustee on behalf of the beneficiaries within the individual states. Over the period fiscal 1960–68, 76% of the total receipts of the UTF (net of interest and profits on investments) consisted of deposits by the states. Therefore, the case can reasonably be made that what are essentially the state funds should be used for purchasing their own obligations.

TABLE 3.—ESTIMATES OF STATE AND LOCAL GOVERNMENT SECURITY HOLDINGS

[Dollar amounts in billions]

	1970		1975	
	Amount	Percent	Amount	Percent
Total	$146.9	100.0	$209.3	100.0
State and local governments	3.1	2.1	2.3	1.1
Other than State and local governments	143.8	97.9	207.0	93.9
Households	44.7	30.4	59.9	28.6
Corporate business	6.6	4.5	11.5	5.5
Commercial banks	70.7	48.1	106.4	50.8
Mutual savings banks	.1	.1	.3	.1
Life insurance	2.8	1.9	2.0	1.0
Other insurance	18.0	12.2	25.4	12.1
Other financial institutions	.8	.5	1.4	.7

(2) The UTF represents a large and growing source of investible funds. At the end of calendar 1968, its portfolio was over $12 billion and, if invested in state and local securities, it would have just equalled the combined holdings of state and local pension funds, business corporations, life insurance companies, and mutual savings banks. Furthermore, this portfolio has doubled from fiscal 1961–68 and may be expected to continue to grow.

(3) The rate of return on state and local obligations is not greatly different from that currently earned in the UTF portfolio. At the end of 1968, 78% of the UTF portfolio was invested in special issues at the average intrest rate of 4.397%. These special issues are non-negotiable obligations of the U.S. Treasury which are required to yield a return to the fund equal to the current average rate of interest on all interest-bearing securities of the United States (rounded to the nearest .125%).

Table 4 shows, for six-month intervals over the period 1960–68, the rate of return on the U.S. interest-bearing debt and the state and local rate as given by the *Bond Buyer* 20-bond index. The average divergence in rate over the period was only 6 basis points, and the maximum was 52 basis points in December 1964. In the last few years, the state and local rate has exceeded the rate on the debt and, in fact, as interest rates in general rise over time, the average rate on the debt tends to lag behind other market rates. Thus, investing in state and local securities rather than special issues will not significantly affect the return on the UTF portfolio.

We should not ignore the issues that are likely to arise in connection with a proposal to allow the UTF to invest its portfolio in state and local securities:

(1) The legal provisions governing the UTF's investments must be changed to make municipal securities eligible. Although the eligibility question has been a subject of some controversy (see *Temporary Income in Debt Ceiling*, Hearings, U.S. Congress, House of Representatives, Committee on Ways and Means, 90th Cong., 1st Sess., January 1967, pp. 31ff.), eligible investments are currently defined as direct obligations of the United States or securities which are guaranteed by the United States as to principal and interest. We would recommend a broadening of these provisions to include state and local obligations explicitly.

(2) Given the volume of municipal securities issued each year—$10–$11 billion in recent years—the UTF would face a decision as to which particular municipal securities to purchase. There are two ways out of this situation. First, if the proposal of this memorandum were adopted in connection with the pending URBANK proposal, the UTF could purchase URBANK obligations and pass the selection problem on to the bank. Secondly, and this would also satisfy the logic of the present eligibility requirements, the UTF could purchase PHA and URA securities which are now guaranteed by the federal government. The gross issues of these securities in 1968 were $5.4 billion. Also with the new federal guaranteed programs in the areas of college housing and water pollution, this type of security is likely to show substantial growth. Furthermore, if liquidity is still a consideration in the investment decisions of the UTF, there is available for purchase an outstanding stock of 3-month to one-year PHA and URA notes of $3.9 billion. It should be noted, however, that the guaranteed obligations are likely to carry yields somewhat below the *Bond Buyer* series of Table 4, perhaps by 25 basis points or more.

(3) This proposal is likely to have some impact on the present interest rate structure. Assuming in the first instance that the total volume of securities held by the public is unchanged, this proposal will result in more Treasury securities and fewer municipals in individual and institutional portfolios. This change in relative supplies would cause Government rates to rise somewhat and municipal rates to fall. The major impact on the Treasury, however, will result from the fact that the greater quantity of Governments held by the public (rather than the UTF) will be at market rates and not at the substantially lower special issue rates. Furthermore, if we drop our original assumption of no change in the volume of securities held by the public in favor of the more likely and desirable occurrence of some significant increase in municipal issues under this proposal, then the general level of interest rates will be forced up somewhat for all borrowers.

TABLE 4. RATES OF RETURN ON THE INTEREST-BEARING DEBT AND STATE AND LOCAL SECURITIES

Period	Interest rate on debt	State and local rate
June 1960	3.30	3.52
December 1960	3.14	3.39
June 1961	3.07	3.54
December 1961	3.14	3.37
June 1962	3.24	3.24
December 1962	3.30	3.05
June 1963	3.36	3.22
December 1963	3.49	3.26
June 1964	3.56	3.20
December 1964	3.59	3.07
June 1965	3.68	3.30
December 1965	3.76	3.53
June 1966	3.99	3.90
December 1966	4.22	3.76
June 1967	4.04	4.07
December 1967	4.29	4.38
June 1968	4.50	4.48
December 1968	4.63	4.85

Subsidy Proposal to Induce State and Local Retirement Funds to Invest in State and Local Securities

In our other memorandum on the Unemployment Trust Fund, we demonstrated the need for broadening the market for state and local securities in order to finance the large and growing demands for public facilities. Under present arrangements, the character of this market is determined by the tax-exempt status of municipal securities. Participants in the market are confined to those individuals and institutions for which the tax exemption privilege represents an economic gain relative to taxable securities. Thus, high-income individuals, fire and casualty insurance companies, and especially commercial banks constitute the principal lenders, and by year-end 1968, they together held 90 percent of the total stock of municipal securities outstanding. This situation affects the municipal market adversely in two respects. First, the market is unnecessarily narrow, and secondly, municipal borrowers, as residual claimants on commercial bank resources, and extremely vulnerable to changes in both monetary policy and business demands for funds.

It is against this backdrop that a series of proposals have been put forth which are designed to open up new sources of capital funds to state and local governments—proposals such as the Patman-Proxmire subsidy plan, URBANK, and the like. Our approach to the problems of municipal financing is of a somewhat less general nature and is based on the premise that, as a minimum, state and local own funds should become available to the state and local security market. This consideration led to our earlier recommendation that the state reserves in the unemployment trust fund be authorized to purchase municipal securities. In this present memorandum, the state and local retirement funds (SLRF's) will be examined.

In both cases, the issue of the determinants of the portfolio investment decision is paramount. Inasmuch as the returns on municipal securities are below those on taxable securities, institutions which are not subject to taxation themselves derive no benefit from the tax exemption feature of municipals. In the case of the unemployment trust fund, the rate of return on U.S. Treasury special issues, which compose the bulk of the portfolio, is sufficiently low that little or no net loss to the trust fund would result from investment in state and local securities. In the case of the SLRF's this is not the case. Some form of subsidy is, therefore, required to induce these retirement funds to acquire securities of state or local governments.

The dimensions of this potential source of demand for municipal issues are shown in Table 1. In June, 1968, the latest date for which these data are available, total asset holdings of SLRF's were $44.5 billion. Of this total, $38.0 billion (85 percent) was composed of U.S. Government securities, corporate bonds, and mortgages. Although corporate stock holdings are growing both absolutely and relatively, fixed interest market securities are clearly the major assets of these funds.

The rate of growth of the SLRF's has been substantial. Their portfolios have doubled since 1961 and have increased almost sevenfold since 1952. In recent years, the increment to their asset holdings have amounted to about $4.5 billion per year and have been increasing. Thus, the SLRF's seem ideally suited as a potential source of investment in public facility financing.

Moreover, these funds historically have held state and local securities, and through the late 1950's municipals consisted of over 25 percent of their total asset holdings. Since then, a combination of more flexible investment regulations and the desire of SLRF managers for higher yields has led to the declining position of municipals in SLRF portfolios. By June 1968, only 5.3 percent of total asset holdings consisted of state and local securities.

Table 2 demonstrates the extent to which an increase in earnings has paralleled the decline in state and local security holdings of the SLRF's. Since 1959 when the proportion of municipal security holdings fell below 25 percent of the total portfolio, the increment in portfolio earnings as a percentage of the increment in portfolio size has almost always been above 4.5 percent.

There is an obvious lack of economic incentive for the SLRF's to invest in municipal issues. The remainder of this memorandum is devoted to the presentation of a subsidy device which would provide this incentive.

A subsidy mechanism ideally should possess the following characteristics:

(1) It should provide a clear incentive for SLRF's to invest in municipal securities as opposed to their present asset holdings.

(2) It should be simple to administer and free from federal regulation and control.

(3) It should be relatively inexpensive in terms of cost to the U.S. Treasury.

The subsidy plan which we are proposing satisfies these criteria.

TABLE 1.—STATE AND LOCAL PENSION FUND ASSET HOLDINGS, YEAREND

[Amounts in billions of dollars]

	1952		1957		1960		1963		1964		1965		1966		1967		1968 [1]	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Total asset holdings	6.9	100.0	13.7	100.0	19.7	100.0	27.2	100.0	30.2	100.0	33.5	100.0	37.2	100.0	41.9	100.0	4.45	100.0
U.S. Government securities	3.4	49.4	5.2	37.7	5.9	30.0	6.9	25.2	7.4	24.6	7.8	23.3	8.0	21.5	8.2	19.5	8.6	19.2
State-local securities	1.9	27.4	3.5	25.9	4.4	22.4	3.3	12.1	2.9	9.6	2.6	7.8	2.5	6.7	2.4	5.7	2.4	5.3
Corporate bonds	.9	13.3	3.8	27.9	6.7	34.1	12.3	45.2	14.2	47.0	16.3	48.7	18.9	50.8	22.3	53.2	24.3	54.5
Corporate stock	.1	.8	.2	1.5	.4	2.2	1.0	3.6	1.3	4.2	1.6	4.8	2.1	5.7	2.8	6.6	3.1	7.1
Mortgages	.1	2.1	.5	3.9	1.4	7.4	2.6	9.6	3.1	10.2	3.7	11.2	4.5	12.2	5.0	11.9	5.2	11.6
Other	.5	7.1	.4	3.0	.8	3.9	1.2	4.3	1.3	4.5	1.4	4.1	1.2	3.1	1.2	3.0	1.0	2.2

[1] As of June 1968.

Source: Federal Reserve Board.

Table 2.—Increment in portfolio earnings as a percentage of the increment in portfolio size

Year:[1]	Percent
1954	2.68
1955	3.19
1956	2.85
1957	3.27
1958	3.49
1959	4.54
1960	4.61
1961	4.96
1962	4.55
1963	4.67
1964	4.24
1965	4.76
1966	4.45
1967	4.89
1968	5.16

[1] From 1953 to 1963, calendar years; from 1964 to 1968, fiscal years.
Source: Bureau of the Census.

It is similar to suggestions that have been put forth for subsidizing the entire municipal market although we are applying it here only to SLRF's (and also to the unemployment trust fund as will be considerd later). Our proposal is that a subsidy be given to holdings of municipal securities by SLRF's on all such securities—general obligation bonds, revenue bonds, and short-term notes—issued after a predetermined date. The subsidy would be a fixed percentage of the coupon rate on the municipal securities issued after that date and would be paid by the U.S. Treasury upon receipt from the state and local retirement funds of a copy of the coupon. As a precaution against misuse of this subsidy, the individual state and local governments would certify to the Treasury that their respective retirement funds are bona fide institutions established for the purpose of providing retirement benefits to their employees. The Treasury would maintain a list of such certified funds. Under this plan, administrative work would be kept to a minimum. The subsidy would be paid automatically and would require no federal supervision.

To make the plan operational, decisions must be made concerning (1) the issuance date after which municipal securities acquired by the SLRF's would be eligible for the subsidy and (2) the amount of the subsidy as a percentage of the state and local interest rate.

To aid in this latter determination, Table 3 has been prepared. This table presents quarterly data on the municipal rate, the U.S. long term rate, and the corporate rate from 1960 to mid 1969 along with the ratios of the two other rates to the municipal rate. The table indicates that for much of the period, a subsidy equal to 25 percent of the municipal rate would be a sufficient incentive to retirement funds to acquire municipal as opposed to long term government securities, and a subsidy of 50 percent of the municipal rate would induce retirement funds to prefer municipals to corporate issues as well. Therefore, in this memorandum, we shall examine the consequences of four alternative subsidy percentages between these ranges—25 percent, 33⅓ percent, 40 percent(and 50 percent of the state and local rate. The higher the subsidy, of course, the greater the incentive to acquire municipal securities.

The cost to the Treasury will also vary with the subsidy percentage. This subsidy cost is a product of the percentage subsidy, the municipal interest rate, and the dollar volume of municipal securities acquired by the SLRF's. If S=the subsidy cost, s=the percentage of the municipal rate subsidized, r_m=the municipal rate, and D=the dollar volume of securities held, $S=sr_mD$.

TABLE 3.—QUARTERLY INTEREST RATES

	Municipal rate[1]	U.S. long-term rate[2]	Corporate rate[3]	U.S. rate/ municipal rate (2)/(1)	Corporate rate/ municipal rate (3)/(1)
	(1)	(2)	(3)	(4)	(5)
1960:					
I	3.65	4.22	4.87	1.1562	1.3342
II	3.43	4.11	4.78	1.1983	1.3936
III	3.58	3.83	4.64	1.0698	1.2961
IV	3.44	3.91	4.64	1.1366	1.3488
1961:					
I	3.39	3.83	4.59	1.1298	1.3540
II	3.47	3.80	4.59	1.0951	1.3228
III	3.51	3.97	4.72	1.1311	1.3447
IV	3.43	4.01	4.71	1.1691	1.3732
1962:					
I	3.22	4.06	4.69	1.2609	1.4565
II	3.14	3.89	4.60	1.2389	1.4650
III	3.21	3.98	4.63	1.2399	1.4424
IV	3.06	3.88	4.55	1.2680	1.4869
1963:					
I	3.10	3.91	4.48	1.2613	1.4452
II	3.15	3.98	4.47	1.2635	1.4190
III	3.16	4.01	4.50	1.2690	1.4241
IV	3.27	4.11	4.54	1.2569	1.3884
1964:					
I	3.22	4.16	4.56	1.2919	1.4161
II	3.23	4.16	4.59	1.2879	1.4211
III	3.20	4.14	4.57	1.2938	1.4281
IV	3.18	4.14	4.58	1.3019	1.4403
1965:					
I	3.12	4.15	4.56	1.3301	1.4615
II	3.19	4.14	4.58	1.2978	1.4357
III	3.30	4.20	4.66	1.2727	1.4121
IV	3.47	4.35	4.77	1.2536	1.3746
1966:					
I	3.64	4.56	4.98	1.2527	1.3681
II	3.71	4.58	5.21	1.2345	1.4043
III	4.06	4.78	5.52	1.1773	1.3596
IV	3.88	4.70	5.67	1.2113	1.4613
1967:					
I	3.55	4.44	5.43	1.2507	1.5296
II	3.85	4.71	5.58	1.2234	1.4494
III	4.05	4.93	5.92	1.2173	1.4617
IV	4.34	5.33	6.34	1.2281	1.4608
1968:					
I	4.33	5.24	6.42	1.2102	1.4827
II	4.45	5.30	6.59	1.1910	1.4809
III	4.32	5.07	6.43	1.1736	1.4884
IV	4.64	5.42	6.60	1.1681	1.4224
1969:					
I	5.07	5.88	6.98	1.1598	1.3767
II	5.43	5.92	7.18	1.0902	1.3223
Averages 1960–1969 II				1.2124	1.4138

[1] Bond Buyer 20-Bond Index.
[2] Federal Reserve Bulletin, various issues.
[3] Moody's Investors Services; Includes all classes of bond ratings.

The net cost to the Treasury is less than this subsidy outlay, however, since taxable securities that would otherwise be acquired by the SLRF's will, for the most part, now find a taxable investor and will, therefore, generate tax receipts for the Treasury. These receipts will be a product of the marginal income tax rate of the new holders of these securities, the interest rate on these securities, and the dollar volume involved. If R=tax receipts, t=the marginal income tax rate of the new holders, r_o=the interest rate on these securities, and D=the dollar volume.

$R = t\ r_o\ D.$

The net cost (NC) to the Treasury is $S-R = s\ r_m\ D - t\ r_o\ D.$

$NC = D(s\ r_m - t\ r_o) = D[s - t(r_o r_m)].$

Thus, the net cost varies directly with the dollar volume, D, and the subsidy percentage, s, and inversely with the marginal tax rate of the new holders, t, and the ratio of the rates on the securities sold by the SLRF's to the municipal rate, (r_o/r_m).

For the Treasury to break even under this plan, S=R, or
$s\ r_m\ D = t\ r_o\ D$, or $t = s/(r_o/r_m)$.
Thus, the higher the subsidy percentage and lower the ratio of the alternative interest rates to the municipal rate. the higher the marginal tax rate required for the subsidy to yield no net loss to the Treasury.

This information is summarized in Table 4. The left hand column lists the four alternative subsidies as a percentage of the municipal rate. The top row presents five r_o/r_m ratios which may be compared with those calculated in Table 3 for the U.S. long term rate and the corporate rate. Moving along a row for a given subsidy percentage, we see that the higher the r_o/r_m ratio, the lower the break-even tax rate. Similarly, for a given interest rate ratio, the higher the subsidy percentage, the higher the break-even tax rate.

The entries in the table marked with an asterisk are those combinations of subsidy and interest rate which would put the portfolio manager on the margin of indifference between acquiring the subsidized municipal securities and buying alternative assets such as corporate or Treasury bonds. Thus, if the subsidy is 40 percent of the municipal rate, retirement fund managers would be indifferent between buying municipals and another asset yielding 1.4 times as much as the current municipal rate. For this reason, all space to the right of the entries marked with an asterisk are left blank since they represent combinations that would be unattractive to the retirement funds. A subsidy of 40 percent of the municipal rate, for example, will not induce the retirement fund investors to buy state and local securities if rates on alternative forms of investment are 50 percent above the municipal rate.

As Table 3 indicates, from 1960 mid-1969 Treasury long term rates, on average, were approximately 20 percent above the municipal rate, and corporate rates were about 40 percent above the municipal rate. If a subsidy of 40 percent were put into effect, then a marginal tax rate of 33⅓ percent would be required from the new holders of Treasury long term securities and 28.6 percent from the new holders of corporates for the Treasury to break even. Since the insurance companies, that are the largest holders of corporate bonds, and the commercial banks and other financial institutions, that are the main holders of U.S. securities, pay tax rates above these levels, a 40 percent subsidy would not involve much if any net cost to the Treasury.

TABLE 4.—BREAK-EVEN MARGINAL TAX RATES, *t*

[In percent]

Alternative interest rate/municipal rate (r_o/r_m) ratios Subsidy as percent of municipal rate (r_m)	1.1	1.25	1.33	1.4	1.5
25	22.73	[1]20.00			
33⅓	30.30	26.67	[1]25.00		
40	36.36	32.00	30.00	[1]28.57	
50	45.45	40.00	37.50	35.71	[1]33.33

[1] Subsidy puts investor on margin if indifference between acquiring subsidized municipal securities and acquiring alternative assets.

Therefore, we would make the following recommendation as a miniumum position:

(1) A subsidy of 40 percent of the municipal coupon rate should be paid to state and local retirement funds on their holdings of such state and local securities issued after a specified date, e.g., January 1, 1970.

(2) This subsidy would be paid automatically by the U.S. Treasury to public retirement funds established and managed by public officials upon receipt from them of a copy of their coupons.

In this way, SLRF reserves could be made available to state and local governments for the financing of needed public facilities. As in the case of the unemployment trust fund proposal, benefits will accrue to the State and local governments in three important respects:

(1) To the extent that credit availability limits municipal borrowing, opening up an additional source of funds can ease this constraint somewhat.

(2) As a stable and growing source of funds, SLRF's can partially insulate state and local governments from the effects of changes in the available resources of commercial banks.

(3) Municipal rates may be expected to decline to some degree. This would occur because a smaller volume of municipal securities would have to be held by individual investors to absorb the total supply, and the municipal rate would no longer have to induce individuals in lower tax brackets to enter the market.

Several additional points should be made concerning the above analysis. First, the calculations of Table 3 on the ratios of municipal interest rates to the rates on alternative assets are only suggestive and do not reflect the relative returns on a specific municipal security as compared to a specific corporate or Treasury issue. The subsidy we have proposed would apply to all categories of state and local securities—short-term notes and revenue bonds as well as general obligations—and SLRF asset holdings also include a variety of Treasury and corporate obligations. Hence, after the subsidy had been put into effect, SLRF managers would still have to make portfolio decisions among competing assets to achieve their investment objectives.

Secondly, in addition to the gross subsidy cost (which as mentioned may be completely offset by additional tax receipts) the Treasury may incur somewhat higher interest cost to the extent that the subsidy succeeds in causing SLRF's to acquire municipal rather than federal government securities. A higher interest rate on governments would then be required to induce other investors to hold more of these issues.

On the other hand, this proposal could go some way towards achieving another Treasury objective, that of distributing more equitably the income tax burden. By reducing the volume of tax-exempt securities in the hands of the taxable public, this proposal would narrow this avenue of tax avoidance.

In terms of the administration of this subsidy plan, it may be desirable to restrict the subsidy to SLRF holding of securities issued by governments other than their own. Enforcing an arm's length transaction in this manner would avoid conflicts which may arise between the state or local government and its employee retirement system and would allow portfolio managers to make investment decisions solely on the basis of liquidity, yield, and other objectives.

One final matter remains for consideration. In the earlier memorandum on the unemployment trust fund (UTF) the point was made that the return on the trust fund portfolio was sufficiently low that trust fund investment in the tax-exempt state and local securities would not impair its earning position. It is, nonetheless, still true that investment of UTF reserves in municipal securities would not carry out the trust type obligation of the Treasury to the states whose funds are held in the UTF. Higher yielding market instruments consistent with the liquidity requirements of the UTF would appear more appropriate. Thus, in terms of the responsibility of the Treasury to the state, we would recommend consideration of a subsidy on state and local securities acquired. and that the plan outlined above be applied to UTF investments in municipal obligations.

The results of such a program would be the following:

(1) The Treasury would not be able to borrow from the UTF at below market rates and would borrow more from the general public instead.

(2) A smaller volume of state and local securities would be available to the public.

(3) The UTF would hold the state and local (subsidized) securities rather than the special Treasury issues.

The subsidy would involve some net cost to the Treasury. The increased tax receipts resulting from the public holdings of governments rather than tax-exempt municipals will not cover both the higher rates that the Treasury must pay for its own borrowing and subsidy on UTF holdings of municipals. But this situation results only from the fact that the states through the UTF have historically been subsidizing the Treasury. There appears little justification for continuing this practice.

The CHAIRMAN. The next witness will be Mr. Austin J. Tobin, executive director of the Port of New York Authority.

Be seated, sir.

STATEMENT OF AUSTIN J. TOBIN, EXECUTIVE DIRECTOR, THE PORT OF NEW YORK AUTHORITY

Mr. TOBIN. If the Senators please, in the limited time which we must all observe here, I will try not to be repetitious of the points that have been made by the witnesses who have preceded me, and I will talk about a different aspect of State and local government and that is the fact which we seldom think of, that the whole American transportation, public transportation system, in all of its elements, is built and financed by State and local government.

The port authority, a bistate instrumentality of the States of New York and New Jersey, has invested $2 billion raised through the sale of its revenue bonds to develop a comprehensive network of transportation and terminal facilities in the Port of New York. It is specifically denied the power to levy taxes or pledge the credit of either State to finance its capital programs. It is required and has been able to do so on the basis of its own credit.

The financial capability of the authority to develop this complex of transportation facilities has depended in large part upon the exemption of the interest on its bonds from Federal taxation. These public transportation facilities include three major airports, modern docks and marine container ship terminals, six interstate vehicular bridges and tunnels, bus and truck terminals, and a trans-Hudson commuter railroad.

We simply would have been unable to provide these vital public services for our area and to provide them without any burden to the general taxpayers of our two States if the bonds we issued to obtain the necessary capital funds had to be marketed at interest rates 40 percent higher to make them competitive with those offered by private industry.

But the issues precipitated by these attempts to tax State and municipal bonds are not restricted to their destructive economic consequences.

As the witnesses before me have emphasized and as the committee has emphasized they raise most serious constitutional questions.

As executive director of a bi-State agency I will focus principally on the consequences of these new proposals to our national and regional transportation programs. Last year some $2,800 million in municipal bonds were issued by State and local government solely for transportation, public transportation purposes.

The enactment of any of these proposals would mean at least a 1-percent increase in the interest rate on the bonds to be sold hereafter and would drastically curtain the ability of our States, counties, and cities to meet their transportation needs. On the basis of future annual bond issuances equal to the 1968 volume there will be at least $28 billion of transportation bonds issued during the decade from 1970 to 1980.

The additional interest cost imposed upon State and local government as a result of these borrowings, the additional costs would amount to the staggering total on these public transportation bonds throughout the country of $3,800 million over the life of those bonds. These amounts will have to be raised, as has been pointed out heretofore, largely from regressive State and local real estate property and sales taxes which would fall most heavily upon our already overtaxed middle income and poorer people.

The States of New York and New Jersey alone have committed themselves to issue $3,100 million in bonds for transportation improvements in our two States over the next few years.

If the new tax proposals are approved our two States will have to levy an additional $420 million in taxes to meet their increased borrowing costs on these issues.

Turning to the problem of capital financing requirements of airport development, and I will deal just with that and I will leave port development to my colleague of the Port of New Orleans who I think will follow me on the program, but just as to airport development it is estimated that more than $14 billion of public funds will be needed in the next 10 years to finance the absolutely esential expansion of our national airport system. Historically 80 percent of the funds expended on our Nation's airports have been derived from State and local sources. In the case of New York-New Jersey metropolitan airports, 96 percent of the cost has been borne by the two States through their agency, the port authority. Even assuming increased Federal assistance in the future, it probably will still be necessary for as much as $10 billion to be expended by the States and local government for essential airport construction, and this borrowing over the life of the bonds to be issued would involve more than $1,300 million in additional interest costs as a result of these new tax proposals if these plans and necessary aviation program are to be carried out.

The borrowing capacity of State and local government will also be severely tested by the Nation's mass transit needs.

Our present transit systems have projected capital needs of $20 billion over the next 10 years of which at least $10 billion will have to be raised by State and local governments also at a total additional borrowing cost if the tax proposals before you are enacted of $1,300 million over the life of those bonds.

So with respect to these two aspects of public transportation, our airports and our mass transit requirements, these tax proposals would impose upon State and local governments the frightful burden of raising more than $2,600 million of additional revenues with the regressive tax impact that the Governors and the mayors have been stressing here before me.

Lest I be accused of viewing with undue alarm, I need point only to the chaos that exists in the municipal bond market today. Even the threat of this attack on the immunity of municipal bonds has brought in its wake a market reaction which has required State and local governments in many cases to pay the highest borrowing costs in their history. Many units of government have been unable, because of constitutional and statutory interest rate limitations to borrow at all. Many municipalities have deferred borrowings, although the futility of postponements in anticipation of better days was demonstrated most forcefully on September 9 when the city of Newark was obliged to accept a 7.68 percent interest rate on its general obligation bonds after it had earlier rejected a 7.43 percent rate. Ironically, the earlier bid was rejected as excessive due to the uncertainty of the market attributable to these pending proposals to tax municipal bonds.

In the past few weeks the State of Hawaii and the cities of Chicago, Houston, and Jacksonville, among others, could not find a market for bonds valued in total at over $100 million.

There is no sign that the deterioration in the market is slackening. If these new proposals are enacted in any form, the result will be to insure the continuance of chaotic market conditions for years to come, until the constitutionality of these proposals is reviewed by the Supreme Court.

To summarize other points made in my full statement submitted to the committee, holders of municipal bonds pay very substantial taxes now since they agree to take an interest rate 30 percent lower than the rates they could obtain by investing in private obligations. I have also noted that many workers in the building and construction trades and the industries that will support them will be grievously affected by the cancellation or postponement of State or municipal bond issues.

In that statement, the longer statement, I have set forth my opposition, also expressed here by the Secretary of the Treasury, as I understand it, to the suggestion contained in H.R. 13270 that Federal payments be made to States and cities to soften the blow of increased interest costs.

Ironically, it appears that the ultimate result of these new tax proposals could be a reduction in the amount of revenues flowing into the Treasury itself. This loss would derive from the increased deductions for State and local taxes taken by Federal taxpayers who will have to pay [illegible] increased State and municipal borrowing costs and who would be permitted to deduct those increased taxes. Thus, the rather amazing results of these new proposals would ultimately be to produce losses for everyone concerned: for the Treasury, for State and local government, and for State and local taxpayers.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, sir, for a very good statement. Any further questions?

Thank you, Mr. Tobin.

(Mr. Austin J. Tobin's prepared statement follows:)

STATEMENT OF AUSTIN J. TOBIN, EXECUTIVE DIRECTOR, THE PORT OF NEW YORK AUTHORITY

SUMMARY OF PRINCIPAL POINTS

I. The Port of New York Authority could not have developed its complex of terminal and transportation facilities in the Port of New York, in which it has invested $2 billion, if its bonds had been subject to federal taxation. And the Authority's contribution to current and future transportation requirements would, because of punitive borrowing costs, be substantially curtailed if the House or Treasury proposals were enacted.

II. These proposals squarely present a fundamental constitutional issue, for their effectuation would permit ultimate federal control of the powers reserved to the States under the Constitution.

III. Capital expenditures throughout the nation for essential transportation services and facilities, which are developed and financed primarily by state and local government, would be sharply cut back as a result of these new tax proposals.

IV. Based on future annual issuances for transportation purposes equal to the $2.8 billion borrowed by state and local government in 1968, these proposals would generate additional costs which would total $3.8 billion after ten years.

V. The States of New York and New Jersey have committed themselves by referendum to issue $3.1 billion in bonds for transportation. Their additional interest costs would total $420 million. These costs must be passed on principally in the form of regressive property, sales and other taxes.

VI. Even with increased federal assistance, state and local government must spend some $10 billion for airport capital requirements over the next 10 years. These new tax proposals would generate additional interest costs of more than $1.3 billion.

VII. The construction of the vitally-needed $600 million fourth jet airport for the New York/New Jersey metropolitan area on a self-supporting basis would be critically jeopardized if additional financing costs were to be added to the obstacles already delaying it.

VIII. State and local government also must contribute $10 billion in capital funds for mass transit in the next decade. An additional $1.3 billion in borrowing costs would be incurred should any of the new proposals be effectuated.

IX. Even the *threat* of impaired tax exemption has thrown the bond market into chaos. Many state and local governments have not been able to borrow at all, or have done so at punitive interest rates.

X. The enactment of any form of these proposals would ensure the continued disarray of the market for years to come, until their constitutionality was reviewed and conclusively determined by the U.S. Supreme Court.

XI. There is no reform in tax proposals that would impose staggering burdens on state and local government solely to capture a meager $45 or $80 million annually from wealthy taxpayers. Five years after the enactment of these proposals, state and local governments would be taxing in amounts of $540 million annually to pay increased borrowing costs.

XII. Inasmuch as these taxes are deductible from federal income tax returns, the Treasury will probably suffer a net *loss* if any of the new proposals are effectuated.

XIII. Muncipal bond holders have in fact paid substantial taxes to state and local government by accepting interest rates 30 to 35% less than those available on comparable corporation obligations. Based on the 1968 issuances of $16 billion alone, this represents "tax" income to state and local government averaging more than $200 million annually.

XIV. The provision in the House bill for a federal payment to recompense state and local bond issuers for additional interest costs is unacceptable both to the Treasury and to our states and cities. The Treasury is given too wide a discretion to fix the size of the payment, and the statutes authorizing this payment would be subject to amendment or repeal at any time.

XV. Banks, corporations and other institutional investors in municipals, although exempted from the operation of the present tax proposals, are on notice that they may be taxed in the future on their current holdings. The dismal state of the bond market now is attributable largely to the substantially higher returns demanded by those investors.

XVI. The Committee on Finance should therefore reject those provisions of H.R. 13270 and of the Treasury plan, and any other proposal which would tax, directly or indirectly, the interest on municipal bonds.

STATEMENT

I am Austin Tobin, Executive Director of The Port of New York Authority. I appreciate the courtesy of this Committee in affording me the opportunity today to submit my views on the proposals to tax municipal bond interest recommended in H.R. 13270 and again in the Treasury Department plan which was outlined to this Committee at the commencement of your hearings.

The Port of New York Authority is the bi-state instrumentality of the States of New York and New Jersey, created in 1921 to develop public terminal and transportation facilities in the Port of New York and to promote the commerce of the Port. It has no power to levy taxes or to pledge the credit of either State to finance its capital programs. Yet, over the past half century, it has been able to finance, construct and develop, at a cost of $2 billion, a comprehensive network of public airports, piers and docks, public bus and truck terminals, a commuter railroad and vehicular bridge and tunnel facilities, almost exclusively on the basis of its own credit, with Federal and state grants representing less than 3% of its total investment. Its outstanding bonded indebtedness at the end of 1968 was $1,180,000,000.

This complex of New York and New Jersey's public transportation facilities includes, among others, Kennedy, LaGuardia and Newark Airports, the modern docks and containership terminals at Ports Newark and Elizabeth and along the Brooklyn waterfront, the George Washington Bridge and the Holland and Lincoln Tunnels, the Manhattan Bus Terminal, and a trans-Hudson commuter railroad linking the Cities of New York and Newark.

It would have been quite impossible for us to have financed this complex of public terminal and transportation facilities if our bonds has been subject to federal taxation. Even with this advantage, we were practically bankrupt in the early 1930's. Practically every one of our facilities in their very nature, go through a development period of annual losses from five to ten years after they are opened. During this time they are rather marginal credit risks. This is the reason that under the laws of our two States, we are allowed to pool our revenues from all Port Authority projects and pledge these pooled revenues in support of our bonds. But we could never have financed these terminal and transportation facilities at interest rates which were economically practicable if our bonds had been taxable, which would have imposed a 40 per cent increase in our interest costs.

In other words, many of the public works which are so important to the basic economy of our region would not exist today if their financing had required the payment of interest rates which had to compete with those offered in the private sector. Not only would the residents of New York and Northern New Jersey be unable to construct the piers and docks, the airports, the terminals and other transportation services we have been able to provide over the past fifty years on a self-supporting basis (i.e., through revenue bond financing), but the prospects for financing the current and future transportation needs of the people of the Port of New York District would be gloomy indeed.

But the issue precipitated by these attempts to tax state and municipal bonds is not one of economics alone. The constitutional issue squarely raised by these proposals is of even greater consequence and importance, for these proposals are an attack on the basic structure of our government. When a similar proposal was advanced many years ago, Senator William E. Borah said that it would "wrench the Constitution from its harmonious proportions." Without any question, if the central government has the power to tax the financial operations of the States, it has the power to control every exercise of the governmental powers that were expressly reserved to the states under the Constitution. That would mean that the future form of our federal system of government will have been radically changed.

You have already heard extensive testimony from representatives of state and local government describing the destructive consequences of these proposals to the fiscal condition of our states, counties and cities. I understand that the Governors of some forty of our great states asked your Committee to be heard in opposition to the House bill and the Treasury's proposals, as did also some 200 elected and appointed state and local officials. While I fully share their shock and their forebodings of the incredible fiscal consequences of these proposals, I will try to avoid reiterating the points they have made. Rather, in my capacity as the Executive Director of a bi-state transportation agency, I would like to address myself to the consequences of the House bill and the Treasury recommendations to our national and regional transportation programs.

Under our federal system of government, our transportation services and facilities are in the main developed by our State, county and municipal governments. They are financed—for the most part—through those State, county and municipal governments. They are designed and financed and built to meet local and regional, as well as inter-regional transportation requirements. Yet the sum total of these locally and regionally developed facilities is a vast national transportation network that is not only vital to each region of our country, but also to the nation's whole economy, its defense, and its standing among nations.

The Port of New York typifies the dual stake which the people of the United States have in their transportation system. The primary purpose of the transportation facilities of the Port of New York is to meet the transportation needs of the civilian population during times of peace. At the same time, the existence of these facilities is an inherent part of our defense structure. And in time of war, their existence and operational efficiency is critical. During World War I, three-quarters of our overseas troop movements were through the Port of New York. And during World War II, one-half of all our armies overseas and one-third of all our material moved through New York.

As you may now be aware, state and local governments in 1968 issued more than $16 billion in municipal bonds. Of this total, some $2.8 billion were issued solely for transportation purposes. It has, I think, been amply demonstrated that the enactment of any of the tax proposals recommended in the House bill or by the Treasury Department would generate at the very least an average one per cent increase in the interest rate on municipal bonds, which is to say an increase of from 20 to 25 per cent over the historic levels of state and municipal interest rates. Even assuming no increase in the $2.8 billion of future annual financing for transportation purposes, the effect of the proposals under consideration by this Committee would be to increase interest payments by state and local government by a total of $380 million for the life of each year's borrowings for transportation purposes. In other words, after a ten-year period, the total liability for additional interest costs imposed by these Treasury proposals will have reached the staggering total of $3.8 billion and this final impact on state and local borrowing would relate only to public financing for transportation purposes.

Only recently, the Port Authority's parent States of New York and New Jersey have by referendum committed themselves to the issuance in the next few years of $3.1 billion in state bonds for the development and improvement of transportation facilities in both states. A one per cent increase in interest rates on these transportation bond issues alone would require the two states to levy an additional $420 million in taxes to pay increased borrowing costs.

The amounts the States of New York and New Jersey are committed to expend in capital funds for their transportation requirements, together with the Port Authority's capital requirements over the next few years, reach the formidable total of $4.85 billion. All of the projects on the drawing boards for which these funds are allocated are in some measure jeopardized by the new tax proposals. The financing and construction of these projects depend entirely upon the fiscal and political ability of the two States and their public transportation agencies to pay these tremendous increases in the cost of their financing. Unfortunately, these increased costs would have to be derived primarily from relatively regressive property, sales, and other taxes or charges assessed without respect to the ability to pay.

Turning to the problem of capital financing requirements for aviation development, it is estimated that more than $14 billion of public funds will be needed in the next ten years to finance the absolutely essential expansion of our national airport system. Historically, 80 per cent of the funds expended on our nation's airports have been derived from state and local sources. In the case of New York-New Jersey metropolitan airports, 96 per cent of the cost has been borne by the two States through their agency, the Port Authority. Even assuming increased federal assistance in the future, it probably will still be necessary for as much as $10 billion to be expended by the states and local government for essential airport construction; and this would involve more than $1.3 billion in additional interest costs if these planned and necessary aviation programs are to be carried out.

I am sure you are all aware of the critical necessity to upgrade the nation's air transportation system. In 1968, the American aviation industry transported over 150 million air passengers, representing an increase of 110 per cent over passenger volume just five years earlier. Those of you who regularly fly in and out of the New York metropolitan area have more reason than most to appreciate how essential it is that we provide additional airport capacity and reconstruct our existing airports. The new 360-passenger jumbo jets will be coming into service in a few months, and in New York, as in other urban areas, we are at work on the formidable problem of providing adequate mass transit (rail) connections between Kennedy Airport and Manhattan. The financing of these vital airport programs will be severely disrupted by these proposals—even by their consideration by the Congress.

One of the most critical needs of the metropolitan region of New York and Northern New Jersey is the provision of a fourth airport to meet the demands for air service to and from our area. Such an airport is not just a regional necessity; it is essential to the flow of air traffic across the nation. The cost of such an airport is now estimated at $600 million, and the assumption has validly been made that such an airport could, nevertheless, be developed on a self-supporting basis. However, the massive additional interest costs which would be incurred as a result of these proposals would most certainly jeopardize the prospect of constructing such an airport on a self-supporting basis. It would be nothing less than a tragedy, not only to New York and New Jersey, but also to our national air transport system, if these additional costs were to be piled on top of the formidable obstacles which are already delaying the construction of this vital facility.

The needs of the nation's mass transportation systems are equally impressive. These systems, which transport more than 8 billion passengers a year in our metropolitan areas, have projected capital needs of $20 billion over the next ten years.

Adequate mass transportation, by itself, will not solve the urban problem. However, without good public transportation, the urban problem cannot be solved. Workers must get to their jobs and back. Poverty pockets must have access to employment. Children must be able to get to school and people of all ages must have a means to get about.

With most urban rapid transit systems operating at heavy deficits even before considering capital costs, it is apparent that the $20 billion of capital needs must come from government sources. As you know, President Nixon has proposed a $10 billion federal aid program for mass transportation. If we assume that the proposal is enacted, there will still be the need of local and state governments to provide an additional $10 billion.

The proposal to tax state and municipal bond interest would increase the total borrowing cost of these bonds by another $1.3 billion. This increased cost would, of course, be reflected in higher fares to the users and increased taxes to the residents of the metropolitan areas. More importantly, the increased costs could very well cause the deferral or absolute abandonment of many urgently needed mass transit projects.

To recapitulate, just in these two vital areas alone—airports and mass transit—the additional fiscal burdens which these new tax proposals would impose on our states and cities would amount to the enormous total of $2.6 billion.

Lest I be accused of viewing with undue alarm, I need point only to the chaos that exists in the municipal bond market today. Even the *threat* of this attack on the immunity of municipal bonds has brought in its wake a market reaction which has required state and local governments in many cases to pay the highest borrowing costs in their history. Many units of government have been unable, because of constiutional and statutory interest rate limitations, to borrow at all. Many municipalities have deferred borrowings, although the futility of postponements in anticipation of better days was demonstrated most forcefully on September 9th when the City of Newark was obliged to accept a 7.68 per cent interest rate on its general obligation bonds after it had earlier rejected a 7.43 per cent rate. Ironically, the earlier bid was rejected as excessive due to the uncertainty of the market attributable to these proposals to tax municipal bonds. In the past few weeks, the State of Hawaii and the Cities of Chicago, Houston and Jacksonville, among others, could not find a market for bonds valued in total at over $100 million.

There is no sign that the deterioration in the market is slackening. If these new proposals are enacted in any form, the result will be to insure the continuance of chaotic market conditions for years to come, until the constiutionality of these proposals is reviewed by the Supreme Court. In the meantime, a market which has been developed over the years to the point where it can now readily absorb the capital requirements of our states, cities and counties approaching $20 billion annually is crumbling, and its rehabilitation—even if the Congress of the United States rejects these proposals—will be achieved only at great cost to the taxpayers of the nation.

I can perceive absolutely no "reform" in tax proposals designed to capture a few dollars from the rich which have as their primary consequence the imposition of debilitating economic burdens on state and local government—burdens which must be passed on to our already over-taxed middle-class and poorer people. Actually a large majority of outstanding municipal bonds are held by public and institutional investors and only a fraction are in the hands of the very wealthy. Moreover, the recovery by the Treasury of even the $45 million, which the Secretary of the Treasury estimated in his testimony a week or so ago before this Committee, is comparatively a very small sum when placed against the loss of hundreds of millions of dollars in increased interest costs that would be sustained by the states and cities. The ultimate fact is, however, that these proposals would probably result in a net loss for the Treasury itself. The municipalities' increased borrowing costs could only be met by increasing municipal real estate taxes or state income or sales taxes. These are deductible items on the federal tax returns of state and local taxpayers.

Assuming that the level of state and local borrowing remains constant at $16 billion a year, in but five years it would be necessary for state and local government to raise an additional $540 million annually. With deductions from federal income tax returns, it is apparent that the $45 million return to the Treasury estimated here by the Secretary of the Treasury from the allocation of deduction proposal, or the $35 million return estimated by the Treasury from the limited tax preference proposal, would be offset by the loss in revenues due to increased deductions. Just on the basis of economics alone, these proposals should be rejected.

Moreover, the Treasury and the proponents of the House bill apparently refuse to recognize that the holders of municipal bonds are now paying very substantial taxes indeed. Those taxes are being paid not to the federal government, but to state and local government whose financial situation is so desperate that the Administration is, under its "New Federalism" policy, now proposing to share federal revenues with them.

The holder of municipals has historically agreed to take an interest rate of 30 to 35 per cent lower than the rate he could obtain by investing in comparable private obligations. The difference in interest rates between these two types of obligations—municipal and corporate—now represents real "taxes" for the benefit of state and local government. For example, using the $16 billion issuances in 1968 alone, these "taxes" average well over $200 million a year. The new tax proposals would serve only to deprive state and local government of a very significant financial advantage and, instead, divert negligible gross revenues to the Treasury. The rather amazing result of these proposals will ultimately be to produce losses for everyone concerned: for the Treasury, for state and local government, and for taxpayers generally.

Also badly hurt would be workers in the building and construction trades and in the industries which support them. Higher borrowing costs must inevitably result in a sharp deceleration of public works programs, causing layoffs, reduced work opportuities and consequent economic hardship. In the last year alone, more than 300 bond issues valued close to $2 billion were cancelled or postponed in the face of soaring interest rates.

The House bill includes a provision for federal payments which would allegedly save state and local governments harmless from increases in interest costs if their bonds were to become fully taxable. The Secretary of the Treasury opposed this provision of the House bill when he appeared before your Committee. I also oppose it. The wide discretion afforded the Secretary of the Treasury in fixing the size of the payments would in itself make this proposal unacceptable to the states and cities. Moreover, the payment provisions may be amended or indeed repealed by any future Congress. The confidence of investors in municipals will be restored only as the result of a clear indication by this Congress that the immunity of state and local bond interest from federal taxation will not be invaded.

Although both the House bill and the Treasury would exempt banks and other corporate and institutional holders of municipal bonds from taxation, these corporations and institutions realize full well the implications of the proposals now before you. Both the Ways and Means Committee and the Treasury have put all investors on notice that the holders of municipals may be subject to some form of taxation even with respect to investments they have made prior to the enactment of new tax legislation. If this can happen to individual investors, corporate buyers would be apprehensive that it might happen to them. In fact, the amount of return corporate and institutional investors demand in the present market from invetsment in municipals clearly reflects their apprehension and concern.

Therefore, I respectfully urge rejection by this Committee of all the provisions of the House bill and the Treasury plan and of any other proposal which would, directly or indirectly, tax the interest on municipal bonds.

Thank you.

The CHAIRMAN. All right, now the next witness will be Mr. Eads Poitevent who will speak for the Port of New Orleans, Commissioner of the Port of New Orleans.

STATEMENT OF HON. EADS POITEVENT, COMMISSIONER, PORT OF NEW ORLEANS, LA.; ACCOMPANIED BY COL. WILLIAM LEWIS

Mr. POITEVENT. Thank you, Mr. Chairman.

The CHAIRMAN. I see you are accompanied by Col. Bill Lewis who did a very fine job for us at one time in protecting us from floods down there. So far as I know, nobody had the water come over the top while he was in charge.

Mr. POITEVENT. Bill is my gun bearer from New Orleans. I would like to add, before I start, one word. You seized on the word "incredible" that was used. I think another appropriate word in this situation is "appalling"—the appalling consequences of the possible action that could be taken with the approval of H.R. 13270 bill.

The CHAIRMAN. I think, the record should indicate that in addition to being a commissioner of the Port of New Orleans you are also president of one of the major banks——

Mr. POITEVENT. Right.

My name is Eads Poitevent, a member of the board of commissioners of the Port of New Orleans, and I am testifying in behalf of the board, an agency of the State of Louisiana.

The CHAIRMAN. But your other hat is that of a banker, you are the president of a bank.

Mr. POITEVENT. Yes; in private employment, and where I derive my income, I am president of the International City Bank & Trust Co., a New Orleans bank, and I live in New Orleans.

My testimony here is in opposition to certain provisions of H.R. 13270, specifically sections 301, 302, 601, and 602. Much of what we have prepared apparently has been done in concert with others who have testified, and I am going to attempt to telescope the repetitious part because I have heard much of this before.

However, we have a very good case in point as to what will happen, and is happening now, to the development of the agency of which I am a member.

The board of commissioners of the Port of New Orleans is charged with the responsibility of constructing and maintaining wharves and other public port facilities, and of administering the affairs of the port and the harbor of the Port of New Orleans. The board owns and operates public wharves for handling of cargo having a total frontage of over 54,000 lineal feet and affording an area of 10,845,000 square feet. In addition the facilities of the port include a public grain elevator, public commodity warehouse, Foreign Trade Zone No. 2, a public bulk terminal, and the Rivergate, an international exhibition and convention facility. The Port of New Orleans is a major world port handling foreign trade cargo valued at $2.7 billion annual and generating custom collections of $76 million annually.

The port is Louisiana's largest single industry and the mainstay of economy of the metropolitan area of New Orleans.

The port is directly responsible for 36,500 jobs and $201 million in annual wages. The total impact on the Louisiana economy is $1.6 billion. Earnings on cargo handling account for $6.7 million in city sales taxes and $18.9 million in State income and sales taxes.

In the past 15 years the board has spent over $130 million on major port improvements. These have been financed by direct reinvestment of operating revenues, and by bond issues secured by the full faith and credit of the State of Louisiana.

Extensive additional investments are now needed to upgrade existing port facilities, to construct new facilities to meet the demands of growth, and to accommodate revolutionary changes in the shipping industry.

This board has initiated a planned 4-year program for the rehabilitation and construction of needed public port facilities which program will require $60 million in capital funds to be obtained by the sale of State bonds. The prompt commencement and orderly prosecution of this rehabilitation and construction is absolutely essential if the Port of New Orleans is to meet the pressing needs of the Nation's world commerce and trade.

New construction is needed to accommodate new logical advances in the shipping industry, including containerization, LASH, CB vessels, and other new and efficient methods of cargo movement.

The Louisiana Legislature, in its 1969 regular session, authorized the State Bond Commission to issue $106 million in bonds, including $31 million to be applied to the facilities program of the Port of New Orleans in the next 2 years. The issuance and sale of the first phase of this issue, $15 million in principal amount of bonds, has been authorized by the bond commission with a limitation on the interest rate of 6 percent. Now, from the figures we have heard today, in going to the marketplace on September 30, you can imagine our apprehension and concern. We are apprehensive, to say the least. We are apprehensive that no bids will be offered at all; or, if those that are offered will allow us to sell our bonds at the maximum rate of 6 percent.

The CHAIRMAN. You just heard the city of Baton Rouge witness testify that they can't sell theirs at 6; didn't you?

Mr. POITEVENT. That is correct, and it is very realistic and reasonable to assume that we will not be able to.

The CHAIRMAN. That has the full faith and credit of the city of Baton Rouge behind it.

Mr. POITEVENT. Right.

The CHAIRMAN. And if the city of Baton Rouge can't sell.

Mr. PAITEVENT. There is very little reason to believe we can.

The CHAIRMAN. Is the Port of New Orleans in any better position to than the city of Baton Rouge?

Mr. POITEVENT. No; ours is full faith and credit of a State; theirs is a municipality; but the differential in the credit risk is not that great to justify a large differential in interest costs.

So we feel, in quick summation, that the provisions of sections 301, 302, 601, and 602, as have all been covered very ably by the gentlemen who preceded me, will have appalling consequences not only on the market as it is today, creating uncertainty and chaos, but they will also have tremendous consequences in the future. There is the question of the constitutionality of the entire proposal which will take years to litigate. There is the creation of an atmosphere of apprehension concerning the future of municipal bonds. If one step is taken it is logical to assume that others may be taken in the future to destroy the tax advantage of municipals.

Municipals themselves, and I am speaking more as a banker now than as a board commissioner, will be taken out of their hitherto private niche in investment thinking and will not receive the investment reception that they have had in the past. They will be thrown in direct competition with the mass of other issues having broader scope and possibly more glamour, as opposed to the individual consideration they had before.

Embedded deeply in this is the Federal subsidy question which implies that the approval or disapproval of each individual project will not necessarily be on the basis of local need but may be on other considerations.

In cutting through all of the statements and arguments I think we come to two bedrock inescapable facts: First, municipal bonds financing, as we have known it in the past, is the very lifeblood of public and capital improvement programs. Second, the lifeblood of municipals in turn and their real attraction in the investment market, is their tax exemption; and any legislative action changing this, these basic decisions, will court disaster, and must be judged against the rather minimal possible improvement in tax savings to the U.S. Government.

This completes our statement for the Board of Commissioners of the Port of New Orleans, and with your kind permission, I would like to file with the committee a statement from the American Association of Port Authorities indicating the dependency of the entire U.S. public port system upon tax-exempt bonds for investment capital. Any deterrent placed upon the marketability of such issues will have a serious effect upon the Nation's entire port industry. We thank you for allowing us to present this testimony, and the submission of the statements for record of hearing.

Thank you, gentleman.

(Statement of American Association of Port Authorities follows:)

Statement of the American Association of Port Authorities

(By Paul A. Amundsen, Executive Director)

Public marine terminals have never been attractive to private capital. With a few exceptions they have been developed by city or state governments or agencies thereof.

Local government has been able to provide such facilities at low investment rates because of the marketability of fully tax exempt general obligation or revenue bonds.

Historically, the total local public investment in marine terminals had reached $861,000,000 by 1941.

As attachments show, investment by city and state port agencies for 1964–65 has been $2,127,464,000. An additional $692,789,000 is being spent in the 1966–70 period, bringing all-time expenditures to almost $3.7 billion.

While minor portions of this total investment stem from direct appropriations by state and city governments, and from direct reinvestment of operating revenues, almost the entire dependency of the U.S. public port system is upon the fully tax exempt revenue bond or the general obligation bond for investment capital.

For this reason the member ports of The American Association of Port Authorities are opposed to any direct or indirect Federal taxation of interest on State and Municipal bonds. The effect of any such taxation on the bond market, already brought out by other witnesses, is, on the nation's seaport system, total and direct. Consider that system.

State port agencies apply in Maine, Massachusetts, New York and New Jersey (bi-state), Philadelphia, Pa.-Camden, N.J. (bi-state), Maryland, Virginia, North and South Carolina and Georgia as well as in Alabama. New York, Philadelphia, Norfolk, Savannah and others also have City agencies. Wilmington, Delaware is a city Port Commission. The Louisiana ports of New Orleans, Lake Charles and Baton Rouge are administered by agencies deriving their powers from the State. The Port Commissions of Mississippi are agencies of the State's Board of Agriculture and Industry. In Florida, a system of county port agencies applies (not unlike Navigation Districts). Well defined and more autonomous port authorities exist in Jacksonville and Tampa.

As the United States developed westward, from the Mississippi River, it is notable that port development began in local public hands and then remained so, there being very little private operation of commercial waterfront facilities in the West Gulf, and almost none in the states of California, Oregon, Washington. Texas ports are governed by Navigation Districts deriving their powers from the State. The port cities of California were given "commerce and navigation" responsibilities by the State and hence the California pattern has been one of City development primarily. San Diego has within the last several years changed from a City agency to a regional Port Authority. San Francisco, long the lone State agency, within recent months has become a City agency.

Oregon has City agencies generally and a State agency identified with the Columbia River and airport structure. Washington has a system much like that of Florida, involving districts and elected commissioners, emanating from State powers.

Turning to the Great Lakes, the City harbor departments there in many cases have been replaced by port authorities including Duluth, Toledo, Cleveland and Buffalo. In Chicago there is both a City port department and a Chicago Regional Port District under State auspices. Milwaukee remains a City department whereas Detroit is a port commission under County auspices.

Every one of the port agencies has developed in an atmosphere of local self-determination. As each port area evolved, protection of the public interest of that area, from the standpoint of waterborne commerce and harbor development has resulted in a port agency particularly tailored to that area's needs. As a result, no two of the agencies are alike as political structures. Nor are they alike as business entities.

Competing for a fair share of the nation's export-import tonnage is a large part of the job of protecting the local public interest, and this competition is very keen among ports in the cargo producing centers here and abroad.

Competing for industrial locations is likewise very keen, for this is "captive cargo" which is built into the port physical plant.

Seaport competition for cargo, given equal freight rates and frequency of sailings, really boils down to the provision of port facilities which offer efficiencies to the shipper and steamship line. This competition has resulted in the finest national port system on the globe.

It consists of 2,121 deepwater cargo terminals of all types (bulk as well as general cargo)' of which 1,254 were constructed since 1940. The average age of the total plant is 24.6 years, well under the typical amortization period of 35 years.

In general cargo terminals, where the competition is very keen, 720 of the above terminals were built since 1946, their average age being 11 years.

Of these, 49 are container terminals built since 1965, average age 4 years. Another 24 container terminals are under construction and another 45 are in the planning stage.

Almost the total investment in this system has been by local public agencies through fully tax exempt bond issues.

The Federal investment in ports has been mainly in the form of deepwater channels, the U.S. Engineers being responsible for navigable waterways.

The all-time Federal investment in channels since 1824 totals almost $1.5 billion, including maintenance. Comparing this to the historic local public investment in marine terminals ($3.7 billion) means that port authorities have invested more than $2.00 for every Federal dollar.

Customs collections at marine terminals for fiscal 1969 totalled $3 billion (excluding air cargo). The Federal deep channel appropriation for fiscal 1970 will probably be $35.5 million.

Thus on ports alone, the Federal Government has a very advantageous arrangement here. A 10,000% annual cash flow return on its dollar of annual investment as the minor partner in the joint venture.

The technology of world shipping is undergoing rapid change. Thanks to the competitive public port system of the United States, the nation's world gateways are keeping pace and indeed assumed an early leadership position in urging new technology.

The Senate Finance Committee should very carefully consider that a major national asset, totally dependent upon local tax exempt issues for its progress, is being destructively dealt with by those provisions of H.R. 13270 which directly or indirectly hamper marketability through taxation.

The CHAIRMAN. Thank you very much, Mr. Poitevent, and we are pleased to have Bill Lewis here with you. We are proud of what you have done to help Louisiana and in your community in particular.

Mr. POITEVENT. Thank you.

The CHAIRMAN. May I say just as one member of this committee I don't want to vote for anything that will defeat anything that you and Col. Bill Lewis are doing down there to help New Orleans.

Mr. POITEVENT. This is a very vital thing. We must change drastically and dramatically the tremendous revolution of cargo handling which is thrown on the top of normal maintenance and rehabilitation programs.

The CHAIRMAN. You are doing your best to try to modernize a port that had a lot of old docks and wharves that needed improving.

Mr. POITEVENT. Right.

The CHAIRMAN. And I hope you can find some money somewhere to build some facilities along that new tidewater channel that Bill Lewis built for you down there when he was with the Corps of Engineers.

Mr. POITEVENT. Yes.

The CHAIRMAN. But you are not going to be able to do that if you can't sell those bonds.

Mr. POITEVENT. That is right, without money we are dead.

(Mr. Eads Poitevent's prepared statement follows:)

STATEMENT OF EADS POITEVENT, COMMISSIONER, BOARD OF COMMISSIONERS OF THE PORT OF NEW ORLEANS

SUMMARY

The Board of Commissioners of the Port of New Orleans is charged with the responsibility of constructing and maintaining wharves and other public port facilities. The Port of New Orleans is a major world port, handling foreign trade cargo valued at $2.681 billion and generating customs collections of $76 million yearly.

The Port is the mainstay of New Orleans' economy, directly responsible for 86,500 jobs and $201 million in annual wages. The total impact on the Louisiana economy is $1.6 billion. Earnings on cargo handling account for $6.7 million in City sales taxes and $18.9 million in State income and sales taxes.

Capital investment is needed to upgrade existing port facilities, to construct new facilities to meet the demands of growth and to accommodate revolutionary changes in the shipping industry. The port facilities program calls for expenditure in the next four years of $60 million, to be financed by general obligation bonds of the State.

We oppose the provisions of H.R. 13270 which place taxation on municipal bonds and impair the tax-exempt bond market. The threat of taxation has already created chaos. Interest rates have increased sharply in the past four months. Passage of H.R. 13270 would cost the issuer two additional percentage points of interest, placing an additional burden on the local taxpayer. Construction of urgently needed port improvements are being delayed and may have to be abandoned.

We oppose the elimination of tax exemption on interest of "arbitrage bonds".

We oppose the provisions for the issuance of taxable bonds with an interest subsidy by the Federal Government. These place the polices and the programs for local development entirely under Federal control.

Taxation of municipal bonds violates the doctrine of intergovernmental immunity, raising substantial issues of constitutional law which will involve protected litigation.

We urge the Senate Finance Committee to defeat the provisions of H.R. 13270 which impair the marketability and increase the cost of tax-exempt municipal bonds, and other provisions which place the control of State and local investment capital under the Federal Government.

The Board of Commissioners of the Port of New Orleans, created by the constitution and statutory laws of the State of Louisiana, is empowered and charged with the responsibility of constructing and maintaining wharves and other public port facilities, of regulating the commerce and traffic of the port and harbor of New Orleans, and of administering the affairs thereof in such a manner as may, in the Board's judgment, be best for the maintenance and development of the port. The Board is composed of five members prominently identified with the commerce and business interests of the port. The Commissioners of the Board are appointed by the Governor of the State of Louisiana, each to serve a term of five years.

The jurisdiction of the Board of Commissioners of the Port of New Orleans embraces the Parishes (Counties) of Orleans, Jefferson and St. Bernard in Louisiana.

The facilities and activities of the Port of New Orleans are centered on the banks of the Mississippi River approximately 120 river miles from the Gulf of Mexico. Port facilities also extend along the Inner Harbor-Navigation Canal and the Mississippi River-Gulf Outlet, the latter being a Federal seaway project providing a deep-water link with the Gulf of Mexico over a distance of 70 miles. The extensive inland waterway system of the Mississippi River and its tributaries provides for a major transportation network connecting the Port of New Orleans with the mid-continent area of the Nation. The Gulf Intracoastal Waterway crosses the Mississippi River in the Port of New Orleans, extending east and west from Florida to Mexico.

The Board of Commissioners of the Port of New Orleans owns and controls public wharves for the handling of cargo having a total frontage of 54,525 lineal feet and affording an area of 10,845,000 square feet. In addition, the facilities of the port include a Public Commodity Warehouse, Foreign Trade Zone No. 2, a Public Bulk Terminal and the Rivergate, an international exhibition-convention facility.

The Port of New Orleans is a major world port, second largest in the Nation in the value of its foreign trade and in the volume of its total waterborne commerce. It is the largest port in the Gulf of Mexico area in all categories.

Within the reporting area covered by the statistics of the U.S. Army Corps of Engineers, the Port of New Orleans recorded 113,511,000 tons of waterborne commerce during 1968, shattering all previous tonnage records. This represents an increase of more than two million tons over the previous year. Foreign traffic in and out of New Orleans totaled 27.8 million tons, an increase of 400,000 tons over 1967, with exports accounting for 21 million tons and imports 6.7 million tons. Coastwise traffic was 28.1 million tons in 1968. Barge movements totaled 55 million tons, up about 5 million over 1967. Local traffic accounted for 2.7 million tons.

Within the reporting area of the U.S. Department of Commerce, the value of foreign trade cargo in the Port of New Orleans for 1968 was $2.681 billion, for an increase of 13% over 1967. Exports accounted for $1.615 billion and imports for $1.066 billion. Duty collected by U.S. Customs on cargoes passing through the Port of New Orleans in 1968 amounted to $75,960,000, an increase of 31% over 1967.

During the past 10 years the foreign waterborne commerce of the Port of New Orleans has shown an average annual gain of 7% per year, exceeding the average growth of foreign trade in the United States of 5%.

The Port of New Orleans is Louisiana's largest single industry and the mainstay of the economy of the Metropolitan Area of New Orleans. The Port is directly responsible for 36,500 jobs and more than $201 million in annual wages. It is indirectly responsible for 19,800 other jobs in Louisiana agriculture and 10,700 other jobs in Louisiana industry. The total impact on the Louisiana economy of this payroll money, earned directly by individuals from port activities, is a staggering $1.6 billion.

Earnings on cargo handling operations in the Port of New Orleans accounts for $6.7 million in City sales taxes and $18.9 million in State sales and income taxes.

For many years the Port of New Orleans has consistently plowed back gains from its operating revenue into construction and modernization of port facilities.

In the past 15 years alone the port has spent $130 million on major improvements, with $58 million of these funds coming from port earnings, $62 million from tax exempt bond issues supported by port income and $10 million from tax exempt bonds supported by a portion of the State gasoline tax.

The outstanding bonded debt of the Board of Commissioners of the Port of New Orleans on June 30, 1969, was $71,205,000. Maximum annual bond service requirements for payment of principal and interest, occurring in 1973, is $4,396,-000. All bonds issued by the Board are secured by the full faith and credit of the State of Louisiana, representing general obligations of the State, the interest on which, under present laws, are exempt from Federal taxation. As previously stated, the outstanding bonds of the Port of New Orleans are serviced largely from the net revenues of the Port, and additionally from the proceeds of a portion of the State gasoline tax.

Despite the huge sums spent on port improvements in recent years, the Port of New Orlenas today has great need for additional capital funds to upgrade its existing port facilities, to construct new facilities to meet the demand of growth in traffic and to accommodate technological changes in the shipping industry. In the history of the port the need for additional and improved facilities never have been more critical than it is today. This condition exists because of the advanced age and obsolescence of many of the port's cargo handling facilities, coupled with revolutionary changes in modes of port transportation and cargo handling techniques. The latter includes the growing practice of containerization and unitization of cargoes, intermodal concepts of transportation, the rapid development of containerships, barge carrying vessels and other innovations.

The containerization phenomenon is having a revolutionary effect on ocean transportation. Ports, as never before, find that they must quickly develop and adapt to reap the benefits of the "container revolution". Adaptation to containerized facilities presents unprecedented economic complications.

Special consideration must be given to the construction of highly sophisticated port facilities for the accommodation of LASH (Lighter Aboard Ship) and other barge carrying vessels which are now entering the shipping industry. Such requirements are highly important in the future development of the Port of New Orleans.

Two major steamship lines have announced the introduction at an early date of services operating between the Port of New Orlens and the North Atlantic Ports of Europe and the United Kingdom, utilizing such barge carrying vessels. Central Gulf Lines will initiate the LASH system with its vessel the "Acadia Forest" in October 1969, with a second vessel entering the service in early 1970. Lykes Bros. Steamship Company, Inc. has placed under construction three specially designed vessels for the SEABEE system, another version of the barge carrier. The first of these vessels will be placed in service late in 1971, with the other two vessels to be in service within six months thereafter. Holland-American Lines has invited tenders for two LASH ships, tailored for U.S. Gulf Ports service. Other steamship lines are also entering this field of transocean carrier.

Never has there been such a rapid change in ocean transportation as there has with the switch to containers, creating a massive requirement for new port facilities. Market researchers estimate that 1970 will be the year of the greatest growth with an estimated 70 new containerships delivered. As of April 1, 1969, there were 199 containerships under construction and on order in the United States and other shipyards. With the advent of the containership there are heavy pressures on the ports to construct new and improved facilities.

In addition, the Port of New Orleans, being a very old port, is faced with the problem of modernizing existing facilities. General cargo facilties which are deteriorated and obsolete and require replacement represent cargo handling capability 2½ million tons per year. The Port of New Orleans is confronted with the pressing need to replace these facilities, while at the same time adding capacity to accommodate gains in port traffic and to meet the technological changes. Keen competition from ports in the Atlantic, Pacific and elsewhere in the Gulf, where modern port facilities are going up at a rapid rate, emphasizes the urgent need for new and improved facilities in the Port of New Orleans if it is to survive as a viable force in the port industry and in the State's economy.

The facilities program of the port calls for the expenditure in the next four years of $60 million. Contrary to the past conditions, the Board of Commissioners of the Port of New Orleans does not have within its means the financing of such additional capital expenditures. Accordingly, the funds for this program must come from the State of Louisiana through the issuance of general obligation bonds supported by the entire resources of the State.

The Louisiana Legislature in its 1969 Regular Session authorized and directed the State Bond Commission to issue general obligation bonds of the State of Louisiana in an amount not to exceed $106,985,000, including $30,827,000 to be applied tó the facilities program of the Port of New Orleans.

At a meeting of the State Bond Commission held on August 12, 1969, resolutions were adopted to implement the bond issues as authorized by the legislature, and particularly authorized the issuance and sale of $15 million principal amount of bonds to mature within 30 days from the date of sale, at an average net interest rate not exceeding 6%. No bid will be accepted for a price less than par. The sale of said bonds is scheduled for September 30, 1969.

The prompt commencement and orderly prosecution of the rehabilitation and construction program, to be financed by the present and subsequent bond sales as authorized by the legislature for the benefit of the Port of New Orleans, is essential if the Port is to meet the needs of its commerce and trade.

H.R. 13270, if enacted into law, will be destructive to the ability of the Port of New Orleans to commence and prosecute its rehabilitation and construction program by placing in jeopardy the ability of the State of Louisiana to finance its capital programs.

Certain provisions of H.R. 13270, particularly Sections 301 and 302 thereof, directly and adversely affect the ability of the State to market tax-exempt bonds. It is apparent, in fact, that the threat of taxation of interest on State and local obligations by including the interest from these bonds in the limit on tax preference and allocation provisions of the bill has already created an extremely chaotic situation in the bond market. The potential financial impact on State and local government, should the provisions of the bill affecting tax exempt bonds be enacted into law, is appalling.

Analyses by the Conference on Intergovernmental Relations indicate that comparable municipal and corporate bonds historically have had a relationship as to yield in the vicinity of 70%; that is, municipal yields have been generally running at about 70% of those on comparable corporated (e.g., if a corporate bond was selling at 8%, a comparable municipal bond would yield about 5.60%). This 70% relationship has now increased to about 80%; or the municipal bond comparable to an 8% corporate bond is selling at a yield of 6.40% rather than 5.60%.

During 1967 and 1968 the differential between yields of taxable and tax exempt securities generally averaged in the range of 2%. The difference in July 1969 was 1.39%. Should H.R. 13270 be enacted into law, a substantial further narrowing, or even complete disappearance, of this differential could be expected. Accordingly, bond analysts are of the opinion that the provisions of the bill would cost the issue of tax-exempt bonds up to two additional percentage points of interest.

If the additional two percentage points is assumed the issuance of $60 million principal amount for needed port improvements involves additional interest cost of $24,840,000 over the assumed 30-year life of the bonds, thus adding 41.4% to the cost of the facilities. This is a small but typical example of the manner in which taxation of municipal bond interest will increase borrowing costs and wreak havoc with the capital improvement programs of the State and local governments.

Interest rates on municipal bonds have sharply increased since January. The increase in the past four months has been drastic. Bond Buyer's Index shows an average yield of 4.97% in January, 4.09% in April, 5.93% in July, 6.26% in August and 6.37% in September 5, 1969. Although there is reflected in these rates strong inflationary pressures and the monetary restraints imposed as counter-inflationary measures, a large portion of the increases are attributable to expectations respecting tax exemption of municipal bond interest. This apprehension has spread in the past four months.

State and local governments presently are unable to finance projects at reasonable interest levels, or at interest rates within legal limits, as demonstrated by the fact that tax exempt municipal bond issuances for 1969 are running at an annual rate 40% below that which would reasonably have been expected this year. This substantial forced reductions in bond issuances in 1969 are delaying the financing of essential public works at State and local levels. The provisions of H.R. 13270, if enacted into law, will compound the situation, further delaying urgently needed public works and creating a backlog of requirements which can be met in succeeding years only by adjustments in State and local tax measures to meet higher borrowing costs so that the crushing need for public facilities may be fulfilled despite the additional financial burden on the local taxpayer. Of necessity some meritorious capital improvements would be limited in scope, others abandoned altogether.

H.R. 13270 would deny tax exemption in certain cases to interest on State and local government "arbitrage bonds" issued for the purpose of purchasing U.S. Government obligations, the interest on which is used to pay debt service on municipal bonds. These provisions likewise are detrimental to the ability of the Port of New Orleans, the State of Louisiana and other public agencies to finance capital improvements.

Sections 601 and 602 of the bill provide for the issuance by a State or political subdivision to issue taxable bonds in exchange for an interest subsidy by the Federal Government. The Secretary of the Treasury would determine the subsidy percentage which would apply in the case of each bond issue. This is apparently designed to impair and ultimately eliminate the tax exemption of municipal bonds, to coerce State and local government to adopt a voluntary tax subsidy of their obligations, and to intrude the Federal Government into State and municipal financing.

Interest rates on municipal bonds issued without the benefit of the subsidy provisions will climb so drastically as to make the election of taxable subsidized bonds mandatory. It will only be a matter of time before the Federal Government would possess complete control of State and local financing.

The port industry of the United States is the product of competitive independent action by the various local and State port authorities without the interference of Federal control and regulations. The independent status of the State and local port industry would be destroyed in this process. The Federal government will inevitably exercise control over the funds. This will shift the decisions as to what is to be construed, when and how, from the local level to the Federal level.

The exemption of State and local bond interest from taxation stems from the constitutional mandated doctrine of inter-governmental immunity which is designed to permit the continued functioning of the Federal system of government. Because of diversity of legal opinion upon this point, no one could be certain of the outcome until a decision was reached by the U.S. Supreme Court. In the meantime, the municipal market would be in a state of apprehension and uncertainty, and the net effect would be to diminish sharply the acquisition of State and municipal bonds until this question was settled. Under these circumstances, banks and other institutional investors in tax-exempt bonds may assume that the next change in the tax law could directly reduce the value of the tax exemption to them. Any municipal financing that could be done at all will be at sharply higher interest rates, the cost of which would be borne by the local taxpayers. In the interim, needed port improvements and other public works will be at a standstill.

In the particular instance of the program for the Port of New Orleans as presently authorized by the legislature of Louisiana the issuance of bonds on September 30, 1969, is definitely compromised. The threat of taxation has created a sharp upturn in the yield of municipal bonds to the point that the sale of bonds at an interest rate of 6% or less is highly improbable. The Constitution and laws under which general obligations of the State may be issued makes no provisions for the issuance of taxable bonds with or without a Federal subsidy. New legislation enabling the issuance of taxable bonds must await an additional session of the legislature and possibly a referendum vote which may be scheduled at the earliest in November 1970.

The Board of Commissioners of the Port of New Orleans considers that the provisions of H.R. 13270 which impair tax exemption of State and municipal bonds as well as those which make allowances for the issuance of taxable bonds under Federal subsidy arrangements are highly prejudicial to the development and expansion of the Port of New Orleans. We urgently request that the Senate Finance Committee defeat the provisions of the bill which pertain to the taxation of State and local government bonds, as well as the provisions which tend to place the control of State and local financing under the Federal Government.

Presented herewith is a certified true copy of the Resolution adopted by the Board of Commissioners of the Port of New Orleans at its Regular Meeting held in New Orleans on September 11, 1969, setting forth the position of the Board in this matter and authorizing my appearance before the Senate Finance Committee to submit this testimony in opposition to the enactment of said provisions of H.R. 13270.

Attachment.

CERTIFICATION

I, Emero S. Stiegman, Assistant Secretary of the Board of Commissioners of the Port of New Orleans, do hereby certify that the following is a true and correct extract from the minutes of the Board adopted at a Regular Meeting held in the City of New Orleans, State of Louisiana, on September 11, 1969:

"Whereas the House of Representatives of the United States of America did, on August 8, 1969, pass H.R. 13270, a bill to reform the income tax laws, to be cited as the 'Tax Reform Act of 1969': and

"Whereas certain provisions of said bill will limit the income tax exemption on interest earned on state and municipal bonds, thereby conflicting with the long established decisions of the United States Supreme Court relating to the doctrine of intergovernmental immunity from taxation; and

"Whereas the limitation on preferences on minimum tax plan and the allocation of deductions as are set forth in Sections 301 and 302 of said bill would seriously prejudice the states and municipalities in exercising control over their financial resources and in the carrying out of their governmental functions; and

"Whereas the requirement to allocate deductions will have the effect of reducing other deductions which are otherwise allowable merely by reason of a taxpayer earning interest on state and municipal bond holdings and will further discourage the sale of such bonds and thereby make it impossible for a state to obtain the finances necessary to carry out its legal functions and purposes; and

"Whereas, Sections 601 and 602 of said bill provide for an election by states and municipalities to issue taxable bonds in exchange for an interest subsidy by the Federal Government, and would repeal the exemption from Federal income taxation of so-called arbitrage bonds, thus destroying the constitutionally tax exempt status of state and municipal bonds, as well as destroying the historically lower interest rates on state and municipal bonds; and

"Whereas, the purchaser of state and municipal bonds is actually paying a so-called 'minimum tax' by accepting a lower interest rate than if the bonds were taxable; and

"Whereas, the exemption of interest from federal taxation is the result of the constitutional right under the doctrine of intergovernmental immunity from such taxation, designed to permit states and municipalities to carry out their respective governmental functions; and

"Whereas, the provisions of said bill as they relate to the taxation of interest on state and municipal bonds will drive interest rates thereon to such exorbitant heights as to make mandatory the election by states and municipalities to issue taxable bonds in order to obtain such federal subsidies: and

"Whereas, it can be reasonably expected that legislation will follow to provide federal criteria for the granting of such subsidies in the future, thus placing complete control in the Federal Government of state and municipal government financing; and

"Whereas, notice to the public of said bill has already affected the sale of state and municipal bonds at the highest rates of interest ever made applicable to such bonds, and will continue to prejudice states and municipal governments from financing their governmental functions as the result of such tax-free bonds being made less attractive by the relatively high rates of interest being quoted; and

"Whereas, if many state goverments are compelled, by virtue of such increase in rates, to issue taxable bonds under provisions of Sections 601 and 602 aforesaid, interest rates will generally be forced upwards, to such extent that state and municipal governments will be forced into competition with private corporations and with the United States Government for available funds from investors; and

"Whereas, the demand from such source of funds becoming greater, from time to time, the higher the whole interest rate structure will become, thus making it impossible for state and municipal governments to finance their public obligations; and

"Whereas, the enactment of the aforesaid provisions of said bill will certainly bring about the institution of suits to establish the unconstitutionality of said provisions: Now, therefore, be it and it is hereby

"*Resolved* by Board of Commissioners of the Port of New Orleans that certain provisions of said bill, H.R. 13270, insofar as they relate to the taxation of the interest on state and municipal bonds, all as more particularly set forth in Sections 301 and 302 and in Sections 601 and 602 of the said bill are detrimental to the State of Louisiana, and to said Board as an agency thereof, in that they will seriously prejudice the ability of said Board to obtain the necessary finances for the construcion of required port terminal facilities and improvements for the obvious reasons aforesaid; and, that said Board is opposed to the enactment of the said certain provisions of said bill: "Be it and it is hereby further

"*Resolved*, That Eads Poitevent, Commissioner, of the Board of Commissioners of the Port of New Orleans, be and he is hereby empowered to present a copy of this resolution to the Finance Committee of the United States Senate, and to the members of the Congressional Delegation of the State of Louisiana, and the said Eads Poitevent, Commissioner, is further authorized and empowered, on behalf of said Board, to appear before said Senate Finance Committee for the purpose of offering testimony in opposition to the enactment of said certain provisions of H.R. 13270, at any hearing or hearings that may be called in the consideration of said bill, and to take such further steps and procedures as may be appropriate toward the end of procuring the ultimate defeat of the enactment of said provisions of said bill: be it and it is hereby further

"*Resolved*, That the Acting Director of the Port of said Board is hereby empowered and directed to take such additional steps and procedures, to attend such public hearings as may be called in consideration of said H.R. 13270, to offer testimony therein and take any and all other actions that may be appropriate and necessary, all in furtherance and in aid of the aforesaid efforts of said Commissioner Eads Poitevent, toward the end and purpose aforesaid."

Witness my hand and the seal of this Board, on this 12th day of September, 1969.

EMERO S. STIEGMAN, *Assistant Secretary*.

The CHAIRMAN. I have had a request for two additional witnesses. One was from Senator Stennis and one from a member of the committee. I would like to call Mr. Ed Khayat, if he is here. Will you come forward, Mr. Khayat. Mr. Khayat is secretary of the Mississippi Association of Supervisors. Senator Stennis requested he be heard today because I don't believe he could be in town tomorrow. Mr. Khayat, your other distinction is that you are the father of the defensive line coach of the New Orleans Saints.

STATEMENT OF ED KHAYAT, SECRETARY, MISSISSIPPI ASSOCIATION OF SUPERVISORS

Mr. KHAYAT. Yes.

The CHAIRMAN. What I want to know what was the matter with that secondary last Sunday?

Mr. KHAYAT. We are looking at that matter this week.

The CHAIRMAN. It was just that Jurgensen throws those passes so accurately.

Mr. KHAYAT. His accuracy was unfortunate for us. He threw a long bomb to Charley Taylor and that was the end of the day. But we are very happy to be with you, Senator, and we are very thankful for your allowing us to appear.

The CHAIRMAN. If you talk to your son, I would recommend they do something for the pass defense in the secondary.

Mr. KHAYAT. I will see that he gets the message. I will give it to him this afternoon.

Thank you very much, Senator. Thank you for the privilege of allowing me to appear before this distinguished committee. Much of what has been said already would be what I would say but I will not say it because I would be repetitive. All of these things the previous witnesses have mentioned, the Governors, the officials from the Port Authorities, and others, are all in my prepared testimony for the county supervisors of Mississippi. There are one or two points I would like to make, Senator, that have not been brought out.

The CHAIRMAN. May I say, Mr. Khayat, that is what we hope to get from witnesses, not just repetition of what has been said.

Mr. KHAYAT. Yes.

The CHAIRMAN. Because we know that, we have heard it before, we have read it before as well. We want to know what you are going to add to.

Mr. KHAYAT. Thank you, sir.

In addition to the information given, I would like to respectfully call to your attention the fact that millions of dollars in bonds issued by the State of Mississippi, city and county governments have built industries which cause the employment of several thousand people. We emphatically state that these buildings and equipment and this employment have created for the Federal Government a new broad tax base. Yet at the same time counties and cities grant 10-year ad valorem tax exemptions to industry on the assumption that other tax benefits come from these industries. And in order to serve the people who are employed at these new industries the counties and cities are called on to construct new schools, water and sewer systems, roads and bridges and recreation facilities as well as hospitals.

We, therefore, feel that we are sharing a burden with the Federal Government at the same time the Government is a direct recipient of tax income, 10 years prior to any income which may come to the State, county and city.

For example, the Standard Oil Co. of California merged into a company called Calky that has built in Pascagoula, Miss., a $130 million refinery. One of the major reasons they came to us is because we had a 40-foot channel built up the Pascagoula River financed a $2 million local bond issue. Now these people from California did not close their plant in California. They built a new one in Mississippi with an additional 700 employees plus the building and equipment which has created for the Federal Government, Senator, some additional tax money it didn't have.

Subsequently, the State of Mississippi issued $130 million in bonds to build a modern shipyard owned by the State of Mississippi, and operated by Litton Industries. But when this installation was built those bonds were bought because they were municipal bonds and we had that tax exempt feature which helped it, but consequently 12,000 people are at work in this shipyard. We are saying that the income that comes from these people, the income tax as well as the construction of buildings and the manufacture of equipment owned by Litton Industries brings to the government something new.

In addition to that, you all have been most compassionate with us in this hurricane thing. You have come across with help. We can build back most of the gulf coast and part of Louisiana and Alabama. You are putting up matching funds, you put up half and we are putting up the other half. The other half comes from bonds we have to issue, we have no funds in our Treasury, the only source of taxation for counties are ad valorum taxes and some others. Whatever we have to match comes from bonds issued. We have to sell bonds in this market, and they just have told us stay off the market. It is just as plain as that. That is my testimony and thank you very much for giving me this time.

The CHAIRMAN. May I wish you all the luck in the world in rebuilding after that hurricane hit Mississippi. We have had experiences like that in Louisiana. We had the full effect of Hurricane Betsy which did about a billion dollars damage. I don't wish you bad luck, but I am just as happy that it didn't go a little bit more to the west and hit us again. We have had about all we can take from those disastrous hurricanes. The previous time, when the disastrous hurricane destroyed all your sea walls and your front property improvements along that Mississippi gulf coast you did a magnificent job of rebuilding and by the time you were through what you had was better than what you had when the hurricane hit. I hope very much that the bill we pass will be of some help to you in doing as fine a job as you did the time before.

I hope by the time you are through with this disaster, poorer though you may be, you will have an even more beautiful gulf coast to show for it.

Mr. KHAYAT. I would also like to thank the Senator for the fine support you gave to Senators Eastland and Stennis and Congressman Colmer, the tremendous support, and we appreciate the compassionate support by good Americans as you are.

The CHAIRMAN. They helped us to pass the Betsy bill and——

Now, Mrs. Priest is here and we will call Mrs. Priest to present her statement. We are pleased to have you here.

STATEMENT OF MRS. IVY BAKER PRIEST, CALIFORNIA STATE TREASURER; ACCOMPANIED BY GEORGE HERRINGTON, BOND CONSULTANT

Mrs. PRIEST. Thank you, Senator Long, and Senator Bennett, Senator Curtis, well, Senator Williams, and Senators Anderson, it is so nice for me to be back here.

The CHAIRMAN. We are pleased to have you, and I think Senator Bennett would be pleased.

Mrs. PRIEST. Mr. Chairman, I would like to introduce George Herrington, our bond counsel for the State of California. He is a partner in the firm of Orrick, Herrington, Rowley and Sutcliff——

The CHAIRMAN. We are happy to have you.

Mrs. PRIEST (continuing). Who is here for any technical information you might need.

The CHAIRMAN. Senator Bennett.

Senator BENNETT. Mr. Chairman, Mrs. Priest is a product of my State of Utah. She was Treasurer of the United States during the Eisenhower administration, and the people of California know a good thing when they see one, so she is now treasurer of the State of California. Maybe she has more money out there than she had——

Mrs. PRIEST. Oh, Senator Long you still have money with my name on it. It is wonderful.

Senator BENNETT. Unfortunately it won't buy as much now as when you signed it. [Laughter.]

Senator BENNETT. That is one of the reasons we are meeting in this hearing to see what we can do about it. I am very happy to have the privilege of welcoming you to these hearings.

Mrs. PRIEST. Thank you, Senator Bennett, and I am most happy to be able to appear before this distinguished committee. You referred to how much money we might have out there, I understand that, in our bond operations, we are second only to the U.S. Government. So we do have a big setup and I would like to tell you a little about it, Senator Long and distinguished Senators.

The CHAIRMAN. We have a telegram, Mrs. Priest, from Governor Reagan saying that you are speaking for him. So you are speaking for the Governor of California.

Mrs. PRIEST. Well, I am very glad, because I like to feel that he thinks I could speak for him. He is doing a great job out there for us. We do have our problems, too, and the bond problem is one of the bigger ones. I would like to tell you a little of our problem for your consideration here today. In the interest of time, I think you Senators have a complete brief which we sent in, but in the interest of time I have some of the highlights of that I would like to review with you today.

The CHAIRMAN. We have your statement. It has been printed and it will appear in the hearings and in addition to that we will carry whatever summary you wish to add to that.

Mrs. PRIEST. Thank you, Senator.

Our State of California which I have the honor to represent before this committee opposes the provisions of H.R. 13270 which, as presently written, would tamper with the existing Federal-State relationship concerning tax-exempt municipal bonds. We contend that the so-called tax reform law would cause far more harm than good in attempting to solve some of the existing inequities, would jeopardize Federal-State relationships of all kinds and touch off a bitter round of litigation or bitter rounds of litigation might be better.

In this summary statement we seek to point out as concisely as possible what we believe would be some of the adverse effects on California of this proposed legislation. These, together with some of our views on the principles involved, are as follows:

1. We believe the proposal to tax State and local bonds, commonly referred to as "municipals," is unconstitutional, regardless of whether the Federal Government subsidizes all or only part of the increased interest costs resulting from State or local issuance of taxable bonds instead of the traditional nontaxable bonds.

2. Federal taxation of "municipals" will immediately and automatically increase market interest rates to compensate investors for the altered status of such bonds. The inevitable result must be increased State and local taxes to pay for the increased interest costs. The low- and middle-income taxpayer thus would bear an even larger share of the burden than he now does.

3. Once the principle is breached, there would be no fixed stopping point. Once Congress takes the first step away from tax exemption on municipal bonds, it can always take another step whenever circumstances make it expedient to do so. Federal subsidy of the extra interest costs involved in issuing taxable municipals can be withdrawn just as easily as it was first offered.

4. The very fact that Congress has been seriously considering legislation of this type already has had adverse effects upon the bond market. The fears and uncertainties surrounding current proposals to tax these bonds have led to (*a*) a shrinking of available money supply and demand for investments of this type because many would-be investors shy away entirely from the muncipal bond market until congressional intentions solidify, and (*b*) further increase in interest

rates on those municipal bonds which do manage to attract bidders in these unsettled times. Selling prices of stocks and bonds are affected by such intangibles as investor confidence and optimism, or the lack thereof, fully as much as they are by earnings records, credit ratings and the caliber of management. This is as true with municipal bonds as with corporate bonds. Investor buying patterns are influenced very markedly by any threat or suspicion of threat such as presented by current congressional actions toward State and local bonds.

5. Greater dependence upon the Federal Government as the source of major public works funding for State and local needs will be the inevitable result of any tampering with the historic status of tax-exempt bonds. If the States and their political subdivisions no longer can sell their bonds without having to pay extremely high interest, cannot find buyers at all because of Federal interference with the orderly marketing processes of the past, or can't raise taxes enough to fund a pay-as-you-go policy, then the only other major source of funds for State and local capital outlay projects has to be the Federal Government itself. That would be in direct contradiction to current efforts to bring about better working relationships between the National and State governments and would force the States to rely almost completely on Washington to solve their fiscal problems involving capital outlay projects. I doubt that any of us want that to occur.

6. California at present is unable to sell general obligation bonds in the normal manner or volume at the present time because inflation has boosted interest rates above the State's legal limit (5 percent). In June, 1970, with voter approval, the limit on interest may rise to 7 percent. However, even if this does occur, the entire matter may become moot if, through Federal taxation, national bond interest rates are forced to remain above the new ceiling. Our problems would be just as intense and just as severe.

Administration efforts to curb inflation's effects on the bond market may be nullified if the Congress through action which we consider most unwise, brings about a condition of permanent fear and uncertainty regarding investments of all types, including municipal bonds.

7. Those who will be most hurt in California if our bonds are made taxable will be the young people now reaching college age who will be denied the new buildings and facilities they need for their education. It will be the youngsters now in school or about to be enrolled in our public school system who will lack the classrooms they need. It will be the California veterans who depend on bond funds to provide the loans they deserve for buying farms and homes. It will be the growing millions of people who use and enjoy our State parks and historical sites made possible by bond financing. Perhaps most urgent of all at this point in time, those millions of Californians who are depending on the State water project to deliver to them the surplus waters of the north, as promised. In short, most of our 20 million population would be adversely affected by the taxation of State and local bonds as proposed under H.R. 13270.

We feel that all of these are very strong reasons for our belief that taxation of State municipal bonds is not only undesirable but perhaps even tragic for California.

Also you know, Senator, our State is second only to the U.S. Government itself in the annual bond sales. We have, in the complete brief, Senator Long, a record of our complete bonded indebtedness. There are something over $4 billion worth of bonds already sold outstanding. There is perhaps $1,300 million to be sold, authorized, but yet to be sold. I gave you in the summary a complete breakdown of our bond program and the various departments of State government using the bond financing so you would have that factual information.

We do urge you gentlemen to give this serious consideration, as I am sure you will, in your deliberations, because to our State of California it is of vital importance. Not to being able to sell our bonds in a market like today's is already posing many, many problems and we feel it would be disastrous.

The CHAIRMAN. You get hold of Governor Reagan and be sure that he makes sure your two Senators understand it. I believe Senator Cranston was the comptroller of your State, was he not, or some such thing?

Mrs. PRIEST. Who was that?

The CHAIRMAN. Wasn't Senator Cranston the comptroller or some such thing?

Mrs. PRIEST. Yes, he was, he was State comptroller. I had a letter——

The CHAIRMAN. He handled the money of California at that time and he knows what the problem is.

Mrs. PRIEST. Yes, he understands it thoroughly. I had a letter from Senator Cranston pledging his support and saying he would do what he could because he understands it as thoroughly——

The CHAIRMAN. I think you will make out as well with the two Louisiana Senators as the two California Senators because they understand the problem.

Mrs. PRIEST. I felt that way, Senator Long, because I knew all of you from years past and I knew it would be a pleasure to come here. Any questions you have to ask or any information you need I was sure if I couldn't supply it Mr. Herrington, our bond counsel, who has been, incidentally, the counsel for many years, and knows the history of our bonds, could do so.

The CHAIRMAN. Any further questions, Senator?

Thank you very much, Mrs. Priest.

Mrs. PRIEST. Thank you so much. May I say it has been a pleasure even though I am on this side of the table, to at least greet you again and wish you well.

The CHAIRMAN. Well, now that the Republicans occupy the White House we will be glad to have you again.

Mrs. PRIEST. Well, my family is living out there.

The CHAIRMAN. Washington hasn't improved since you left.

Mrs. PRIEST. Thank you again, Senator Long. If anything brings you to our great State please come up there to see us; we would be happy to see you. Give my regards also to Mrs. Bennett.

(Hon. Ivy Baker Priest's prepared statement follows:)

STATEMENT OF HON. IVY BAKER PRIEST, CALIFORNIA STATE TREASURER

The State of California, which I have the honor to represent before this committee, opposes those provisions of H.R. 13270 which, as presently written, would tamper with the existing federal-state relationship concerning tax-exempt municipal bonds.

We oppose also any changes in charitable trust provisions of tax law which would cause unintended but seriously adverse effects on California's and the entire nation's educational institutions. Any action which shuts off or diminishes the flow of gift funds to private schools will yield only added burdens to the public tax structure.

It is our contention that H.R. 13270, the so-called tax reform law, would cause far more harm than good in attempting to solve some of the existing inequities. It would open a Pandora's box of horrors, jeopardizing federal-state relationships of all kinds and touching off bitter rounds of litigation. For the most part, however, we will restrict our testimony to the proposed taxation of state and municipal bonds.

From this nation's earliest days these bonds have been considered as tax-exempt without serious question. We have not attempted here to present the full weight of data and expert opinion available to support our views, but instead seek to point out as concisely as possible what we believe would be some of the adverse effects of this proposed legislation.

This committee's goal of tax reform is a most desirable one. However, because California would be so seriously affected we must oppose H.R. 13270 in its present form on the following grounds:

1. We believe the proposal to tax state and local bonds, commonly referred to as "municipals", is unconstitutional, regardless of whether the federal government subsidizes all or any part of the increased interest costs resulting from state or local issuance of taxable bonds instead of the traditional non-taxable bonds. We believe that it really makes no difference whether the interference is direct or indirect on this point.

2. Federal taxation of municipals will immediately and automatically increase market interest rates to compensate investors for the altered status of such bonds. The inevitable result must be increased state and local taxes to pay for the increased interest costs. The low and middle income taxpayer thus would bear an even larger share of the burden than he now does.

3. Once the principle is breached, there would be no fixed stopping point. Once Congress takes the first step away from tax exemption on municipal bonds, it can always take another step and yet another whenever circumstances make it expedient to do so. Thus, a federal subsidy of the extra interest costs involved in issuing taxable municipals can be withdrawn just as easily as it was first ordered.

4. The very fact that Congress has been seriously considering legislation of this type already has had adverse effects upon the proposals to tax these bonds have led to (a) a shrinking of available money supply and demand for investments of this type because many would-be investors shy away entirely from the municipal bond market until congressional intentions solidify, and (b) further increase in interest rates on those municipal bonds which do manage to attract bidders in these unsettled times. It must be recognized that selling prices of stocks and bonds are affected by such intangible factors as investor confidence and optimism, or the lack thereof, fully as much as they are by earnings records, credit ratings and the caliber of management. This is as true with municipal bonds as with corporate bonds. Investor buying patterns are influenced very markedly by any threat *or suspicion of threat* such as presented by current congressional actions toward state and local bonds.

5. Greater dependence upon the federal government as the source of major public works funding for state and local needs will be the inevitable result of any tampering with the historic status of tax-exempt bonds. If the states and their political subdivisions no longer can sell their bonds without having to pay extremely high interest, or cannot find buyers at all because of federal interference with the orderly marketing processes of the past, then the only other major source of funds for state and local capital outlay projects has to be the federal government itself. That would be in direct contradiction to current efforts to bring about better working relationships between the national and state governments and would force the states to rely almost completely on Washington to solve their fiscal problems involving capital outlay projects. I doubt that any of us want that to occur!

6. California, along with other states, finds herself unable to sell general obligation bonds in the normal manner or volume at the present time because inflation has boosted interest rates above the state legal limit—in our case, five percent. Steps are under way to alleviate this situation through referendum in June, 1970, so that, with voter approval, the state's legal limit on interest may rise to seven percent. However, if and when this does occur, the entire

matter may already be or soon afterward become moot *if, through federal taxation of our bonds, inerest rates are forced to remain above even the new ceiling.* Administration efforts to curb inflation's effects on the bond market may be nullified if the Congress, through action which we consider most unwise, brings about a condition of permanent fear and uncertainty regarding investments of all types, including municipal bonds.

7. Those who will be most hurt in California if our bonds are made taxable to investors will be the young people now reaching college age who will be denied the new buildings and facilities they need for their education. It will be the youngsters now in school or about to be enrolled in our public school system who will lack the classrooms they need through 12 years of schooling. It will be the California veterans who depend on funds from the sale of state bonds to provide the loans they deserve for the purchase of farms and homes. It will be the growing millions of people who use and enjoy our state parks and historical sites made possible by bond financing. Perhaps most urgent of all at this point in time, those who will be hurt will be the farmers and cities of California who are depending on the State Water Project to deliver the surplus waters of the north, as promised, two years from now. All of these groups of people—probably most of the 20 million population—would be adversely affected by the taxation of state and local bonds as proposed under H.R. 13270.

At this point, I would like to present some specifics about California's population, geography, economy and state financing policies. These are germane to your understanding of why we believe so strongly that taxation of municipal bonds would be not only undesirable but perhaps even tragic in its effects on California.

FACTS ABOUT CALIFORNIA SCHOOLS AND COLLEGES

According to a researched feature article in the San Francisco Examiner and Chronicle for September 7, 1969, approximately six million of a population totaling approximately 20 million were expected to be in California schools this month. That's a school enrollment equal to an entire nation the size of Switzerland. Add to these students some 600,000 school employees and you have more Californians involved in some phase of education than in all other jobs and professions combined. As a state, we spend $4.5 billion a year to run our schools, about what it costs each year to put men on the moon. We are the most college-oriented political entity on earth: nearly one million of us, 50 out of every 1,000, now attend college, which is half again as many as in New York and three times as many as in Illinois.

Our investment in school property is more than $17 billion, according to a study by Crocker-Citizens National Bank economists. The biggest part of our tax dollar goes for education, a large share, of course, paying for the three million youngsters in elementary school and the 1.3 million in high school. We have had to build 150 new classrooms *each week* to house our growing public school population. We have the largest and most extensive adult education program in the nation; each year 1.8 million adult Californians take courses in some 500 locations around the state. Our extensive junior or community college system at last count totaled some 89 two-year colleges throughout California.

Between 1955–1967, California's population increased 47 percent—but at the same time, enrollment in all colleges and universities increased 160 percent and in the state college system 222 percent. The *increase* in college enrollment in our state has been averaging about 50,000 a year.

These facts and figures are cited to stress that education in California is, indeed, big business. To guarantee good schools for all of its people wherever they happen to live, the state provides its share of school support according to district need. For many years a state program of loan-grants has assisted local school districts with their building needs. These *state* funds are provided through the sale of bonds authorized by popular vote. In turn, local matching funds also are usually provided through *local* bond issues.

The University of California has an enrollment of about 100,000 on its nine campuses and the State College system has an enrollment of about 200,000. Buildings for these college and university campuses are financed largely through state general obligation bonds. Any action which would disturb California's ability to sell such bonds, or which would greatly increase the interest which state taxpayers would have to pay on such bonds, can only work to the detriment of higher education in California.

FACTS ON STATE WATER PROJECT

Planner, builder and operator of a $2.8–$3 billion project which will transfer surplus waters from northern California to thirsty lands and cities throughout the state, the State Department of Water Resources is at a crucial stage of construction in its timetable. Water already is flowing through the aqueduct system as far south as the Tehachapi Mountains, which separate the great San Joaquin Valley from southern California. Contract deliveries are being made to northern California, the San Francisco Bay area and to the San Joaquin Valley. However, getting the rest of the contracted supplies through and over the mountains to southern California by means of the world's greatest pump lift and difficult tunneling across earthquake faults still present a challenge before the end of the 600-mile water route is reached in 1972. Water is scheduled to reach Los Angeles County in 1971 and nearly to the Mexican border the following year.

Contracts for water service provide that costs of construction, operation and maintenance of the facilities will be paid tor by the users, with interest. Until completion of the project, however, the largest proportion of the revenue cannot start flowing back into the state treasury to meet principal and interest payments on the general obligation bonds which have been issued in series as needed to finance construction. Thus, it is imperative that no unnecessary and controllable factor intervene to disrupt the sale of California water bonds or to cause extra interest charges to be assessed against all contracting parties.

Approximately $600 million of the initial $1.75 billion in water bonds remain to be sold to complete the project as presently planned. Taking a long-range look, however, the project will have to be extended to tap new sources of surplus water from California's north coastal rivers, making further bond financing a necessity. It would be an unnecessary burden to carry on the back of California water users who pay for these projects if the federal government were to enact tax legislation which would increase the cost of bond financing, as would H.R. 13270 or any other similar bill.

FACTS ABOUT CALIFORNIA'S BOND SELLING PROGRAM

At the end of fiscal 1968–69. California's bonded indebtedness (general obligation bonds only) totaled $4.7 billion. Bonds already authorized by the voters but still unissued as of September 1, 1969, totaled $1.34 billion. The state ranks second only to the United States government itself in the dollar volume of bond sales. Under normal market conditions, our bond sales in recent years have been totaling $500–600 million per year.

There is a direct link between California's unusually rapid population growth and the need for public works on a large scale. There is no letup in sight. Because the need is so great (the population increase *each year* being comparable to adding a city of 500,000) bond financing has been the only feasible means of keeping up reasonably well. It is the fastest way to obtain large sums of money for capital outlay beyond the scope of pay-as-you-go financing. It also is a matter of principle and fiscal common sense that long range benefits should be paid for by future beneficiaries and future taxpayers as well as present ones.

California's general obligation bonds are used, for example, to finance capital outlay needs for:

1. *The Cal-Vet farm and home loan program.*—This has been successfully funded for decades in this manner. A total of $2.285 billion in bonds has been authorized during that period. Ending of the Viet Nam involvement will result in increased requests for loans from returning veterans.

2. *Public school construction.*—The public school system's building needs are aided by the state through bond sales. State aid is of a loan-grant type, partly repaid with interest. Since 1946 the state has approved applications for approximately $2 billion in state funds to help in constructing facilities for approximately two million students.

3. *Junior college construction.*—Authorized in 1968, the $65 million in bonds for this purpose is another type of bonding program in California which is directly affected by national bond market conditions. At the beginning of this year, there were 89 community colleges operated by 69 separate junior college districts. These are required to match state building construction funds. Last November, the first series of these bonds was sold; no more have been sold since then because of prevailing high interest rates.

4. *Park, recreational and historical site facilities.*—In 1964, California voters approved a $150 million bond issue for expanding the state park system, for local parks and for additions to Wildlife Conservation Board hunting and fishing improvement facilities. In a state of 20 million population, augmented in the summer by visitors numbering in the hundreds of thousands, at least, it has become imperative to provide more parks and recreational facilities. Bonds meet these capital outlay needs.

It should be noted that these have been examples, not an all-inclusive list.

Authorized but unissued state bonds as of September 1, 1969, include: $600 million for the water project, $60 million for construction of state buildings, $80 million for university and state college construction, $75 million for the state park system, $275 million for public school system building aid, and $50 million for junior college construction.

VIEWS ON TAX IMMUNITY UNDER THE CONSTITUTION

The question of tax exemption of municipal bonds may be phrased as follows:

Does the right of states and their political subdivisions to borrow by means of bonds whose interest is exempt from federal taxation stem from the permissiveness of a beneficient central government, or is this right a part of the very nature of our republic's political partnerships?

California contends that Congress by itself cannot abolish by statutory enactment that which has been recognized as a constitutional right by the U.S. Supreme Court and which, therefore, can be changed only by amending the Constitution. This principle has been reiterated by the Supreme Court since adoption of the Sixteenth Amendment (the income tax amendment). Since California's presentation here today is not intended to be a legal brief, we will not set forth the citations in case history which substantiate our position. In our view, they are solidly based.

We contend that the federal government has no right to tax municipal bonds even indirectly, or by offsetting such taxes through the device of interest subsidy. To extend this point, if the states are to be required to yield *their* immunity in this matter, the *federal government should reciprocally give up its own immunity,* thus opening the way for counter taxation of its bonds by the states. It should work both ways if it is going to be brought into the picture at all. No one would gain by such a chaotic scheme. We merely suggest that a cutting sword usually has two edges!

California contends that any alteration of the principle of reciprocal immunity from taxation could pull down the entire framework of federal-state relationships and would destroy the principal means open to the states to finance their major capital outlay projects. Once any exception is made to the principle of immunity, immunity no longer exists!

VIEWS ON CHARITABLE CONTRIBUTIONS

The proposed changes in the treatment of charitable contributions suffer from the same weaknesses as those dealing with tax-exempt bonds. The House Ways and Means Committee, in trying to eliminate abuses of present regulations, has proposed changes which in our opinion will lessen the flow of charitable contributions.

Although California would not be affected as much as her sister states by such changes because our private institutions carry only about 11 percent of the total enrollment in higher education, we nevertheless are concerned about the negative impact that this proposal would have on gifts to private educational institutions. They already are at a competitive disadvantage relative to public institutions. This move to tighten regulations on charitable contributions would heighten that disadvantage at a time when private schools need all the help they can get if they are to remain a viable part of our educational framework.

Every enrollment gain by private institutions lessens the burden which otherwise would fall on our taxpayers. Moreover, we feel that the increased competition between public and private schools helps to achieve our goal of excellence in higher education.

For these reasons, therefore, only summarized here, the State of California respectfully urges the Congress to take no action in developing a tax reform bill which would tend to diminish the ability and willingness of contributors to support private colleges as in the past.

NEWS CLIPS: LOCAL COMMENTS ON AND EFFECTS OF TAXING MUNICIPAL BONDS, SACRAMENTO BEE, SEPT. 4, 1969

From a story describing a meeting of the Los Rios Junior College District board of education:

"The board rescinded its action of two weeks earlier, awarding a $1,875,400 contract to Harbison and Mahoney for construction of the American River College library. Assistant Superintendent George Rice explained the district had been unable, in the current confused bond market, to sell the bonds needed to finance the project. Rice said *proposals in Congress, to remove the tax-exempt status from such bonds and to alter the capital gains tax, have combined with high interest rates to dry up the bond market* . . ." (emphasis added).

Sacramento Bee, Sept. 5, 1969

From a story reporting proceedings of a Sacramento City Council meeting:

". . . Christensen (City Councilman Walter Christensen, former Mayor) warned that 'the community center is down the drain' if Congress passes a tax reform bill which eliminates or reduces the tax-free status of municipal bonds, thus making some or all interest on such bonds taxable to investors."

SAN FRANCISCO CHRONICLE, SEPT. 4, 1969, FINANCIAL EDITOR SIDNEY P. ALLEN'S COLUMN

". . . Bonds go begging, more than ever.

"Here's fresh evidence of it. The Bond Buyer Index, the major gauge for the tax-exempt bond sector, topped six per cent 10 days ago, and currently has shot up to a new high record at 6.26 per cent.

"Right here at home, to be more specific, the California Municipal Bond Index of Glore Forgan, Wm. R. Staats Inc. topped 6.21 per cent. That, too, was up a whopping 21–100ths in one week!

"Obviously investor confusion and fear regarding possible tax reform that might eliminate or reduce state and municipal bond tax exemption has knocked the final prop from that sector. It's a punch to the solar-plexis (sic) for California . . ."

SACRAMENTO BEE, SEPT. 7, 1969

"DAVIS—Failure of the Davis Joint Unified School District to market $330,000 in bonds has prompted a warning that taxpayers may face increased taxes because of the current condition of the money market.

"The Davis bonds, authorized by voters in 1963, failed to attract any bidders at the legal maximum interest rate of 5 per cent.

"The business manager of Davis district, Melvin H. Keubnhold, said, 'The money market is like a yo-yo at the moment. No one's buying bonds—particularly at the interest rate of 5 per cent.

'*One of the major problems is the tax reform discussions in Washington* (emphasis added). At present interest earnings on bonds are tax-free. But the indications are that they will become taxable—with taxes being applied retroactively. So no one is buying.'

". . . The Davis bonds were to finance a new gymnasium and shop at Holmes Junior High School, a project considered 'top priority' by officials."

The CHAIRMAN. We will next call Mr. Lanford Jorgensen of North Platte, Nebr.

Senator CURTIS. Mr. Chairman, Mr. Jorgensen is city administrator at North Platte. There are here in Washington, many of them in this room, 20 officials or attorneys from Nebraska representing various municipalities that, for whom, Mr. Jorgensen is speaking, many of whom have already submitted their statement, isn't that correct?

Mr. JORGENSEN. That is correct.

Senator CURTIS. Mr. Chairman, I ask that entire list of the delegation be printed in the record.

(The list referred to follows:)

NEBRASKA REPRESENTATIVES TO SENATE FINANCE COMMITTEE HEARING ON H.R. 13270

City	Representative	Title
Millard	Harry P. Anderson	Mayor—MAPA (Metropolitan Area Planning Commission of Douglas, Sarpy Counties in Nebraska and Pottawattamie County, Iowa).
Fremont	Bill Buch	Mayor.
Hastings	Bill Gettman	Mayor and school district.
South Sioux City	Ernest Albertson	Mayor (chairman of the Siouxland Area Planning Commission, Sargent Bluff, Iowa; Sioux City, Iowa; South Sioux City, Dakota City, North Sioux City, S. Dak.; Woodbury County, Iowa, Dakota County, Nebr.; Union County, S. Dak.).
Ogallala	Paul Cassel	Mayor.
Grand Island	John Ditter	Do.
Do	John Carpenter	City manager.
Bellvue	John Rice	City attorney.
Lincoln	Ralph Nelsonp	City corporation counsel.
North Platte	Lanford Jorgensen	City administrator.
Do	Patrick H. Rensch	(Special counsel) North Platte schools—North Platte Vocational Technical schools and member State School Board Association.
Kimball	Don DeBoot	Mayor.
Gering	Bill Hackman	President school board and also representative city of Gering.
Norfolk	Paul Harm	City administrator.
Do	Bob Otte	City attorney, Norfolk city schools.
Battle Creek	do	Schools and village of Battle Creek.
Hadar and Oakdale	do	Village of Hadar, Oakdale.
South Sioux City	Wayne Body	City attorney.
Village of Homer	do	School district counsel.
Village of Dakota City	do	Do.
School districts of South Sioux City, Homer, Allen, Winnegabo:		
Chadron	Harry Dutrow	City councilman.
Do	Chuck Poore	Special adviser.
Metropolitan utilities district	Cecil Brubaker	General counsel.
Nebraska League of Municipalities	Del Rasmussen	Ex secretary.

The Chairman. I would like to ask that they stand so we can recognize them. I am happy to see Nebraska is so well represented here today.

Senator Curtis. Now you know where the cheering came from.

STATEMENT OF LANFORD L. JORGENSEN, ADMINISTRATIVE ASSISTANT TO MAYOR OF NORTH PLATTE, NEBR.

Mr. Jorgensen. Chairman Long and our distinguished Senator Curtis and other Senators, I represent the city and school district of North Platte, the junior college of North Platte, and the Mid-Plains Vocational and Technical College.

First of all I would thank you for allowing me to speak to you. We were set for a hearing on Thursday, and because we were in town you have been gracious to allow me to appear here today. I thank you very much.

You have our official statement. To save time, I will not read our statement as I am sure the distinguished Governors and mayors have covered the points far better than I could.

I would only like to bring out two points that I think have not been mentioned before.

Most of the people you have heard so far represent our great States across the country and our major cities. I have the responsibility and the privilege of representing the smaller cities and towns, and often they are the backbone of our country. This brings me to my first point. You were very courteous in allowing these men to stand up but I believe this is a point that should be brought out, and I am sure you are aware from the testimony brought out today of the general concern of those officials who are responsible for taxation in our municipalities. These gentlemen, on their own, and without any chance of any hearing, took the time out of their busy schedules, many of them mayors and councilmen on a part-time basis, to come back to Washington D.C., just to have this chance to stand up and be counted. I think this is an important point for you gentlemen to consider—that they thought enough, and are concerned enough, to come back here.

I would like to make a second point. I am sure many of you Senators get the feeling many times that cities large and small have their hands out for grants in aid programs. Maybe this is so. There is only so much money to go around. At times we have to come to you to get certain things done. But nothing has been said about self-help and pride in our cities, whether it is the city of New York or the city of North Platte, and I would bring this out as an example only gentlemen, to make my point.

In the city of North Platte we have organized a steering committee composed of a member of each of the governmental units in that region, and the sole purpose of the steering committee is to organize our community completely, down to the block level, for one thing—for a self-help program. In other words, we realize that even a community of 20,000 has its slums, has its poor, has its needs to be fulfilled, and we would like to see what we could do on a self-help basis. As one of the Governors pointed out, the markets for municipal bonds, even at their very best, are slim, and believe me, when you get down to a town of 20,000 competing with even our major cities in Nebraska, Lincoln, and Omaha, it is difficult. I am sure you can see what will happen if our municipal bonds are taxed.

When we come out of a study that shows the priorities in our communities in the area of North Platte, I am sure there will be minimum housing for the elderly, there will be a new civic center to help promote the tourist industry, there will be many other things. Our town is growing and we will have to have new schools and new roads, and the only place we can turn to have new schools and new roads, and the only place we can turn is to bonds. For 1 minute, if you could put yourself in our position in the smaller community, and there are many towns that are smaller than North Platte, I am sure you can appreciate in what position we will be if this bill is allowed to be passed. I have heard many words to describe it, such as incredible. But, gentlemen, we will just be out, that is it. I can't appeal to you too much.

So, on behalf of the smaller towns, without this privilege of having tax immunity on municipal bonds we stand little or no chance.

I thank you very much for the privilege of appearing before you here. I have a lot of talent backing me up in the audience here. If there are any questions you might wish to ask I would be very happy to find the answers.

Senator ANDERSON. We appreciate your testimony and we would be glad to——

Senator CURTIS. I want to express my gratitude not only to Mr. Jorgensen but to these men of the delegation who have come here. I mentioned to them earlier today that we have a very systematic way of getting their testimony before the members at the actual time that they vote. We feel very strongly that you are right in this, and for the record and for the benefit of the committee, I want to say something about North Platte.

During World War II a great portion of the troop trains carrying members of our Armed Forces from the East to the West passed through North Platte. The people of North Platte had a program. Their slogan was that no servicemen would go through North Platte without being greeted and given something. And, night or day, 24 hours a day, for the 5 long years of the war, every member of the Armed Forces who went through North Platte was awakened, offered some refreshments, some homemade cookies, writing material or anything else he wanted. If it wasn't late, I could make a nice speech about the communities these other gentlemen represent but I could not fail to say this about your fine city Mr. Jorgensen. We still receive letters from veterans across the country on the North Platte canteen.

Mr. JORGENSEN. I appreciate your comment, Senator.

Senator CURTIS. I believe that the statement you presented and those of the Governors, and others, have made a very good case.

Senator ANDERSON. Thank you very much.

Mr. JORGENSEN. Thank you very much.

(Prepared statement submitted by Mr. Jorgensen follows:)

STATEMENT BY PATRICK H. RENSCH, SPECIAL COUNSEL FOR THE MAYOR AND COUNCIL OF NORTH PLATTE, NEBRASKA; AND LANGFORD L. JORGENSEN, ADMINISTRATIVE ASSISTANT TO THE MAYOR OF NORTH PLATTE, NEBRASKA

All provisions of H.R. 13270 relating to taxation, direct or indirect, or under subsidy and tax waiver agreement are opposed. Results will be increased financing costs, loss of local governmental interest and economical operation; local taxes and the costs of utilities paid by most tax-payers will be increased; confusion caused by threat of taxation; lack of confidence due to taxation of outstanding bonds and anticipation of court litigation pose long-term uncertainties compounding the results of anticipated tax; and taxation of bonds is not tax reform but political, social and Constitutional reform. The subsidy provision is part of this reform, and unwise and costly.

We believe in the principal of the sovereign state as a partner with the Federal Government, not its tool, and the taxation of municipal bonds is the key to this independent action. We ask you to strike all references to tax and subsidy.

STATEMENT

Mr. Chairman and Members of the Committee:

The Mayor and Council of the City of North Platte, Nebraska, have gone on record as strongly opposed in principal to any language in H.R. 13270 or any other Bill which would in any way directly or indirectly tax the income of any bonds or obligations of any State, or any governmental subdivision of any State. They also have gone on record opposing any language in H.R. 13270 or other legislation which would in any way establish voluntary relinquishment by a State or subdivision thereof of the tax exemption for any reason, whether it be subsidy, aid grant or control. They have also gone on record as being opposed to any language in H.R. 13270 which might relate to the subject called arbitrage which in any way would give the federal government a right to question legitimate financing plans or programs, whether required to be in the form of advance refunding or other programs where the only logical investments, or the only legal investment, might be an interim investment in United States government bonds. This written statement is a brief summary of these objections and some of the reasons for the objections.

This statement is made not only on behalf of the City of North Platte, but is authorized to be and is presented as the official expression of the School District of North Platte and of the Mid-Plains Area Vocational Technical School, a multi-county vocational technical school district is Western Nebraska, and that reference hereafter to the official body of North Platte, we refer also to the other political subdivisions above mentioned.

First let us say that we do not believe that the inclusion of the taxation of the income of municipal bonds in H.R. 13270 is tax reform. We consider it to be more in the nature of the political or constitutional reform under the guise of tax legislation. We feel it is unconstitutional and we feel that it is politically and fiscally unwise in that its consequences, in addition to being a more costly method of financing municipal improvements, involves a threat to the whole concept of the separation of the powers of the federal government and the States and their subdivisions.

We believe in the principal of the separation of the powers between the Federal Government and the States as provided for in our constitution and as they have developed under the laws of the United States Government and the decisions of the United States Supreme Court. We recognize that the present ability of States to sell bonds at a rate which is competitive with the cost of financing of the federal government is probably the biggest single factor today in retaining the principal of the separation of the powers of the federal government for those of the state local government. We feel that any change in the nature of this relationship will only lead to more and stronger centralized federal control over matters which are rightly within the prerogative and the concern of the State and local governments. We feel that the right of taxation of municipals is politically and financially unsound and will ultimately lead to chaos in the municipal bond market, will lead to higher financing cost and ultimately to the assumption by the Federal Government of the function of financing of the local improvements resulting in the loss of local control and decision making.

We feel that the passage by the House of Representatives of H.R. 13270 shows a lack of understanding of this concept not an intent to change our constitutional birthright which is subject to ultimate termination by the logical extension of this legislation. We know that the impression which has been given by publicity in the national news media from statements made by those espousing the taxation of municipals are misleading and that the true picture of the problems involved has not been recognized, possibly because of this. You should recognize that our bonds are purchased by those in an income tax bracket which makes the purchase of our bonds advantageous to them—the margin is thin. To say that the purchaser of a municipal bond does not pay a tax is grossly in error. When an investor buys a North Platte bond with a tax free rate of 4%, whereas he could buy a taxable bond of similar quality for 6%, he pays directly to the city whose bond he purchases a tax of 33% since his return is one-third less. The treasury department in their proposals acknowledge that this difference may be between 30% and 40%.

We have here an ingenious system for the return of tax dollars to municipalities which preceeds and complements announced plans for returning tax dollars to cities and states. In one sense the city whose bond is purchased receives a tax from the purchaser in the form of reduced interest. Without developing a bureaucracy or creating other problems we have one solution, the return to the local government of federal income taxes, which should be expanded, not curtailed. The publicity concerning about 150 to 200 millionaires who do not pay taxes was unfortunate and inaccurate as it relates to municipal income.

Title III, Section 301 of H.R. 13270 makes possible a direct income tax on the income from municipal bonds owned by individuals, estates and trusts in that tax preference income will not be permitted to exceed one half of the total income and the taxpayer will be required to pay tax on the remaining half (in case of taxpayers with total tax preferences in excess of $10,000). This applies equally to outstanding bonds as well as new bonds and is hereafter referred to as "*limited tax preference*".

Title III, Section 302 H.R. 13270 would in certain instances deprive taxpayers of their present ability to deduct fully the amount of personal income tax deductible against their taxable income. This does not apply to bonds issued prior to the specified date. This will hereafter be referred to as "*allocations of deductions*".

Title VI, Sections 601 and 602 H.R. 13270—There is provision for a State or political subdivision to elect to issue bonds the interest from which will be taxable, and the United States will pay an interest subsidy so as to reduce the interest payments made by the State or a local subdivision. This will be referred to as the *"interest subsidy provision"*.

Ample testimony will be presented to show the fiscal impact on municipal financing and to support our feelings as set out above; that no need for a federal subsidy will be shown by those involved and objections come from all levels of government of the States and subdivisions as well as citizens (other than those attempting to justify their political, social and constitutional reform program); to show the wiseness in our present system; to show that the actual result of such a tax will be an increase in the tax of those with lower incomes; to show the legislation will complicate unduly the income tax provisions relating to bonds; to show the extent to which such legislation will be resisted in court causing additional continued market uncertainty and therefore higher costs to municipalities; that feasible projects will not be financeable thus increasing the demand for grants and aids and federal expenditures and be an impetus to further inflationary trends.

We feel the Federal Government is physically unable to fill the void. Consider the multi-agencies involved with grants and attempts to aid smaller communities in financing improvements for water, sewer and recreation. The lack of success of the loan program is indicative of the general lack of needs of governmental involvement in financing. Where costs exceed ability to repay, grant in aid programs have been useful to obtain desired results.

Public housing financed by municipal corporations has been successful because the United States Government is willing to guarantee payment of bonds and pay all deficiencies of rentals set low for income groups. This would not work where bonds are payable from taxes or from assessments on a local level. Tax legislation will take municipalities out of federal housing or raise financing costs. For the United States Government to have all States and local municipalities as a partner in this program independently financing, planning and executing is one of our Federal Government's major assets and this is one sane approach not to be tampered with.

We feel the Subsidy Provision is absolutely unnecessary and is as conducive to higher costs and uncertainty as is taxation of the bonds themselves. We do not agree that a compromise enactment of these provisions is possible. The confusion created by conflicting interpretations and controls which would develop together with governmental promotion of their program would be costly, cause delay and increase costs.

Our Governor, before the Ways & Means Committee proposed a detailed study of the problems. In this we concur. We do not concur in any inference in his other testimony or any testimony before this committee, that a subsidy system for higher interest on bonds incurred where taxation immunity is waived by States would be useful in any way—but rather harmful as outlined above.

Senator ANDERSON. Is Mayor Tate here? We will be here at 9:30 tomorrow at this place.

(Whereupon at 12:35 p.m., the hearing was recessed to reconvene, Wednesday, September 24, 1969, at 9:30 a.m.)

TAX REFORM ACT OF 1969

WEDNESDAY, SEPTEMBER 24, 1969

U.S. Senate,
Committee on Finance,
Washington, D.C.

The committee met, pursuant to recess, at 9:15 a.m., in room G-308, New Senate Office Building, Senator Clinton P. Anderson, presiding.

Present: Senators Long (chairman), Anderson, Talmadge, McCarthy, Harris, Byrd Jr. of Virginia, Williams of Delaware, Jordan of Idaho, and Fannin.

Senator Anderson. The first witness this morning is Mr. William Simon, who is the municipal director, Investment Bankers Association.

STATEMENT OF WILLIAM E. SIMON, MUNICIPAL SECURITIES COMMITTEE, INVESTMENT BANKERS ASSOCIATION OF AMERICA

Mr. Simon. I am chairman of the Municipal Securities Committee of the Investment Bankers Association, Senator Anderson, and we are deeply concerned about the implications of the current proposals for indirect taxation of the interest on State and local government securities. The complete text of our testimony has been submitted and, with your permission, I would very briefly like to summarize this testimony.

We expect to continue to serve as bankers for these States and municipalities, whether their bonds are wholly exempt from income taxation, wholly taxable or partially taxable. Accordingly, we can be objective in appraising the effects of the dispute about tax exemption and tax equity.

Nevertheless, we feel a heavy responsibility to offer you our opinion as to the market effect of the proposed infringement of the existing tax exemption. This market effect is vitally important to the States, because they must have the continued confidence and support of investors in order to obtain the huge sums of capital needed for public projects.

To the degree that investment interest is alienated, State and local governments will pay more than necessary for their future borrowing. That added cost can be met only by raising the rates of income and sales and local property taxes. Thus the Federal tax aimed at investors in municipal bonds will be passed along to the average taxpayer and especially to homeowners.

In our testimony before the House Ways and Means Committee on March 11, we warned that any impairment of the income tax exemption of State and municipal bonds would drastically increase the cost of future local government financing.

This prediction has been fully realized in the cumulative reaction of investors to H.R. 13270, and specifically to section 301 (the limit on tax preferences) and section 302 (allocation of deductions). By late August, the market for municipal bonds had become almost completely demoralized. Many local governments were unable to issue their bonds at rates within the maximum limits fixed by their controlling State finance laws. It was difficult to get realistic bids for municipal bonds which investors wanted to sell.

For many years new issues of municipal and local government bonds had commanded interest rates about one-third lower than the rates on comparable quality corporate bonds. This favorable ratio held through the credit crunch of 1966. However, by late August of 1969, States and municipalities were paying 80 to 85 percent of corporate rates. The increase in relative cost is at least 1 percent at today's interest rate levels; and we believe that at least a half of 1 percent of this is attributable to the threat that municipal bond interest will be partially taxed. And this higher cost relationship is obviously only anticipatory. The actual enactment of legislation assessing Federal income tax in relation to ownership of State and municipal bonds, in our opinion would further increase the interest penalty on local government.

We believe that if the treatment of municipal bond interest proposed in H.R. 13270 is enacted into law, investors will want "tax exempt" rates closer to taxable rates than anything we have seen to date. From the minimum of one-half of 1 percent already indicated, we fear that the resulting penalty on municipal bond costs could easily rise to a full 1 percent or more, at current levels of long-term interest rates.

Even if the threat is limited to allocation of deductions, investors must conclude that the wall of reciprocal sovereignty has been breached, and their psychological reaction would surely exceed the actual reduction in the income value of tax exemption. If the rules of the game can be changed in relation to outstanding bonds, investors will demand a margin of protection against further deterioration.

The allocation of deductions would affect many more taxpayers than would the limit on tax preferences, and the definition recommended by the Treasury is much harsher than that in H.R. 13270, in that the full amount of interest on municipal bonds, both outstanding and future issues, would immediately be a factor in the allocation of deductions.

Furthermore, commercial banks and other institutional investors would have to infer that the allocation formula with some modification could easily be extended to them; and that prospect would be absolutely catastrophic to the market for municipal bond issues, because of its prime dependence on bank support. Hundreds of small commercial banks, heavily invested in municipal bonds, should not be subjected to the possibly serious capital consequences of tax-imposed further depreciation of their portfolio with subsequent economic effects.

In testifying before the committee on September 4, the Treasury disclosed the estimate that the inclusion of municipal bond interest in the base for allocation of deductions, according to its proposed formula, would yield revenue of only about $45 million a year. In contrast, the minimum increase of one-half of 1 percent would add $75 million in additional interest cost burden on State and local governments. Where is the saving?

Furthermore, within 5 years, the cost to the State and local governments would be in excess of $300 million or about five times the Treasury's annual revenue estimated by projecting the $45 million figure.

The initial reaction of investors to the tax proposals affecting State and municipal debt was one of incredulity that Congress would or could legislate such a drastic change in the mutually soverign relations of the State governments and the Federal Government, established by the Constitution as hitherto interpreted by the Supreme Court of the United States. Particularly incredible was the proposal that the interest on outstanding bonds be included in the computation of tax liability; because investors had believed that the interest rate advantage obtained by offering tax exemption was in effect a contract consideration assuring them of exemption throughout the terms of their loans. Putting it another way, the investor who accepted an interest rate which was 70 percent of a comparable taxable rate, in effect is paying a 30-percent tax on the higher gross income which he might have had.

The sudden breaching of this longstanding exemption, even though it is indirect, has caused a major reduction in the market value of all outstanding bonds by an amount we estimate to be $5 billion.

More serious from the viewpoint of the State and local governments, this breach of what was believed to be a constitutional exemption will permanently deter many investors from buying municipal bonds. The acceptance of Stato and local government bonds is based on beliet in the good faith of government at all levels.

The Treasury understandably opposes the House plan for a Federal subsidy to compensate the States for their added cost if they will voluntarily convert their financing to fully taxable form. Such a conversion, if comprehensive, would put State and local borrowing into direct competition with bonds of the Federal Government and its agencies, with private industry borrowing, and with mortgages. In sum, the effect of the carrot and stick campaign to drive local government out of the tax exempt form of financing would be a general rise in the level of interest rates on taxable securities, both those of Federal Government and those of private industry.

A comprehensive study of institutional investors conducted by Dr. Sally S. Ronk, well known as an authority on the flows of funds in the capital markets, shows that the participants in the study expect an across-the-board increase of three-quarters of 1 percent on all long-term fixed income investments, and it could well be more. The resulting annual cost to the Treasury is estimated at $121 million.

The mortgage market especially would be further diminished, as State and local pension funds diverted their buying power from mortgages to the bonds of their own municipalities.

To us it is inconceivable that at a moment of unprecedented restraint on money supply, when the bond markets are already close to disorder, an attempt is made to revolutionize the status of municipal bonds for the sake of getting at a handful of presumed tax avoiders, who if they ever did invest in municipal bonds must wish most heartily that they had not.

We respectfully urge upon this committee that interest paid on State and municipal bonds should be exempted from both the limit on tax preferences and the allocation of deductions. In our opinion, the indirect taxation proposed in H.R. 13270 would cost the States much more than it would yield in revenue to the Treasury. This would mean a heavier tax burden falling mainly on the middle-income homeowner. The efficiency of the municipal bond market must be preserved if we are to supply the capital requirements of the States and their political subdivisions. That market cannot function efficiently if it is to be harassed by complex applications of indirect taxation of municipal bond interest.

Mr. Chairman, I thank you for the opportunity of presenting our case. It is a very complex subject, and I hope we have genuinely helped you in your thinking on this matter. We would be delighted to spend whatever time you could spare to answer any questions either from this witness table or in another area. We are at your disposal, sir. Thank you.

Senator WILLIAMS. Mr. Simon, would you agree with some previous witnesses that the problem confronting the market today is not so much the adverse effect as proposed under the House bill or the Treasury recommendations but rather the uncertainty that is created in the minds of the investors as to what this Congress or some other Congress may do once we take this step in the direction of taxing municipal securities?

Mr. SIMON. I agree with that; yes sir.

Once Congress directly or indirectly taxes municipal securities, however small, it has put doubt in the investors' mind and it sows the seed of the ultimate destruction of the municipal market.

Senator WILLIAMS. And it is this element of doubt that causes problems in the market. And as soon as we can answer this question and get it settled once and for all the better it will be for all concerned?

Mr. SIMON. Senator Williams, this doubt is already in the market as expressed in the minimum of one-half of 1 percent of additional interest costs that all States and municipalities are paying today. It is not the tight money and the commercial banks being per se out of our market as some officials have said. In 1966, during the credit crunch, the interest spread between "tax exempt" and taxable bond issues was maintained at the historic ratio of 65 to 70 percent. Today municipal securities bear interest rates close to 85 percent of comparable quality taxable securities of private corporations and this is only anticipatory.

Senator WILLIAMS. And that those who have bought these bonds heretofore have already paid a sizable tax as a result of the depreciated prices?

Mr. SIMON. They most certainly have.

Senator WILLIAMS. Mr. Chairman, I have no other questions but I would like to make this observation both to this witness and to prospective witnesses who are coming, who will be appearing here a little later this morning. I am going to have to leave, and it will be noticed that the Republican membership of this committee will not be here this morning. We are having a caucus for the purpose of selecting a leader, and we have to be there in person to vote. The fact that the minority members will not be present this morning should not be interpreted as lack of interest on our part in your problem, and I am sure you understand why we will not be able to be with you for a short period.

Mr. SIMON. Yes, sir.

The CHAIRMAN. Thank you very much, sir.

Let me just ask a question about one item which does concern me and which has become a serious problem. When we talk about some 154 people who made a large amount of money and paid no Federal income tax one of the big tax evasion routes is through the purchase of tax exempt securities. Now, some have suggested that we ought to have a very modest tax on municipals for individuals who make a large amount of money and have no tax liability.

Suppose we left out the banks and the insurance companies and simply applied to individuals some type of a municipal tax concept in the event that a person made more than $100,000 and paid the Federal Government no income tax, do you think that would work havoc on the municipals market?

Mr. SIMON. It already has, Senator Long. Our commercial banking system is now well aware of the fact that if you tax individuals holding municipal bonds, however modestly, that they could be and probably would be next in future Congresses and, as a result, they are not buying our commodity.

The CHAIRMAN. Senator Talmadge.

Senator TALMADGE. No questions.

Senator ANDERSON. I had a letter announcing the transference of some bonds and the offering of 8-percent notes, 7-percent notes, and 7½-percent notes. Those are unheard of yields, I would think, especially for tax exempt securities.

Mr. SIMON. Yes, sir; they certainly are.

Senator ANDERSON. You will see the effects for a long, long time, would you not?

Mr. SIMON. Not since the Civil War have we had interest rates this high.

Senator ANDERSON. I was absolutely amazed.

Mr. SIMON. This is a major point about the tax reform bill. If it passed with these encroachments on municipal bonds you are legislating higher interest rates right down the line.

Senator ANDERSON. It will affect the schools and everything else.

Mr. SIMON. Everything, sir.

The CHAIRMAN. Well, there is just no escaping the fact that no matter how small a tax you put on these municipal bonds if we are going to put a Federal tax on them at all the interest rate must go up. There is just no way around it. That just has to happen, we can't avoid that because making them subject to a Federal income tax in whatever respect whatever means the interest rate on those securities will have to go up, and people would have less confidence in buying them.

Mr. SIMON. That has already happened, Senator.

The CHAIRMAN. Thank you very much, gentlemen.

Mr. SIMON. Thank you.

(William E. Simon's prepared statement, and a supplemental letter from Paul S. Tracy, follow:)

STATEMENT BY THE INVESTMENT BANKERS ASSOCIATION

My name is William E. Simon, and I am Chairman of the Municipal Securities Committee of the Investment Bankers Association of America. In order to answer any questions you may have, I am accompanied by several associates experienced in this area.

I am authorized to represent the more than 600 investment firms and banks, members of our Association, who underwrite and make secondary markets for bonds of the fifty states and their counties, municipalities and special districts.

Many of our member firms have participated in this financing for fifty years. In light of that experience, we are deeply concerned about the wider implications of the current proposals for indirect taxation of the interest paid on bonds of state and local governments.

We expect to continue to serve as bankers for these states and municipalities, whether the interest on their bonds is wholly exempt from income taxation, wholly taxable or partially taxable. Accordingly, we can be reasonably objectives in appraising the capital market and economic effects of the tax reform proposals embodied in H.R. 13270 insofar as they relate to state and municipal bonds. These comprise (1) the limited tax preferences proposal, (2) the allocation of deductions proposal, and (3) a Federal subsidy in aid of municipal borrowing in taxable form.

This proposed alternative financing method, which provides for the issuance of taxable state and municipal bonds with a Federal subsidy to the issuer of between 25% and 40% of the interest, represents an attempt to induce state and local governments to convert their financing to taxable form, voluntarily surrendering tax exemption.

We shall deal in detail with the wider economic and market implications of all three of these proposals today.

THE CONSTITUTIONAL QUESTION

Differing opinions are expressed as to whether tax exemption is implied by the Constitution as a part of reciprocal immunity in the Federal-state relationship. There is no doubt, however, that the origin of tax exemption is Constitutional, and that it was placed in the first Revenue Act following the adoption of the 16th Amendment because the Congress then believed that the Constitution required this provision.

Because of this history and background it is improper to bracket consideration of tax-exempt bond interest with those other exclusions and deductions which Congress has adopted from time to time in order to stimulate certain types of economic or social activity, or with those provisions of the Code which have inadvertently created "loopholes." Nevertheless, much of this year's discussion has linked municipal bond financing in the public's mind with these other devices, and we believe quite unfairly.

RECENT MARKET DEVELOPMENTS: THE IMPACT OF TAX REFORM

The year 1969 has been a difficult one for the municipal market. Measured by Moody's Aa municipals, the average yield has risen from 4.60% in January to 5.93% at the end of August.

During the twenty-five years 1944–1968, state and local governments had been able to borrow capital funds at tax exempt rates averaging about two-thirds of the interest cost of long term taxable bonds issued by private corporations of comparable security quality. This initerest cost relationship held at about 70% despite the rapid increase of total state and local borrowing from $11 billion in 1966 to more than $16 billion in 1968.

In the first eight months of 1969, the amount of new municipal bond issues was 25% less than in the same months of 1968; this meant that the underwriting and distribution load was $2.5 billion lighter. Yet, the interest rate spread between "tax exempt" and taxable bond issues has narrowed significantly. Instead of the long-prevailing 65–70% of taxable rates, bond issues offered in late August by state and local governments bore interest rates approximating 80–85% of those on comparable quality new issues of private corporations. Some part of this rise in the exempt/taxable ratio has been caused by the progressive increase in the intensity of credit restraint affecting especially the commercial banks' ability to buy municipals. But let us look at very similar monetary conditions governing banking in the Summer and Fall of 1966. At that time, commercial banks sold municipal bonds out of their portfolios in greater volume than in 1969. New issue volume was comparable. Yet the ratio of tax exempt to taxable borrowing costs, using the same indices for comparison, in 1966 did not rise above 75%, and then only for a single month. In 1969's higher ratio, by 7 or more percentage points, easily represents, at today's level of interest rates, a half of 1 per cent per annum of added local government borrowing cost attributable to the threat that municipal bond interest will be partially taxed.

As a result of the disclosure in late July by the House Ways and Means Committee of its intention to apply both the limit on tax preferences and the allocation formula to tax exempt bonds, it was necessary to restructure and reword notice of sale, underwriting agreements, and legal opinions in order to put prospective investors on notice that tax exemption is threatened. Both individual and institutional investors have shown sharply diminished confidence in the municipal market because of these changes and the uncertainty thus created.

Some dealers and at least one bank announced their intention to withdraw from bidding on new municipal issues until their tax status was clarified. The new issue bidding on Tuesday, July 29th revealed unmistakably that the municipal market was on the brink of chaos. The $65.0 million "Aaa" rated State of Ohio issue was sold to the winning bidders at 5.94% net interest cost, an increase of nearly ½ of 1% over that which would have prevailed only two weeks earlier. The second bid represented nearly ½ of 1% higher net interest cost over the first bid, an unthinkable bidding spread in any normal market. On that same day two cities, Chicago, Illinois, and Newark, New Jersey, were able to secure only one bid each. No bid at all was received for the $7.4 million Eastern Kentucky University issue. The municipal market, which has continued to function, although with understandably reduced efficiency under the tightest money conditions ever witnessed in modern times, was on the verge of collapse directly owing to the tax proposals under construction by the House Ways and Means Committee.

We think it likely that these proposals, if enacted into law, could cost states and local governments a minimum of 1% per year additional interest on their "tax-exempt" financing. That means an increased financing cost of at least $150 million per year, all of which hard pressed states and municipalities will be forced to raise from taxpayers already groaning under the burden of state, local, and Federal taxation.

LIMITED TAX PREFERENCES (MINIMUM INDIVIDUAL INCOME TAX) PROPOSAL

As we stated before the House Ways and Means Committee on March 11th, the inclusion of the interest on state and local government obligations in gross income, for purposes of computing a limit on tax preferences or a minimum income tax, would do significant and lasting damage to existing and future state and local government bond markets, without achieving any appreciable increase in tax equity. In view of the demonstrated gravity of the market consequences, we feel compelled to draw to the attention of your Committee the following considerations.

Our confidence in the capability of the tax-exempt market to provide for growing state and local capital needs is predicated on continuance of the present unqualified tax exemption provided in Section 103 of the Revenue Code, for obligations of the states and their political subdivisions. The proposal for a minimum income tax comes to you under the name of "equity" and "fairness" in the application of the individual income tax. Equity and fairness in taxation are standards which we all support. In looking at tax exemptions, weight must be given, however, to the policy and historical considerations upon which a particular exemption is based. Furthermore, the question of the presumed greater equity resulting from inclusion of interest on state and local bonds in the expanded base for this proposed alternative tax computation must be weighed against its adverse effect on the value of tax exemption to state and local governments in maintaining a preferred market for state and local borrowing.

Individuals, together with trust departments of banks, and investment counsel acting on their behalf, are important factors in the municipal market, although annual additions to their holdings vary widely in amount. (See Exhibit 2.) The role of individual investors on the municipal market increases in relative importance when the buying by banks and casualty insurance companies is reduced. This phenomenon occurred in 1966 when individuals purchased 40% of net new issues. There is no doubt that inclusion of tax-exempt interest in the alternative minimum tax would significantly reduce municipal bond purchases on behalf of individuals. Those unaffected by the initial minimum tax would only wonder how soon the next step in this direction would affect them.

Undoubtedly there would be a legal test as to whether a law taxing interest on state and municipal bonds would be Constitutional. Because of diversity of legal opinion upon this point, no one could be certain of the outcome until a decision was reached by the U.S. Supreme Court. If the Atlas Life Insurance Company case is any precedent, at least three years could elapse before a decision by the U.S. Supreme Court. During that period, tax-exempt bonds through sheer uncertainty and apprehension would sell at only slightly lower yields than taxable securities of comparable quality, because the intermediate and long term market would in effect have become a game of chance in which the few remaining buyers were merely betting on the outcome of the litigation. Furthermore, some individuals would undoubtedly sell their holdings in fear of an unfavorable decision.

Banks and other institutional investors in tax exempts are fully aware that a minimum tax applying to them was weighed by the House Ways and Means Committee and eliminated at the last moment. Under these circumstances, they could only assume that the next change in the tax law would directly attack the value of tax exemption to them. Their natural reaction would be to reduce their purchases sharply, and, if they bought at all, to confine their buying to the shortest maturities. Any municipal financing that could be done would probably be at sharply higher interest rates, the cost of which would be borne by the general taxpayers in the borrowing states and municipalities.

Putting this matter in proper perspective, tax exemption is not simply a gift from the Federal Government to certain investors. It is a *quid pro quo* for the acceptance of lower rates of return than the investor could obtain on alternative investments. An investor in tax-exempt bonds has accepted close to one-third less income than he could receive from taxable obligations—this is what he has paid for the tax exemption. Thus in a very real sense, and certainly in terms of equity, the investor in tax-exempt bonds has *already paid* the equivalent of a minimum income tax and has paid it in advance.

For this reason especially, the application of either the limit on tax preferences or the allocation of deductions to interest derived from *outstanding* municipal bonds, creates a real shock wave for investor confidence.

In our opinion, there is no such thing as a *limited* exposure of municipal bonds to Federal taxation. Either the interest is exempt or it is taxable to the same degree as private corporation securities. If the U.S. Supreme Court rules that Congress can impose a conditional tax based on the circumstances of the bondholders, then investors must assume that some future Congress may go all the way to direct taxation. See Appendix A for a detailed discussion of the effects of the limit on tax preferences (minimum income tax) treatment of tax exempt interest.

THE ALLOCATION OF DEDUCTIONS PROPOSAL

The proposal for allocation of deductions, in theory would increase the taxes collected from taxable income rather than collect a tax on tax-exempt bond interest. But as it would reduce the net income value of such interest, its effect actually would be that of an indirect tax on tax-exempt interest. The allocation of deductions would hit many more taxpayers than would the limit on tax preferences. Section 302 of H.R. 13270 provides that only tax-exempt interest income received from obligations issued after July 12, 1969, be included, and this inclusion is phased in over a ten-year period. In testimony before this Committee, the Treasury has advocated that allocation be applied retroactively to outstanding issues as well as future, and that the full amount of interest received on municipal bonds would immediately be a factor in the determination of tax liability.

For either concept, the extent of the effect of allocation depends upon the relationship of certain defined preference income to total income, applied to the aggregate of allocable non-business deductions. The larger the relative amount of such deductions, the greater the impact. A study of the effect of allocation on typical investors (attached hereto as Appendix B) suggests that allocation would reduce the net yield of tax-exempt income by ¼ to ¾ of 1%, the averaging being about ½ of 1%. This would mean that a 5½% tax-exempt yield would be worth only about 5% to the investor.

If tax-exempt income is made less attractive, more individual investors will be persuaded to follow the present trend toward heavier concentration in common stocks or other investments. With substantial losses already suffered in his bond portfolio, an individual investor is certainly in no mood to absorb this added blow. As a result individual investors would require substantial leeway in the form of greater yield on tax-exempts, as protection against changes in his individual exposure to allocation.

The application of allocation to individuals would raise serious questions for institutional investors, particularly commercial banks, who must fear that they might be next in line for an extension of this proposal. It is well known that H.R. 13270 at one point contained an extremely harsh provision applying this proposal to commercial banks; and that this provision was deleted only at the last moment. Given the banks' important position as buyers of tax-exempt bonds, their warranted fears can be absolutely catastrophic to the market.

The municipal market has already experienced the results of an allocation arrangement, contained in the Life Insurance Tax Act of 1959. The Atlas Life Insurance Company contested these provisions in litigation which lasted from May 1962 until May 1965. There was one victory along the way in the Circuit Court of Appeals, but the Company finally lost in the U.S. Supreme Court.

The attached Exhibit 3 shows what actually happened to the life insurance companies' share of the tax-exempt market during this period as the result of the allocation of income formula. In 1961, state and local holdings of life insurance companies were $3.9 billion or 3.07% of total assets, and acquisitions were $506 million or 2.01% of total acquisitions. By 1968, municipal holdings were down to $3.2 billion or 1.69% of total assets, and acquisitions were down to $278 million or 0.58% of total acquisitions. The results speak for themselves. The life insurance companies' sector of the municipal market was severely constricted. Since 1962, life insurance companies have been net sellers of state and local bonds in every single year, as shown in Exhibit 2.

Furthermore, many life insurance company acqusitions of state and local securities are motivated by other than purely investment considerations such as yield and quality. For example, insurance companies derive important advantages from the purchase of municipal bonds of certain states in order to reduce the rates of taxation on their premium income from those states. Although other assets within the states may be similarly used, municipal bonds are satisfactory for this purpose in all of such states. Also, it should be noted that a considerable share of life insurance company municipal bond acquisit'ons are of discount bonds at low percentage of par value with coupons as low as 1/4, 1/10, and 1/20 of 1%.

As far as these bonds are concerned, the tax-exempt interest feature is of minimal significance, and attention is focused on the capital gain aspects of the transaction.

As we look at this precedent and contemplate the possible application of allocation of deductions to individuals, we should note that individual investors are a factor in the tax-exempt market some ten times as large as were the life companies at their peak.

THE FINANCIAL EFFECTS OF THE LIMITED TAX PREFERENCES AND ALLOCATION OF DEDUCTIONS PROPOSAL

In testifying before this Committee on September 4th, the Treasury disclosed the estimate that the inclusion of municipal bond interest in the base for allocation of deductions, according to its proposed formula, would yield revenue of about $45 million a year.

We submit that this estimate proves our contention that if this indirect tax is imposed, the states and their municipalities will pay far more in interest costs than the Treasury will ever gain in revenue. On the basis of a presently indicated bond rate increase of at least ½ of 1% per annum, impairment of the tax immunity of municipal bond interest would impose an added cost of $75,000,000 a year on the $15 billion of state and local borrowing which is the minimum annual amount necessary to maintain the present rate of construction of public projects. Whereas the tax yield to the Treasury would grow very slowly at the rate of a few million dollars a year, the cost to the states and their agencies would mount rapidly. Within five years, their cost would be in excess of $300 million a year, or about five times the Treasury's annual revenue estimated by projecting the $45 million figure.

In our opinion, this estimate of added cost to state and local governments is conservative in that it measures only the already demonstrated harm to the municipal market. We believe that if the treatment of municipal bond interest proposed in H.R. 13270 is enacted into law, investors will want "tax exempt" rates closer to taxable rates than anything we have seen to date. From the ½ of

1% already indicated, we fear that the resulting penalty on municipal borrowing costs could easily rise to a full 1% or more, at current levels of long-terms interest rates. This would double the estimate of annual cost increase, to $600 million, without yielding any significant addition of revenue to the Treasury.

On these comparisons, any fiscal purpose of the proposed tax law amendments appears to be self-defeating. There remains the question whether tax equity is improved. On this score we assume that the purpose is to discourage a very small number of individuals in high income brackets from minimizing their taxable income through ownership of municipal bonds.

There is reliable evidence that most wealthy persons do not invest heavily in tax exempts; (see page 12) and that an extremely low percentage of taxable estates was invested in state and municipal bonds. Finally, the Treasury has never demonstrated that the famous 154 individuals having incomes in excess of $200,000 on which they paid no Federal tax, ever relied to any significant degree on investment in tax exempt bonds.

PUTTING STATE AND LOCAL GOVERNMENT FINANCING IN PERSPECTIVE

In order to establish the basic facts related to the financing of state and local government, we offer brief discussions of the distribution of municipal bond ownership, the cost of tax exemption to the Federal Government, the recent growth and projected growth in state and municipal bond issues, and the size and composition of the new issues of long-term fixed-income obligations.

Outstanding State and Local Debt and its Ownership

Outstanding state and local debt, and the interest paid on it is as follows:

TABLE I

	1966	1967	1968
Beginning	$104,700,000,000	$111,600,000,000	$122,000,000,000
End	111,600,000,000	122,000,000,000	132,300,000,000
Total	216,300,000,000	233,600,000,000	254,300,000,000
Average outstanding debt	108,150,000,000	116,800,000,000	127,150,000,000
Interest paid	3,451,000,000	3,813,000,0C0	4,437,000,000
Interest cost (percent)	3.19	3.26	3.49

Exhibit 4 shows the total outstanding debt each year since 1946, who owned it, and in what proportions:

Looking at the principal classes of ownership, it is readily observable that the holdings of commercial banks increased from 25% of the total in 1945 to 44% in 1968, and that the holdings of fire and casualty insurance companies increased from 1.5% in 1945 to 11% in 1958 and have since stabilized at that level. The holdings of individuals declined from 46% in 1945 to 32% in 1968.

Since the current hearings have emphasized individual ownership, it is of especial interest to examine the relationship of municipal bond ownership to income brackets. Contrary to popular belief, a survey made by Professor Benjamin Okner, using results gathered by the Michigan Survey Research Center[1] from a sample of high income persons, concluded that most wealthy persons do not invest heavily in municipals. Based on 1964 data, he estimated that only 10 per cent of the persons with incomes of over $10,000 owned any municipals and that only 1 per cent of them derived as much as 25 per cent of their income from such securities. While 65 per cent of those persons in the highest category, those with incomes of $315,000 or more, held *some* municipals, only 18 per cent of them derived as much as 10 per cent of their income from this source, and only 6 per cent derived as much as 25 per cent from this source. (See Exhibit 5)

Affording corroboration of this survey, the estate returns filed in 1966 with the Internal Revenue Service (the most recent year for which a report is available) demonstrated that an extremely low percentage of taxable estates was invested in state and municipal bonds. Investments in corporate stocks were 17 times as large as investments in municipal bonds.

[1] *Income Distribution and the Federal Income Tax,* Michigan Governmental Studies No. 47, Institute of Public Administration, University of Michigan, 1966, Appendix A.

Only 4 brackets of decedents' total estates held more than 5 per cent of their assets in municipal bonds. These were the $2 to $10 million estates in which almost 800 estates held an aggregate of $234.1 million of such bonds which constituted 7.3 per cent of the assets of such estates. The percentage of assets invested in municipal bonds reached no higher than 8.63 per cent, which was recorded for the $5 to $10 million estate bracket. Estates of the larger and smaller size brackets held a smaller part of their assets in municipal bonds. The average of the municipal bond holdings of all taxable estates reported on a total estate basis was 2.7 per cent of total assets. (See Exhibit 6) *Recent Growth in State and Municipal Financing Volume and Project Growth.*

As can be seen from Column 1 of the following table, municipal bond financing has been growing at a compounded growth rate of 8.7% in the period from 1960 through 1968, after deleting the industrial revenue financing which was an extraneous and foreign element in the market and which has been terminated for all practical purposes by the provisions of the Revenue Control and Expenditures Act of 1968.

TABLE I

[In millions]

	Growth at 8.7 percent	Actual	Joint Economic Committee estimate [1]
1960	7,230	7,230	
1961	7,859	8,360	
1962	8,543	8,558	
1963	9,286	10,107	
1964	10,094	10,544	
1965	10,972	11,084	
1966	11,927	[2] 10,589	14,200
1967	12,965	[3] 12,088	14,900
1968	14,093	[4] 14,044	15,700
1969	15,319		16,600
1970	16,652		17.600
1971	18,101		18.600
1972	19,676		19,500
1973	21,388		20,800
1974	23,249		21,800
1975	25,272		22,700

[1] "State and Local Public Facility Needs and Financing," a study prepared for the Joint Economic Committee of the Congress of the United States, December 1966. The National League of Cities, in conjunction with the Urban Institute is currently engaged in updating data on anticipated capital outlays of States and municipalities through 1975. Data from this study are not yet available.

[2] Excludes $500,000,000 industrial aid financing.

[3] Excludes $1,300,000,000 industrial aid financing.

[4] Excludes $1,600,000,000 industrial aid financing, and $730,000,000 anticipatory financing to avoid provisions of Revenue Control and Expenditures Act of 1968, Watson amendment in California and similar measure in Oregon.

Furthermore, in its December 1966 study, the Joint Economic Committee indicated that capital outlays through 1975 could be handled by the present market mechanism. The Joint Economic Study estimates at present are well ahead of actual financing volume, considering that much of 1968 new issue municipal borrowing can be attributed to anticipatory borrowing (California, Oregon and Port of New York Authority) and industrial development financing. Other studies of the fiscal outlook of state and local government financing through 1975 [3] came to a similar conclusion.

Size and Composition of the Capital Market

Tables A and B show the gross acquisitions of long-term fixed-income obligations, averaged for the period 1965–1968 by categories of borrowers, also a percentage distribution of such acquisitions by investor groups. This study for the first time gives a comprehensive picture of the new-issue market. It was constructed by Dr. Sally S. Ronk, Vice President of Bankers Trust Company, New York. This demonstrates how state and municipal bonds fit into the total market of fixed income obligations.

[3] *Fiscal Outlook for State and Local Government to 1975*, Tax Foundation, Inc. *1966 Fiscal Issues in the Future of Federalism*, a CED Supplementary Paper, Committee for Economic Development *1968*.

Inflation and the Capital Markets

The major difficulty experienced by state and local governments in raising long-term money in the capital market today is part of a general problem faced by borrowers in all sectors of the market for fixed-income obligations in an inflationary environment.

The bear market trend in bonds since 1946 and the severe decline in bond prices over the past four years have left many investors disillusioned with fixed-income obligations. In many cases, declining bond prices and the erosion in the purchasing power of the dollar have resulted in a negative return on an investor's funds in recent years. In the face of this experience, the financing of many essential social programs at supportable interest rates depends critically on investors' expectations about the future course of inflation.

Appendix C depicts the comparative performance of investments in (a) municipal bonds of 20-years maturity, average quality, (b) high grade corporate bonds, and (c) common stocks represented by Standard & Poor's 500-stock average.

The appendix demonstrates that investment in municipal bonds has been anything but profitable over the past 10 years, despite the complete exemption of income from Federal taxation. In view of this record, it is easy to understand why investors prefer stocks. The comparatively poorer showing for taxable corporate bonds indicates why individual investors of upper income brackets would be unlikely to invest in taxable municipal bonds.

Inflationary expectations are already reflected in the portfolio decisions of institutional investors. This is shown by the preference for common stocks. Net purchases of common stocks by non-bank financial institutions gained momentum only gradually in the past 20 years, but have sharply accelerated during the last four. In the period from 1948 through the early 1960's, whenever non-bank financial institutions occasionally stepped up their purchases of stocks, they also increased their net investment in bonds. Since 1963, net acquisitions of mortgages and bonds have been on a plateau of around $27 billion annually, with the exception of the credit crunch year of 1966 when net new bond investments fell sharply. Thus, in contrast to earlier years, in which annual net new investments in both bonds and stocks increased irregularly, the annual commitment in bonds has been held in check lately while the acquisition of stocks has increased significantly. (See Exhibit 1)

If inflationary expectations are not retarded, this trend may well persist. Public retirement funds are continuing to liberalize their portfolio policies in favor of equities, although a large percentage of net funds is still invested in bonds. Corporate pension funds are allocating an increasing proportion of new money to equities. Life insurance companies are stepping up their equity purchases.

During the next decade, much of the cost of new capital facilities will have to be financed by flotation of debt securities, which will be made much more difficult if inflation does not abate.

ECONOMIC COSTS OF ISSUANCE OF TAXABLE MUNICIPAL BONDS WITH A FEDERAL SUBSIDY

The proposal that the Federal Government subsidize state and local government borrowings by paying the differential between the tax-exempt and taxable interest rate is based partly on the assumption that the Federal government could recoup the subsidy through taxing all of the interest on municipal bonds. This would be true, of course, if purchasers of taxable municipal bonds had an average effective tax rate equal to or higher than the percentage required for the subsidy.

The contention that the Federal government would end up without loss under this proposal appears to reflect the belief that the buyers of taxable municipal bonds would be the same as the buyers of tax-exempt municipal bonds. Since the marginal tax rate of the buyers of the average volume of new issues of tax-exempt municipal bonds, 1965–68, was 44.7 per cent, the subsidy could be quite high, if this were so. However, the assumption that taxable municipal bonds could continue to be sold to the previous buyers of tax-exempts is not valid.

In order to ascertain what the shifts in the flows of funds through the credit markets might be if only taxable municipal bonds were issued, the Investment Bankers Association sent out a questionnaire to 1,500 leading institutional investors and investment advisers. The results of 350 replies have been tabulated, and turned out to represent past experience for each investor group very satisfactory.

New issues of tax-exempt bonds in 1965–68 averaged $13.3 billion annually. This was 13½ per cent of total new issues of long-term fixed-income obligations including mortgages (Tables A and B). The average yield on high-grade municipal bonds over the same four years was 3.87 pre cent, so the interest cost to state and local governments of this borrowing at that average yield would be $515 million each year. The average yield on high-grade corporate bonds was 5.68 per cent, so that state and local governments were able to save 181 basis points, or about 32 per cent of the corporate rate, because of tax exemption; this amounted to about $241 million a year.

The actual averages for 1965–68 of the net flows of funds through the credit and equity markets, by major type of fund—long-term fixed income investments, short-term obligations and corporate stock—are shown in Table C. In Table D, the breakdown of long-term fixed-income obligations into mortgages, corporate bonds, etc. is given.

On the basis of the questionnaire results, we have taken what investors said they would do with their funds, if only taxable municipal bonds were issued, as the best method of showing how the flow of funds would be redirected. The results are shown in Tables E and F. Finally, we have translated the net flows of long-term fixed-income obligations shown in Table F to gross acquisitions (Table G). The changes from the actual 1965–68 averages are dramatic and would involve greatly increased upward pressures on long-term interest rates.

In the case of municipal bonds, not enough interest was expressed on the part of buyers to take up the same volume of taxable issues as was issued in tax-exempt form in 1965–68. The assumption was made, therefore, that $2½ billion of former bond financing by state and local governments would be shifted to the short-term market.

Since savings institutions, with fairly low tax rates, indicated that they would be somewhat more interested in taxable municipal bonds that they have been in tax exempts, and since commercial banks, fire and casualty insurance companies and individuals indicated that they would be less interested, the average marginal tax rate on gross new issues of taxable municipal bonds would fall to 33⅓ per cent, as shown in Table H.

However, changes in the flows of funds and shifts among buyers in various tax brackets would also affect the average marginal tax rate on the gross volume of all new long-term taxable obligations. This rate averaged 23.2 per cent in each year 1965–68. The average marginal tax rate of buyers of tax-exempt bonds in 1965–68 was 44.7 per cent, so that if the same buyers should buy taxable municipal bonds, the average marginal rate on all new long-term issues of fixed-income obligations would rise to 26.1 per cent, an increase of 2.9 percentage points. Because of the interest of lower tax-bracket buyers in taxable municipal bonds, however, the marginal tax rate on the redirected gross flow of long-term fixed income obligations would rise only to 25.1 per cent, an increase of 1.9 percentage points. Thus, it is erroneous to compute a gain to the Treasury as arising from the excess of tax revenues on municipal bonds over subsidy costs which is based on current buyers of tax exempts.

When the redirected flows of funds and a minimum subsidy are accounted for, the Treasury would actually come out with only a minimal net gain; a more realistic subsidy at the 40 per cent rate contemplated in HR 13270 would change this to a loss, and, in either event, as noted below, other indirect results would produce an even larger loss. The figures are as follows:

	Millions
New issues of taxable municipal bonds under assumed conditions (Table G)	$10, 700
Interest at average high-grade corporate rate, 1965–68, of 5.68%	608
Interest at average high-grade municipal rate, 1965–68, of 3.87%	414
Taxes returned on interest of $608,000,000 at marginal tax rate of 25.1%	153
Taxes returned on interest on other taxable obligations for which marginal tax rate rises from 23.2% to 25.1%	60
Total taxes returned	213
(a) Minimum subsidy required (1.81%, or 32% of corporate rate)	194
Net Gain to Treasury with 32% Subsidy	19
(b) Subsidy at 40% of corporate rate	243
Net Loss to Treasury with 40% Subsidy	30

Incidentally, the subsidy might have to average substantially higher than 40 per cent. Many municipal bond issues are relatively small and in order to be marketed would, in the judgment of many observers, need to carry higher interest rates than the generally larger corporate issues of comparable quality. Furthermore, since any loss to the Treasury reflects only one year's bond financing, the Treasury's losses would mount year after year.

In addition to the above loss, the Treasury, as well as state and local governments and all borrowers, would lose as a result of the permanent rise in long-term interest rates above what they would otherwise be caused by the shifting of municipal bonds to the taxable market.

The Investment Bankers Association included a question in its questionnaire regarding the anticipated change in interest rates if only taxable municipal bonds were issued. The answers from 329 respondents in the financial community—portfolio managers and investment advisers—indicated that the average rise expected was in the neighborhood of 75 basis points. (Table I)

Such a rise would mean an additional cost to the Federal government on its $7.1 billion of gross new long-term issues (Table G) of $53 million, making a total loss to the Treasury of $83 million a year.

In addition, the Treasury would have to pay more because its 40 per cent subsidy on taxable municipal bonds would have to rise; this would amount to $32 million. Thus, the total cost to the Treasury would be $115 million, while state and local governments would incur additional costs of $48 million (60 per cent of 75 basis points higher interest on $10.7 billion of new issues).

Not only would costs to all levels of government rise, but homeowners and business too would be required to bear higher interest costs on mortgages and corporate bonds. A 75 basis points rise in interest rates on gross new mortgages alone would be $434 million.

These more or less direct costs of shifting municipal bonds to the taxable market (including higher interest on corporate bonds of $129 million) total $726 million, a not inconsiderable figure.

Not all of the costs would be direct, however; there would be side effects because business would attempt to pass along its increased interest costs in higher prices. The inflationary effects would be enhanced if the rise in long-term interest rates were transmitted to the short-term credit markets, where we have already assumed increased pressure from larger state and local government borrowings.

Finally, the average marginal tax rate of borrowers in the credit markets is higher than that of lenders. Since borrowers may deduct their interest cost and this lowers their taxes, while lenders who receive this interest pay taxes at varying rates on it, this means that, when interest rates rise, the Treasury loses money. Business, with high marginal tax rates, accounts for a large proportion of total net funds raised, while savings institutions, with relatively low marginal tax rates, loom fairly large in the total of net funds supplied. The average marginal tax rate of borrowers, at 32 per cent (Table J), exceeds that of lenders, at 28.9 per cent (Table K), by 3.1 percentage points. Because short-term funds, included in these totals, may turn over several times a year, it is not possible to calculate accurately the loss to the Treasury on this score, but it could be significant.

CONCLUSION

Therefore, our studies indicate strongly that the issuance of taxable municipal bonds will involve an across-the-board interest rate increase of about ¾ of one per cent. When all of the economic and capital market side effects are taken into account, the U.S. Treasury will be poorer by $115 million. At the same time, homeowners, states and municipalities and business together with the Treasury will suffer increased interest costs amounting to $726 million. These results do not bear out previous contentions that the issuance of taxable municipal bonds is cost free.

Furthermore, we respectfully urge upon this Committee that interest paid on state and municipal bonds should be exempted from both the limit on tax preferences and the allocation of deductions. In our opinion, the indirect taxation proposed in H.R. 13270 would cost state and local governments much more than it would yield in revenue to the Treasury. This would mean a heavier tax burden falling mainly on the middle-income homeowner. The efficiency of the municipal bond market must be preserved if we are to supply the capital requirements of the states and their political subdivisions. That market cannot function efficiently if it is to be harassed by complex applications of indirect taxation of municipal bond interest.

NET NEW INVESTMENTS OF NONBANK FINANCIAL INSTITUTIONS IN BONDS AND STOCKS

[Dollar amounts in billions]

Years	Total	Bonds[1]	Stocks	Stocks as percent of total
1949	$8.8	$7.7	$1.1	12.5
1950	9.6	8.4	1.2	12.5
1951	10.7	9.6	1.1	10.3
1952	13.8	12.1	1.7	12.3
1953	14.7	13.6	1.1	7.5
1954	18.2	14.5	3.7	20.3
1955	19.4	16.1	3.0	15.5
1956	17.2	15.0	2.2	12.8
1957	17.4	14.7	2.7	15.5
1958	20.2	17.2	3.0	14.9
1959	22.2	18.8	3.4	15.3
1960	21.8	18.1	3.7	17.0
1961	25.5	20.7	4.8	18.8
1962	27.9	23.6	4.3	15.4
1963	28.9	26.8	2.1	7.3
1964	28.9	27.0	1.9	6.6
1965	32.3	26.6	5.7	17.6
1966	27.2	20.7	6.5	23.9
1967	33.5	26.6	6.9	20.6
1968[2]	37.0	27.0	10.0	27.0
ANNUAL AVERAGES				
1949-53	11.5	10.3	1.2	10.4
1954-58	18.5	15.5	2.9	15.7
1959-63	25.3	21.6	3.7	14.6
1964-68	31.2	25.6	5.8	18.6

[1] Includes mortgages.
[2] Estimated.

STATE AND LOCAL GOVERNMENT FINANCING[1]

[In billions of dollars]

	1961	1962	1963	1964	1965	1966	1967	1968 estimated	1969 projected
Construction put in place (table 32)[2]	13.3	14.0	15.4	16.5	18.0	20.0	22.1	24.2	26.5
Increase in debt:									
New long-term offerings	8.4	8.6	10.1	10.5	11.1	11.1	14.3	16.4	14.5
Less:									
Refundings[3]	.1	.3	.4	.3	.4	.2	.2	.2	.1
Retirements and other adjustment[4]	3.8	3.7	3.5	4.9	4.6	5.4	5.3	6.1	6.0
Increase in long-term debt	4.5	4.6	6.2	5.4	6.1	5.5	8.8	10.1	8.4
Increase in Federal Government loans (table 29)	.3	.6	.3	.4	.4	.8	.3	.3	.4
Increase in short-term debt	.4	.4	.5	.5	1.3	.4	1.3	−.1	.7
Increase in gross debt (table 2)	5.2	5.6	7.0	6.2	7.8	6.8	10.5	10.3	9.5
Increase in ownership:									
Savings institutions:									
Life insurance companies (table 15)	.3	.1	−.2	−.1	−.2	−.4	−.1		.1
State and local government retirement funds (table 17)	−.1	−.6	−.4	−.4	−.3	−.1		−.2	−.2
Fire and casualty insurance companies (table 18)	.9	.6	.7	.3	.2	.6	1.5	1.5	1.7
Contractual-type savings institutions	1.0	.1	.2	−.2	−.3	.1	1.3	1.3	1.6
Mutual savings banks (table 20)		−.2	−.1		−.1	−.1			
Total savings institutions	1.1		.1	−.2	−.4	.1	1.3	1.3	1.6
Commercial banks (table 25)	2.8	4.4	5.2	3.6	5.1	2.4	9.0	8.3	5.0
Nonfinancial corporations (table 27)	−.2	−.4	.9	.2	.7	.8	.7	.1	.8

STATE AND LOCAL GOVERNMENT FINANCING[1]—Continued

[In billions of dollars]

	1961	1962	1963	1964	1965	1966	1967	1968 estimated	1969 projected
Other investor groups:									
Federal agencies (table 29)	.3	.6	.3	.4	.4	.8	.3	.3	.4
State and local governments (table 29)	.1	−.3	−.3	−.1	−.1	−.1	------	−.2	---------
Total other investor groups	.4	.3	------	.3	.3	.7	.3	.1	.4
Residual: Individuals and others[5] (table 31)	1.1	1.3	.8	2.3	2.1	2.8	−.8	.5	1.7
Total	5.2	5.6	7.0	6.2	7.8	6.8	10.5	10.3	9.5
Memorandum: New industrial bond offerings[6]		.1	.1	.2	.2	.5	1.3	1.6	.3

[1] 1961–67, construction put in place from Construction Review, U.S. Department of Commerce (new series beginning in 1963); new long-term offerings from the Bond Buyer; data or changes in debt based on flow of funds accounts, Federal Reserve; ownership data based on book values.

[2] Financed by Federal grants-in-aid as well as by State and local funds.

[3] 1961–67, based on the Bond Buyer; excludes advance refundings.

[4] Residual. Includes adjustments for issues offered in the calendar year before issuance.

[5] Includes revaluation of book assets of some holders.

[6] 1961–67, Investment Bankers Association data.

U.S. LIFE INSURANCE COMPANY HOLDINGS AND ACQUISITIONS OF U.S. STATE AND LOCAL BONDS, 1959–68

[Dollar amounts in millions]

Year	State and local holdings	Total assets	S. & L. holding as percent of total assets
1959	$3,200	$113,650	2.82
1960	3,588	119,576	3.00
1961	3,888	126,816	3.07
1962	4,026	133,291	3.02
1963	3,852	141,121	2.73
1964	3,774	129,470	2.52
1965	3,530	158,884	2.22
1966	3,260	167,455	1.95
1967	3,145	177,832	1.77
1968	3,194	188,663	1.69

Year	S. & L. acquisitions	Total acquisitions	S. & L. acquisitions as percent of total acquisitions
1959	$670	$20,022	3.35
1960	466	20,354	2.29
1961	506	25,150	2.01
1962	486	28,558	1.70
1963	371	32,167	1.15
1964	365	33,959	1.07
1965	296	39,451	.75
1966	215	36,955	.58
1967	212	43,447	.49
1968	278	47,970	.58

Source: Institute of Life Insurance.

OWNERSHIP OF STATE AND LOCAL GOVERNMENT SECURITIES, END OF YEAR 1945-68[1]

[In millions of dollars]

	1945	1946	1947	1948	1949	1950	1951	1952
Savings institutions:								
Life insurance companies	722	614	609	872	1,052	1,152	1,170	1,153
Fire and casualty insurance companies	240	229	301	490	723	1,026	1,387	1,784
State and local government retirement funds	1,110	1,000	1,090	1,210	1,410	1,585	1,665	1,800
Mutual savings banks	84	58	57	73	93	96	140	335
Total savings institutions	2,156	1,901	2,057	2,645	3,278	3,859	4,362	5,072
Business:								
Nonfinancial corporations	300	300	400	400	500	500	600	700
Commercial banks	4,000	4,400	5,300	5,700	6,500	8,100	9,200	10,200
Total business	4,300	4,700	5,700	6,100	7,000	8,600	9,800	10,900
Government:								
Federal agencies	500	500	500	600	500	600	800	1,100
State and local governments	1,500	1,400	1,400	1,400	1,700	2,000	2,100	2,200
Total government	2,000	1,900	1,900	2,000	2,200	2,600	2,900	3,300
Residual: Individuals and others	7,544	7,599	7,843	8,855	9,922	10,241	10,938	11,728
Total debt outstanding	16,000	16,100	17,500	19,600	22,200	25,300	28,000	31,000

	1953	1954	1955	1956	1957	1958	1959	1960
Savings institutions:								
Life insurance companies	1,298	1,846	2,038	2,273	2,376	2,681	3,200	3,588
Fire and casualty insurance companies	2,523	3,337	4,092	4,726	5,307	6,019	6,909	7,871
State and local government retirement funds	2,075	2,385	2,725	3,115	3,535	3,950	4,235	4,370
Mutual savings banks	428	608	646	676	685	729	721	672
Total savings institutions	6,324	8,176	9,501	10,790	11,903	13,379	15,066	16,501
Business:								
Nonfinancial corporations	800	1,000	1,200	1,300	1,500	2,000	2,600	2,400
Commercial banks	10,800	12,600	12,700	12,900	13,9 0	16,500	17,000	17,600
Total business	11,600	13,600	13,900	14,200	15,400	18,500	19,600	20,000
Government:								
Federal agencies	800	500	500	700	600	1,000	1,200	1,500
State and local governments	2,200	2,300	2,400	2,500	2,500	2,600	2,700	2,800
Total government	3,000	2,800	2,900	3,100	3,200	3,600	3,900	4,300
Residual: Individuals and others	14,076	15,624	18,999	21,910	24,097	24,321	26,334	29,399
Total debt outstanding	35,000	40,200	45,300	50,000	54,600	59,800	64,900	70,200

OWNERSHIP OF STATE AND LOCAL GOVERNMENT SECURITIES END OF YEAR 1945-68[1]—Continued

[In millions of dollars]

	1961	1962	1963	1964	1965	1966	1967	[2] 1968
Savings institutions:								
Life insurance companies	3,888	4,026	3,852	3,774	3,530	3,260	3,145	3,194
Fire and casualty insurance companies	8,723	9,333	10,073	10,378	10,612	11,261	12,735	14,200
State and local government retirement funds	4,225	3,775	3,315	2,915	2,640	2,490	2,450	2,200
Mutual savings banks	677	527	440	391	320	251	219	194
Total savings institutions	17,508	17,661	17,680	17,458	17,102	17,262	18,549	19,788
Business:								
Nonfinancial corporations	2,200	1,800	2,700	2,900	3,600	4,400	5,100	5,200
Commercial banks	20,300	24,800	30,000	33,500	38,600	41,000	50,000	58,100
Total business	22,500	26,600	32,700	36,400	42,200	45,400	55,100	63,300
Government:								
Federal agencies	1,800	2,400	2,700	3,100	3,500	4,400	4,600	4,900
State and local governments	3,100	3,000	2,700	2,400	2,200	2,000	1,700	1,500
Total government	4,900	5,400	5,400	5,500	5,700	6,400	6,300	6,400
Residual: Individuals and others	32,392	35,239	34,920	38,342	39,698	42,538	42,051	42,812
Total debt outstanding	77,300	84,900	90,700	97,700	104,700	111,600	122,000	132,300

[1] Total from U.S. Department of Commerce, "Gross Public and Private Debt," Survey of Current Business, May 1969; ownership from various sources, as follows: life insurance companies, Institute of Life Insurance, "Life Insurance Fact Book"; fire and casualty insurance companies, Best & Co., "Aggregates and Averages"; State and local government retirement funds, Bureau of the Census, "Employee Retirement Systems of State and Local Governments" (based on data for fiscal years); mutual savings banks, National Association of Mutual Savings Banks, "National Fact Book"; commercial banks, nonfinancial corporations, and Federal agencies, Federal Reserve, "Flow of Funds Accounts"; State and local governments, U.S. Department of Commerce total for State and local governments (or difference between gross and net debt in source cited above) less holdings of retirement funds.

[2] Preliminary.

WORK SHEET FOR THE DISTRIBUTION OF TAX-EXEMPT INTEREST—BY ADJUSTED GROSS INCOME CLASS

Item	Under $10,700	$10,700 to $16,400	$16,400 to $31,000	$31,000 to $73,000	$73,000 to $165,000	$165,000 to $315,000	$315,000 and over	Total
1. Did not own municipals (percent)	100.0	97.1	93.0	77.4	53.3	51.7	35.3	89.8
2. Owned municipals, interest as percent of income		2.9	7.0	22.6	46.7	48.3	64.7	10.2
3. Under 10 percent		2.7	6.1	15.9	22.6	37.6	47.0	7.7
4. 10 to 24 percent		.2	.4	5.0	7.8	7.2	11.8	1.4
5. 25 percent or more			.5	1.7	16.3	3.5	5.9	1.1
6. Total, percent	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
7. Average interest as percent of income, for those with		2.6	9.0	7.5	17.1	6.7	8.5	8.4
8. Total number of returns (thousands)	56,336	4,542	1,275	466	83	4	4	62,711
9. Number of returns with interest (thousands)		131.7	88.6	105.4	38.8	2.4	2.6	369.5
10. Average amount interest, for those with, unadjusted		$319	$1,818	$2,784	$13,235	$15,664	$46,264	$3,159
11. Aggregate interest, unadjusted (millions)		$42.0	$161.1	$293.3	$513.2	$37.8	$119.7	$1,167.1
12. Percentage distribution of aggregate interest		3.6	13.8	25.1	44.0	3.2	10.3	100.0
13. Aggregate interest, adjusted (millions)		$36.0	$138.0	$251.0	$440.0	$32.0	$103.0	$1,000.0
14. Average amount interest, for those with, adjusted		$273	$1,557	$2,382	$11,347	$13,256	$39,799	$2,706

Source: Okner.

ESTATE TAX RETURNS FILED DURING 1966 BY SIZE OF ESTATE AND COMPOSITION OF ASSETS

[In millions of dollars]

Size of total estate	Number of returns	Total estate	Amount held in State and municipal bonds	Percent held in State and municipal bonds	Percent held in corporate stock	Percent held in other assets
$0.06 under $0.08	8,770	631.2	0.9	0.14	23.74	76.12
$0.08 under $0.10	8,707	778.1	1.7	.21	26.52	73.27
$0.10 under $0.15	15,919	1,980.5	5.4	.27	29.28	70.45
$0.15 under $0.20	10,465	1,808.5	7.0	.38	33.44	66.18
$0.20 under $0.30	9,712	2,354.7	16.8	.71	38.15	61.14
$0.30 under $0.50	6,689	2,543.4	33.5	1.31	44.63	54.06
$0.50 under $1.00	4,133	2,818.8	84.9	3.01	52.22	44.77
$1.00 under $2.00	1,532	2,079.2	97.5	4.68	56.49	38.83
$2.00 under $3.00	400	964.7	60.8	6.30	55.72	37.98
$3.00 under $5.00	236	898.1	62.5	6.95	61.07	31.98
$5.00 under $10.00	130	890.8	76.9	8.63	57.42	33.95
$10.00 under $20.00	33	449.8	33.9	7.53	65.40	27.07
$20.00 or more	19	599.9	26.1	4.35	71.36	24.29
Total	66,745	18,797.7	507.9	2.70	45.43	51.87

Note: Data presented here relate only to taxable estates. Total estate differs from gross estate by the inclusion of life insurance at face value (before deduction of outstanding loans), and the exclusion of gifts made during the decedent's life.

Source: Statistics of Income, 1965, Estate tax returns filed during calendar year 1966, U.S. Treasury Department, Internal Revenue Service, Washington, D.C., Nov. 2, 1967, pp. 71–72.

TABLE A.—GROSS ACQUISITIONS OF NEW ISSUES OF LONG-TERM FIXED INCOME OBLIGATIONS, AVERAGE 1965–68, BY INVESTOR GROUP[1]

[In billions of dollars]

	Mortgages	Corporate bonds	U.S. Government bonds and notes	Federal agency securities	Total taxable issues	Municipal bonds	Total
Savings Institutions:							
Life insurance companies	9.4	5.3		0.1	14.8	0.2	15.0
Private noninsured pension funds	.7	2.2		.1	3.0		3.0
State and local government retirement funds	1.3	3.3		.2	4.8	.2	5.0
Fire and casualty insurance companies		.7	0.1	.1	.9	1.5	2.4
Savings and loan associations	20.8		.2	.1	21.1		21.1
Mutual savings banks	7.5	.9	.1	.4	8.9		8.9
Credit unions	.2				.2		.2
Investment companies		.4			.4		.4
Total, savings institutions	39.9	12.8	.4	1.0	54.1	1.9	56.0
Business:							
Business corporations	.3		.1	.2	.6		.6
Commercial banks	12.8	.1	1.6	1.0	15.5	7.9	23.4
Total, business	13.1	.1	1.7	1.2	16.1	7.9	24.0
Government:							
Federal agencies	3.9				3.9		3.9
State and local governments	.2	.9	.1	.2	1.4	.2	1.6
Total, government	4.1	.9	.1	.2	5.3	.2	5.5
Foreign investors		.1			.1		.1
Residual: Individuals and others	2.9	3.4	.9	1.6	8.8	3.3	12.1
Total	60.0	17.3	3.1	4.0	84.4	13.3	97.7

[1] For each instrument represents net change in holdings of each investor group plus estimated retirements and refundings; data for U.S. Government and agency securities are for issues offered during the period with maturities of 2 years or more; data for municipal bonds are for new issues of 1 year or more to maturity.

TABLE B.—PERCENTAGE DISTRIBUTION OF GROSS ACQUISITIONS OF NEW ISSUES OF LONG-TERM FIXED INCOME OBLIGATIONS, AVERAGE 1965-68[1]

[In percent]

	Mortgages	Corporate bonds	U.S. Government bonds and notes	Federal agency securities	Total taxable issues	Municipal bonds	Total
Savings institutions:							
Life insurance companes	62.7	35.3		0.7	98.7	1.3	100
Private noninsured pension funds	23.3	73.3		3.3	100.0		100
State and local government retirement funds	26.0	66.0		4.0	96.0	4.0	100
Fire and casualty insurance companies		29.2	4.2	4.2	37.5	62.5	100
Savings and loan associations	98.6		.9	.5	100.0		100
Mutual savings banks	84.3	10.1	1.1	4.5	100.0		100
Credit unions	100.0				100.0		100
Investment companies		100.0			100.0		100
Total, savings institutions	72.1	22.9	.7	1.8	96.6	3.4	100
Business:							
Business corporations	50.0		16.7	33.3	100.0		100
Commercial banks	54.7	.4	6.8	4.3	66.2	33.8	100
Total, business	54.6	.4	7.1	5.0	67.1	32.9	100
Government:							
Federal agencies	100.0				100.0		100
State and local governments	12.5	56.2	6.2	12.5	87.5	12.5	100
Total, government	74.5	16.4	1.8	3.6	96.4	3.6	100
Foreign investors		100.0			100.0		100
Residual: Individuals and others	24.0	28.1	7.4	13.2	72.7	27.3	100
Total	61.4	17.7	3.2	4.1	86.4	13.6	100

[1] For each instrument represents net change in holdings of each investor group plus estimated retirements and refundings; data for U.S. Government and agency securities are for issues offered during the period with maturities of 2 years or more; data for municipal bonds are for new issues of 1 year or more to maturity.

TABLE C.—NET FUNDS RAISED AND SUPPLIED IN U.S. CREDIT AND EQUITY MARKETS, AVERAGE, 1965-68 [1]

[In billions of dollars]

Funds supplied by—	Total funds raised	Long-term fixed-income obligations: Total	Long-term fixed-income obligations: Term loans and foreign securities	Long-term fixed-income obligations: Other [2]	Short-term fixed income obligations [3]	Corporate stock
Savings institutions:						
Life insurance companies	8.3	6.8	0.2	6.6	0.6	0.8
Private noninsured pensions funds	5.9	1.7		1.7	−.2	4.4
State and local government retirement funds	3.7	3.4		3.4	−.3	.5
Fire and casualty insurance companies	1.8	1.8		1.8	−.4	.5
Savings and loan associations	8.2	7.7		7.7	.5	
Mutual savings banks	4.0	4.5		4.5	−.8	.2
Credit unions	1.1	.1		.1	1.0	
Investment companies, open end	1.8	.4		.4	.2	1.2
Total savings institutions	34.7	36.4	.3	26.2	.6	7.6
Business						
Business corporations	10.6	.5		.5	10.0	
Commercial banks	30.4	16.6	2.5	14.1	13.7	
Brokers and dealers	1.2				1.2	
Other consumer lenders	.8				.8	
Total business	42.9	17.0	2.5	14.6	25.7	
Government:						
Federal agencies	2.9	2.9		2.9		
State and local governments	3.0	1.1		1.1	2.0	
Total government	5.9	4.0		4.0	2.0	
Foreign investors	.3	−.2		−.2	−.1	.6
Residual: Individuals and others	2.1	8.1	.9	7.2	1.7	−7.5
Total funds supplied	86.1	55.4	3.6	51.8	30.0	.7

[1] Based on Bankers Trust Co., "Investment Outlook for 1969" except for U.S. Government bonds and notes and Federal agency securities which are based on U.S. Treasury Department, Treasury Bulletin, "Treasury Survey of Ownership."

[2] Comprises mortgages, corporate bonds, U.S. Government bonds and notes, and Federal agency securities offered during period with maturities of 2 years or more, and municipal bonds.

[3] Comprises other U.S. Government and agency securities, short-term municipal securities, open market paper, other business credit (including bank short-term loans), security credit, consumer credit, other bank loans, and policy loans of life insurance companies.

TABLE D.—NET FUNDS RAISED AND SUPPLIED THROUGH LONG-TERM FIXED-INCOME OBLIGATIONS IN THE U.S. CREDIT MARKETS, AVERAGE 1965–68[1]

[In billions of dollars]

Funds supplied by—	Total funds raised	Taxable issues					
		Total	Mortgages	Corporate bonds	U.S. Government bonds and notes[2]	Federal agency securities[2]	Municipal bonds
Savings institutions:							
Life insurance companies	6.6	6.8	3.7	3.0	....	.1	–.2
Private noninsured pension funds	1.7	1.7	.3	1.3	....	.1	....
State and local government retirement funds	3.4	3.6	.6	2.8	....	.2	–.2
Fire and casualty insurance companies	1.8	.8	....	.6	.1	.1	1.0
Savings and loan associations	7.7	7.7	7.4	....	.2	.1	....
Mutual savings banks	4.5	4.5	3.2	.8	.1	.4	....
Credit unions	.1	.1	.1	....	....	....	....
Investment companies (open end)	.4	.4	....	.4	....	....	....
Total, savings institutions	26.2	25.6	15.3	8.8	.4	1.0	.6
Business:							
Business corporations	.5	.5	.2	....	.1	.2	....
Commercial banks	14.1	8.0	5.4	....	1.6	1.0	6.1
Total, business	14.6	8.5	5.6	....	1.7	1.2	6.1
Government:							
Federal agencies	2.9	2.5	2.5	....	....	....	.4
State and local governments	1.1	1.2	.2	.7	.1	.2	–.1
Total government	4.0	3.7	2.6	.7	.1	.2	.4
Foreign investors	–.2	–.2	....	–.2	....	....	....
Residual: Individuals and others	7.2	6.1	.6	3.0	.9	1.6	1.1
Total funds supplied	51.8	43.7	24.1	12.4	3.1	4.0	8.1

[1] Based on Bankers Trust Co., "Investment Outlook for 1969," except for U.S. Government bonds and notes and Federal agency securities; excludes term loans and foreign securities.

[2] Based on U.S. Treasury Department, Treasury Bulletin, "Treasury Survey of Ownership"; comprises issues offered during the period with maturities of 2 years or more.

TABLE E.—NET FUNDS RAISED AND SUPPLIED IN U.S. CREDIT AND EQUITY MARKETS, AVERAGE 1965-68 [1]—ADJUSTED FOR SHIFTS RESULTING FROM ISSUANCE OF ONLY TAXABLE MUNICIPALS [2]

[In billions of dollars]

		Long-term fixed-income obligations				
Funds supplied by—	Total funds raised	Total	Term loans and foreign securities	Other [3]	Short-term fixed income obligations [4]	Corporate stock
Savings institutions:						
Life insurance companies	8.3	6.7	0.2	6.5	0.6	0.9
Private noninsured pensions funds	5.9	1.6		1.6	—.2	4.5
State and local government retirement funds	3.7	3.3		3.3	—.3	.6
Fire and casualty insurance companies	1.8	1.7		1.7	—.4	.6
Savings and loan associations	8.2	7.7		7.7	.5	
Mutual savings banks	4.0	4.5		4.5	—.8	.2
Credit unions	1.1	.1		.1	1.0	
Investment companies—open end	1.8	.4		.4	.2	1.2
Total savings institutions	34.7	26.0	.3	25.8	.6	8.0
Business:						
Business corporations	10.6	.5		.5	10.0	
Commercial banks	30.4	14.8	2.5	12.3	15.6	
Brokers and dealers	1.2				1.2	
Other consumer lenders	.8				.8	
Total business	42.9	15.3	2.5	12.8	27.6	
Government:						
Federal agencies	2.9	2.9		2.9		
State and local governments	3.0	1.1		1.1	2.0	
Total government	5.9	4.0		4.0	2.0	
Foreign investors	.3	—.2		—.2	—.1	.6
Residual: Ind viduals and others	2.1	7.5	.9	6.6	2.4	—7.9
Total funds supplied	86.1	52.8	3.6	49.2	32.7	.7

[1] Based on Bankers Trust Co., "Investment Outlook for 1969" except for U.S. Government bonds and notes and Federal agency securities which are based on U.S. Treasury Department, Treasury Bulletin, "Treasury Survey of Ownership".

[2] Based on results of Investment Bankers Association questionnaire.

[3] Comprises mortgages, corporate bonds, U.S. Government bonds and notes and Federal agency securities offered during period with maturities of 2 years or more, and municipal bonds.

[4] Comprises other U.S. Government and agency securities, short-term municipal securities, open market paper, other business credit (including bank short-term loans), security credit, consumer credit, other bank loans, and policy loans of life insurance companies.

TABLE F.—NET FUNDS RAISED AND SUPPLIED THROUGH LONG-TERM FIXED-INCOME OBLIGATIONS IN THE U.S. CREDIT MARKETS, AVERAGE 1965-68 [1]—ADJUSTED FOR SHIFTS RESULTING FROM ISSUANCE OF ONLY TAXABLE MUNICIPALS [2]

[In billions of dollars]

Funds supplied by—	Total funds raised	Taxable issues					Municipal bonds
		Total	Mortgages	Corporate bonds	U.S. Government bonds and notes [3]	Federal agency securities [3]	
Savings institutions:							
Life insurance companies	6.5	6.2	3.5	2.7			0.3
Private noninsured pension funds	1.6	1.3		1.0	0.1	0.2	.3
State and local government retirement funds	3.3	3.0	.7	2.1		.1	.4
Fire and casualty insurance companies	1.7	1.4	.4	.8	.1	.1	.3
Savings and loan associations	7.7	7.6	7.3		.2	.1	.1
Mutual savings banks	4.5	4.4	3.2	.8	.1	.3	.1
Credit unions	.1	.1	.1				
Investment companies—open end	.4	.4		.4			
Total savings institutions	25.8	24.4	15.2	7.8	.5	.8	1.5
Business:							
Business corporations	.5	.5	.2		.1	.2	
Commercial banks	12.3	9.4	4.7	.1	2.9	1.7	2.9
Total business	12.8	9.9	4.9	.1	3.0	1.9	2.9
Government:							
Federal agencies	2.9	2.5	2.5				.4
State and local governments	1.1	1.2	.2	.7	.1	.2	—.1
Total government	4.0	3.7	2.6	.7	.1	.2	.4
Foreign investors	—.2	—.2		—.2			
Residual: Individuals and others	6.6	5.9	1.4	3.9	—.5	1.1	.7
Total funds supplied	49.2	43.7	24.1	12.4	3.1	4.0	5.5

[1] Based on Bankers Trust Co., "Investment Outlook for 1969," except for U.S. Government bonds and notes and Federal agency securities; excludes term loans and foreign securities.

[2] Based on result of Investment Bankers Association questionnaire.

[3] Based on U.S. Treasury Department, Treasury Bulletin, "Treasury Survey of Ownership"; comprises issues offered during the period with maturities of 2 years or more.

TABLE G.—GROSS ACQUISITIONS OF NEW ISSUES OF LONG-TERM FIXED-INCOME OBLIGATIONS, AVERAGE 1965-68 BY INVESTOR GROUP [1]—ADJUSTED FOR SHIFTS RESULTING FROM ISSUANCE OF ONLY TAXABLE MUNICIPALS [2]

[In billions of dollars]

	Mortgages	Corporate bonds	U.S. Government bonds and notes	Federal agency securities	Total taxable issues	Municipal bonds	Total
Savings institutions:							
Life insurance companies	9.2	4.9			14.1	0.8	14.9
Private noninsured pension funds	.3	1.9	0.1	0.2	2.5	.3	2.8
State and local government retirement funds	1.4	2.8		.1	4.3	1.1	5.4
Fire and casualty insurance companies	.4	.9	.1	.1	1.5	.8	2.3
Savings and loan associations	20.7		.2	.1	21.0	.1	21.1
Mutual savings banks	7.6	.9	.1	.3	8.9	.1	9.0
Credit unions	.2				.2		.2
Investment companies		.4			.4		.4
Total savings institutions	39.8	11.8	.5	.8	52.9	3.2	56.1
Business:							
Business corporations	.3		.1	.2	.6		.6
Commercial banks	12.1	.1	2.9	1.7	16.8	4.7	21.5
Total business	12.4	.1	3.0	1.9	17.4	4.7	22.1
Government:							
Federal agencies	3.9				3.9		3.9
State and local governments	.2	.9	.1	.2	1.4	.2	1.6
Total government	4.1	.9	.1	.2	5.3	.2	5.5
Foreign investors		.1			.1		.1
Residual: Individuals and others	1.6	4.3	−.5	1.1	6.5	2.6	9.1
Total	57.9	17.2	3.1	4.0	82.2	10.7	92.9

[1] For each instrument represents net change in holdings of each investor group plus estimated retirements and refundings; data for U.S. Government and agency securities are for issues offered during the period with maturities of 2 years or more, data for municipal bonds are for new issues of 1 year or more to maturity.

[2] Based on results of Investment Bankers Association questionnaire.

TABLE H.—MARGINAL TAX RATES PAID BY LONG-TERM LENDERS IN U.S. CREDIT MARKETS, WITH AND WITHOUT MUNICIPAL BONDS AS TAXABLE

[Dollar amounts in billions]

				If only taxable municipal bonds are issued	
Funds supplied by	Marginal tax rate (percent)	Gross taxable long-term funds supplied, average 1965–68	Gross tax-exempt municipal bonds supplied, average 1965–68	Gross taxable municipal bonds supplied	Gross taxable long-term funds supplied
Savings institutions:					
Life insurance companies	20.0	$14.8	$0.2	$0.8	$14.9
Private noninsured pension funds	0	3.0		.3	2.8
State and local government retirement funds	0	4.8	.2	1.1	5.4
Fire and casualty insurance companies	48.0	.9	1.5	.8	2.3
Savings and loan associations	20.0	21.1		.1	21.1
Mutual savings banks	20.0	8.9		.1	9.0
Credit unions	0	.2			.2
Investment companies, open end	0	.4			.4
Total savings institutions		54.1	1.9	3.2	56.1
Business:					
Business corporations	48.0	.6			.6
Commercial banks	48.0	15.5	7.9	4.7	21.5
Total business		16.1	7.9	4.7	22.1
Government:					
Federal agencies	0	3.9			3.9
State and local governments	0	1.4	.2	.2	1.6
Total government		5.3	.2	.2	5.5
Foreign investors		.1			.1
Residual: Individuals and others:					
Taxable debt securities and mortgages	28.5	8.8		2.6	9.1
Dividends	36.7				
Municipal bonds, tax-exempt	42.3		3.3		
Total funds supplied		84.4	13.3	10.7	92.9
Marginal tax rate on total long-term funds supplied (percent)		23.2	44.7	33.5	25.1

TABLE I.—ANTICIPATED EFFECT ON GENERAL LEVEL OF LONG TERM INTEREST RATES IF ONLY TAXABLE MUNICIPAL BONDS ARE ISSUED HEREAFTER (IRRESPECTIVE OF ALL OTHER FACTORS)—INVESTMENT BANKERS ASSOCIATION QUESTIONNAIRE, AUGUST 1969

	Number anticipating			Number anticipating, rise (basis points)					Average change anticipated[1] (basis points)
	Total responses	Decline	Stay the same	Total	Less than 50	50 to 99	100 to 149	150 or more	
Savings institutions:									
Life insurance companies	59	3	15	41	17	21	3		29
Private noninsured pension funds	49	1	2	46	7	24	9	6	80
State and local government retirement funds	19	3	3	13	8	3	1	1	23
Fire and casualty insurance companies	45	2	5	38	7	16	11	4	76
Savings and loan associations	16	1	5	10	4	1	2	3	26
Mutual savings banks	31	1	3	27	14	8	5	0	39
Total	219	11	33	175	57	73	31	14	65
Commercial banks	56			56	5	24	11	16	92
All institutions	275	11	33	231	62	97	42	30	70
Investment advisers to individuals	54	1	3	50	6	25	13	6	83
Total	329	12	36	281	68	122	55	36	72
Percentage distribution	100.0	3.6	10.9	85.4	20.7	37.1	16.7	10.9	

[1] Median.

TABLE J.—MARGINAL TAX RATE ON INTEREST PAID BY ISSUERS ON NET NEW ISSUES OF DEBT, 1965–68 AVERAGE

	Net new issues	Marginal tax rate
Investment funds:		
Home mortgages	13.4	23.7
Multifamily and commercial	8.5	48.0
Farm mortgages	2.2	22.0
Total mortgages	24.1	
Corporate bonds	12.4	48.0
State and local government securities	8.8	
Foreign securities	1.2	
Term loans	2.4	48.0
Total investment funds	48.9	
Short-term funds:		
Stock market credit, except bank loans:		
Brokers and dealers	.6	48.0
Customers	1.2	36.9
Consumer credit	8.2	23.7
Policy loans	1.0	23.7
Other short-term funds	19.8	48.0
Total short-term funds	30.8	
U.S. Government and agency securities:		
U.S. Government securities, publicly held	1.4	
Federal agency net borrowing, publicly held	4.2	
U.S. Government and agency securities, publicly held	5.6	
Total funds	85.3	32.0

TABLE K.—MARGINAL TAX RATES PAID BY LENDERS IN U.S. CREDIT MARKETS—WITH AND WITHOUT MUNICIPALS AS TAXABLE

[Amounts in billions of dollars]

Funds supplied by	Marginal tax rate	Net taxable funds supplied (average 1965-68)	Net municipal bonds (excluding municipal short-term debt issues) average 1965-68	Net taxable funds supplied (if only taxable municipal bonds are issued[1])
Savings institutions:				
Life insurance companies	20	8.5	−0.2	8.3
Private noninsured pension funds	0	5.9		5.9
State and local government retirement funds	0	3.9	−0.2	3.7
Fire and casualty insurance companies	48	.8	1.0	1.8
Savings and loan associations	20	8.2		8.2
Mutual savings banks	20	4.0		4.0
Credit unions	0	1.1		1.1
Investment companies—open end	0	1.8		1.8
Total savings institutions		34.2	0.6	34.7
Business:				
Business corporations	48	10.0		10.0
Commercial banks	48	24.2	6.1	28.3
Brokers and dealers	48	1.2		1.1
Other consumer lenders	48	.8		.8
Total business		36.2	6.1	40.2
Government:				
Federal agencies	0	2.5	.4	2.9
State and local governments	0	3.1	−.1	3.0
Total government		5.6	.4	5.9
Foreign investors	0	.3		.3
Residual: Individuals and others:				
Taxable debt securities and mortgages	28.5	8.7		9.0
Dividends	36.7	−7.5		−7.9
Municipal bonds:				
Tax-exempt	42.3		1.1	
Taxable	28.5			.7
Total		1.1	1.1	1.8
Total funds supplied		77.4	8.1	82.9
Marginal tax rate on total funds supplied		27.9	46.7	28.9

[1] Excludes estimated tax-exempt short-term debt of State and local governments.

APPENDIX A

ADDITIONAL COMMENT ON LIMITED TAX PREFERENCE (MINIMUM INDIVIDUAL INCOME TAX) TREATMENT OF TAX-EXEMPT INTEREST

In the arithmetic used in discussions of tax reform there is generally a failure to consider one major point. This point is that a substantial price has been paid by the investor for tax exemption in the form of acceptance of a lesser interest rate.

(1) One way to look at this is in terms of capitalizing it in price. The following table shows this by indicating the value of 25-year bonds with a coupon based on the level of the tax-exempt market at a yield based on the corporate market. The relation between yields in the two markets is computed at 70%, the approximate level which has held over a number of years. Given stability in this relationship it will be seen that the price paid by the investor for tax exemption goes up as yields rise. The outgoing Treasury minimum tax plan overlooks this factor.

Tax-exempt coupon	Corporate bond yields (percent)	Dollar price at corporate yield	Price paid for tax exemption[1]
5¼ percent, at	7½	74.76	25.24
4.90's, at	7	75.37	24.63
4.20's, at	6	76.84	23.16
3½'s, at	5	78.72	21.28
3.15's, at	4½	79.86	20.14

[1] It is assumed that the investor paid 100 for the tax-exempt bonds in each case.

The inclusion of percentage depletion in oil and other minerals is "in excess of capital investment". Equal treatment for tax-exempt income would require consideration of the price paid for it as above.

(2) One of the questions Congressman Byrnes posed to witnesses during the House Ways and Means Committee hearings was "doesn't the individual taxpayer get much more out of the tax exemption than the borrowing municipality?" One of the answers given him at the time was that the investor has to estimate what his advantage will be because he cannot know his prospective tax bracket 10, 20, 30 years hence (and in the intervening years). Thus he needs a margin solely to assure that he will come out even.

Computations of relative advantage must make some assumption as to future tax rates and income brackets, and usually assume a continuance of the present situation. Those which follow make this assumption. Statements of the most extreme cases of tax sheltered income are based on instances where adjusted gross income is large, but no tax is paid. Tax-exempt interest on municipal bonds is not included in these instances, because it is not a part of adjusted gross income. Because the minimum tax is designed to reach such persons, and because some of them may also have tax-exempt interest income, we have prepared some examples to show (1) relative benefit to the taxpayer and to the borrowing municipality in such instances and (2) the impact of the proposed minimum tax. A later example shows this comparison for a taxpayer with at least $200,000 of *taxable* income.

Each example shows the alternative result if, instead of an investment in tax-exempt bonds, the individual had purchased taxable bonds and was paying annual income tax on the interest from them. The 70% ratio of tax-exempt income to taxable income is again used in these comparisons. The income tax rates used are those for joint husband and wife returns. The surtax is not included as it seems inappropriate to apply this temporary measure over the life of a long-term bond. In computing the impact of the minimum tax it is assumed that tax-exempt bond interest amounts to only about a quarter of total income. This is in line with investment proportions recommended by professional investment advisers, and very few investors have a much larger concentration in tax-exempt bonds.

In the first example (Exhibit 4) $50,000 tax-exempt interest income is received, and any other income is protected by various exclusions and deductions. If the investor had purchased taxable bonds instead, he would have received $71,400 in taxable income (100 over 70 times $50,000). The tax on $71.400 would be $28,490 (an average rate of 40%), and there would remain $42,910 after tax. By having tax-exempt income the taxpayer has benefited $7,090 ($50,000—$42,910). The borrowing municipality—assuming for simplicity that only one is involved—has saved $21,400 ($71,400—$50,000) by being able to do its financing in the tax-exempt market instead of having to sell taxable bonds. If the minimum tax as proposed were applied to the $50,000 tax-exempt income and it became taxable at as much as a 30% rate, the $15,000 tax would wipe out the taxpayers' benefit in having bought tax-exempts, and in fact he would be penalized $7,910 net.

Three other examples with larger amounts of tax-exempt income are shown in Exhibits 4. 5 and 6. These computations are based on approximate relationships, but they do help to answer the question of who gets the larger benefit from tax exemption, the borrowing municipality or the investor. It is not until we get to a holding of tax-exempt producing $200,000 of tax-exempt income that a taxpayer's advantage begins to equal the advantage to the municipality. Even with holdings producing one-quarter of a million dollars of tax-exempt income the advantage to the taxpayer is only nominally more than the advantage to the municipality.

Interestingly enough, when the minimum tax proposal is applied it would wipe out the taxpayer's benefit in the first two examples and would take away most of his advantage in the last two. The maximum advantage of tax-exempt interest to the individul taxpayer occurs when it is on top of at least $200,000 of *taxable* income Exhibit 8 shows how this works out. Here the taxpayer does gain more than the municipality, but only one-third more. If it applied, the minimum tax would leave him some benefit, but less than 40%; it would probably *not* apply because of the large amount of income presently taxable.

What do these figures say about the minimum tax idea? They seem to say that it would have no impact where the advantage to the taxpayer is greatest (Exhibit 8), and that its impact on present non-taxpayers (Exhibit 4–7) would be so severe, as to reflect not *equity*, but a kind of retaliation. A fuller realization of this would further alienate individual investors, who would doubtless diminish their purchases of tax-exempt bonds, with the resulting adverse effect on the municipal market stressed in our previous testimony. Local government borrowing would then cost more, and the ultimate burden would fall on local taxpayers.

EXHIBIT 1

BENEFIT FROM TAX-EXEMPT INTERESTS IMPACT OF LIMITED TAX PREFERENCES

(Minimum tax)

$50,000 from tax-exempts.
$50M × 100 over 70 equals $71,400 alternative taxable income.

Alternative taxable income	$71,400
Less tax (40 percent)	28,490
Total	42,910

Distribution of benefit

Municipality ($71,400 less $50,000)	$21,400
Taxpayer ($50,000 less $24,910)	7,090
Total	28,490

Should the $50,000 tax-exempt income become taxable at as much as 30% i.e., $15,000, the taxpayer's benefit would be wiped out and he would be penalized $7,910 net.

EXHIBIT 2

BENEFIT FROM TAX-EXEMPT INTEREST IMPACT OF LIMITED TAX PREFERENCES (MINIMUM TAX)

$125,000 from tax-exempts.
$125M × 100 over 70 equals $178,500 alternative taxable income.

Alternative taxable income	$178,500
Less tax (46 percent)	82,560
Total	95,940

Distribution of benefits

Municipality ($178,000 less $125,000)	$53,500
Taxpayer ($125,000 less $95,940)	29,060
Total	82,560

* * * * * * *

A 30 percent minmum tax on $125,000 equals $37,500, more than wiping out taxpayer's gain of $29,060. (In this case 35 percent minimum tax is possible, which would be $43,750.)

EXHIBIT 3

BENEFIT FROM TAX-EXEMPT INTEREST IMPACT OF LIMITED TAX PREFERENCES (MINIMUM TAX)

$200,000 from tax-exempts.
$200M×100 over 70 equals $285,700 alternative taxable income.

Alternative taxable income	$285,700
Less tax (60 percent)	170,970
Total	114,730

Distribution of benefit

Municipality ($285,700 less $200,000)	$85,700
Taxpayer ($200,000 less $114,730)	85,270
Total	170,970

* * * * * * *

Minimum tax of 30 percent on $200,000 equals $60,000, takes most of taxpayer's advantage. At 35 percent, which is likely, it would be $70,000.

EXHIBIT 4

BENEFIT FROM TAX-EXEMPT INTEREST IMPACT OF LIMITED TAX PREFERENCES (MINIMUM TAX)

$250,000 from tax-exempts.
$250M×100 over 70 equals $357,100 alternative taxable income.

Alternative taxable income	$357,100
Less tax (62 percent)	220,950
Total	136,150

Distribution of benefit

Municipality ($357,100 less $250,000)	$107,100
Taxpayer ($250,000 less $136,150)	113,850
Total	220,950

* * * * * * *

Minimum tax of 35 percent on $250,000 equals $87,500, which would take most of taxpayer's advantage.

EXHIBIT 5

BENEFIT FROM TAX-EXEMPT INTEREST IMPACT OF LIMITED TAX PREFERENCES (MINIMUM TAX)

Gross income includes over $200,000 *taxable.*
$70,000 tax-exempt income.
$100,000 alternative taxable income.

Distribution of benefit

Municipality ($100,000 less $70,000)	$30,000
Taxpayer (70 percent) ($70,000 less $30,000)	40,000
Total	70,000

*   *   *   *   *   *   *

A 35 percent tax on $70,000 equals $24,500 which would leave some 39 percent of the taxpayer advantage.

But here the minimum tax would probably not apply because of larger amount of income presently taxable.

APPENDIX B

ADDITIONAL COMMENT ON PROPOSAL FOR ALLOCATION OF DEDUCTIONS

Further study of the allocation of deductions proposal indicates that this would affect many more taxpayers and thus might have even greater adverse market impact than the minimum income tax.[1] Investment in municipal bonds by individuals would be made less attractive, and more individuals would find in this another reason to shift their investment programs even more heavily toward the common stock area. This would risk a drastic reduction in the support for State and local financing supplied by individual investors, particularly during periods when buying by banks is reduced owing to credit restraint such as that now being applied by the Federal Reserve System. Furthermore, institutional investors might well anticipate a growing risk that the principle of allocation would in time be applied to them, to the detriment of their programs for investment in tax-exempts. Accordingly, we believe that this allocation proposal would also have a very serious effect on the municipal market.

The three principal categories of deductions which would be involved in this allocation are (1) contributions (2) State and local taxes, and (3) interest paid. The allocation proposal might have an adverse effect on charitable giving as well as on individual investment in the municipal market, risking major hardships in both of these areas in return for an uncertain minor gain in tax equity.

With current revenue needs of State and local governments at an all-time high, it would be unfortunate to downgrade in any way the present deductibility of State and local taxes. To do so would make it even more difficult for States and cities to raise taxes and hence tend to widen the gap between the taxing power of the Federal government on the one hand and that of State and local governments on the other; the need today is for moves in the opposite direction.

With respect to the question of interest deductions we note that this is not a problem for the Treasury in relation to tax-exempt interest on State and local bonds. Section 265 of the Internal Revenue Code and the regulations thereunder already forbid the deduction of interest on loans to purchase or carry an investment in tax-exempt securities. Similarly disallowed are expenditures for investment management, or for custody or safe deposit box facilities insofar as they are incurred in the production of tax-exempt income.

[1] Attached are some computations (Exhibits 1, 2 and 3) which indicate the reduction in the value of tax-exempt interest to an individual investor if all of the resulting increase in tax is charged against the tax-exempt income. In each case tax-exempt interest is assumed at ¼ of total income including taxable income. It is assumed that there are no other excluded items in order to highlight the impact on tax-exempt interest. It will be noted that the impact rises as the ratio of deductions to income rises.

EXHIBIT 1

EFFECT OF ALLOCATION OF DEDUCTIONS

$60,000 Taxable Income—before Deductions
$20,000 Tax-exempt Interest

A. $10,00 Deductions

	Subject to Tax	*Tax (joint return)*
$60,000−$10,000=	$50,000	$17,060
$60,000−($60,000×$10,000)=	$52,500	18,325
($80,000)		+1,265

$20,000 Exempt Interest effectively reduced to $18,735—
5% rate reduced to 4.68%
4½% rate reduced to 4.22%
4% rate reduced to 3.75%

B. $20,000 Deductions

$60,000−$20,000=	$40,000	$12,140
$60,000−($60,000×$20,000)=	45,000	14,560
($200,000)		+2,420

$20,000 Exempt Interest effectively reduced to $17,580—
5% rate reduced to 4.39%
4½% rate reduced to 3.95%
4% rate reduced to 3.51%

Note referring to *A.* above: Using the method of computing benefits to borrower and taxpayer used in the attached discussion of the minimum income tax, benefit to the borrower was $8,570.00 and to the taxpayer was $6,880.00. Allocation of deductions would reduce the taxpayer benefit by $1,265.00 to $5,615.00.

EXHIBIT 2

EFFECT OF ALLOCATION OF DEDUCTIONS

$150,000 Taxable Income—before Deductions
$50,000 Tax-exempt Interest

A. $15,000 Deductions

	Subject to Tax	*Tax (joint return)*
$150,000−$15,000=	$135,000	$67,180
$150,000−($150,000×$15,000)=	138,750	69.580
($200,000)		+2,400

$50,000 Exempt Interest effectively reduced to $47,600—
5% rate reduced to 4.76%
4½% rate reduced to 4.27%
4% rate reduced to 3.80%

B. $60,000 Deductions

$150,000−$60,000=	$ 90,000	$39,180
$150,000−($150,000×$60,000)=	105,000	48,280
($80,000)		+9,100

$50,000 Exempt Interest effectively reduced to $40,900—
5% rate reduced to 4.09%
4½% rate reduced to 3.67%
4% rate reduced to 3.27%

Exhibit 3

Effect of Allocation of Deductions

Taxable income before deductions	$300,000
Tax-exempt interest	100,000

A. $30,000 dcductions

	Tax (joint return)
Subject to tax:	
$300,000 less $30,000 equals $270,000	$159,980
$300,000 over $400,000 times $30,000 equals $277,500	165,230
Total	+5,250

$100,000 exempt interest effectively reduced to $94,750:
5-percent rate reduced to 4.73 percent
4½-percent rate reduced to 4.62 percent
4-percent rate reduced to 3.79 percent

B. $100,000 deductions

	Tax (joint return)
Subject to tax:	
$300,000 less $100,000 equals $200,000	$100,980
$300,000 over $400,000 times $100,000 equals $225,000	128,480
Total	17,500

$100,000 exempt interest effectively reduced to $82,500:
5-percent rate reduced to 4.13 percent
4½-percent rate reduced to 3.71 percent

Note.—Referring to B. above: Using the method of computing benefits to borrower and taxpayer used in the attached discussion of the minimum income tax, benefit to the borrower was $43,000.00 and to the taxpayer was $57,100.00. Allocation of deductions would reduce the taxpayer benefit by $17,500.00 to $39,600.00.

Methodology

Two different investment procedures were used for two different periods of time. Roman numerals I and II represent investments made in the past ten years and Roman numerals III and IV represent investments made in the past five years. In I and III the full investment of $1,000,000 was made at the beginning of the respective 10- or 5-year period. In II and IV an equal proportion of the total $1,000,000 was invested at the beginning of each year.

For municipals, it was assumed that the bonds were 20-year bonds roughly equivalent to a Moody A and they were purchased at par.

Column A is the Total Capital Worth (market value) of the municipal bonds as of the end of 1968. For II and IV this figure is a total of the market values of the bonds purchased in successive years.

Column B is the coupon rate for each of the bonds. It is based on a rounded Bond Buyer 20 bond average for the first of each year. Column C is the total interest received per bond at the appropriate coupon rate.

There is no tax on the interest income because municipal bonds are tax-exempt as to interest income, and no attempt was made to calculate the effect of state and local tax consequences.

Column D is a calculation of the tax credit that would be applicable if the bonds were sold. If these bonds were sold they would represent a capital loss. Assuming other capital gains, these capital losses would act to offset the capital gain. In a sense, there would be a tax credit at the same tax rate of 25%, to be subtracted from any taxes on capital gains, and this would reduce the capital loss on municipals.

Column P is Net Profit (+) or Loss (—) and is calculated by summing Columns C and D.

APPENDIX C

TABLE I.—MUNICIPAL BONDS

	Total capital worth (as of Dec. 31, 1969)	Coupon rate (percent)	Total interest earned	Tax credit	Net profit (+) or loss (−)[1]
	(A)	(B)	(C)	(D)	
10 YEARS					
I. Investing $1,000,000 at 1 time, Dec. 31, 1958	$790,000	3.40	$340,000	[2] $−210,000 [3] +52,500	+$182,500
Total				[4] −157,000	
II. Investing $100,000 each year, 1959-68:					
1959	79,000	3.40	34,000	[2] −165,000	+63,750
1960	80,000	3.75	33,750	[3] +41,250	
1961	81,000	3.40	27,200		
1962	82,000	3.37	23,500		
1963	83,000	3.00	18,000		
1964	84,000	3.25	16,250		
1965	85,000	3.10	12,400		
1966	86,000	3.50	10,500		
1967	87,000	3.75	7,500		
1968	88,000	4.40	4,400		
Total	835,000		187,500	[4] −123.750	
	5 YEARS				
III. Investing $1,000,000 at 1 time, Dec. 31, 1963	840,000	3.25	162,500	[2] −160,000 [3] +40.000	+42,500
Total				[4] −120.000	
IV. Investing $200,000 each year, 1964-68:					
1964	168,000	3.25	32,500	[2] −140,000	−2,900
1965	170,000	3.10	24,800	[3] +35,000	
1966	172,000	3.50	21,000		
1967	174,000	3.75	15,000		
1968	176,000	4.40	88.000		
Total	860,000		102,100	[4] −105,000	

[1] P=C+D.
[2] Capitol loss
[3] Tax credit.
[4] Net loss

This table is similar in many respects to Table I. It was assumed that the following bonds were purchased:

1. 1958: Aaa Philadelphia Electric, 4⅜'s issued December 1958; due, 1986.
2. 1959: Aa Conn. Light & Power, 4⅞'s issued January 1960; due, 1990.
3. 1960: Aa Georgia Power, 4⅞'s issued November 1960; due, 1990.
4. 1961: Aa Commonwealth Edison, 4¾'s issued December 1961; Due 2011.
5. 1962: Aaa Ches. & Pot. Tel., 4⅜'s issued January 1963; due, 2002.
6. 1963: Aa New England Power, 4½'s issued November 1963; due, 1993.
7. 1964: Aa Texas Electric Service, 4½'s issued February 1965; due 1995.
8. 1965: Aaa Dallas Power & Light, 4⅞'s issued January 1966; due 1996.
9. 1966: Aaa American Tel. & Tel., 5½'s issued January 1967; due, 1997.
10. 1967: Aa Central Power & Light, 6⅝'s issued January 1968; due, 1998.

For I, $1,000,000 was invested in the Aaa Philadelphia Electric bond; for II, $100,000 was invested yearly in successive bonds (bonds nos. 1–10); for III, $1,000,000 was invested in the Aa New England Power bond, for IV, $200,000 was invested yearly in five successive bonds (bonds nos. 6–10).

Columns A through D are similar to the columns in Municipal Bonds, Table I. Column E is the income taxes payable annually on the dividend income. The tax rate was assumed to be a constant 50% over the period. The $100 deduction allowable on dividend income was disregarded, and no attempt was made to calculate the effect of state and local taxation.

Column P is the Net Profit (+) or Loss (—) and is calculated by adding Columns C and D and subtracting Column E.

TABLE II.—CORPORATE BONDS

10 YEARS	Total capital worth (as of Dec. 31, 1968) (A)	Coupon rate (B)	Total interest earned (C)	Tax credit (D)	50 percent income tax on interest (E)	Net profit (+) or (−)[1]
I. Investing $1,000,000 at 1 time, Dec. 31, 1958	$737,500	4.375	$437,500	[2] −$262,500 [3] +65,625	$218,750	+$21,875
Total				[4] −196,875		
II. Investing $100,000 each year 1959-68:						
1959	73,750	4.375	43,750	[2] −242,641	21,875	−52,694
1960	78,030	4.875	43,875	[3] +60,660	21,938	
1961	76,800	4.875	39,000	[4] −181,981	19,500	
1962	69,156	4.75	33,250		16,625	
1963	69,975	4.375	25,950		12,975	
1964	70,338	4.5	22,500		11,250	
1965	69,558	4.5	18,000		9,000	
1966	74,293	4.875	14,625		7,313	
1967	81,004	5.5	11,000		5,500	
1968	94,451	6.625	6,625		3,312	
Total	757,359		258,575		129,288	
5 YEARS						
III. Investing $1,000,000 at 1 time, Dec. 31, 1963	703,380	4.5	225,000	[2] −296,620 [3] +74,155	112,500	−109,965
Total				[4] −222,465		
IV. Investing $200,000 each year, 1964-68:						
1964	140,676	4.5	45,000	[2] −220,712	22,500	−92,784
1965	139,116	4.5	36,000	[3] +55,178	18,000	
1966	148,586	4.875	29,250	[4] −165,534	14,625	
1967	162,008	5.5	22,000		11,000	
1968	188,902	6.625	13,250		6,625	
Total	779,288		145,500		72,750	

[1] P=C+D−E.
[2] Capital loss.
[3] Tax credit.
[4] Net loss.

The same investment procedures were used here, again for the 10- and 5-year period. Prices were based on Standard & Poor's indices for 500 common stocks, while dividends represent the Standard & Poor's average yearly dividend for this same group of stocks.

Column A is the Total Capital Worth (market value) when the stocks were sold at the end of 1968. Column B is the Gross Profit, or Column A minus the initial investment of $1,000,000. Column C is calculated at the highest tax rate, 25% of gross profit for long-term capital gains. Column D is the additional 7.5% surtax necessary because the capital gains were realized in 1968.

Column E is cash dividends. The dividends paid varied each year as did the number of shares owned. The total dividend income (dividends per share times the number of shares owned) is shown for each year.

Column F is yearly income taxes paid on dividend income. As in Table II, the rate was assumed to be constant at 50%.

Column P is Net Profit (+) or Loss (−) and is figured by adding Columns B and E and subtracting Columns C, D, and F from this total.

TABLE III.—STANDARD & POOR'S AVERAGE OF 500 STOCKS

	Total capital worth (as of Dec. 31,1968)	Gross profit	25 percent capital gains tax	1968 surtax (7.5 percent)	Cash dividends		50 percent income tax on dividends	Net profit (+) or loss (−)[1]
					Year	Amount		
	A	B	C	D		E	F	
10 YEARS								
I. Investing $1,000,000 at 1 time, Dec. 31, 1958....	$1,881,200	$881,200	$220,300	$16,523	1959	$32,602	$16,301	+$860,090
					1960	35,318	17,659	
					1961	35,681	17,841	
					1962	37,673	18,837	
					1963	40,028	20,014	
					1964	43,650	21,825	
					1965	47,816	23,908	
					1966	51,438	25,719	
					1967	52,706	26,353	
					1968	54,517	27,259	
Total						431,429	215,716	
II. Investing $100,000 each year 1959-68	1,460,375	460,375	115,094	8,632	1959	3,260	1,630	+445,135
					1960	6,788	3,394	
					1961	10,248	5,124	
					1962	13,728	6,864	
					1963	18,089	9,045	
					1964	22,938	11,469	
					1965	28,243	14,122	
					1966	33,455	16,728	
					1967	37,903	18,952	
					1968	42,324	21,162	
Total						216,976	108,490	
5 YEARS								
III. Investing $1,000,000 at 1 time, Dec. 31, 1963...	1,384,431	384,431	96,108	7,208	1964	32,125	16,063	+373,157
					1965	35,191	17,596	
					1966	37,857	18,929	
					1967	38,793	19,397	
					1968	40,123	20,062	
Total						184,089	92,047	
IV. Invesfing $200,000 each year, 1964-68	1,220,666	220,666	55,167	4,138	1964	6,425	3,213	+213,189
					1965	13,269	6,635	
					1966	20,420	10,210	
					1967	28,169	14,085	
					1968	35. 377	17,689	
Total						103,660	51,832	

[1] P=B+C−D+E−F.

The same methodology was used here as that applied in Table III, only equal investments were made in five growth stocks: Xerox, Kodak, IBM, Avon, and Polaroid.

TABLE IV.—FIVE GROWTH STOCKS

	Total capital worth (as of Dec. 31, 1968) (A)	Gross profit (B)	25 percent capital gains tax (C)	1968 surtax (7.5 percent) (D)	Cash dividends Year (E)	 Amount	50 percent income tax on dividends (F)	Net profit (+) or loss (−)
10 YEARS								
I. Investing $1,000,000 at 1 time, Dec. 31, 1958 ($200,000 in each stock):								
Xerox	$12,000,000	$11,800,000	$1,424,697	$331,852	1959	$12,874	$6,437	+$13,206,224
Kodak	973,309	773,309			1960	17,200	8,600	
IBM	1,016,190	816,190			1961	19,903	9,952	
Avon	2,822,194	2,622,194			1962	25,016	12,508	
Polaroid	1,887,093	1,687,093			1963	34,037	17,019	
					1964	47,407	23,703	
					1965	62,459	31,230	
					1966	81,093	40,547	
					1967	104,087	52,044	
					1968	123,904	61,952	
Total		17,698,786				527,980	263,993	

II. Investing $100,000 each year, 1959–68 ($20,000 each year in each stock):								
Xerox	2, 846, 160	2, 646, 160	1, 161, 583	87, 119	1959	1, 264	632	+3, 476, 754
Kodak	476, 836	276, 836			1960	2, 771	1, 386	
IBM	538, 335	338, 335			1961	4, 086	2, 043	
Avon	877, 316	677, 316			1962	6, 012	3, 006	
Polaroid	907, 686	707, 686			1963	9, 394	4, 697	
					1964	14, 007	7, 004	
					1965	19, 719	9, 860	
					1966	26, 216	13, 108	
					1967	34, 161	17, 081	
					1968	40, 620	20, 310	
Total		4, 646, 333				158, 250	79, 127	
5 YEARS								
III. Investing $1,000,000 at 1 time, Dec. 31, 1963 ($200,000 in each stock):								
Xerox	630, 588	430, 588	572, 510	42, 938	1964	11, 288	5, 644	+1, 720, 233
Kodak	503, 448	303, 488			1965	14, 730	7, 365	
IBM	477, 273	277, 273			1966	18, 082	9, 041	
Avon	564, 444	364, 444			1967	21, 904	10, 952	
Polaroid	1, 114, 286	914, 286			1968	25, 280	12, 640	
Total		2, 290, 039				91, 284	45, 642	
IV. Investing $200,000 each year, 1964–68 ($40,000 each year in each stock):								
Xerox	377, 076	177, 076	263, 166	19, 737	1964	2, 258	1, 129	+792, 681
Kodak	318, 134	118, 134			1965	5, 506	2, 753	
IBM	377, 685	177, 685			1966	8, 814	4, 407	
Avon	376, 047	176, 047			1967	12, 813	6, 407	
Polaroid	603, 720	403, 720			1968	16, 454	8, 227	
Total		1, 052, 662				45, 845	22, 923	

[1] P=B−C−D+E−F.

INVESTMENT BANKERS ASSOCIATION OF AMERICA,
Washington, D.C.

COMMITTEE ON FINANCE,
U.S. Senate,
Washington, D.C.

GENTLEMEN: We are filing this supplementary statement to emphasize certain major points made in our testimony on September 24, 1969, and to challenge directly certain contrary assertions made before your committee the following day by former Assistant Secretary Stanley S. Surrey. These assertions deal largely with the market and investment impact of those sections of H.R. 13270 which concern the tax treatment of State and local bond interest. Mr. Surrey's statements, which we believe to be in error, include: (1) An insistence on the claim that the Treasury would gain if State and local financing was shifted to the taxable market, and (2) An attempt to downgrade the adverse effect, both actual and potential, of H.R. 13270 on the municipal bond market.

Concerning the first point, Mr. Surrey claims: "Now the Secretary of the Treasury could pay close to 50% of the interest on State and local bonds and the Federal Government would not lose anything on the matter." On questioning, he admitted that this statement was based on calculations by "others more expert on this than I." We are familiar with the studies to which he refers, and note for the record that they were made several years ago, and also that they were deficient in that they did not deal with the resulting major shifts in all capital markets and major economic side effects such as across-the-board rises in long-term interest rates.

In our initial testimony, we described the up-to-the-minute study of this matter made under the direction of Dr. Sally S. Ronk, well known as an authority on the flow of funds in the capital markets, and based on the results of a questionnaire which the Investment Bankers Association directed to portfolio managers and investment advisors of major financial institutions in late August.

Mr. Surrey's statement that the Treasury could afford to subsidize the State and local goverenments up to 45 per cent or even 50 per cent of the interest cost on their taxable bond issues and still not lose any money, assumes that the present buyers of tax-exempt bonds would be forced to buy taxable obligations (or the equivalent) to the same degree they previously bought tax-exempt. This assumption is not realistic.

The Investment Bankers Association study makes a number of points:

(1) Investors will probably not acquire taxable municipal bonds to the same extent as formerly. They will surely place some funds in other categories of investment.

(2) Furthermore the investors likely to be most interested in the proposed new taxable municipal bonds are pension funds and savings institutions, who either pay no taxes or are in relatively low brackets and individuals in the lower income brackets. Business corporations and commercial banks, on the other hand, are more heavily taxed; they and high-income individuals would surely be attracted much less to the new bonds than they are today to the tax exempts.

(3) The resultant shifts in acquisitions and new issues among holders in various tax brackets would lower the average marginal tax rate on all fixed-income issues acquired. This means that the increase in tax rates to the Treasury would be substantially less than the 45–50 per cent Federal Government subsidy, and indeed would be less than the 40% subsidy permitted by H.R. 13270. The Treasury would be a net loser.

(4) Thus, it would become more difficult to place the new taxable municipal bonds and since they would compete with corporate bonds, Treasury and Federal agency bonds, and mortgages, the result would be to drive interest rates higher and interest costs would rise for all borrowers, the Treasury, Federal Agencies, Corporations, and home owner mortgages.

In sum, after taking into account *all* capital market shifts and economic side effects, the IBA concluded that, even if the Treasury were to subsidize the interest cost of States and municipalities by no more than 32 per cent, the net loss to the Treasury would be $66 million, and to all governments $114 million, on each year's financing. And if the Treasury should subsidize at 40 per cent of the interest cost as permitted in H.R. 13270, the net loss would be $115 million for the Treasury and $163 million for all governments. These figures are for each year's financing and would accumulate year after year.

With respect to market impact, Mr. Surrey argues that inclusion of tax-exempt bond interest in the limit on tax preferences and the allocation of deductions will have only a modest impact on the holders of tax-exempt bonds, and from this concludes that the eventual market impact should also be modest. He is either unaware or unwilling to admit that the market regards a small encroachment on tax exemption as only a first step rather than the final step. In our initial testimony we pointed out that there is no such thing as a *limited* exposure of municipal bonds Federal Taxation, and we indicated the reasons why. The market has already reflected this in a substantial rise in the cost of local borrowing. There has been a corresponding decline in the market value of outstanding municipals, and we now present additional information on this point.

THE IMPACT OF TAX REFORM PROPOSALS ON OUTSTANDING BONDS

In order to estimate the impact of tax reform proposals on outstanding state and municipal bonds, it was necessary to reconstruct a model amortization schedule based on assumptions derived from recent research. From Dr. Reuben Kessel's studies,* it was known that the general obligations have an average life of 14 years and the revenue bonds an average life of 21 years, that the quality of general obligation bonds' averages out to approximately a Moody's "A-1" and the quality of revenue bonds to about a Moody's "A", that revenue bonds yield approximately 10 basis points more than general obligation bonds of the same quality and maturity. From Bond Buyer data it was known that outstanding bonds consist of approximately 60% general obligation bonds and 40% revenue bonds. On the assumption that all such bonds were being amortized on a level debt service basis (an assumption which tends to over extend somewhat the retirement of general obligation bonds), a model amortization schedule was developed which corresponds with all the other known characteristics of the outstanding bonds. (See Exhibit A attached.) The two separate portions of the outstanding market, i.e. an average 14-year Moody's A-1 3.45% general obligation bond and an average 21-year Moody's "A" 3.55% revenue bond were valued as of early-January 1969 and again as of October 1, 1969 to determine the price deterioration during this period. The results are as follows:

OUTSTANDING AMOUNT, AVERAGE 1968

[In billions of dollars]

Par value	Value Jan. 1, 1969	Value Oct. 1, 1969	Market value decline
$76.3 G.O. 3.45 percent	63.2	52.6	10.6
$50.9 revenue 3.55 percent	38.2	31.2	7.0
$127.2 Total	101.4	83.8	17.6

During the period January 1 to October 1, 1969, yields generally increased, as measured by representative indexes—the Bond Buyer's 20-bond index, White's Value of 100 and Moody's "Aa" average—about 150 basis points, of which we ascribe between ⅓ and ½ to the negative effects of tax reform proposals and the remainder to the effects of inflation and Federal Reserve tight money policies. On this basis, outstanding State and local bonds are estimated to have suffered overall market damage of between $5.9 billion and $8.8 billion as the result of tax reform proposals.

Bank Underwriting of Revenue Bonds. Hearings before the Subcommittee on Financial Institutions of the Committee on Banking and Currency, United States Senate, Ninetieth Congress, First Session, on S. 1306. U.S. Government Printing Office; Washington, 1967, pp. 192, 195.

DAMAGE NOW, WINDFALL (?) LATER

Mr. Surrey justifies subjecting existing securities to the limit on tax preference and the allocation of deductions proposals, because this is "only a mild offset to the windfall gains that are involved if tax-exempt securities tend to be smaller and smaller in proportion to the volume of taxables outstandings." Translated, this means that the Federal Government is justified in inflicting a sure loss on existing bondholders *now* because they might be benefitted at some distant date in the future *if* a highly controversial scheme for issuing taxable municipals is adopted, *if* it turns out to be workable, and *if* interest rates do not further deteriorate. With over $130 billion now outstanding, and with nearly $75 billion of these due to remain outstanding fifteen years from now, as shown in Exhibit A, "windfall gains" owing to scarcity seem a long way off.

LEBENTHAL & CO. INC., SURVEY

We have important new evidence as to the reaction of the individual investor to the direct and indirect taxes imposed by the limited tax preference proposal and allocation of deductions proposal embodied in H.R. 13270. On September 5, 1969, Lebenthal & Co., Inc., of New York City, a municipal dealer firm specializing in municipal bonds for the individual investor, mailed its own questionnaire to 6,500 individual owners and prospective owners of municipal bonds. 770 replies were received by Lebenthal in the one week September 9th through September 16th. Lebenthal's questionnaire and its analysis of the results are set forth in Appendix A.

Among the more important conclusions of the Lebenthal survey are the following: 1. The answer to Question 6 of the survey indicates that 72% of the sample received less than $10,000 per year in tax-preference items and hence would be unaffected by either the limit on tax preferences or the allocation of deductions. 28% would presumably be affected by the allocation of deductions proposal. As indicated in our previous testimony to the Committee, this is a substantial portion of individuals who would be affected by the allocation of deductions proposal and a much greater portion than would be affected by the limited tax preferences proposal. The Lebenthal survey indicates that only 5% of the sample would be hit by the limited tax preferences proposal.

2. H.R. 13270 would severely damage the individual share of the present market for tax-exempt bonds. 56% of those answering yes or no to Question 7 (42% of the total sample) indicated they would not be willing to invest in municipal bonds even though they were not personally affected by the bill, i.e., their total tax-free income did not exceed $10,000. This was further substantiated by the answers to Question 6, which demonstrated that the *tax-free* feature of municipal bonds was far and away from their most attractive feature.

3. The answers to Question 9 indicate clearly that substantially higher interest rates will be required on taxable municipals than are presently available on comparable corporate bonds. Furthermore, the response to Question 11 indicates that the smaller non-rated communities and the big cities with difficult social and economic problems will suffer the most severely. Although investors are willing to buy such bonds as tax-exempt, they are unwilling to buy them as taxable securities except at prohibitive rates. Incidentally, preliminary results of an extensive IBA research study presently being conducted by Robert King, Research Director of IBA, indicate that smaller non-rated communities receive satisfactory treatment as to interest costs under the present system. and apparently have few borrowing problems.

Respectfully submitted on behalf of Municipal Securities Committee, Investment Bankers Association.

PAUL S. TRACY, Jr.,
Chairman, Municipal Special Committee on Basic Research, Investment Bankers Association.

*The Lebenthal Survey appears elsewhere in this hearing.

EXHIBIT A

MODEL AMORTIZATION SCHEDULE FOR $127,200,000,000 PAR VALUE MUNICIPAL BONDS [1]

	Par value maturing each year (in thousands)				
Year	$76,320,014 general obligation coupon 3.45 percent; average life 14 yrs.	$50,939,978 revenue bonds coupon 3.55 percent; average life 21 yrs.	$127,259,992 total	Par value outstanding at end of each year	Percent of par value outstanding at end of selected years
0				$127,259,992	
1	$1,972,509	$879,575	$2,852,084	124,407,908	
2	2,040,561	970,800	3,011,361	121,396,547	
3	2,110,960	943,133	3,054,093	118,342,454	
4	2,183,788	976,614	3,160,402	115,182,052	
5	2,259,129	1,011,284	3,270,413	111,911,639	88
S	2,337,069	1,047,185	3,384,254	108,527,385	
7	2,417,698	1,084,360	3,502,058	105,025,327	
8	2,501,109	1,122,855	3,623,964	101,401,363	
9	2,587,397	1,162,716	3,750,113	97,651,250	
10	2,676,662	1,203,992	3,880,654	93,770,596	74
11	2,769,007	1,246,734	4,015,741	89,754,855	
12	2,864,538	1,290,993	4,155,531	85,599,324	
13	2,963,365	1,336,823	4,300,188	81,299,136	
14	3,065,601	1,384,280	4,449,881	76,849,255	
15	3,171,364	1,433,422	4,604,786	72,244,469	57
16	3,280,776	1,484,308	4,765,084	67,479,385	
17	3,393,963	1,537,001	4,930,964	62,548,421	
18	3,511,055	1,591,565	5,102,620	57,445,801	
19	3,632,186	1,648,066	5,280,252	52,165,549	
20	3,757,496	1,706,572	5,464,068	46,701,481	37
21	3,887,130	1,767,155	5,654,285	41,047,196	
22	4,021,236	1,829,889	5,851,125	35,196,071	
23	4,159,969	1,894,850	6,054,819	29,141,252	
24	4,303,488	1,962,117	6,265,605	22,875,647	
25	4,451,958	2,031,772	6,483,730	16,391,917	13
26		2,103,900	2,103,900	14,288,017	
27		2,178,588	2,178,588	12,109,429	
28		2,255,928	2,255,928	9,853,501	
29		2,336,013	2,336,013	7,517,488	
30		2,418,941	2,418,941	5,098,547	4
31		2,504,813	2,504,813	2,593,734	
32		2,593,734	2,593,734		

[1] $127,200,000,000 represents the average gross outstanding State and local government long-term debt in 1968.

The CHAIRMAN. Now, I would like to call Hon. Jack Williams, Governor of Arizona.

Governor, we are pleased to have you here. Senator Fannin is a member of this committee and, as Senator Williams pointed out, he is engaged with the other Republicans and in a caucus they are holding today in order to elect their Republican leader of the Senate. It might be a close vote so I am sure he would want to be there, and you can understand his absence at this particular moment, I am sure.

STATEMENT OF HON. JACK WILLIAMS, GOVERNOR, STATE OF ARIZONA; ACCOMPANIED BY THOMAS F. ALLT, MAYOR, YUMA, ARIZ.; AND BUD TIMS, MAYOR, SCOTTSDALE, ARIZ.

Governor WILLIAMS. Thank you very much, Senator Long. I have with me two mayors of the towns of Arizona for very brief statements, and I will brief mine. One is Mr. Bud Tims, of Scottsdale, Ariz. The other is Mayor Thomas Allt, of Yuma, Ariz. Also in the audience I have Joe Refsnes, Jr., and Fred Rosenfeld for any technical matters I might run into.

My name is Jack Williams and I am Governor of the State of Arizona. As a Governor I am most concerned with the impact of certain provisions of the Tax Reform Act of 1969.

Arizona is one of the fastest growing States in the Nation in terms of population. Many new families move into the State every day. Additionally, new businesses are developing within the State and many manufacturers have seen fit to locate additional facilities in Arizona. We welcome these individuals and firms to share our vision of the good life and the future of our State. However, their arrival creates a demand for additional public facilities and services.

In Arizona, as in many States, such major public facilities cannot be constructed on a "pay as you go" basis. Existing operating revenues of the school districts, the cities, the counties and the State are not sufficient to permit this. Nor, if the example of major private enterprise may be taken as a guide, would this be sound management practice. Good financial management seems to involve the option in certain instances of borrowing to construct facilities as needs arise, and amortization of construction costs over a period of years. Governments in Arizona can become indebted—can borrow money—only through the issuance of bonds. The provisions of H.R. 13270 will have a substantial impact on the marketability and costs of municipal bonds. The interest subsidy program proposed under this legislation, in our view, is "Too little, too late" an poses a number of problems, some of which go to the very heart of our federal system.

Two provisions of H.R. 13270, the allocation of deductions rule, and the limit on tax preference, will have the net effect of placing a tax on municipal bond interest. We are advised that there are some constitutional questions surrounding this matter. It may be assumed that the constitutionality of this measure will be challenged in the court, resulting in lengthy litigation.

During this time, the tax status of municipal bonds will be unclear and investors will be either unwilling to invest in these bonds, or will demand high enough interest rates to protect themselves against taxation. Turning aside for the moment from the question of the cost and marketability of municipal bonds, legislation of this nature could create an inequitable situation in which bond investors may reap a substantial windfall at the expense of local property taxpayers. If investors demand interest rates sufficient to offset possible taxation, and such taxation is later declared unconstitutional, those individuals who purchase municipal bonds will be receiving interest payments at a rate which would normally apply to taxable securities. Yet those payments will be nontaxable, thus resulting in a substantial gain for the investor. Needless to say, this windfall will be subsidized by local taxpayers across the Nation.

As I indicated a moment ago, there are serious questions about the marketability of a taxable municipal bond. This is, in effect, a new form of security, and certainly will be in competition with corporate bonds. In the case of States, larger cities, and some urban counties and large school districts, the competition will be between municipal securities and top-rated corporate bonds. In our smaller cities, counties, and school districts, however, and we have many of them in a small State, the competition will be between municipal bonds and second-ranking corporate securities. Few public agencies have a credit rating and repayment ability approaching that of major American corporations. The point here is that a taxable municipal bond is a new and strange entity in the marketplace, and will be in competition with bonds of a well-known character issued by large corporations with excellent credit ratings and established borrowing histories. We may find that under these circumstances investors are unwilling to purchase municipal bonds or will demand a very substantial premium for such investments.

The cost of borrowing by State and local governments is already high. In Arizona and in most Western States, there are statutory limits on the maximum interest rate at which municipal bonds may be sold. In my State, we have now passed those limits in many cases, and certainly, if municipal bonds become taxable, our statutory limits will have to be revised. At best, this will result in the delay of needed public improvements until such time as the various State legislatures may act on the matter. And apropos I might mention we have a jail that is falling down in Graham County which must be replaced. This cannot be done without borrowing some money to do it.

Such legislative action can be delayed and will delay such action.

In any case it is obvious that the cost of borrowing at the State and local level will be increased. Anticipation of future taxation has already had its effect. The bond buyer's index has shot up 70 points since July 18 when the House Ways and Means Committee made known its intention to tax municipal bond interest. These increased costs have very significant and practical results for State and local governments. Let me give you just two brief examples:

1. The city of Phoenix recently initiated a street improvement district in the inner-city area. In the few months between the time of initiation of the district and the final call for bids, estimaed costs of the project increased 35 percent.

2. Maricopa County Junior College provides another example of this problem. On April 1, 1969, the college sold $5 million of bonds at an effective interest rate of 5.037 percent. A second issue was scheduled for sale on September 22; however, this sale could not be made because of increased interest rates.

This increase in borrowing costs is recognized in H.R. 13270 and an attempt is made to offset it through an interest subsidy program. In order "to encourage States and their political subdivisions to voluntarily relinquish the privilege of tax exemption." H.R. 13270 provides for the subsidy payable either to the issuing jurisdiction or to its paying agent, ultimately ranging from 25 to 40 percent with the exact percentage to be determined by the Secretary of the Treasury on a quarterly basis. Although we understand that no review of the advisability of local projects or the ability of the issuing jurisdiction to repay is contemplated, we feel that such an element of review at the Federal level is almost inevitable. Action of this nature strikes at the very heart of our federal system.

The matter is no less significant than that. Under our federal system of government, the States and their political subdivisions exist as a matter of right, and not for the administrative convenience of the National Government. Any action which weakens these entities—which limits their ability to discharge their proper and legitimate functions—weakens the federal system. Under the interest subsidy program, States and their political subdivisions would be wholly dependent upon the whim of the Federal Government in a number of ways:

1. State and local indebtedness is on the increase and as the demands for new services and facilities increase, this indebtedness will increase. Local bond issues are now coming onto the market at the rate of $15 billion per year and, as I have indicated, this rate is likely to increase. There is no assurance that appropriations will be adequate to subsidize all bonds issued.

2. When the demands for subsidy payments exceed the available appropriations, someone somewhere will have to make a decision as to which bond issues are to be subsidized and which are to be unsupported. All of our experience with Federal aid programs, and the logic inherent in this system, lead us to believe that the determinations will be made by Federal employees, whose value judgments will supersede the decisions of local citizens who, through the ballot box, authorize the issuance of the bonds in question.

3. Given the above, the entire history of Federal-aid programs leads us to the conclusion that a broad range of considerations and criteria, certainly including national social policy, will be employed in making such determinations. Thus, we foresee that ultimately the interest subsidy program will become as hedged with restrictions as are the various functional grant programs at the present time.

4. We have been told that the operation of the interest subsidy program will be "automatic." Assuming that this is true, and given the best of circumstances; that is, adequate appropriations by Congress to fund all State and local bond issues subsidy payments, it will still be necessary to instigate certain administrative procedures to obtain these subsidies. Such procedures will, of necessity, be an added burden over and above the present procedures necessary for bonds sales. This additional cost will be borne, in large part if not totally, by the State and localities.

5. As I have indicated previously, State and local bond issues will be in competition with corporate bonds, and will be viewed as less desirable in many cases than corporate bonds. We are advised by persons of considerable competence in this field that a normal spread between the prime interest rate and the interest rate of nontaxable securities should be approximately 50 percent. H.R. 13270, however, provides interest subsidy ranging between 25 and 40 percent. Thus, the interest subsidy will range from the marginally adequate to the inadequate.

In summation then, we are seriously concerned about the marketability of municipal bonds if H.R. 13270 becomes law, and about the cost of such bonds if, in fact, they are marketable. Additionally, we feel that the interest subsidy program, because of its implications for modification of the federal system, is an unacceptable solution to this problem. The cure, in fact, may well be worse than the disease.

My statement, and the concerns it expresses, have the agreement and endorsement of the Arizona School Board Association, the supervisors of Arizona's 14 counties, the irrigation districts, and municipalities.

In support of the latter I have two of our prominent majors here. I would like to introduce Mayor Thomas Allt who heads the Arizona League of Cities and Towns. Mayor Allt.

Mayor ALLT. Thank you, Governor Williams.

Senator Long, Mr. Chairman, and gentlemen. My name is Thomas F. Allt and I am the mayor for the city of Yuma, Ariz., and president of the League of Arizona Cities and Towns.

The cost and marketability of municipal bonds is a matter of vital concern to the cities of Arizona. Cities in our State, like those in just about every other State, are faced with the problem of increasing demands for services and facilities in a time when the buying power of revenues available is static or in some cases actually declining.
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The CHAIRMAN. May I just say this, we have a total of 18 witnesses we are going to have to hear today. We will be glad to print your statement, Mr. Mayor, in the record, but we are not going to be able to hear others than those we scheduled. We did have the Governor here and at Senator Fannin's request. Yesterday we had five Governors who were speaking for all the Governors. We will be glad to have the entire statement and read it and we will have to get on with the next witnesses unless we have some questions we want to ask the Governor. Senator Anderson.

Governor, thank you very much. I may say that on yesterday, there were five Governors here, Governor Love, Governor McKeithen of my State, and three others. What they are saying is basically what you are saying and they made a magnificent presentation. You have honored them and they have honored you. They made a very fine presentation on behalf of all 50 sovereign States of the Union.

We also had a number of mayors speaking for the mayors' conference. Mayor Tate was planning to be in on the afternoon meeting, but we did not meet in the afternoon because we finished up the morning. I will be glad to see your entire statement is included in the record.

Governor WILLIAMS. Thank you very much, Senator.

(Mayors B. L. Tims and Thomas F. Allt's prepared statements follow:)

STATEMENT OF THE HONORABLE B. L. TIMS

Mr. Chairman, gentlemen, my name is Bud Tims and I am the Mayor of Scottsdale and Chairman of the Regional Council of the Maricopa Association of Governments (MAG).

The Maricopa Association of Governments (MAG) is a council of governments in the Phoenix metropolitan area. Our member jurisdictions account for two-thirds of the population of the State, and we are undergoing very rapid growth. The ability to issue bonds at a reasonable cost is vital if we are to continue to meet the needs of our citizens.

I want you to know that on the behalf of Scottsdale and the Maricopa Association of Governments, I concur wholeheartedly in what Governor Williams and Mayor Allt have told you.

STATEMENT OF MAYOR THOMAS F. ALLT, YUMA, ARIZ.

Mr. Chairman, Gentlemen: My name is Thomas F. Allt and I am the Mayor for the City of Yuma, Arizona, and President of the League of Arizona Cities and Towns.

The cost and marketability of municipal bonds is a matter of vital concern to the cities of Arizona. Cities in our state, like those in just about every state, are faced with the problem of increasing demand for services and facilities in a time when the buying power of revenues available is static, or in some cases, actually declining. Major capital improvements can only be provided through long-term borrowing, and in our state, bonding is a city's only means of borrowing.

A tax, even an indirect tax, on the interest of municipal bonds poses two very real problems for our cities. First, is the question of marketability of the bonds. The second problem concerns the cost of bonds if they are, in fact, marketable.

I am not an attorney and certainly not an authority on constitutional law. However, a number of persons who are knowledgeable in this field have raised questions concerning the constitutionality of a tax on municipal bond interest. If constitutional questions do exist, almost certainly we will face a law suit on this matter at some point in the future. When this occurs, we may well find that investors are unwilling to buy municipal bonds at reasonable rates. Certainly, the investor will demand an interest rate high enough to provide an adequate return on his investment. This rate could well be prohibitive for many cities and towns. My point is that this legislation will create an uncertain situation with regard to municipal bonds. Investors want, and have a right to demand, security for their investment. When taxable municipal bonds—a new entity—are placed in competition with corporate bonds of well-known quality, why should an investor purchase municipal bonds?

If municipal bonds are saleable, our next concern is their cost. Municipal bonds are a good investment. They are usually paid promptly, and the interest they earn is tax-free. If this interest is taxed, the investor will have to demand a higher interest rate in order to recover the same return on his investment. Higher interest rates will, of course, lead directly to higher costs of borrowing and a higher cost to the taxpayer for needed public facilities. It is entirely possible that this increased cost will place some needed public improvements out of the range of many cities and towns.

In my City, for example, the cost of construction of a downtown mall has risen 24 percent in the past two years, due in part to rising interest costs. The City Council has recently had to increase the maximum interest rate payable on bonds for this purpose from 5½ to 8 percent. We are advised by investment bankers that our bonds cannot be sold at lower rates. The cost of borrowing is now very high—further increases, such as would result from this legislation, would place needed public improvements beyond our ability to pay.

I realize that an Interest Subsidy Program is proposed to offset the increased cost of municipal bonds, and that this program is intended to be automatic, in nature, without review of the program for which bonds are to be issued. My experience as a Mayor and as President of the League leads me to believe that Federal programs just do not work that way. The Interest Subsidy Program will be expensive in the beginning and will become more expensive every year. At some time we will find that the costs of the subsidy are greater than appropriations. Who then will decide which bond issues will be subsidized, and on what basis will this decision be made?

If history is any guide, someone will establish "standards" for funding, and we will have to "qualify" for subsidies. We will undoubtedly find ourselves in the same red tape jungle that now surrounds all Federal assistance programs. Even if adequate money is available, we will certainly have to go through a great deal of effort to obtain subsidy payments, and this in itself, will increase our costs.

In summary then, we are concerned about a period in which we would not be able to sell bonds at all, pending a decision on the constitutionality of the legislation now being contemplated; and secondly, that the cost of bond sales would be increased by this legislation; and thirdly, that the Interest Subsidy Program is not an effective answer to the problem.

Gentlemen, we urge you not to tamper with the tax-exempt status of municipal bonds.

The CHAIRMAN. Thank you. The Governor and the mayors have made a very fine presentation on this issue.

We expect to have a panel now for the National Association of Counties. That will include the Honorable Conrad Fowler of Shelby

County, Ala.; the Honorable William Conner, county executive of Newcastle County, Del.; Hon. Dale Anderson, Baltimore County, Towson, Md.; Hon. John Brewer, Kent County, Mich.; Hon. George R. Long, executive director, Virginia Association of Counties and chairman of the Conference of Executives of State Associations of Counties; Hill Healan, executive director, Georgia Association of County Commissioners; and Arthur Sypek, first vice president of the New Jersey Association of Chosen Freeholders.

Gentlemen, we have your statement here, and we hope you say here to more or less summarize what you said in your statements.

Senator Williams explained why he couldn't be here this morning, and he particularly wanted me to address myself to you, Mr. Conner, and explain that because the Republicans are holding their conference to elect their minority leader, who they hope some day will be a majority leader—we have some doubts about that on our side of the aisle—they couldn't be here. Go right ahead.

STATEMENT OF HON. CONRAD FOWLER, COUNTY PROBATE JUDGE, SHELBY COUNTY, ALA., PRESIDENT, NATIONAL ASSOCIATION OF COUNTIES

Judge Fowler. Thank you, Mr. Chairman, and members of the committee. I am Conrad Fowler, county chairman of the governing board of Shelby County, and I also appear here as the president of the National Association of Counties.

We wish to express a firm belief before this committee that the House-passed bill, H.R. 13270, which would tax the interest on municipal bonds would be extremely harmful to local government. It has, in fact, already posed a tragic blow.

We have recently concluded our annual conference which was attended by some 3,000 county officials throughout the land and this conference adopted, sir, in unequivocal terms the offices, a statement in opposition to any direct or indirect taxation on the interest on municipal bonds.

We have for years argued with reference to intergovernmental relation matters that bonds of this nature should not be taxed by Congress and in the past our pleas have been respected and heard, sir.

We feel that this latest effort of a quickly enacted House proposal that would drastically affect local programs and projects throughout the land depending upon municipal bonds such as schools, hospitals, public housing, and other public facilities should be put to rest.

We believe the imposition of the proposed tax would precipitate an irreparable damage to the local bond market. We have some 3,049 counties throughout the land, and their 70,000 elected officials join a host of other organizations, States, cities, towns, authorities, special districts, in expressing concern over the proposed tax on municipal bond interest.

The Governors' Conference this past summer affirmed the basic belief that "neither the Federal nor the State Governments, without mutual agreement, have the authority to tax the other." I will explore this a bit further, sir.

The Governors also strongly oppose the provisions of H.R. 13270 which impair the marketability of State and municipal bonds.

Hon. Bev Briley, sir, he is the mayor of Davidson County, Tenn., former president of the National Association of Counties, had this to say recently in an appearance before the House Ways and Means Committee:

> The issues go to the heart of the ability of the three levels of government to coexist and function effectively in our Federal system." So we have statements from State and local governments in opposition to that which we consider today.

The impact of these proposals is already significantly affecting efforts to borrow money and that, in turn, affects critically numerous local projects throughout the land. Interest rates on new bond issues are exorbitantly high. Bids from investors have not been forthcoming on many issues. We feel strongly that action which directly or indirectly taxes interest on local government bonds would precipitate fiscal disaster for a county government. The size of the new issue market available to local government is shrinking. Many county officials are postponing or canceling bond sales because of the progressive deterioration of the market. This has become to local governments, sir, a very serious situation.

As long as this bill is before Congress, foreshadowing a possible tax on the bond interest with a possible constitutional battle in the courts, the market for municipal securities will remain uncertain. One reliable bond counsel has stated that a rise of about $300 million in the borrowing costs to State and local governments over the past 4 months is traceable to a large extent, perhaps 60 percent, to the adverse effect upon the market resulting from the treatment of this issue in the House of Representatives.

In my home State, Alabama, and in many other States, local construction of schools, hospitals, bridges, airports, and other vitally needed public projects are vastly more difficult. In some States it has become impossible to commence construction or continue construction of these type facilities.

Our association receives information from our members indicating that areas with local credit ratings or with unrated credit or with statutory or constitutional interest limits are not able now to borrow at all. Legal public financing is dead in those States.

In the final analysis then it will be the local property tax paying citizen who will have to bear the significanty increased cost of local projects or such citizen will be deprived of needed public facilities, canceled because of financing problems resulting from H.R. 13270.

It is particularly necessary to insure the continued rate of State and local public works construction in view of the announced 75-percent cutback in Federal construction projects, sir. The inevitable result of taxing municipal bond interest will be a substantial curtailment in scheduled construction on the State and local level. New and higher taxes will be required and, unfortunately, because of the relative regressive nature of such taxes, for example, the real property and, the real property taxes and, the sales taxes, this increased tax burden on the local level will fall most heavily upon the average workingman.

Chances are that many who are employed in the construction industries and related trades will be without work in consequence of the passage of the pending tax legislation and the Federal cutback in construction.

We suggest that the House-imposed taxes on State and local bonds are wrong on other counts as well. They are economically unsound. They would obtain for the Federal Government a comparatively insignificant tax return amounting at most to, we are told, $80 million a year, and in so doing they threaten the fiscal integrity of local government. We cannot overemphasize this danger. The financial independence of local government to us is the key issue in this matter.

Also at issue is the hope of decentralization, bringing government closer to the people. This committee well knows that the President and this administration are seeking to bolster the responsiveness and responsibilities of State and local government. If the States, counties and cities are to have the real capacity to experiment, to innovate, and to provide leadership, they must have adequate methods of financing, especially the effective use of tax-exempt municipal bonds. This must be kept available.

There is a need to strengthen, not weaken, the fiscal process by which local government responds to the needs of their citizens.

The demand for physical facilities at the State and local level is overwhelming and unprecedented. There is a backlog of—on the books over the Nation of—almost $8 billion in demand for water-sewage construction alone. The public housing programs and the administration's plans for 500,000 units of low-cost housing are placing an additional burden on our tax-exempt market.

Other federally stimulated programs, including such other expensive areas as mass transit, airport development, and health and mental health facilities construction, these also require a substantial outlay of local funds. This is in addition to the expanding needs that we experience in the more traditional local functions such as city streets, county roads, schools, hospitals, recreation facilities and so forth.

May I comment briefly, sir, on the constitutional aspects relating, related, to the proposal to tax interest on municipal securities. As one who has had a long interest in this issue, I believe that the proposed tax, as enacted by the House, is unconstitutional. The body of our law supports this now, as does the thinking of many outstanding legal minds in our Nation. Under the Constitution the doctrine of reciprocal tax immunity is implicit, it is a bulwark of our Federal system dating back to the old decision *McCulloch* vs. *Maryland*.

If the benefits of tax exemption are abrogated and disaster follows, we may have to deliver to the Federal Government full control over the determination of vital public projects in our home localities. This is totally against what we need to do in the country at this time in our history.

Let us not forget that everyone purchasing an exempt security pays a tax to the issuing government since he accepts a lower interest rate compared to more lucrative securities available to the investor.

In conclusion, I would like to reaffirm that the very heart of our democratic process lies in how well we, the local governments of this Nation, function as responsive servants of our citizens.

We have been criticized for years for not doing enough and now with the consent of new federalism perhaps forthcoming, we find ourselves stymied. That is the prime issue, and its resolution will not be helped by these new tax proposals.

The magnitude of our local financing requirements in the years ahead will be tremendous. Some estimate $400 billion cf debt for State and local government by 1975.

Living as we do in a society which demands more and better local services the financial crisis confronting local government becomes enormous.

The proposals to tax the municipal bonds are a major obstacle to our continuing efforts to serve the local community, the State and the Nation.

In sum, the tax on municipal-bond interest produces more problems than solutions for the Federal as well as the local government.

Mr. Chairman, our organization has had research done relating to the experience in other countries where there has been a degree of control of the Central Government on the power of the local government to borrow. We ask permission of the chairman and the committee to include in the record the result of the study which has been made by our organization, sir.

The CHAIRMAN. Very well.

(The study referred to and Mr. Fowler's prepared statement follow:)

THE EXPENSE OF CENTRAL GOVERNMENT CONTROL OVER LOCAL BORROWINGS FOR THE UNITED KINGDOM, FRANCE, ITALY, NEW ZEALAND AND THE NETHERLANDS

SUBMITTED BY THE NATIONAL ASSOCIATION OF COUNTIES AS A SUPPLEMENT REPORT TO ITS TESTIMONY ON THE TAX REFORM ACT OF 1969; H.R. 13270

Many leading State and local public officials agree that one of the local government's great strengths is its relative independence, especially financial independence, of which the tax exempt privilege is a part. It is believed that the taxation of municipal bond interest will have a devastating effect on local government financing.

To understand, in more concrete terms, the possible repercussions on local government financing, a review has been prepared of five other countries describing their central government control over local financing. The review should clearly show that, in light of foreign expense, the American local government's fiscal integrity should be preserved. One way to preserve local government financial independence is to retain tax free municipal bond interest.

The United Kingdom

Because the present Great Britain was formed during the course of history from a number of independent kingdoms, its internal legal structure is somewhat complicated. It is not possible to generalize about practices for the entire Kingdom. Therefore, the following discussion will confine itself to the history of local government in England. Since England includes London and most of the other major urban centers, the major local administration problems are found within this area.

The system of local government financing in Great Britain has been beset with ever-changing rules and regulations imposed upon it by the central government. Continually facing restrictions, reforms, limitations, re-phasing or re-funding, the local governments have competed with the Bank of England and the nationalised industries in the long-dated gilt-edged market—a market managed by the Bank of England also has direct control over all financing of local government, the Bank of England. As the arm of the central government, the Bank of England also has direct control over all financing of local governments in either new bond issues, through the mortgage market, from Public Works Loan Board, or when borrowing short-term in the Euro-currency markets.

Since 1945, the local authorities' techniques of obtaining capital have changed a number of times, as a result of changes in central government policy. From 1945–1953 local authorities mainly financed their capital needs through Public

Works Loan Board (PWLB) which borrows from the Exchequer (the central cash account of the government, kept by the Treasury at the Bank of England). The rates for these PWLB loans were equal to "gilt-edged" or government security rates for the same maturities. From 1953 to 1955 they had the option of borrowing either through PWLB or through issuing securities and mortgages, but still tended to rely heavily on PWLB. Beginning in 1955, they were permitted to borrow from PWLB (at rates equal to an average or prevailing market rates for local authority securities of the same maturity) *only* if they could not raise the money in the stock or mortgage markets.

The difficulties, however, of local governments raising money in the securities market are described in a report written by the Radcliffe Committee in 1959:

"While somewhat more money has been raised by local authority stock issues since October, 1955, than in the previous period, given the conditions prevailing in the gilt-edged market, it has only been possible for a very small part of the funds required to be raised by this method. Local authorities who wished to make an issue have had to wait for a period of years before being allowed to go on to the market; a long queue of would-be borrowers developed, despite the monetary authorities decision in May, 1956, to shorten the queue by putting a minimum of 3 million on the size of issues. Authorities whose issues were postponed or frustrated by this difficulty of access to the stock market were forced to turn extensively to the mortgage market, despite the higher rates ruling in that market."

Thus, the local authorities begin to be major users of Eurodollars; they borrowed short and invested long, presumably on the expectation that long-term interest rates would be lower or at least not higher in the future, and on the belief that the Exchequer would come to their relief if for some reason they were required to pay off the Eurodollar borrowings on short notice.

The tendency for local authorities borrowing to become too heavily weighted on the short side became a source of concern to the market and to the government. After a period of discussions between the government and the local authorities on possible changes in financing arrangements, a government white paper proposing new limitations and privileges for local authorities was issued in October, 1963. The new procedures came into effect the following April placing restrictions on temporary borrowing by local authorities, but giving them greater access to the PWLB at government lending rates plus a small service charge.

According to the August, 1966, issue of the Midland Bank Review, new regulations were effected in July of 1964. In order to ensure orderly marketing of bonds, the terms and timing of bonds issued "to or through the agency of any bank, discount house, issuing house or broker" *were made subject to approval by the Bank of England.*

Most of the bonds received a Stock Exchange quotation, and were placed in the market by stock brokers, but a few were issued without quotation. Some were distributed by merchant banks among discount houses, thus providing them with a new form of asset; but the Bank of England does not accept local government bonds as security for loans, and the clearing banks do so only to a limited extent. However, for both quoted and unquoted local issues a small market does exist.

In 1965 the year's total for local government borrowing reached a new record level due to market conditions and changes in official policy. The queue of potential borrowers had been long in previous years so that presumably the larger totals reflect the view of the local governments that the market could absorb the increased volume. It also followed upon the changes in the channels for local authority borrowing that came into effect in 1964 when short-term borrowing by local governments was restricted but they were given readier access to the Public Works Loan Board. But by the middle of 1965, local authorities were borrowing heavily from the PWLB, and so considerable was the rate of drawing that the Chancellor imposed some "re-phasing" when introducing further measures of general restraint in July. *Local governments were required to spread the remainder of their permitted borrowing from the PWLB evenly throughout the rest of the year, and those which had used more than half of their quota before July were required to wait until October before they could make any further loans.*

In the bank of England *Report for the Year ended 28th February 1966*, these measures are reported in the context of the national situation and illustrate precisely how the local government's finances are an instrument of fiscal and monetary adjustment of the central government:

"Despite the measures taken in the budget, the pressures of demand remained uncomfortably high and overseas confidence in sterling weak. Accordingly, the Chancellor acted on 27th July to reinforce his Budget. Further steps were taken to limit the growth of home demand. Public authorities were required to contain their expenditure on building houses, schools and hospitals within existing programs; and to defer many other non-industrial capital projects for six months. Local authorities (governments) were asked to limit their lending on mortgage for house purchase to L 180 million in 1965/66. *Loan sanction and grants would be refused for non-essential local projects, and local authorities would be required to phase their borrowing from the Public Works Loan Board more evenly during the remainder of the financial year.* Public authorities were to review their staff position, defer current purchases, and especially look closely at expenditures overseas.

This central control of local financing is brought into sharp focus in a report issued by the Committee on the Management of Local Government (printed by Her Majesty's Stationery Office, 1967). The following quotation reflects the essential points made in the study concerning local finance and borrowing:

"Local authorities are heavily dependent for their income on the central government . . . local authorities in England and Wales were dependent on grants from the central government for over 52% of their revenue in the financial years 1962/63, 1963/64, 1964/65 and 1966/67. It was intended that the general grant (which replaced many, but not all, specific grants) should increase the independence of local authorities in the spending of their money, but there was little change in the position. *It is significant that the new rate support grant which replaces the general grant on 1 April 1967, has been designed to allow the central government for the first time to influence tne expenditure on all local authority services.*"

The study goes on to verify what has been alluded to above—that it is in the sphere of borrowed money that the greatest control is exercised. Under an act passed in 1933, local governments have a general power to borrow for acquiring land, erecting buildings, executing any permanent work or any other purpose for which they are authorized under any enactment to borrow, but permission to borrow is required from the Minister of Housing and local government (and as we have seen, subject to the monetary controls of the Bank of England.) *This takes the form of a loan sanction which is issued only after detailed scrutiny.* Even the largest municipalities have to submit applications for individual projects.

Control of borrowing was originally instituted to prevent local governments from entering into commitments beyond their means. Today, however, it is used for the purpose of economic control: *to keep local investment programs in step with national programs and current financial situations.* The National and Local Government Officers Association (NALGO) considers that if municipalities in England are to have a large measure of independence from the central government they must either have a larger degree of financial autonomy, or the arrangements under which grants from central funds are made must be designed to preserve or strengthen the independence of local governments should not be regarded as necessitating a further whittling away of local independence. "There is a need for partnership with the central government—not overlordship by it," NALGO insists.

Professor Marshall's study commission concludes its report with this observation:

"Central government control should be used only for fiscal and economic purposes and not to hamper the direction of local authorities in the development of their services, nor to impose the will of the (central government) Department on designs and technical or administrative considerations in schemes or projects."

(It is our contention that central control of local finances for fiscal and economic purposes is also wrong. There are ample tools at the disposal of the Federal government to control the national economy without interfering with the financial programs of State and local governments. Later we shall illustrate the adverse effects central control of local finances for fiscal and economic purposes can have on local governments when we discuss the situation in New Zealand.)

Two conclusions are justified by the above discussion of the central control exercised by England over its local sub-divisions. First, local government in England has suffered significantly through its lack of financial independence;

and, second, despite good intentions, central government has proved insensitive to local problems under the pressure of other concerns. It should be noted that, as the comments on borrowing indicate, London attempts to watch local government activities closely through auditing procedures and that local governments are also generally held subject to *ultra vires* doctrines which tend to discourage innovation. In the following discussion, we will note the same situation existing in France.

France

More than either Britain or the United States, France has had a strong centralized administration dominated by Paris. Under the French Kings royal appointees governed the provinces. The current governmental form dates from Napoleon's time when the original provinces were redivided into 91 departments. Each department is governed by a Prefect, a high level central government official actually located in Paris. This central control of local governments (the 91 departments and their 37,000 communes) through the authoritative powers of the Prefects have, in the words of John Ardagh in *The New French Revolution*, led to an uneasy balance of power between State and commune.

There are over 37,000 communes including numerous small villages and towns as well as cities such as Lyon and Marseille. Unlike the departments, they are real traditional entities, often with strong local pride. Each has a mayor and council, local men locally elected as in this country; but the mayor, once elected becomes a servant of the State, responsible to the Prefect. *The council's own budget, and many of its decisions, require formal approval by the Prefect*, who also has the right to suspend Mayor or councilors from office or take over some of their duties. The council derives its modest budget from local taxes and State subsidies, and spends it on local services and public works. This system depends on good relations between mayor and Prefect and there is no doubt that a wealthy commune with a good mayor can initiate a great deal if he has the Prefect's backing. But a great many local services, for which in Britain the council is autonomous, in France require the collaboration and aid of the relevant Ministry in Paris or of its local officials acting in liaison with the Prefect. For instance, the council has to pay for building new schools, *but the State runs them*. The same situation appears to be true of hospitals. Housing, highways and bridges, and larger civic projects are usually built or maintained jointly by the commune and the State, and though the commune can in some cases go ahead on its own, *it will rarely feel it has the money for the luxury of forgoing State aid*. Thus, according to Mr. Ardagh, the local governments are dependent on the endless delays and muddles of the bureaucratic Ministries, or on arbitrary last-minute budget cuts by the Ministry of Finance. Even worse, if a local government has demonstrated a political antagonism toward the central government, it may even face Government vengeance or blackmail.

Indeed, this practice is true to some degree in this nation as evidenced by the Federal government's ability to curtail grants and loans to states or municipalities who fail to observe certain sections of the Civil Rights Bill and as further evidenced by current threats to cut off Federal aid to universities and colleges who fail to prevent student disorders. Under recent urban bank and subsidy-in-lieu-of-tax exemption proposals, similar sanctions could be brought against local governments for a number of political and quasi-political reasons. Similarly, as is presently the case in France, states and local governments whose potential value to the party in power is significant might receive preferred treatment, particularly during a tight money situation when long queues for Federal assistance prevailed. In terms of the LTP and Allocation of Deductions provisions of the tax reform bill being studied by this Committee, the same danger exists since many communities, unable to pay inevitably higher interest rates on new bond issues, would find themselves at the mercy of the Federal government for grants and subsidies.

Under the French system described above, many local governments, continually under pressure from Paris, feel either powerless or resentful, and often will in turn block State projects for their area. In this country, states and municipalities feeling equally resentful at having their local bonds taxed, might well retaliate by invoking heavy local income taxes on Federal government paper and oppressive local property taxes on government installations located in their respective sub-divisions—if the "power to tax is the power to destroy," it can work both ways.

Turning again to the French situation, John Ardagh who we have referred to previously, makes these observations:

"On the level of the department, a locally elected council generally acts as a kind of enfeebled country council, with its own little budget for some services such as secondary roads, public assistance and drainage. It meets only twice a year, its budget has to be approved by the Ministry of the Interior, and in practice, it usually does what the Prefect tells it. It is elected on a 'rotten borough' basis, heavily weighted in favor of villages rather than towns, and its members are usually elderly. If rejuvenated, it would have the constitutional power to wield more influence than it does. As it is, people tend to forget about it.

"In terms of practical results, no less than of ideology, it is extremely hard to draw up a fair balance sheet of the present French system. Though a town with a vigorous mayor, like Rennes or Marseille, could certainly benefit from more autonomy on the English model, yet in an area like Caen or the Languedoc all the driving force and ideas seem to have come from the State; or rather, they come mainly from a few dynamic individuals, prefects or others, who are serving the State without necessarily sharing the Government's views. Though the Prefect is still the political servant of the Minister of the Interior, under modern conditions his daily functions are inevitably becoming more economic than political. Often his working relations even with anti-government mayors and communes are perfectly good whenever they share the same aims of progress and expansion."

We are told that the Prefects and mayors in fact are frequently victims of the same common enemy—a centralized State machine that despite some recent reforms is still too slow and bureaucratic for modern needs. This is one of today's two main problems of local government in France. The other is much more fundamental—a century and a half of State control over local affairs has sapped the spirit of civic initiative. Mr. Ardagh sums it up this way, "So long as the State nanny holds its children tight, they will not break their legs—but they will not learn to walk either, and they will not feel any incentive to try."

Time and space will not permit us to comprehensively evaluate the circumstances in numerous other foreign countries where the central government controls the financing of local government projects. We will, however, briefly summarize a few such situations wherein, in every case, a central bank or central grants and subsidies are employed in lieu of the tax-free bond concept that exists in this country.

Italy

Local government financing is virtually completely controlled by the central government in Italy. For example, in 1963, bonds of local authorities represented only 0.5 billion lire out of the 1,340 billion lire total net new securities. The most important source of credit for local governments' capital expenditures are the Treasury and the Cassa Depositi e Prestiti (Deposit and Loan Fund), a Treasury agency.

Recently, literally billions of lire have been appropriated by the Italian government for local schools, roads, hospitals and other public improvement purposes, but owing to an almost unbelievably complicated network of bureaucratic processes and red tape, it is doubtful that the first school will be constructed in the near future. Emilio Colombo, Minister of the Treasury, explains it this way:

"The intense expansion momentum that has taken place in our productive sector has made it possible to place a large and growing portion of resources at the State's disposition for the undertaking of the task of satisfying the demand, which is increasing continuously, in the vast sector of special services: schools, housing, hospitals, etc.

But while the political choices of expenditures have followed these indications, the technical capacity for spreading has not grown in the same proportion as that which we have succeeded in placing appropriations at the disposition of the various agencies. This is caused by the long itinerary that the Government's decision to spend must follow before it becomes effective. Along this itinerary there are the parliamentary discussions, the preparation of programs and the relative technical projects by the agency involved, the complex administrative procedures, continually more complicated, which become adopted through the laws, despite all the declarations in favor of simplification. A few examples: the law on school building was approved by the Government on December 22, 1965—it became law through publication in the Official Gazette on August 28, 1967. As yet nothing or practically nothing has been spent due to the length of time needed for parliamentary approval and due to the complex procedure that had been introduced into the law: the series of consultations and opinions by the peripheral and central committees have resulted in the fact that the abundant financial means appropriated for this purpose has still not been transformed into classrooms and school equipment."

New Zealand

New Zealand has an urbank facility known as the National Provident Fund. An article in the "New Zealand Herald" dated February 5, 1969, reads as follows:

"The New Zealand Minister of Finance, Mr. Muldoon, recently wrote to local authorities informing them that the availability of loan finance for the current financial year may be reduced. The Minister explained that the National Provident Fund might be able to finance only $NZ 52 million (US $58.2 million) of the nearly $NZ 93 million requested by local authorities for financing. This compares with estimates for the previous financial year, when requests amounted to $NZ 78 million and available funds to $NZ 50 million. The Minister explained that it was imperative that local authorities were aware of the tighter financial position. He explained that the relative ease of financing in the previous year was brought about by the improvement in the fluidity in the economy caused partly by the improvement in the balance of payments. An expected increase in economic activity in the current year would result in some tightening of the supply of loan finance, which would undoubtedly make raising loans difficult."

Netherlands

Because there was a shortage of funds on the capital market, the central government organized a system of centralized finance through the Bank for the Netherlands Municipalities (similar in concept to the proposed Urbank) which was begun to *supplement* municipalities' borrowing on the capital market but quickly evolved into one to *prevent* their borrowing on the capital market.

In addition to the ceiling which the central government placed on local government borrowing at times of cyclical pressures, local governments as of December, 1965, were forbidden to borrow on the market and were only allowed to go to the Bank for the Netherlands Municipalities for their capital expansion and improvements. This specialized credit institution acts as an intermediary to centralize demand from local government and satisfies it by refinancing on the capital market. The cost of the Bank's borrowing need not be reflected in the interest rates charged the municipalities—market factors determining the cost of financing have been replaced by central political decisions.

In short, the central government can control expenditures of the municipalities not only by limiting their overall borrowing and by dictating the terms of their financing, but by directly controlling individual projects. This, I suppose we could label "the foot in the door approach" wherein the central government, at a time when money was tight, offered the municipalities access to a central bank, then later demanded that they use *only* the central bank for *all* of their capital needs.

Conclusion

Because of the speed with which the House acted on the highly complex and comprehensive tax reform bill, little time was made available to us to prepare a more thorough discussion of centralized government financing as it relates to local independence and autonomy. Certain conclusions do appear to be valid, however: The growth of local government is associated in time with the development of the urban, industrial economy in the west. Serious observers of the European situation in recent years have related the strength of local government to economic potential in a very direct way and moreover have tended to equate strong local administrations with financial independence. Obviously, the existence of more than one sophisticated decisionmaking organization causes conflicts of interest, but these observers are advocating increasing the real independence of non-central governments as a means of helping reduce internal economic differentials.

The United States already has a system of local government with a tradition of independent action. Except when the system is having difficulty, many citizens are not fully aware of the complexities of local government operations. Nevertheless, if the recommendations of these foreign observers have merit, it may be that this system is among our significant national assets.

The tax exempt market as it now exists is an integral part of local government's financial independence. Any proposal to change the present state of affairs should be carefully evaluated in the light of foreign experience with other ways of doing things.

PREPARED STATEMENT OF JUDGE CONRAD FOWLER

GENERAL ASPECTS—NACO'S POSITION ON HR 13270

Mr. Chairman, Members of the Senate Finance Committee: My name is Judge Conrad Fowler, and I am here today as President of the National Association of Counties. I come before you on behalf of the National Association of Counties to formally express its firm belief that the House-passed bill, HR 13270, which would tax the interest on municipal bonds, would be extremely harmful, and, in fact, has already posed a tragic blow to effective local government. A resolution recently passed by 3,000 members of the Association at our annual meeting in July opposes, in unequivocal terms, *any* direct or indirect taxation of the interest on municipal bonds. The Congress has heard our very strong arguments on this "intergovernmental" subject before, and through the years, has for very good reasons rejected the various attempts to remove the tax exemption from municipal bonds. We urge you now to reject this latest, ill-conceived, quickly-enacted House proposal, so we can continue to proceed with the multitude of desperately needed and essential local programs and projects which depend on financing through municipal bonds—schools, hospitals, public housing, etc.

The National Association of Counties, after lengthy discussion and review of the problems growing out of the proposed tax on bond interest, believes that inclusion of the proposed tax has, and would, precipitate irreparable damage to the present municipal bond market.

The nation's 3,049 county governments and their 70,000 elected officials join a host of other organizations—states, cities, towns, authorities, special districts—in expressing their concern over the proposed tax on municipal bond interest. At its national conference last summer, the Governors' Conference affirmed the basic principle that "neither the Federal or State governments without mutual agreement have the authority to tax the other"—a subject which I will explore further. The Governors have already strongly opposed those aspects of the tentative House Ways and Means proposal which would impair the marketability of state and local securities and thus retard the provision of needed public services and facilities.

In our joint statement before the House Ways and Means Committee with the Mayors and Cities, Mayor Briley, our past president, referring to what is at stake for all of us at the local level, said, "The issues go to the heart of the ability of the three levels of government to co-exist and function effectively in our federal system."

The impact of these tax proposals is already significantly affecting efforts to borrow necessary monies for critical local projects across the nation. Interest rates on new obnd issues are exorbitantly high on many issues, and bids from investors have just not been forthcoming. We feel strongly that new action which, directly or indirectly, taxes interest on local government bonds would precipitate fiscal disaster for county government. The size of the new issue market in local government financing is shrinking as officials postpone or cancel bond sales because of the progressive deterioration of the market. Senators, this is really a most serious situation for us.

As long as the tax bill remains a matter of debate in Congress, foreshadowing a possible tax on the bond interest, which if enacted would precipitate an extensive constitutional battle in the courts, the market for municipal securities remains uncertain. The problem is more costly for us than for you. One reliable bond counsel argues strongly that a rise of about $300 million in the borrowing costs to State and local governments over the past four months is traceable to a large extent, perhaps as much as 60%, to the adverse market implications due to the House of Representatives discussion and treatment of this issue.

In Alabama, and I know in many other states, local government construction of schools, hospitals, streets, bridges, airports, and other vitally needed public projects is already vastly more difficult. In some states, it is impossible. The information our Association is now receiving from its membership indicates that areas with local credit ratings, or with unrated credit, or with statutory or constitutional interest limits are not able to borrow at all. Local public financing is dead in those states. In the final analysis, then, it will be the local property taxpaying public which will have to bear a significantly increased burden for local projects with increased or new tax programs, or suffer without needed public facilities.

It is particularly crucial at this time to sustain at least a moderate level of public services and facilities. The inevitable result of taxing municipal bond interest will be a substantial curtailment in scheduled public construction of projects vitally needed on the State and local level. New and higher taxes will be required. Unfortunately, because of the relatively regressive nature of such taxes, particularly real property and sales taxes, they will fall most heavily on the average working man. Chances are most probable that many who are employed in construction industries—and related trades—will be without work if there is a cutback in scheduled public construction due to the higher interest rate which could result from passage of the pending tax legislation as well as the federal cutback in construction.

Gentlemen, it seems clear to us that the House taxes on state and local bonds are wrong on many other counts as well. We feel that they are economically unsound, and they would obtain for the Federal government a comparatively insignificant tax return—amounting at most to $80 million a year. In doing so, they further threaten the fiscal integrity of local government. We cannot overemphasize this enough. The key issue largely remains the financial independence of local government.

As this Committee well knows, the President and this Administration are seeking to bolster, where possible, the responsiveness and responsibility of the states and local governments. If the states, counties, and cities are to have the real capacity to experiment and innovate, sufficient methods of financing, especially the effective use of tax exempt municipal bonds, must be kept available.

There is, then, a need to strengthen, not weaken, the fiscal process by which local governments respond to the needs of their citizens in finding a better, fuller way of life.

The demand for physical facilities at the state and local level is overwhelming and unprecedented. There is a backlog on the books over the nation of almost $8 billion in demand for water-sewer construction alone. The public housing programs and the Administration's plans for 500,000 units of low-cost housing are placing an additional burden on our tax-exempt market. Other federally stimulated programs include such other expensive areas as mass transit, airport development, pure waters, and health and mental health facilities construction. These, too, require a substantial outlay of local funds. This is in addition to the unprecedented need for more traditional local functions—city streets, schools, hospitals, correction facilities, etc.

I want, as others will do or have done, to comment in broad terms briefly on the constitutional aspects related to the proposal to tax interest on municipal securities. As one who has had a long interest in this issue, I believe that the proposed tax, as proposed by the House or the Treasury, is clearly unconstitutional. The body of our law supports this now, as does the thinking of many outstanding legal minds in our nation. Under the Constitution, the doctrine of reciprocal tax immunity is implicity, and is a bulwark of our federal system dating back to *McCullouch* v. *Maryland*. If the benefits of tax exemption are abrogated, and disaster follows, we might as well deliver to the Federal government full control over the determination of vital public projects in our home localities. This is totally against what we need to do in this country at this time in our history.

Let us also not forget that everyone purchasing an exempt security pays a tax to the issuing government, since he accepts a lower interest rate compared to other more lucrative securities available to the investor.

In conclusion, Gentlemen, I would like to reaffirm that the very heart of our democratic process lies in how well we—the local governments of this nation—function as responsive servants of our citizens. We have been criticized for years for not doing enough, and now with the concept of new federalism perhaps forthcoming, we find ourselves stymied. This is the prime issue, and its resolution will not be helped by these new tax proposals. The magnitude of our local financial requirements in the years ahead will be tremendous. Living as we do in a society which demands more and better local services, the financial crisis confronting local governmental units becomes enormous. It becomes discouraging to those elected local officials who carry the burden of providing the wherewithal for necessary local public programs. Every year record levels of expenditure by local governments are reached, and the end is not in sight.

The proposals to tax the municipal bonds are major obstacles to our continuing effort to serve the local community, the State, and our Nation. In sum, the tax on municipal bond interest produces more problems than solutions for the Federal as well as the local governments.

Judge FOWLER. Now then, may I present, sir, Mr. William Conner? He is a county executive of New Castle County, Del. He is an officer in the National Association of Counties. Thank you.

STATEMENT OF WILLIAM CONNER, COUNTY EXECUTIVE, NEW CASTLE COUNTY, DEL.

Mr. CONNER. Mr. Chairman, and members of the committee, I am appearing today as vice president of the National Association of Counties and on behalf of Delaware local government. I can't overemphasize the importance that county officials across the country attach to this issue or the concern that all local officials of my State feel with regard to these provisions of H.R. 13270 that would tax the interest on municipal bonds.

Clearly, taxation of this interest, while initially beguiling to would-be tax reformers, will inevitably expose our Nation to a series of traumatic economic shocks during the years ahead. In brief, it is our considered opinion that taxing the interest on local bonds through limited tax preference and allocation of deductions strikes at the very keystone of financing State, county, and municipal government; it poses serious challenges to our federal system; it will adversely affect construction employment through the stoppage of essential public works; and most importantly, and unemphasized by many, if this same tax had been applied to the $16 billion of State and local bonds issued in 1968, those governments' local taxpayers would have a liability to pay over $12 billion of additional interest costs during the life of 20-year bonds.

That is figuring it, Mr. Chairman, at the rate of 1 percent, and if the increase in interest costs had been 2 percent the increased costs of the interest on those bonds would have been almost $4½ billion.

This would raise local taxes and rents for millions of citizens throughout our land.

These are estimates that we would like to report to you.

Our National Association of Counties has consistently opposed taxation on local bond interest, for its members across this land know only too well that such a tax would do more than clog county finances; it might completely stop us from capital financing as has already occurred in some States. Our counties are a key element in the overall pattern of local government finance. They account for one-fifth of all government expenditures in the United States and participate importantly in the $16 billion issued annually in the municipal bond market. This market had been growing steadily; the 1968 issuances were 60 percent higher than 1963's, 10 percent a year average. Counties have a current outstanding debt of $16 billion themselves, and the rate of increase even exceeds that of our Nation's cities.

Unfortunately for counties across the Nation, since "tax reform" became a popular byword in 1968, the municipal bond market has been under a cloud, the turbulence of which is gathering force as each day passes. The possibility of lost tax exemption has increased interest rates to the point where many local government bond issues have been rejected, postponed, or have not received bids on going to market. During the past 11 months, throughout the Nation, some 316 bond issues bearing a valuation of nearly $2 billion have struck out with investors as unremunerative, or have been placed in abeyance by the various potential issuing agencies, and this tempo is increasing.

My prepared testimony shows you how this has worked out in Lousiana which has fallen off by two-thirds. In Tennessee where only one-sixth as many bonds have been issued this year as opposed to last. In Iowa, sales are off by one-third. Counties, joined by the States and cities, are having great difficulty in funding rising capital costs. Interest rates are now in the neighborhood of 6½ percent, two full points higher than offered as recently as a year ago. We are having to have emergency legislation to allow the interest rates to rise in some States, and in some States they can't even do that until the constitution is amended, it is even tougher.

This bleak outlook for county government comes at a time when counties are faced with an expansion into functions and service areas once cnsidered the exclusive province of municipalities—such fields as hospitals, health services, utility systems, airports, libraries, and so on.

We have been called upon by Members of Congress and many others to awaken to the urban challenge in our county governments and now we find ourselves being discouraged from acting to meet this challenge by the proposal that stands before you today.

Let me speak just a moment about my home State of Delaware. In my own county of New Castle, Del., bond financing for capital projects between 1968 and 1975 will exceed $56 million. If the interest rate should rise 2 percent because bonds are made taxable, New Castle County will pay an additional $15 million over the life of these $56 million worth of bonds and we need them for all kinds of purposes for varying lengths of time and we just can't afford that kind of an increase in cost.

Let's take a brief look on the impact on the State of Delaware and its finances. A 5-year projection of its capital requirements indicates that it will need to sell approximately $300 million worth of bonds. As a result of the rise in interest rates since the beginning of the year in the neighborhood of 1 percent the taxpayers of Delaware will have to pay $47 million more to support this debt than if this cloud had not been placed on the market. If the differential in the rates reaches 2 percent then the added cost to Delaware taxpayers becomes $86,003,000 worth of bonds.

So we are certainly in sympathy with the widespread desire to see nontaxpayers in the higher brackets pay their fair share. However, tax reformers make a big mistake when they try to establish a direct relationship between tax-exempt bonds issued by local governments and the few rich men who pay little or no Federal income tax. I cannot overemphasize this. No no has told me or you how many of our bonds are held by these so-called millionaires.

The taxing of interest on government bonds issued not only in the future, but in the past as well, is unwise and imprudent at any time, but I submit the fall of 1969 is a particularly inappropriate time to tamper with traditional Federal-State tax relationships. High-interest rates and inflation are twin problems of all our constituencies across the Nation. Clearly, a so-called tax reform measure that exacerbates the average person's fight against the high cost of living is certain to be a most unpopular one, to say the least.

I would like to close by saying that it seems to me that in the name of tax reform and an attempt to close loopholes affecting a few hundred people, we are imposing increased financial burdens on millions of small taxpayers and seriously impairing the efforts that have been made in intergovernmental relationships to increase local responsibility and ability to finance local projects.

I would like to call the committee's attention to the lead article in this morning's Wall Street Journal which certainly spells out very clearly the nature of our concern, and also on the editorial page of that publication a very interesting article by Harry Lutz, professor emeritus of public finance at Princeton, who makes this very brief comment on our subject:

> Final treatment of state and municipal bond interest to be neat and tidy should await Supreme Court determination. The split level approach in the House bill is neither neat nor tidy.

(William Conner's prepared statement follows:)

Prepared Statement of William Conner

IMPACT OF LTP AND ADR ON COUNTY GOVERNMENT

Mr. Chairman, Members of the Senate Finance Committee: I am William Conner, County Executive of New Castle County, Delaware. I appear today as a Vice President of the National Association of Counties, and on behalf of Delaware local government. I cannot over-emphasize the importance that county officials across the country attach to this issue or the concern that all local officials of my state feel with regard to these provisions of HR 13270 that would tax the interest on municipal bonds.

Clearly, taxation of this interest, while initially beguiling to would-be tax reformers, will inevitably expose our nation to a series of traumatic economic shocks during the years ahead. In brief, it is our considered opinion that taxing the interest on local bonds through limited tax preference and allocation of deductions strikes at the very keystone of financing state, county, and municipal government; it poses serious challenges to our federal system; it will adversely affect construction employment through the stoppage of essential public works; and most importantly, and unemphasized by many, if this same tax had been applied to the $16 billion of State and local bonds issued in 1968, those governments' local taxpayers would have a liability to pay over $2 *Billion* of additional interest costs during the life of 20 years BONDS! This is startling but conservative. It will raise local taxes and rents for millions of citizens throughout our land. These are estimates that we are reporting to you.

We hope you will consider the thinking of Mr. Justice Cardozo, who said in interpreting the landmark decision in the Federal-State tax field, the *Pollack* case of 1894, "an income tax, if made to cover the interest on government bonds, is a clog upon the borrowing power such as was condemned in *McCulloch v. Maryland*." Also see *Hale v. Iowa State Board*, 302 U.S. 95, 107 (1937).

The National Association of Counties has consistently opposed taxation on local bond interest, for its members across this land know only too well that such a tax would do more than clog county finances; it might completely stop us from capital financing as has already occurred in some states.

Storm warnings are already up in the listening posts of the municipal bond market. Ever since the House began consideration of this package, the interest rate has moved steadily up at a frightful cost to county and other local governmental units throughout the 50 states, and is now almost one full percentage point over the level which would normally be expected at this time.

Counties are a key element in the over-all pattern of local government finance. They account for one-fifth of all government expenditures in the United States and participate importantly in the $16 billion issued *annually* in the municipal bond market. This market had been growing steadily; the 1968 issuances were 60% higher than 1963's (10% a year average). Counties have a current outstanding debt of $16 billion themselves, and the rate of increase even exceeds that of our Nation's cities.

Unfortunately for counties across the nation, since "tax reform" became a popular by-word in 1968, the municipal bond market has been under a cloud, the turbulence of which is gathering force as each day passes. The possibility of lost tax exemption has increased interest rates to the point where many local government bond issues have been rejected, postponed, or have not received bids on going to market. During the past eleven months, throughout the nation, some 316 bond issues bearing a valuation of nearly $2 billion have struck out with investors as unremunerative, or have been placed in abeyance by the various potential issuing agencies. That the tempo of such rejections is increasing can be seen from the January through August attrition in sales of local bonds. During the first two-thirds of 1969, there was a sharp fall-off of $2½ billion, representing a drop from $10½ billion to slightly less than $8 billion.

In Louisiana, bond sales this year are only 35% of those a year ago, recording a fall-off from $75 million to $26 million. Tennessee also has been having a difficult time with its bonds. So far during 1969, that state has marketed only one-sixth of the value of bonds it sold last year—a reduction from $85 million to $14 million. Iowa has also felt the impact of rising interest and investor disenchantment, since its sales are off by one-third. With but few exceptions, the story is the same throughout the country. The national financial outlook at the state, county, and city level is bleak, indeed, with the various implications of HR 13270 largely responsible.

Counties, joined by the states and cities, are having great difficulty in funding rising capital costs. Interest rates are now in the neighborhood of 6½%, two full points higher than offered as recently as a year ago. Emergency legislation is being enacted in many of these states to keep borrowing capability abreast of the surging rates. Obviously, those states where the ceiling was as low as 5% have not floated an issue for some time, and even those with new 7% levels may have to resort to still another increase. In some states, it is impossible to finance new facilities until the state constitution is amended.

This bleak outlook for county government comes at a time when counties are faced with an expansion into functions and service areas once considered the exclusive province of municipalities—such fields as hospitals, health services, utility systems, airports, libraries, and outdoor recreation. Entirely new areas of county governmental responsibility, engendered by new federal and state statutory programs, present further fiscal difficulties. Such pressing problems as water and air pollution control, waste disposal, and highway safety are very much county problems. Counties have been awakened to the urban challenge, only to find themselves being discouraged from acting to meet it by the same Congress which promised to help.

In my own County of New Castle, Delaware, bond financing for capital projects between 1968 and 1975 will exceed $56 million. With an expected increase in the interest rate, New Castle will pay an additional $7 million in interest over the life of just these $56 million of bonds. We need over $16 million for sewer construction during this seven-year period, and over $9 million to solve overflooding problems by storm water drainage projects. Also included in the $56 million is $12 million for an addition to our water supply through the construction of a reservoir. So you can see, Gentlemen, the impact on even a smaller county can be and will be great.

A significantly increased tax burden is going to hit local taxpayers as a result of these proposed measures. In fact, by the fifth year after enactment of the application of the allocation of deductions rule, local taxpayers would be paying about ten times the sum garnered by the U.S. Treasury.

The widespread desire to see non-taxpayers in the highest brackets pay their fair share is understandable. However, the tax reformers are making a big mistake when they attempt to establish a direct relationship between the tax-exempt bonds issued by local governments, and a few rich men who pay little or no federal income tax. I cannot over-emphasize this. No one has told me, or you, how many of our bonds are held by the so-called millionaires.

Taxing interest of local bonds issued not only in the future, but in the past as well, is unwise and imprudent at any time, but I submit the fall of 1969 is an exceedingly untimely period to tamper with traditional federal-state tax relationships. High interest rates and inflation are twin problems of all our constituencies across the nation. Clearly, a so-called tax reform measure that exacerbates the average person's fight against the high cost of living is certain to be a most unpopular one, to say the least.

With regard to the proposed alternative to the current method of capital financing, our citizens will be greatly concerned over the increased power granted the Federal government under the proposed subsidy plan. It is wholly unrealistic to expect the Federal government to make substantial subsidies available to local governments to finance, on a taxable basis, all kinds of local capital improvements, without exercising some control over which subjects warrant the subsidies. I cannot conceive that this Congress would approve a blanket authority to all local governments to authorize projects at their own discretion if it involves substantial sums of money.

It seems to me that in the name of tax reform and an attempt to close loopholes affecting a few hundred people, we are imposing increased financial burdens on millions of small taxpayers and seriously impairing the efforts that have been made in intergovernmental relationships to increase local responsibility and ability to finance local projects.

The CHAIRMAN. I thank you for your courtesy, and I would like to introduce our next witness, Mr. Brewer, the chairman of the Board of Supervisors, Kent County, Mich.

STATEMENT OF JOHN BREWER, CHAIRMAN, BOARD OF SUPERVISORS, KENT COUNTY, MICH.

Mr. BREWER. Thank you.

Mr. Chairman, and members of the Senate committee, I appear here today speaking as chairman of the Taxation and Finance Committee for the National Association of Counties for the Michigan Association of Counties.

The State of Michigan and its subordinate units of government—cities, counties, and school districts—issued in 1968, $694 million in municipal bonds and in 1970, they expect to issue $839 million. The county of Kent and its subordinate units of government within the county has a State equalized valuation of one and a half billion dollars and a total bonded indebtedness of approximately $121 billion.

The citizens of Kent County, Mich., have already been adversely affected by the bill before you. At this moment our county has some very real requirements for increased water lines, storm drains and expanded sewerage disposal systems. This is rather typical of the counties across the country. However, when Kent County, whose bonds have been rated double A and triple A, wished to sell bonds recently to finance these projects, we were turned down. There were no buyers, despite stated interest rates of 5½ percent to 6 percent—the highest permitted by our constitution. These projects are now being held in abeyance while we consider the next move. The citizens are waiting—not happy.

For those who have no maximum ceiling on bond interest as we do in Michigan, the interest on tax-exempt bonds has already jumped to record levels merely since this legislation was proposed. Like Kent County, many States and local governments cannot even attract bids for their bond issues—and their projects are at a standstill, unable to move ahead. Houston, Tex.; Jefferson Parish, La.; Hawaii; Jacksonville, Fla.; New London, Conn., are only a few unable to sell their bonds.

I will now try to contain my remarks to talk briefly about the alternative so-called subsidy approaches which have been proposed in this legislation.

The House-passed bill provides alternative capital financing approaches which would provide a somewhat automatic, but variable, Federal interest payment to those local governments which waive their tax exemption. State and local governments that voluntarily elect to issue taxable bonds could automatically become eligible for an interest payment, the amount of which would be governed by the difference between the yields on outstanding tax-exempt bonds and comparable taxable issues.

Several problems exist with the legislation before you. The first of these problems revolves around who will determine the difference in taxable versus tax-exempt yields. The bill gives the authority directly to the Treasury Department and, in addition to having wide discretion with respect to setting regulations and conditions for the payments, the Treasury also has the authority to vary their amount.

In fact, the "subsidy" plan gives State and local government no real options. The choice is to issue partially taxed bonds without a "subsidy" or fully taxable bonds with it, when the bonds are now fully exempt from tax.

Moreover, municipalities cannot exercise the "option" to issue taxable bonds since they have no power to trade away their immunity from taxation which inheres in the sovereignty of their parent States. Certainly Congress cannot grant them this power.

The crucial flow in the "subsidy" is, of course, its ephemerality. There is simply nothing to prevent Congress from curtailing, or indeed eliminating it at any time. The program would be a tool for further Federal fiscal control over internal State and local affairs.

None of these "subsidy" proposals present any real alternative to the present tax-exempt system. Certainly none of them can be accepted when offered in tandem with "limited tax preference" or "allocation of deductions" proposals, which, in effect, destroy any option to disregard them.

We should like to make this point very clear. If any form of a subsidy is ever to be acceptable to county government, it must be allowed to operate as an optional alternative and not under the pressures of present tax reform proposals upon our present market.

Once Congress acts to tax the interest on our bonds, either by an allocation of deductions rule or by the limit on tax preference formula, and with the resulting chaos expected from a constitutional test, there is a danger we might very well be forced economically into accepting a subsidy. Our bonds would be competing with high grade corporates and this very competition alone in a presently rising market would raise the yield that would have to be paid on taxable municipals to about 9 or 9½ percent. And the rising interest would, of course, increase the amount of Federal subsidy required to attract municipalities, counties, and States into the taxable bond field.

A word of caution would be appropriate at this point. If Congress did provide a permanent and unrestricted appropriation to subsidize through taxable bonds——

Senator ANDERSON. Will you repeat that 9 and 9½ percent?

Mr. BREWER. Yes, sir.

Our bonds would be competing with high grade corporates and this very competition alone in a presently rising market would raise the yield that would have to be paid on taxable municipals to about 9 or 9½ percent.

What I was saying, Senator, is if the bonds were taxable the rate would go to 9 and 9½ percent in today's market.

The CHAIRMAN. Proceed.

Mr. BREWER. If Congress did provide a permanent and unrestricted appropriation to subsidize through taxable bonds the projects of state and local governments throughout the Nation, the level of subsidy would be immense.

For example, if we assume that one-half of last year's $16 billion bond market were financed by taxable securities rather than the tax-exempt securities, and taking into account a conservative subsidy of say the difference between 6 percent tax-exempt and 9 percent taxable bonds, it has been estimated the Treasury would be paying out $250 million worth of interest subsidy cost every year. This could generate a possible revenue loss (not a tax gain) to the Federal Government in the subsidy process, and if this were so, we fear that it would not be long before restrictions and further Federal control would be imposed to somehow restrict the amount of projects qualifying for subsidy.

If any capital financing alternatives are to meet the test, they must be justified by their value to State and local governments, as well as their effect on Federal programs. The climate created by tax reform is definitely no place to scrutinize the immense impact of any capital financing proposal on our markets, particularly the ill-considered House-passed subsidy. Capital financing alternatives should not be developed as an instrument of tax reform.

We therefore urge that the question of subsidy be removed from the emotional context of the tax reform, and be the subject of further hearings, including awaiting the results of the very significant study being conducted by the Advisory Commission on Intergovernmental Relations.

(Hon. John Brewer's prepared statement follows:)

PREPARED STATEMENT OF JOHN BREWER

ALTERNATIVE FINANCING METHODS—THE "SUBSIDY" PROPOSAL IN HB 13270

My name is John Brewer and I am Chairman of the Board of Supervisors, Kent County, Michigan. I am speaking here today as Chairman of the Taxation and Finance Committee of the National Association of Counties and for the Michigan Association of Counties.

This is a critical hearing because, as my colleagues who preceeded me have demonstrated, unless the sections jeopardizing tax-exempt bonds are deleted from the proposed act, the financial capabilities of states, counties and municipalities throughout the country will be permanently damaged, essential projects necessary for the welfare of our citizens will be delayed or cancelled, and the already staggering tax burden placed on our citizens will be further increased.

The State of Michigan and its subordinate units of government: cities, counties and school districts, issued in 1968 $694 million in municipal bonds and in 1970 they expect to issue $839 million. The County of Kent and its subordinate units of government within the County has a state equalized valuation of one and a half billion dollars and a total bonded indebtedness of approximately $121,000,000,000.

The citizens of Kent County, Michigan have already been adversely affected by the bill before you. At this moment our county has some very real requirements for increased water lines, storm drains and expanded sewerage disposal systems. This is rather typical of the counties across the country. However, when Kent County, whose bonds have been rated double A and triple A, wished to sell bonds recently to finance these projects, we were turned down. There were no buyers, despite stated interest rate of 5½% to 6%—the highest permitted by our Constitution. These projects are now being held in abeyance while we consider the next move. The citizens are waiting—not happy.

For those who have no maximum ceiling on bond interest as we do in Michigan, the interest on tax-exempt bonds has already jumped to record levels merely since this legislation was proposed. Like Kent County, many states and local governments cannot even attract bids for their bond issues—and their projects are at a standstill, unable to move ahead. Houston, Texas; Jefferson Parish, Louisiana; Hawaii; Jacksonville, Florida; New London, Connecticut, are only a few unable to sell their bonds.

We have head here today numerous adverse impacts that the "limit on tax preference" and "allocation of deductions" proposals have had and will have on the citizens of state and local governments alike. I should like to talk briefly about alternative so-called "subsidy" approaches which have been proposed.

The House-passed bill provides alternative capital financing approaches which would provide a somewhat automatic, but variable, federal interest payment to those local governments which waive their tax exemption. State and local governments that voluntarily elect to issue taxable bonds could automatically become eligible for an interest payment, the amount of which would be governed by the difference between the yields on outstanding tax-exempt bonds and comparable taxable issues.

Several fatal problems exist with the legislation before you. The first of these problems revolves around who will determine the difference in taxable versus tax-exempt yields. The bill gives the authority directly to the Treasury Department and, in addition, allows it to vary the "subsidy" from 25% to 40%. Thus, in addition to having wide discretion with respect to setting regulations and conditions for the payments, the Treasury also has the authority to vary their amount.

In fact the "subsidy" plan gives state and local government no real options. The choice is to issue partially taxed bonds without a "subsidy" or fully taxable bonds with it, when the bonds are now fully exempt from tax.

Moreover, municipalities cannot exercise the "option" to issue taxable bonds since they have no power to trade away their immunity from taxation which inheres in the sovereignty of their parent states. Certainly Congress cannot grant them this power.

The crucial flaw in the "subsidy" is, of course, its ephemerality. There is simply nothing to prevent Congress from curtailing, or indeed eliminating it at any time. The program would be a tool for further federal fiscal control over internal state and local affairs.

None of these "subsidy" proposals present any real alternative to the present tax-exempt system. Certainly, none of them can be when offered in tandem with "limited tax preference" or "allocation of deductions" proposals, which, in effect, destroy any option to disregard them.

We should like to make this point very clear. If any form of a subsidy is ever to be acceptable to county government, it must be allowed to operate as an *optional* alternative and not under the pressures of present tax reform proposals upon our present market.

Once Congress acts to tax the interest on our bonds, either by an allocation of deductions rule or by the limit on tax preference formula, and with the resulting chaos expected from a constitutional test, there is a danger we might very well be forced economically into accepting a subsidy. Our bonds would be competing with high grade corporates and this very competition alone in a presently rising market would raise the yield that would have to be paid on taxable municipals to about 9%or 9½%. And the rising interest would, of course, increase the amount of federal subsidy required to attract municipalities, counties and states into the taxable bond field.

A word of caution would be appropriate at this point. If Congress did provide a permanent and unrestricted appropriation to subsidize through taxable bonds the projects of states and local governments throughout the nation, the level of subsidy would be immense.

For example, if we assume that one-half of last year's $16 billion bond market were financed by taxable securities rather than the tax-exempt securities, and taking into account a conservative subsidy of say the difference between 6% tax-exempt and 9% taxable bonds, it has been estimated the Treasury would be paying out $250 million worth of interest subsidy cost every year. This could generate a possible revenue *loss* (not a tax gain) to the Federal government in the subsidy process, and if this were so, we fear that it would not be long before restrictions and further federal control would be imposed to somehow restrict the amount of projects qualifying for subsidy.

Obviously, there are serious disadvantages to the proposals on tax-exempt bonds as set forth in the bill. We are talking here about a $130 billion bond market growing, until last February, at a rate of more than 10% a year. Yet there has been very little substantive review of the potential impact the bill has on so sizable and important a market. The present lack of information as to the marketability of a taxable municipal and its effect on the tax-exempt and taxable markets requires that this matter be given far more study.

If any capital financing alternatives are to meet the test, they must be justified by their value to state and local governments, as well as ther effect on federal programs. The climate created by tax reform is definitely no place to scrutinize the immense impact of any capital financing proposal on our markets, particularly the ill-considered House-passed subsidy. Capital financing alternatives should *not* be developed as an instrument of tax reform. We therefore urge that the question of subsidy be removed from the emotional context of the tax reform, and be the subject of further hearings, including awaiting the results of the very significant study being conducted by the Advisory Commission on Intergovernmental Relations.

Mr. Brewer. I thank you for the privilege of being here and I would like to now introduce George Long, from the Virginia Association of Counties and chairman of the National Conference of Executives of State Associations of Counties.

Thank you.

STATEMENT OF GEORGE R. LONG, EXECUTIVE DIRECTOR, VIRGINIA ASSOCIATION OF COUNTIES

Mr. Long. Mr. Chairman, and members of the committee, I am George R. Long, and I am the executive director of the Virginia Association of Counties whose membership embraces 93 of the 96 counties of Virginia. I am also chairman of the National Conference of Executives of State Associations of Counties whose members are the executives of associations of counties in 46 of the 50 States of the United States and, may I say, Mr. Chairman, I am happy to be here to see the Longs doing so well.

The Chairman. I suspect that you might find somewhere a couple of hundred years ago we might have some kinship. There was a Dr. Long, I think he was sort of a sawdust preacher who operated in southern Maryland and Virginia about a couple of hundred years ago, and after a while he moved on. Some people in the family seem to have thought he got into some sort of a controversy with some of the congregation and he finally wound up in Louisiana and I think you may find we are some 50th yet cousins or some such thing.

Mr. Long. I think that is correct, sir. I appreciate the opportunity to appear before you and to present the critical position of Virginia and other county governments in the bond market as a result of the consideration by the Congress to tax interest accruing on local government bonds. Please note that the discussion pertains primarily to what has already occurred and does not treat what is likely to occur if the proposal for such taxation is enacted into law. Virginia's position is described here because it is that State with which I am most familiar; however, the position of Virginia is parallel to the position of every other State.

To set the State, Virginia's Public Finance Act of 1958, is typical of legislation of other States in providing that any county may issue bonds to obtain revenues for capital construction projects. The statute establishes a Commission on Local Debt to aid and assist local governments in the issuance and sale of bonds, and it sets certain standards and specifications with which the issuing jurisdiction must comply. One of the specifications is that the bonds shall not bear an interest rate of more than 6 percent per annum. Such ceilings on interest rates as you know, are set by legislatures the local taxpayers from the additional costs of higher interest rates. Until very recently such limitations have served Virginia and other States quite effectively in obtaining the most advantageous financing of State and local public construction.

In order to allow local governments to let contracts and commence construction on capital projects without delay, Virginia's Public Finance Act also provides for the negotiation of temporary loans in anticipation of revenues from bond issues. Three restrictions are placed on the county government in negotiating such loans: (1) the revenues obtained from the temporary loan must be used for the purpose for which the bonds were issued; (2) the amount of the loan may not exceed the maximum authorized amount of the bond issue; and (3) such loans shall mature and be paid within 2 years from the date of issue of the original loan.

Against this background of standards and arrangements, your attention is directed to the position of Virginia local governments in the bond market. When the Ways and Means Committee of the U.S. House of Representatives began seriously to consider the proposal to tax State and local government bond interest, interest rates in the bond market rose immediately. The competitive position of Virginia's local government in the bond market began to deteriorate and has continued to deteriorate to this date. When the interest rate on local government bonds soared about 6 percent, even before the passage or enactment of the proposal, Virginia local governments were barred from the bond market.

We made remarkable construction progress in Virginia county government in recent years. Note that 3 years ago we floated some $19 million worth of bonds. The following year we floated $40 million worth of bonds, the year following that, the last year for which information is available, we floated $56 million worth of bonds, of the $441,131,000 amount of bonded indebtedness, $295,396,000 of it was for public school construction.

I want to point out I have in my hand here a copy of the minutes of Montgomery County's Board of Supervisors in which they propose $7,500,000 worth of bonds to construct two high schools and two elementary schools and make additions for other schools badly in need which they will not be able to sell on September 30, the date for which the bids were invited.

Now, the Virginia Association of Counties in view of this situation canvassed all 96 Virginia counties to determine precisely what the impact of the increase of the interest rate on general obligation and revenue bonds had been on each county. Returns were received from 80 counties of which 35 revealed plans for issuing bonds during a period beginning 6 months ago and extending into the future.

Attached as table I herewith is a summary of the information received from the canvass of the Virginia counties. Note that due to Virginia's city-county separation none of the data applies to any city in Virginia and the bonded indebtedness and the rate at which we issue bonds is about equal between cities and counties.

Thus the data pertains only to counties, only that part of Virginia which lies outside the boundaries of a Virginia city.

The canvass shows in the past 6 months Virginia counties have issued $25,200,000 in county bonds. Of this amount, $17,200,000 was issued by the rapidly growing, most populous Fairfax County just across the Potomac River in Virginia. And not only has difficulty been encountered in marketing this $25,200,000 but during the period preceding the last 6 months $19,280,000 were all sold for a total of $44,480,000 with which there has been difficulty in marketing and some have not been sold.

Now, further, there are outstanding temporary loans in anticipation of bond revenues of $14 million, some of which have matured, payment is due, and the county has defaulted on the loan and those which are not in that position soon will be because the 2-year period contained in the statute will soon be up and there is no possibility of the county selling the bonds in order to pay the loans negotiated in anticipation of revenue. One county has been in default for some 3 months now on a similar type of arrangement, and in recent weeks only two bond issues have been sold and they have been sold wholly with interest rates of 5.9 and 5.99, and in one of these the loan was spread among several banks in order to share the risk.

Now, the canvass reveals that Virginia counties continue to progress and had plans for issuing $139,310,000 in bonds in the immediate future. A majority of these bond revenues were to be used to construct and replace needed school buildings and facilities in Virginia counties. The second large portion of the bond funds was planned for construction of water and sewer facilities to stem the pollution of Virginia's streams and provide adequate, safe facilities for growth and development in the State and to cooperate with the Federal Government in cleaning up the streams of the Nation.

In summary, the impact of the consideration let me repeat, just the consideration, not the enactment, to tax the interest accruing from State and Government bonds along with the statutory interest rate has worked to remove local government bonds of Virginia, and nearly all States, from the bond market. The removal of such bonds from the market resulting in the reduction in volume offered is reflected in the slight decline in average interest rates in the past 3 weeks. The latest advice is that new issues are selling at the highest rate.

The counties across the country agree with the Virginia counties that it is not the intent of this Congress to stem progress in county government across the Nation. But, in effect, this is what has occurred. Nor do the counties believe that the Congress intends to increase State and local taxes upon those taxpayers whom it is seeking to relieve. But that is what the enactment of the proposal to tax the interest of State and local bonds would do.

Thus, the counties urge that action be taken by the committee to delete promptly the proposal to tax State and local government bond interest in House Bill 13270 known as the tax reform bill. Gentlemen, if it is at all possible that the provision could be separated from the bill and defeat it immediately this is what we would recommend, and return the bond market in a condition of stability. Let progress not be hindered further. Let us resume the task of solving the problems before us. Let us not compromise the obligations of local governments to pay their debts as they have contracted to do in good faith in their bonds. And, gentlemen, we say we are against LTP, we are against ADR, we are against any tampering with the bond situation as it exists at the present time.

I thank you.

(George Long's prepared statement follows:)

Prepared Statement of George Long

ADVERSE EFFECTS OF H.R. 13270 ON THE COUNTIES OF VIRGINIA

Mr. Chairman and Members of the Senate Finance Committee: My name is George R. Long, and I am the Executive Director of the Virginia Association of Counties whose membership embraces 93 of the 96 counties of Virginia. I am also Chairman of the National Conference of Executives of State Associations of Counties whose members are the excutives of associations of counties in 46 of the 50 states of the United States.

I appreciate the opportunity to appear before you and to present the critical position of Virginia and other county governments in the bond market as a result of the *consideration* by the Congress to tax interest accruing on local government bonds. Please note that the discussion pertains primarily *to what has already occurred* and does not treat what is likely to occur if the proposal for such taxation is enacted into law. Virginia's position is described here because it is that state with which I am most familiar; however, the position of Virginia is parallel to the position of every other state.

To set the stage, Virginia's Public Finance Act of 1958, is typical of legislation of other states in providing that any county may issue bonds to obtain revenues for capital construction projects. The statute establishes a Commission on Local Debt to aid and assist local governments in the issuance and sale of bond, and it sets certain standards and specifications with which the issuing jurisdiction must comply. One of the specifications is that the *bonds shall not bear an interest rate of more than 6% per annum.* (Code of Virginia (1950), Sec. 15.1-200.) Such ceilings on interest rates are set by state legislatures to protect the local taxpayers from the additional costs of higher interest rates. Until very recently such limitations have served Virginia and other states quite effectively in obtaining the most advantageous financing of state and local public construction.

In order to allow local governments to let contracts and commence construction on capital projects without delay, Virginia's Public Finance Act also provides for the negotiation of temporary loans in anticipation of revenues from bond issues. Three restrictions are placed on the county government in negotiating such loans: (1) the revenues obtained from the temporary loan must be used for the purpose for which the bonds were issued; (2) the amount of the loan may not exceed the maximum authorized amount of the bond issue; and (3) *such loans shall mature and be paid within two years from the date of issue of the original loan.*

Against this background of standards and arrangements, your attention is directed to the position of Virginia local governments in the bond market. When the Ways and Means Committee of the United States House of Representatives began seriously to consider the proposal to tax state and local government bond interest, interest rates in the bond market rose immediately. The competitive position of Virginia's local government in the bond market began to deteriorate and has continued to deteriorate to this date. When the interest rate on local government bonds soared above 6%, *even before the enactment of the proposal*, Virginia local governments were barred from the bond market.

Now, Virginia counties marketed $19,715,544.01 in bonds in the Fiscal Year 1964–65; they marketed $40,938,722.67 in FY 1965–66; they marketed $56,096,033.32 in FY 1966–67. The total outstanding bonded indebtedness of Virginia counties at the end FY 1966–67 was $444,131,000.00. Of this amount $285,396,000 was issued for public school construction and equipment. (Virginia, Reports of the Auditor of Public Accounts for FY 1964–65, FY 1965–66, and FY 1966–67.)

The Virginia Association of Counties canvassed all 96 Virginia counties to determine precisely what the impact of the increase of the interest rate on general obligation and revenue bonds had been on each county. Returns have been received from 80 counties of which 35 revealed plans for issuing bonds during a period beginning six months ago and extending into the future.

Attached as Table I herewith is a summary of the information received from the canvass of the Virginia counties. (Note that due to Virginia's city-county separation none of the data contained herein includes any statistics which relate to Virginia's 38 cities. This data pertains only to those parts of Virginia lying outside the boundaries of Virginia cities.)

The canvass shows that in the past six months Virginia counties have issued $25,200,000 in county bonds. Of this amount, $17,200,000 was issued by the rapidly growing, most populace Fairfax County just across the Potomac River. Not only has difficulty been encountered in marketing the $25,200,000 issued in the past six months, but a similar difficulty has been found in marketing some $19,280,000 issued in previous months.

REPORT ON BOND ISSUES IN VIRGINIA COUNTIES

[In dollars]

	Bonds issued past 6 months	Difficulty in marketing	Temporary loans in anticipation of bond revenues	Amount of bond issues anticipated
Accomack		300,000		300,000
Albemarle			700,000	5,000,000
Amherst				1,000,000
Augusta		3,500,000	3,000,000	
Buchanan				11,000,000
Campbell				525,000
Chesterfield	4,000,000			
Dinwiddie				1,300,000
Essex		1,000,000	250,000	1,000,000
Fairfax	17,200,000			13,000,000
Fauquier		3,000,000	3,000,000	3,000,000
Frederick		180,000		250,000
Gloucester		350,000	300,000	350,000
Hanover	1,000,000	1,600,000	300,000	1,000,000
Henrico				20,035,000
Isle of Wight				1,500,000
Loudoun		11,250,000	2,100,000	11,250,000
Louisa				2,000,000
Montgomery			75,000	2,500,000
Northumberland				500,000
Patrick	1,000,000			
Powhatan				2,250,000
Prince George		750,000		750,000
Prince William		13,000,000		21,000,000
Pulaski				6,000,000
Roanoke				15,800,000
Rockbridge			1,900,000	1,900,000
Scott				2,000,000
Spotsylvania			500,000	2,500,000
Stafford	2,000,000	2,000,000	1,000,000	5,000,000
Westmoreland				700,000
Wise				1,000,000
Wythe		950,000		950,000
York		6,500,000	400,000	3,750,000
Washington		100,000	475,000	200,000
Total	25,200,000	44,480,000	14,000,000	139,310,000

Further, there are outstanding temporary loans in anticipation of bond revenues of $14,000,000, some of which have matured, payment is due, and the county has defaulted on the loan. In recent weeks, only two counties have been able to negotiate temporary loans and these were negotiated with local banks with interest rates of 5.90% and 5.99%. One of these loans was spread among several banks in order to share the risk.

The canvass reveals that there were plans by Virginia counties to issue and market $139,310,000 in bonds in the immediate future. A majority of these bond revenues were to be used to construct and replace needed school buildings and facilities in Virginia counties. The second large portion of the bond funds was planned for construction of water and sewer facilities to stem the pollution of Virginia's streams and provide adequate, safe facilities for growth and development in the state.

In summary, the impact of the consideration of the proposal to tax the interest accruing from local and state government bonds along with the statutory interest rate has worked to remove local government bonds of Virginia, and nearly all states, from the bond market. The removal of such bonds from the market resulting in the reduction in volume offered is reflected in the slight decline in average interest rates in the past three weeks. The latest advice is that new issues are selling at the highest rate.

The counties across the country agree with the Virignia counties that it is not the intent of this Congress to stem progress in county government across the Nation. But, in effect, this is what has occurred! Nor do the counties believe that the Congress intends to increase state and local taxes upon those taxpayers whom it is seeking to relieve. But that is what the enactment of the proposal to tax the interest of state and local bonds would do.

Thus, the counties urge that action be taken by the Committee to delete promptly the proposal to tax state and local government bond interest in House Bill 13270 known as the Tax Reform Bill, and return the bond market to a condition of stability. Let progress not be hindered further. Let us resume the task of solving the problems before us. Let us not compromise the obligation of local governments to pay their debts as they have contracted in good faith to do.

Mr. Long. I should like to introduce my counterpart, Mr. Hill Healan, who is executive director of the Association of County Commissioners of Georgia.

Senator Talmadge. Mr. Chairman, it is a privilege for me to welcome an old friend and constituent, Hill Healan, executive director of the Georgia Association of County Commissioners, whom I have known a long time and he has performed outstanding service.

STATEMENT OF HILL HEALAN, EXECUTIVE SECRETARY, ASSOCIATION OF COUNTY COMMISSIONERS OF GEORGIA

Mr. Healan. Thank you, Mr. Chairman. I will take the chairman's suggestion, if I may, and ad lib from my prepared presentation, so my remarks will be brief and I will attempt to merely highlight some of the things I think are important in the paper.

First of all, as all of you know without my stating it, that the tools with which local government, in fact State government, have to work for the development of this country are through the securities, that is your general obligation bonds or revenue certificates, that is particularly true of local governments.

Now, in our State, we have attempted as a State association of counties to determine whether or not the proposed legislation under consideration has an adverse impact upon local government as it relates to the bond market, and it has. Fulton County, for instance, needs to sell $150 million in bonds for badly needed improvements in water and sewage facilities. They are of the opinion it is impossible to do so because of the current situation in the bond market.

Now, for instance, in 1966 Fulton County had a substantial bond issue, the credit rating, the interest on those bonds were somewhere in the neighborhood of 3 percent. It is estimated now that it will be in excess of 6 on a similar type issue.

Now, we hear a lot, and we read a lot, in this country today about so-called, as the news media put it, revolution of the taxpayers. I don't know how it is in other parts of the country but in our State it is a very serious situation, meaning, of course, that local governments have to use the ad valorem tax as the basis for taxing most of the improvement. You know what they are. We are talking about building school buildings, we are talking about building roads, we are talking about building city streets and a lot of times it is even bond issues, general obligation bond issues, for water improvements. However, municipal issues usually are revenue certificates. But in any event if you tax the interest rates on these securities, on so-called municipal bonds, in the end what will happen will be simply this: Providing local governments will have an opportunity to market these issues, that will simply mean that the ad valorem taxpayer, if it is a general obligation bond, will have to come across once again on higher ta..es.

Now, if we are talking about a revenue certificate, of course, it merely means that the utility rates will be up. In the end the taxpayer will get it.

So we are merely saying to you gentlemen this morning that look at the problem that local governments have. I want to reiterate something I have already said, the tools we have to work with at local government are through general obligation bonds and revenue certificates.

Now, particularly county governments which we represent, because there is very little other types of revenue available to them use that tool. So then if any kind of legislation is enacted which will make the increased—will increase the costs of financing this kind of work, then you are faced with two issues. One, that you either will do it at a considerable increase in cost to the local taxpayers, the citizens, or you will just absolutely not get your bonds sold.

Now, in that case it is a catastrophe because if we develop America, if we develop our States, if we develop our county and city governments it has got to be done through bond issues and programs that for which you issue revenue certificates.

Now, in conclusion, let me state this, that over the years, I think the records will show, that the credit rating of most municipal bonds in Georgia, county bonds, city bonds, what have you, have had a good credit rating. Now, we know that in the last few months that the credit rating supposedly will have gone up, has gone up, and its effect had the number of issues. Comparing 1969 to a comparable period, 69 to 68 quarter, you had last year about $88 million in volume of issues sold. Now about $45 million in 1969, and the total number of issues have been compared for 68 where you had about 21 you have about 11. So I am saying that the amount of issues and the volume have decreased.

And then finally, in conclusion once again, we have this happening. We have people, individuals who heretofore have purchased municipal bonds, and I am sure this has already been told to you before, you have a lot of them trying desperately to unload. Well then, of course, that affects the morale of the entire market buyers, and I think that has an adverse effect.

I thank you sincerely for the opportunity of making my presentation.

(Hill Healan's prepared statement follows:)

Expected Adverse Impacts of HR 13270 on the Counties of Georgia

My name is Hill Healan and I am the Executive Secretary of the Association of County Commissioners of Georgia. I come before you today as representative of all the 159 counties in the State of Georgia whose membership within the Association is unanimously and unalterably opposed to the legislation now being considered by this Committee which adversely affects the principle of immunity of municipal bonds from federal taxation.

The counties of our state, like so many others throughout our land, have outstanding general obligation bonds. In addition, because the Constitution and statutes of Georgia are relatively liberal in the type of service and revenue which may form the basis of revenue certificates, many counties have revenue bonds for which certain revenues of the county are pledged.

It is a matter of common knowledge that many of the rural counties of Georgia are sadly lacking in public improvements such as streets, libraries, schools, water and sewer systems, and many other needed public improvements which can be obtained only through the issue and sale of bonds. Furthermore, the thickly populated areas, including the larger municipalities, have gigantic problems of sewage disposal, insufficient water supplies, and solid waste disposal which will require billions of dollars of financing if they are to be solved. For example, Fulton County, which includes the City of Atlanta, and has a population of over 550,000 people has a real and continuous need for sanitary sewerage and surface water drainage, requiring a minimum outlay of $150,000,000. The local government is prefectly willing to assume this burden and solve its problem in its own way. But, it is literally beyond the power of local governments in our State to finance these much-needed projects involving enormous sums of money if the principal source of financing, namely, generally obligation and revenue bonds, do not find a ready market at reasonable rates of interest.

Due to the limitations imposed by the Constitution of Georgia, most of the counties of Georgia have heretofore enjoyed excellent credit ratings, and as a result, have paid remarkably low interest rates on their borrowings. Many of the older outstanding bonds in our State bear very low interest rates. And why is this interest so low compared with comparable private credits? Not because of their high rating; not becouse of the assurance of prompt payment—but primarily because the interest coupons are exempt from income tax. The prime factor in the advantage over private bonds is always the exemption of interest on municipal bonds from Federal income tax.

As important as is the willingness of the individual taxpayer to buy and hold until redemption a tax-exempt municipal bond, it is equally important that these bonds be made attractive to the big investors, such as local trust banks and other institutions which, of necessity and partially as a gesture of civic pride, invest a substantial part of their assets in state and local securities. The tax exempt status of a bond is a controlling factor in its purchase by such institutions.

Normally, there has been a great deal of trading among financial institutions in municipal bonds, as they constantly seek to upgrade the income from their securities. This created a steady and active market until the present time.

Both attorneys and advisors who serve the counties of Georgia, and especially the smaller counties who do not have fiscal officers trained and skilled in the management of securities, have advised me not only that the imposition of income tax upon the interest of municipal bonds will effectively impair their market; but they have also told me that the mere threat of future taxation possibly applied even to commercial banks has caused wide-spread alarm. Small individual investors, in many cases, are trying to unload their municipal holdings at this time for fear the Congress will persist in the House bill's plan to levy income taxes upon the outstanding issues. This "unloading" revenue is killing our market for new issues because what is done for individuals today, can be done tomorrow for banks and institutions which hold ⅔ of the municipal bonds.

The threat of this proposed legislation has already adversely affected the sale of millions of dollars of municipal bonds which would have financed desperately needed schools, hospitals, sewage plants, and dozens of other vital projects. These were not projects that were casually decided upon, for communities of people throughout the country do not saddle themselves and, in many cases, their children, with a financial burden to build marginal facilities. On the contrary, they were the subject of lengthy discussion, duly voted for and repayment provided for by a majority of the people. Local public improvements are needed everywhere, and unless the people are permitted to decide and provide for their needs on a local level, as they traditionally have, then only atrophy or stagnation will result, and initiative of local elected officials will be destroyed.

In Georgia, this year's sale of issues in the first quarter alone, are only half of the volume of last year, from $88 million to $45 million, and the number of issues has dropped from 21 to 11. The pace of these financing failures has quickened in recent months as interest rates on local government bonds have risen to their highest levels in American financial history. As long as this "tax reform" bill remains a matter of Congressional debate, the market will naturally remain extremely worried and chaotic. This will naturally keep interest rates at abnormally high levels. For communities in desperate need of a new project, there is no alternative but to pay the added cost and wallow in what one bank referred to as the "disaster area in the financial world."

It is most unfortunate that obligations of such stable, high credit-rated governments as Fulton County and the City of Atlanta are being offered at substantial discount for early maturity because of the psychological effect of the pending tax measure.

Thus we are confronted not only with the real fact that a tax upon municipal bonds will weaken or destroy the market, but we are also faced with the fact that the threat of such taxation has had a bad psychological effect on the market even before a tax has actually been imposed.

One does not have to be a financial wizard to come to the conclusion that this measure does not provide "tax reform" as its title implies. Rather, the elimination of the Federal tax immunity, as it applies to municipal and state bond interest, would force the demand for higher interest rates on these bonds—and higher interest rates mean higher local taxes, including property and sales taxes whose burden rests primarily on those with the least ability to pay. Congress would be merely shifting a considerable burden to local taxpayers, in the name of tax reform.

In conclusion, let me urge the Committee to continue to seek and to study alternatives to supply needed revenue, but to honor our plea to exclude the bonds of local government from any form of federal taxation, whether by way of a "limit on tax preferences" or "allocation of deductions" or otherwise.

The Chairman. At this time I would like to introduce Mr. Arthur Sypek, who is the first vice president of the New Jersey Association of Chosen Freeholders, Mr. Sypek.

STATEMENT OF ARTHUR R. SYPEK, FIRST VICE PRESIDENT, NEW JERSEY ASSOCIATION OF CHOSEN FREEHOLDERS

Mr. Sypek. Chairman Long, and members of the committee, you have heard the presentation of the NACO position by various representatives. You do have my statement in the record, and I will simply briefly summarize additional points, and, specifically, the impact of this type of law on the counties of New Jersey.

The State association of the counties of New Jersey has unanimously passed a resolution opposing the taxing of municipal bonds. New Jersey is a population-growing State, and must provide through its counties the best level of government for regional solution of problems, various services, and I would like to enumerate a few.

The large counties, such as Bergen County and Essex County, where services of our community colleges call for expenditures of $40 million, county administrative building in Essex County of $20 million, and in my own county, Mercer, where a community college total expenditure is in the area of $20 million which was simply begun in the last few years, the effect on the municipal bonds will be of such magnitude that it will simply increase the cost to the local taxpayer, and our greatest source of income are real estate taxes; 80 percent of our income in the counties of New Jersey are derived from local taxation.

Senator Anderson. Will you tell us what a chosen freeholder is?

Mr. Sypek. It is a county commissioner, sir. We are the only State, I understand, in the Union that designates the nomenclature of the county supervisor, county commissioner, as a freeholder, and we have not changed that nomenclature. Although some of our younger members of the county boards would like to change it to a more modern name we have not done it to date, sir.

We are elected officials. I am in my 10th year as a county supervisor, if you will, freeholder, and also head of the Mercer County government, the capital county of New Jersey.

In the area of education, if you will, I covered vocational education, the community colleges are called upon in all the counties of New Jersey, and the great impact if the interest is increased if the moneys for these projects are dried up because of the taxation of municipals.

In the area of transportation, we in New Jersey have found many of our transportation systems are going under and the counties are called upon to salvage the transportation, bus transportation, if you will, and will call for additional funds.

The growth of airports, the need for airports in New Jersey. In my own particular county we have the largest county airport in New Jersey, but other counties are beginning to build airports, these demand great amounts of money for expansion, acquisition of land, if you will.

In recreation, the counties of New Jersey have taken advantage of open space moneys provided by the Federal Government as well as our own program of greenacres moneys, and before lands are acquired the costs have risen as much as 6 to 10 percent a year. In my particular county, our program called for $6 million, $3 million open space funds and $3 million from greenacres from New Jersey. Today we may have to raise an additional $2 million because of increase in cost of lands. This is simply the acquisition of the land for recreational purposes.

We are a small State, our counties are small. We must set aside lands now for future generations. Within the next decade or 15 years we must provide millions of dollars for projects such as golf courses, tennis centers, swimming pools and things of this nature.

We are thinking not only of today but the impact of this type of legislation, gentlemen, and just in short, summarizes the impact on the State of New Jersey.

I thank you for the privilege of appearing before you.

(Arthur R. Sypek's prepared statement follows:)

Prepared Statement of Arthur R. Sypek

EXPECTED ADVERSE IMPACT OF H.R. 13270 ON THE COUNTIES OF NEW JERSEY

Mr. Chairman and gentlemen of the Committee, my name is Arthur R. Sypek, and I am appearing today as the First Vice President of the New Jersey Association of Chosen Freeholders. I am also the elected Director of the Mercer County Board of Chosen Freeholders, the governing body of the capital county of New Jersey.

You have heard statements of the National Association of Counties' position against certain provisions contained in the proposed Tax Reform Act of 1969, and the decidedly adverse impact which these proposals could have on an already high interest rate bond market. I would like, however, to point out to the Committee the specific dollar impact of such changes on certain counties of New Jersey, as well as the deleterious effect on many essential capital improvement projects which could be placed in serious jeopardy if HR 13270 becomes law.

In my own county of Mercer, it is agreed among municipal financial experts that the elimination of tax-exempt status of municipal bonds will result in increasing the interest of municipal bonds by approximately 1.5–2% per year. Its effect, for example, on Mercer County's recent temporary financing of $9.6 million for Community College and general county improvements will be to cost the hard-pressed county taxpayers an additional 1.6–2.1 million dollars in interest costs over a twenty-year period. In addition, any future increase in interest rates of municipal bonds, as a result of eliminating their tax-exempt status, could well jeopardize the contemplated construction of $4 million areawide county vocational school system and the new Mercer County Administration Building.

One of Mercer County's newest and boldest innovations—the proposed regional solid waste disposal system, which would involve bond financing of incinerators and/or regional sanitary land-fill projects—could also be jeopardized by sharp increases in the interest rates, thus hampering the very kinds of regional development projects to which the Federal government itself has been committed for at least a decade.

In Essex County—the major urban county of northern New Jersey—capital projects requiring municipal bonds will exceed $5 million for 1969 and will be well over $7 million in 1970 and 1971. Included in the 1969 capital projects is over $860,000 for construction of the Essex County College Urban Campus. The same project will require over $3½ million in 1970 and over $4 million in 1971. In Newark, we are erecting a new county building including a new jail adjacent to the Hall of Records, at an estimated cost of $2 million. From 1969 through 1973, approximately $1½ million has been allocated for the construction or reconstruction of county highways.

Bergen County—one of the most populace counties in our state—needs about $4 million in capital projects in 1969 and for 1970 and 1971, over $3 million and $4½ million, respectively. In Bergen County, they anticipate county needs of $20 million starting in 1974 for construction of a community college. An additional $20 million needed for that $40 million project would be financed by the State of New Jersey, presumably by municipal bonds. The county also needs between $1 and $2 million from 1969 through 1972 for roads and bridge construction.

If the tax status of municipal bonds is changed, the county colleges, hospitals, bridges, highways, vocational schools, court houses, welfare institutions, jails, youth shelters and other projects and services could be seriously curtailed and additional new tax burdens would fall on already over-burdened New Jersey property taxpayers—the heaviest taxed of any group of home or property owners of any state in the country.

The counties of New Jersey, and the counties of all the states, ask you to maintain the status quo of municipal bonds. To alter the status quo—regardless of the sincere desire to improve the over-all tax structure—would severely hamper the ability of county government in New Jersey to rsepond to the growing needs of its citizens.

Thank you for hearing me.

Mr. Long. At this time, I wish to introduce the Honorable Dale Anderson, county executive, Baltimore County, Md.

STATEMENT OF DALE ANDERSON, COUNTY EXECUTIVE, BALTIMORE COUNTY, MD.

Mr. ANDERSON. Mr. Chairman, and members of the Senate Finance Committee, since I am here to summarize some very pertinent fac' ; I will do so but I will try to do so as rapidly as possible.

I am Dale Anderson, county executive of Baltimore County, Md., and a director of the National Association of Counties. I appreciate this opportunity to summarize the drastic impact which the pending taxation of municipal bonds is having and will continue to have on county government finances.

As my fellow county officials have related, county governments all across the country have been stretched to the complete end of their fiscal capability and are reaching a point where revolt against ever-increasing rates of local taxation is not only possible but highly probable: County expenditures have increased almost 50 percent since 1962, rising from $8.9 billion in that year, to $12.9 billion in 1967. The financial plight of cities is well known, and amply demonstrated in the halls of Congress, but it is not generally known that county expenditures have outstripped even those of the beleaguered cities in the last 5 years. To finance these expenditures, we must depend on a tax which is one of the most regressive and one of the most inelastic in the entire lexicon of painful taxes. According to the Advisory Commission on Intergovernmental Relations, some 93 percent of total county expenditures is funded by the proceeds of property taxes. For every increased dollar of county expenditures, 93 cents has to come out of some local taxpayer's pocket in the form of property taxes.

In the 21 years from 1946 to 1967, State, county, and local property levies increased sharply from $8 billion to $47 billion. As an example of how these tax increases strike most cruelly at those with the least ability to pay, the Advisory Commission on Intergovernmental Relations has estimated that more than one-half of this tremendous increase is directly attributable to new and increased taxes, with less than half due to the response of old taxes to economic growth. I hope you will pardon us, therefore, if we become somewhat frenzied at the prospect of "reforming" the tax system by measures which will lead directly to further increases of property taxes. You must do more to help us. The Nation's domestic priorities cannot afford the injury the House has proposed.

There is no question in our minds that this assault on the historic immunity of State and local government bonds from Federal taxation represents a direct and frontal assault on the local homeowner. Just the discussion alone of the possibility of Federal taxation has shaken the entire municipal bond market to its core. The amount of debt floated so far in 1969 is 40 percent lower than the equivalent amount in 1968, even though requirements for local capital improvements are continuing to increase tremendously. Right now, in September 1969, it has been estimated that a county government floating a bond issue will incur over 100 additional basis points in interests over the amount it would have incurred to market the issue prior to House hearings on this so-called tax reform legislation. It has been suggested that soaring municipal bond interest rates are due principally to the current climate of inflation and only secondarily to possible Federal taxation of municipal bonds. I cannot accept that, since, if this were so, yields on similarly rated corporate and taxable bonds would have increased at the same rate, but they did nothing of the sort. In fact, the increase for similarly rated corporate bonds was only 10 basis points since July.

There is a limit to these rising municipal bond interest rates, but I am not sure it is a limit which people in my county can afford. The limit will be reached when local governments all over the country postpone or cancel many vital public improvement projects which have been anticipated and nurtured for years because they are unable or unwilling to accept impossibly high interest rates. This is not an issue which is going to be centered in one section of the country rather than another. Rather, it has the capabilities of swelling into a public protest the likes of which, I predict, has seldom been seen in this Nation's history. In the name of tax reform, you are considering legislation now which will be felt unfavorably by every person no matter how modest his means. If he owns a house, he will feel it in increased property taxes. If he rents his home, the owner's increased taxes will be reflected in the tenant's rent rise.

When one considers the relative pittance in increased Federal revenues which will emerge from these tax proposals, it is almost impossible to understand how these plans were successfully passed by the House. For example, the Secretary of the Treasury estimates that the allocation of deduction provisions would result in an annual increment of $45 million to the U.S. Treasury. This number is miniscule in comparison to the additional interest costs which State and local governments will incur if the Federal Government is permitted to tax the interest on their obligations.

We have estimated that as a result of inclusion in the allocation of deduction rule alone, State and local taxpayers will have to pay amounts almost 10 times more than the money returned to the Treasury in the 5th year of enactment. This provision seems even more questionable when you consider that all of the increased State and local taxes will be subject to deduction from Federal income tax returns.

What is particularly objectionable to elected county officials like myself about this current legislation is the fact that it is included part and parcel in a package entitled "Tax Reform." This is a wonderful catchword to build widespread public support since it conveys the idea somehow or other, the end result of the legislation will be a lower tax bill for the average citizen of this country. But the provision relating to municipal bonds cannot and will not work that way, and this is patently clear to every local government official if not the local taxpayer at this time.

If our cost for selling bonds increases, our major source of funds is in regressive property taxes and sales tax, the rates of which have to go up accordingly. Throughout the history of this country, we have preserved under the Constitution, the immunity of the sovereign States and their instrumentalities from Federal taxation. It is particularly repugnant to those of us who are struggling with terrible financial burdens on the local level where the domestic ills of our Nation are gathered to have our major revenue source jeopardized in the name of tax reform which promises to correct inequities. This is not tax reform; it is more like tax paralysis which will restrict the fiscal capabilities of local governments.

When we raise the property tax, it doesn't mean the homeowner is earning more income as it usually does when his income taxes go up. It doesn't mean either that he makes a conscious effort to purchase something and pays a sales tax. Nor even that he drives his automobile and pays a gasoline tax. All of these taxes, of course, would have the threat of being increased. The property tax is as high as it can go. We must have some help, from the U.S. Senate particularly.

I don't have to tell you that the property taxes don't work with such a direct relationship between the payer and the beneficiary. I can cite case after case where a homeowner in Baltimore County has an income today about the same as he had 5 years ago, and his property taxes have gone up almost 40 percent. This increase in property taxes has absolutely no relationship to his ability to pay. If I can cite cases in Baltimore County, I'm sure every county official across the country can do likewise. So, when people who are for raising the interest on municipal bonds talk about inequities, I'd like to know inequities to whom. In Baltimore County alone, I could probably match every millionaire who already may be avoiding Federal taxes because of his municipal bond holdings with thousands of hapless and irate homeowners who can't and shouldn't pay a dollar more in local property taxes.

Just last month, this Federal administration announced a sweeping package of welfare, revenue-sharing, mass transit, and housing proposals which promises for the first time to increase substantially Federal assistance to the hardpressed State and local governments. The potential of a hopeful new federalism is particularly appealing to those of us whose citizens and resources have reached the end of the line. President Nixon said:

> After a third of a century of power flowing from the people and the States to Washington, it is time for a new Federalism in which power, funds and responsibility will flow from Washington to the States and the peoples.

How this kind of philosophy can be advanced at the same time that the Federal Government is threatening to destroy the municipal bond market is a puzzle for the future historians to decipher. The rhetoric of the administration and many Members of Congress implies a commitment to decentralization of government, while at one and the same time, the Federal Government is seriously jeopardizing the ability of State and local governments to meet their responsibiilities. You can't have it both ways.

Gentlemen, let me close for NACO by simply stating our overall position. There must be no inclusion of municipal bond interest in the limit on tax preference proposal or in the allocation of deductions rule in any manner whatsoever. Further there must be separate hearings on alternative methods of financing subject to further study. I thank you very much.

The CHAIRMAN. Gentlemen, you have made a very fine presentation here today. If you saw a broad grin on my face during part of your presentation it wasn't because of anything you said. I saw one of my old friends, Robert Kennon, who was my opponent when I ran for

Senator. If there were a change of ½ to 1 percent of the votes he would have been here rather than me.

Since that day he served with distinction as Governor of Louisiana and also as chairman of the Governors' conference. He became so alarmed at the dangerous trend toward federalism that he supported the Republican candidate for President since that date, and finally his conscience required him to leave the Democratic Party and join the Republican Party and I know he would be very much dismayed to find that the Republican Secretary of Treasury is now advocating a Federal tax on State and local bonds because Governor Kennon has always been a great States righter and he found it necessary to leave the Democratic Party because the Democratic Party, once having been the party of States rights, left him. So I know he would speak for a great number of others with that philosophy.

Now, one thing that, a point, Senator Talmadge made on yesterday, I think, is worth noting. This year it looks as though we are going to have 6-percent inflation or 6½ percent, to be more exact, which would be more than these State or local bonds outstanding are presently yielding, so in real terms whoever is getting the interest on these State and local bonds will really be making zero. He will actually be losing money because the depreciation in the value of his investment will offset any interest that he might make.

Now, at the same time one of the things, one of the big items, causing this inflation will be negotiation of these new wage contracts where organized labor is in position, and I applaud them for doing all they can for their members, but they are in position to demand and get major increases which will outstrip productivity, and we have here a revenue bill which undertakes to tax this fellow who in real terms has made nothing, so we can redistribute his income to people who are going to get a tax cut on balance by taxing the other fellow.

Now, in some respects it is very clear that this will impose a very heavy burden on State and local government.

Your testimony in general strikes me as indicating that most of your revenue comes from property taxes, is that correct?

Judge Fowler. That is correct.

Mr. Anderson. Ninety-three percent.

The Chairman. With taxes being as high as they are, it would be impossible to get people to vote for increased taxes on themselves. That is what would have to be done, they would have to vote it on themselves. In some cases you can impose it but in most instances the people have to vote on it. That is how it is in Louisiana and that is how it is in most States.

And furthermore any assessor who goes out here and tries to raise everybody's assessment will be voted out at the next election, isn't that correct? If he goes out and raises everybody's assessment by 6 or 7 percent to try to keep up with the increase in the cost of living he won't be back after the next election, so you just can't very well do that.

So the counties are pretty well frozen where they are in the income that they have available to them, and what we have been recommending here will simply raise their expense so that we will be requiring them either to reduce services or to try to raise taxes on their own people. Isn't that about the size of it?

Judge FOWLER. That is right.

The CHAIRMAN. Rather than to do that it seems to me we would be better advised to consider some, at least one, suggestion that was made yesterday; this is, if the Federal Government really wants to help the States—and this proposal would hurt the States and counties and the cities—if we want to do something about this interest subsidy we might just try to out by simply making up the difference to these State and county trust funds that are set up for the retirement of their own employees so that they could afford to buy their own bonds or their own State and county bonds and make up the difference in interest to them if they borrowed their own trust funds and held some of their own bonds.

That would be a better proposal, I would think, than what we have here where you are going to increase the expense, on the one hand, and hope to give it back, on the other.

Now, with regard to all these ceilings that exist on what can be paid in States and counties, would not that require a great deal of legislation both at the State and local level to change all these ceilings so that one could pay more and, hopefully, get some Federal subsidy out of it?

Mr. CONNER. Not only legislation, Mr. Chairman, but even constitutional amendment in many cases which is even more difficult.

The CHAIRMAN. If we are going to try these things then it would seem to me we should try to do one more thing, see if we can amend the State constitutions by an act of Congress by stating, notwithstanding anything in the State constitution, you go ahead and borrow money at 10 percent if need be to finance a project, but I can't see any State could honor it except by an act of Congress that we have a right to amend the State constitutions. You wouldn't advocate that and I doubt if you would.

Mr. ANDERSON. I would think, Mr. Chairman, it would be just as dangerous as that assessor raising the assessments.

Mr. CONNER. In New Jersey it would make you an unchosen freeholder.

The CHAIRMAN. Senator Harris.

Senator HARRIS. Mr. Chairman, I think you have expressed some of the concerns that are in all of our minds. I just want to say that I am impressed by the persuasive appearance here of all these gentlemen, and particularly I am glad to see my old friend, Dale Anderson, of Baltimore County.

Mr. ANDERSON. Thank you, sir.

The CHAIRMAN. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

This has been an interesting and informative discussion this morning. I see one old friend on the panel I have known a long time, George Long. I know him to be an able and knowledgeable citizen of Virginia, but he has also been recognized throughout the Nation by having been elected chairman of the Conference of Executives of State Associations of Counties.

I want to ask Mr. Long this question: In your capacity as Chairman of this conference have you found the local officials to be rather unanimous in their view that it would be a mistake to change the status of State and municipal bonds?

Mr. LONG. Senator, this is precisely the situation. I found no comment favorable to making this change whatsoever across the Nation.

Senator BYRD. The feeling is then that this would be detrimental to the localities and would increase the cost to the localities and the citizens of those localities?

Mr. LONG. In every State and every locality of the Nation.

Senator BYRD. May I ask Mr. Brewer a question? Mr. Brewer is, I noticed, chairman of the Taxation and Finance Committee, National Association of Counties.

In your capacity as chairman of the finance and taxation committee you have studied, I assume, what you anticipate the interest the localities would have to pay if the tax-exempt status were removed. Did you indicate that that would be 9 to 9½ percent?

Mr. BREWER. Yes, sir.

Senator BYRD. And that would be about 50 percent greater than it is now?

Mr. BREWER. That is right, Senator. This would be on a taxable basis.

Senator BYRD. It would be on a taxable basis?

Mr. BREWER. Yes, sir; this information is drawn from the rates on high-grade corporate bonds today and the fact that counties, municipalities, and the States would be in the taxable bond market. This would reduce the base of the market forcing up even the rates as we know them today on corporate issues which are running around 8½ to 8¾ percent.

Senator BYRD. So instead of the localities paying roughly what would it be, 6 percent now?

Mr. BREWER. Six percent now.

Senator BYRD. Six percent now, they would pay 50 percent more or maybe more than 50 percent additional?

Mr. BREWER. Yes, sir.

Senator BYRD. Of course, the proposal has been made that the Federal Government subsidize part of the interest. I think in considering that proposal we want to be aware of the fact that the Federal Government in this budget that the Congress is now considering is paying $17 billion, the taxpayers are now paying $17 billion, in interest, and so far as I am concerned I am not very anxious to keep increasing the amount of interest that the Federal Government is paying, the Federal taxpayers are paying, above that gigantic figure of $17 billion.

Thank you, Mr. Brewer and Mr. Long and gentlemen.

Thank you, Mr. Chairman.

The CHAIRMAN. I am somewhat concerned that the House bill seems to take the approach that anything that the Federal Government has not yet taxed must be taxed. After this bill I understand the House then hopes to go to work on inheritance taxes, gift taxes and matters of that sort.

This bill reminds me of the statement by one of my favorite Louisiana orators who used to campaign with my Uncle Earl. He would get up there and make the statement that the opposition went down to the State Capitol and he said they taxed everything from bedbugs to billygoats and would have had old nanny next if they hadn't stopped them.

(Laughter.)

Mr. ANDERSON. Mr. Chairman, it seems to me that you are probably in the best position to prevent such a thing as that from happening than anyone else.

The CHAIRMAN. Well, I think we will stop some of it anyway. We will consider your problems, gentlemen. Thank you very much.

Do you have any further comment?

Mr. CONNER. Mr. Chairman, I just wanted to say: sitting here and hearing all this confusing mass of facts, and reading yesterday's testimony and knowing that you have heard the testimony from the other side, which was equally confusing, I have great sympathy for the members of the committee.

The Wall Street Journal says today that whatever else you think about the facts of the municipal bond issue, uncertainty is the real key to this problem. So long as we have that uncertainty, we are going to pay more interest on municipal bonds, whether you gentlemen legislate or whether you don't. We must have certainty.

The CHAIRMAN. Thank you very much, gentlemen.

Now, Mayor Tate was to be on the panel yesterday, and he was not able to be with us in the morning session. He was counting on us to hold an afternoon session but I think the chairman intimidated members not to ask any questions during the morning session so we got through in the morning.

Mayor Tate, we are happy to have you back and we will be pleased to hear your views on this problem.

Senator HARRIS. Mr. Chairman, if I could first say, Mayor Tate is an old friend of mine. I don't think we could have a better spokesman on this issue than he is, being vice president of the U.S. Conference of Mayors and immediate past president of the National League of Cities.

Jim is a sincere and plainspoken man. He says what he believes and believes what he says, and I think we are fortunate to have him here this morning.

The CHAIRMAN. Mayor Tate, I hope you understand the Republicans this morning are holding their Republican caucus to elect their new minority leader, and for that reason they are not with us at this moment but they will all undertake to read your statement in due course.

STATEMENT OF JAMES H. J. TATE, MAYOR OF PHILADELPHIA

Mayor TATE. Thank you, Mr. Chairman.

I want to say to the chairman and especially my friend the national chairman, the great Senator from Oklahoma, all of you have been most kind to allow me to come back before you this morning after the unfortunate set of circumstances yesterday which prevented my appearing before this committee. I looked forward to it for so long because I believe sincerely in my message.

I know that you have listened to this repetitious recitation of problems, but we feel it so strongly.

As you know, Senator Harris was very kind, and I wanted the Senator to know I always enjoy going back to his hometown in Lawton where I have some friends as well as in Oklahoma City.

Yesterday the chairman was very kind to listen to my plea over the telephone and that is the reason I am here and for that reason I am going to be very brief.

As you know, I am the mayor of the city of Philadelphia and have been since 1962. I am now the vice president of the U.S. Conference of Mayors and the immediate past president of the National League of Cities and I do come with some experience with these problems.

We saw this in the offing 5 or 6 years ago. It is not something that happened just yesterday.

On behalf not only of the cities but also of the States and the counties and school districts and all local authorities, I do want to express my own firm opposition to the proposals to tax the interest on municipal bonds as contained in H.R. 1372 and the Treasury Department's recommendation to this committee.

I very strongly appreciate the fact that the Senate committee, the Senate Finance Committee, under your leadership has given us the opportunity to develop this dialog and real understanding of the problem. Unfortunately we did not have that opportunity in the House.

Although there is an understandable desire by the Congress to close all of the loopholes by which individuals escape taxation, I should warn the members of this committee, as others have, that taxing the income from municipal bonds to any extent or by any device at all will create catastrophic conditions in America.

First, I do believe it will fatally undermine further the doctrine of intergovernmental immunity, which protects the State and local governments by subjecting them to coercive financial controls through Federal taxing power.

Second, I do believe it will bring about sharp increases in local real estate taxes, sales taxes, which fall most heavily on low- and moderate-income people. This will generate a "taxpayers' revolt" vastly more serious than anything prevailing today.

I was very much interested in your remarks about assessors. At one time I was an assessor and perhaps that is what happens to old assessors, they become mayors.

Third, I do believe it will result in litigation, long-term litigation, which will go all the way to the Supreme Court, causing utter chaos in the municipal bond market while some $16 million of capital construction projects grind to a halt throughout the country until a judicial determination is made.

I can assure you I am not overstating the effect that these proposals would have on the fiscal condition of our States, counties, and cities. Even the threat of Federal taxation has already thrown the bond market, the local bond market, into a state of chaos.

I want to relate what appears in the issue of September 16, and submit it for the record, of the Municipal Finance Officers Association bulletin newsletter where they state:

> Bond index again registers new high. For the third successive week the Bond Buyers' Index of 20 municipal bonds reached a record high level. On September 4, it was 6.347 percent, up 11 basis points from the previous week. The higher grade 11 bond index also was at a new record high registering an increase of 12 basis points to that it was 6.270 September 4. The lowest level touched by the 20 bond index, 1969 was 4.82 percent recorded on January 23. The chaotic condi-

tion of the municipal bond market is reflected in the Bond Buyers tabulation of displacements. That is no bids received, bids rejected or issues postponed. Since September 3, 1968 to September 5, 1969, 316 issues amounting to $1,800,000,000 have been displaced. Of these no bids were received on 153 issues totaling $816 million. Bids were rejected on 60 issues totaling $158 million, and 109 issues amounting to $950 million were postponed. This period covers the tight money span which began in the last quarter of 1968 and is highlighted by the discount rate change made on December 8 of last year.

Prime rate increase occurred on June 9 of 1969 and reflect the market reaction to the 1969 tax reform act approved by the House unfortunately.

I can go on and on and state this but only yesterday the esteemed mayor of the city of Pittsburgh, which is undergoing a great deal of problems, Mayor Joseph Barr——

The CHAIRMAN. Might I just interrupt you for 1 minute?

Mayor TATE. Yes.

The CHAIRMAN. Does that article itself make the statement that that reflects what the House did?

Mayor TATE. Yes, sir.

The CHAIRMAN. That is both your opinion and also the publication from which you are reading?

Mayor TATE. That is correct. That is correct, sir. Thank you very much.

Mayor Barr of Pittsburgh told me they had a $9 million authorized bond issue on which he could get no takers. He is in a status quo and cannot move ahead, he is undergoing the trials and experiences of a construction strike because of this particular problem. I would say this is the experience of most cities in the country today because of the uncertainty and it certainly reflects what appears officially in this publication.

Even in July of this year Philadelphia, for instance, incurred interest charges of 6.43 percent. We were fortunate because we could go a little high on issues aggregating $60,625,000. We didn't have this opportunity on the school bond issue which has been rejected by the taxpayers in a campaign in the spring of this year but the city government on municipal issues were all right. But this is the highest rate in our history which runs back almost 200 years.

Incidentally, Senator Byrd, we had a very interesting presentation before the Bicentennial Commission. We are very glad to have your support. I am very proud of what Philadelphia did for the Bicentennial Commission when you were in New York.

Senator BYRD of Virginia. I wish I could be with you there.

Mayor TATE. It was very good and I wanted to tell you that.

In the last year there have been a total of 396 bond issues valued at over $1.9 billion rejected or postponed throughout the Nation, depriving our citizens of much-needed services and affecting workers in many industries.

The city of Philadelphia and the Philadelphia School Board's current program for the development of airports, piers, mass transit, health, recreation, public safety, and school facilities will cost $1.4 billion and we can handle it if we don't have this restriction. But the restrictions on our tax exemption will result in at least a 2-percent increase in interest rates, and in order to absorb, of course, an increase of that magnitude, it will require an increase of 25 percent in the city's real estate tax, and in Philadelphia we have the advantage of what we call a wage or income tax which helps us to keep that rate down. But we can't hold the line much longer if we have to go through with this kind of a program.

State and local governments have bonds outstanding in the magnitude of $130 billion today, and a 2-percent reduction in interest charges which the exemption provides would save the local governments about $2½ billion annually. If they do lose this income they will have no recourse but to tax locally to obtain it, and in such formidable amounts as to cause real public outrage at the grassroots levels.

The final irony is that, while these proposals will impose a crushing burden on local government, the Treasury will actually lose money as a result of this particular program.

The U.S. Treasury Department estimates a meager $45 million gain on the allocation-of-deductions plan and only $35 million under the minimum tax proposal. Very heroic proposals but they don't produce anything. It is like a lion producing a mouse.

However, breaching the historic immunity of State and local governments from local taxation, and shattering the confidence of investors, will result in at least a 2-percent increase in interest rates on the bonds. Of course, it is showing already.

Assuming that no increase in the current $16 billion annually of municipal issues, State and local governments would be required to levy an additional $320 million in taxes for the first year to offset a gain of $80 million in the Treasury. After the post-1969 issues reach the present level of $130 billion the local costs would jump to an additional $2.6 billion a year.

However, the final absurdity really is this: All of these taxes levied by the State and local governments are deductible on the Federal return. The amounts gained by the Treasury, U.S. Treasury Department, on the one hand, would be offset by a loss due to increased Federal deductions, on the other. The net result of imposing crushing tax burden on local government taxes which fall most heavily on low-income people would really be a loss to the Federal Treasury.

I don't think we should be taken in by the bond interest subsidy offer in H.R. 13270. Not only is the Secretary of the Treasury given wide latitude in determining the subsidy but we would be completely at the mercy of the House and Senate Appropriations Committees, which could curtail or eliminate the subsidy at any time.

Finally, I earnestly urge you to reject these proposals, which would really cripple our cities, tax more heavily our already harassed local homeowners, which is really the basic fabric of living in America, and undermine control by local voters of the affairs of local government, and I reiterate what was said by the final speaker on behalf of the counties, that we should do something about this now. We should eliminate this uncertainty in the bond market. An expeditious conclusion of the program by your Senate committee would certainly hurry along the day that the bond issues now on the boards and those which are planned for later this year to fill depleted capital treasuries throughout the cities of America can be sold at reasonable rates and certainly would bring about a welcome news to the people of the cities of America.

Thank you very much, Senator. I appreciate the courtesy, and I am sorry I interrupted your procedure today. It has been very thoughtful.

The CHAIRMAN. Thank you very much, Mr. Mayor. I was very much impressed with your statement, particularly the point that you make about intergovernmental immunity. It is nothing new to us to hear some southern mayor or southern Governor make that point, but sometimes it is just as important to a great city like Philadelphia as it is to the cities of our part of the Nation.

Mayor TATE. Thank you, I respect it, sir, and I have always been an advocate of that.

The CHAIRMAN. Any questions?

Senator BYRD. Thank you, Mr. Chairman.

Mayor, I think your statement was a very effective one and I think it is summarized well in points 1, 2, and 3 on page 1 of your statement, and I notice that you use the figure of $130 billion as the bonds outstanding and my understanding is that by the end of this year it will be $140 billion.

Mayor TATE. A very modest estimate, sir.

Senator BYRD. Now, the proposal was made before this committee several days ago that the Federal Government guarantee all State and local bonds and that the Federal Government pay one-third of the interest on those bonds. Would you care to comment on that proposal?

Mayor TATE. Sir, I would comment on that by saying I have no faith in it. We would be subject to the annual allocations system which has already given us considerable trouble. I had been a member of the city council in Philadelphia for 12 years before I became the mayor. We are always worried about the allocations which, of course, reflected the appropriations. I have no faith in it, and while I respectfully say that those that have advocated it have a point, I think we are the losers.

Senator BYRD. You would not favor such a proposal?

Mayor TATE. No, sir.

Senator BYRD. And, as I understand your testimony, you do not favor taking off the tax exempt, eliminating the tax-exempt status but beyond that you will oppose putting municipal and State bonds under the limited tax preferences and the allocation of deductions?

Mayor TATE. That is correct, sir, you read me correctly.

Senator BYRD. So you would oppose any change in the existing status?

Mayor TATE. By any device.

Senator BYRD. By any device.

Mayor TATE. That is correct, sir.

Senator BYRD. Thank you, Mayor. Thank you very much.

Mayor TATE. Thank you, Mr. Chairman.

The CHAIRMAN. I hope to come and see the fine work you are doing in terms of renewing the heart of your city up there, Mr. Mayor.

Mayor TATE. You are welcome any time, sir. I always enjoyed going to your State, too.

The CHAIRMAN. Thank you very much.

Mayor TATE. Thank you.

(Mayor Tate's prepared statement follows:)

STATEMENT OF MAYOR JAMES H. J. TATE, MAYOR OF PHILADELPHIA, PA., ON BEHALF OF THE U.S. CONFERENCE OF MAYORS

My name is James H. J. Tate. I am mayor of the City of Philadelphia. I appear here today on behalf of the United States Conference of Mayors. The Conference is an organization of chief executives of cities located in every part of the United States. I am here specifically to express their firm opposition to the proposals to tax the interest on municipal bonds which are contained both in H.R. 13270 and in the Treasury Department's plan which has recently been outlined to this Committee. The effectuation of either or any part of these proposals, or indeed of any federal attempt to subject the financial obligations of our cities to federal taxation would be, in the view of the Conference of Mayors, unconstitutional and impolitic, and, from a fiscal standpoint, irresponsible and regressive.

These proposals would fatally undermine the doctrine of reciprocal intergovernmental immunity which has heretofore protected both the national goverment, and the sovereign states and their political subdivisions, from unwarranted and obstructive intrusion by either into the other's essential governmental affairs. They would permit the federal government to begin to exercise the most coercive form of dominion over state and local governmental functions, by subjecting them to financial controls through the use of the taxing power.

In thus contributing to the further consolidation of authority in the federal bureaucracy at the expense of state and local government independence and initiative, they move in the opposite direction from the Administration's announced concept of the "new federalism". That concept calls upon states and local government to assume full responsibility for regional and local affairs, with federal assistance, to be provided through such programs as revenue sharing and the funding of minimum welfare standards. We can only regard as self-contradictory a federal policy which proposes distribution of federal revenue to state and local government on the one hand while saddling them with new and tremendous financial obligations on the other.

The fiscal irresponsibility of these new tax proposals with respect to municipal bond interest is conclusively demonstrated by their economic effect. The financial liabilities they would impose upon state and local government would overwhelmingly exceed any gross return to the Treasury in the form of income taxes, and, in fact, the clear effect of these proposals would be to cause a net *loss* in tax revenues to the federal government. To achieve this dubious result it would, nevertheless, be necessary for state and local government to impose additional taxes in annual cumulative amounts which would reach a total of one billion dollars a year just a few years after the enactment of any of these new proposals. In other words, state and local government would be taxing an additional one billion dollars a year just so the Treasury can suffer a net loss.

Unfortunately, the additional revenues needed to pay the higher borrowing costs compelled by these new proposals must be derived primarily from real property and sales taxes which fall most heavily, and most regressively, upon the middle and poorer classes. Yet, both the House bill and the Treasury's proposal are characterized as "tax reform" measures with the professed objective of providing tax relief for these very same classes of citizens.

I emphasize that I cannot avoid overstating the effect of the enactment of these proposals on the fiscal condition of our states and cities. In fact, even the *threat* of federal taxation has thrown the municipal bond market into a state of chaos. No municipality can now market even the most highly rated and secured bond without paying an interest rate so excessive as to be punitive. On July 1st of this year my own City of Philadelphia incurred interest costs ranging from 6.352% to 6.431% on issues aggregating $60,625,000. This was the highest interest cost paid by the City of Philadelphia on record, and there is no question that the primary cause was uncertainty in the market as to the future tax exempt status of our bonds. Yet, this borrowing took place even before H.R. 13270 was reported out by the Ways and Means Committee and passed by the House.

The City of Philadelphia's current program for the development of its airport, seaport, and mass transit system as well as the development of its traditional health, recreation and public safety facilities will cost $903 million. The interest on tax exempt debts to finance that program would be $43.2 million annually.

If the present exempt status of the bonds intended to be issued were jeopardized in the manner recommended by the House Ways and Means Committee, the interest on these bonds would increase at least 2% more than we are currently paying. On the $903 million capital program the extra 2% interest would add $15.7 million to our annual interest cost. To absorb a cost increase of that magnitude it would be necessary to raise the city's real estate tax by 16%.

In addition the school board of Philadelphia has a capital program in excess of $500 million. If the bonds to be sold to finance that program became taxable, the additional interest rate would require another 8% increase in the present real estate tax. In other words, the net increase to the real estate taxpayers of Philadelphia, if municipal bonds are taxed in any form, would be a whopping 24% increase.

And the market has continued to deteriorate. We were more fortunate than the City of Newark, which as recently as September 9th was obliged to accept a net interest rate of 7.684% on a $20,461,000 issue of general obligation bonds. Yet earlier, on July 29th, city officials rejected as excessive a bid for that same issue which would have resulted in a *lower* interest cost of 7.439%. The basis for the earlier rejection was the unsettled state of the market resulting from this threatened tax legislation. The situation since has obviously gone from bad to worse.

Newark was only able to borrow this money because the State of New Jersey had temporarily suspended statutory limits on municipal borrowing interest rates. The existence of constitutional and statutory interest rate limits (which exist in 38 states), coupled with the unwillingness or economic inability of issuers not subject to such limitations to pay punitive interest costs, have resulted in a wholesale cancellation or postponement of borrowings. The consequence will inevitably be severe cutbacks in public works programs on the state and local level which will not only deprive the average citizen of much needed services but will also afflict workers in the construction trades and allied industries. In all, since September, 1968, there have been a total of 316 bond issues valued at well over $1.9 billion which have been rejected or postponed throughout the nation thus depriving many communities work for their building and roads and construction workers. In those cases where borrowings have been consummated during this period, the issuers will have no alternative but to increase local taxes in order to meet the additional interest costs.

The passage of any legislation which would result, directly or indirectly, in taxing the interest on municipal bonds would only insure the continuing chaotic state of the bond market for years to come. Litigation challenging the constitutionality of any such legislation must inevitably follow and until a final and conclusive opinion is rendered by the U.S. Supreme Court, the marketability of municipal bonds will depend entirely upon the ability and the willingness of issuers to pay outrageous interest rates. While I am confident that the unconstitutionality of such taxes would ultimately be confirmed, the additional cost to state and local government in the interim would be staggering. These additional costs soon would reach one billion dollars.

While both H.R. 13270 and the Treasury proposal possess a superficial attractiveness, they cannot survive even a cursory analysis. Both proposals have the laudable objective of preventing affluent persons from escaping income taxation, although there has been no showing of the extent to which these or any persons may have reduced or escaped income tax liability by investing in municipal bonds. The proponents of so-called tax reform would nevertheless require the holders of such bonds to pay a minimum tax to the Treasury. This would be achieved by including a portion of bond interest in taxable income and/or by reducing otherwise available deductions because such income has been received.

What the proponents of these measures fail to realize or fully appreciate is that the purchaser of municipal bonds is paying a very real and a very substantial tax now, and he is paying it to levels of government which most urgently require it. The holder of municipal bonds has accepted an interest rate some 30% or more lower than the rate on comparable taxable investments. This foregone income represents a substantial net gain to state and local government and is the equivalent of the minimum tax so piously sought by proponents of tax reform.

State and local governments have issued bonds now outstanding in the amount of $130 billion. With the owners of those bonds accepting at least 2% less, which is the differential if the exemption is lost, state and local government will in effect lose over $2½ billion annually. If state and local governments are to lose this real income, they will have no recourse but to tax locally to obtain it, and to tax in such formidable amounts as to precipitate public outrage at the grassroots level.

The economics of the new tax proposals make them even more incomprehensible. Under the allocation-of-deduction plan, the Treasury expects to realize a relatively meager $45 million annually. The adoption of the minimum tax proposal would produce in addition only $35 million more. There is no question that the effect of these proposals which would breach the historic immunity of state and local government from federal taxation and shatter the confidence of investors in municipals, could result in at least a 1% increase in the interest rates on the bonds. Assuming no growth in the $16 billion aggregate of new annual municipal bond issues, this means that the Treasury is willing to require state and local government to levy, at a minimum, an additional $160 million in taxes in the first year the legislation is effective to produce income to the Treasury which can only be characterized as negligible. With each additional year, the amounts required to be levied could rise correspondingly and cumulatively. After post 1969 issues outstanding reached only the present level of $130 billion the state and municipal cost would be $1.3 billion a year.

However, the analysis does not end here. All of these taxes required to be levied by state and local government would, of course, be deductible on federal income tax returns. The amounts received by the Treasury as a result of these proposals will thus quite clearly be more than offset by the loss of revenue resulting from increased federal tax deductions. In other words, the Treasury will *lose* revenue by virtue of these proposals but, nevertheless, would impose crushing local tax burdens on our states and cities, burdens which must fall most heavily on the middle- and lower-income classes.

On the basis solely of economics, and that must be the overriding considertion for our cities, these new tax proposals must not emerge in any form from this Committee. We simply cannot afford them.

H.R. 13270 and the Treasury proposal, both by commission and omission, would lull us into a false sense of security. Directing myself to the omission first, I note that only individuals, and not corporations and institutions which hold most outstanding municipals, are subject to the minimum tax and allocation-of-deduction provisions. But we are not taken in and neither are the corporations and institutions. If the Treasury and the proponents of the House bill believe that they can now tax individuals on their interest on outstanding municipal bonds, there is no question but that investors will assume that the same fate ultimately lies in store for corporations and institutions. The current state of the bond market clearly reflects this judgment.

Nor can we find any solace in the bond-interest subsidy provisions included in H.R. 13270. Not only is the Secretary of the Treasury given wide latitude in determining the amount of the subsidy, but the subsidy is completely at the mercy of Congress and may be curtailed and indeed eliminated at any time. The end result will be a debilitating loss of independence by state and local governments over their financial affairs, and ultimate fiscal subservience to the vagaries of an over-centralized federal bureaucracy concerned only incidentally with matters of vital local concern.

The CHAIRMAN. Next we will have a panel of State and local officials. The Honorable Lewis H. Vaden, Virginia State Treasurer; Hon. David B. Buckson, Delaware State Attorney General; Hon. Louis L. Goldstein, comptroller of the treasury, State of Maryland; John Herbert, Ohio State Treasurer; William Summers Johnson, Honolulu Finance Director; Hon. Elmer O. Friday, Jr., Florida State Senator; Thomas M. O'Connor, president, National Institute of Municipal Law Officers, accompanied by Brice W. Rhyne, assistant general counsel; Daniel B. Goldbert, counsel, Municipal Finance Officers Association; Hon. Grady Patterson, South Carolina State Treasurer.

Gentlemen, we have your statements here, and I would hope that you could summarize these statements.

I believe you are well aware of the fact that a very strong case has been made for your position and I am sure you will supplement it.

Senator BYRD. Mr. Chairman, may I say just a word?

The first witness will be Lewis H. Vaden, treasurer of the State of Virginia. He is one of my closest and dearest friends. He is a man of unusual ability. He knows local government and he knows State government. He was an elected official for many years in the urban county of Chesterfield which surrounds the city of Richmond, and since 1962 he has been treasurer of Virginia, and I am glad to welcome him and present him to the committee.

I am glad to see another old friend, Louis Goldstein from Maryland, who was State senator when I first met him.

Mr. Vaden.

The CHAIRMAN. Gentlemen, we, of course, understand that if the committee had time to hear them it would perhaps be possible to prevail upon almost every State officer to come before this committee and explain his concern about this proposal to tax State and local bonds. It is very clear to us from what the Governors have said and what has been testified at this point, and I am sure that is your view as I take it.

Mr. VADEN. Mr. Chairman, I am indeed grateful for the kind remarks of Senator Byrd in my behalf which I appreciate greatly.

He made second reference to another friend who, mutually we have agreed, will appear first on our panel, the Honorable Louis Goldstein, comptroller of the treasury of the State of Maryland.

The CHAIRMAN. I hope you gentlemen understand that the absence of our Republican members is because they are holding their caucus at this moment to elect their new Republican leader.

STATEMENT OF HON. LOUIS L. GOLDSTEIN, COMPTROLLER OF THE TREASURY, STATE OF MARYLAND

Mr. GOLDSTEIN. Good morning. Thank you, Mr. Chairman.

Mr. Chairman and members of the Senate Finance Committee, I thank you for the opportunity to appear here this morning and testify with reference to H.R. 13270.

My name is Louis L. Goldstein. I am the comptroller of the State of Maryland, and immediate past president of the National Association of State Auditors, Controllers, and Treasurers.

I am also cochairman with the Honorable John D. Herbert, State treasurer of Ohio, of the National Association's Committee on Tax Exempt Bonds. I also represent the Honorable Marvin Mandel, the Governor of Maryland, and the Honorable John A. Leutkemeyer, the State treasurer of Maryland.

We have submitted a joint statement along with the Municipal Finance Officers Association here represented by its counsel, Daniel B. Goldberg, who is also counsel to our subcommittee.*

We ask the joint statement be included in the record, together with the respective resolutions of our two associations on the subject of Federal taxation of State and municipal bond interest which we categorically oppose.

I would like to file the resolutions for the record.

In order to avoid repetition in our oral statements, Mr. Herbert, Mr. Goldberg, and I, with Mr. Vail's consent, formed a panel along

*Mr. William Summer Johnson does not subscribe to the joint statement and is making a separate statement.

with our fellow State and municipal finance officers, State Treasurer Lewis H. Vaden of Virginia; State Treasurer Grady L. Patterson of South Carolina, and Director of Finance William S. Johnson of the city of Honolulu; the Honorable Elmer O. Friday of the Florida State Senate, the vice chairman of the Council of State Governments; Hon. David Buckson, attorney general of Delaware, representing the National Association of Attorneys General; and City Attorney Thomas M. O'Connor of San Francisco, president of he National Institute of Municipal Law Officers.

We shall each speak to separate aspects of the proposals of H.R. 13270 to tax State and municipal bond interest. But we do not wish by our limited presentations to be understood to be any less committed in our total opposition to the proposals to tax our bonds.

In a sense each of us speaks for all of us.

The National Association of State Auditors, Controllers, and Treasurers and Municipal Finance Officers Association between them include the finance officers of all the States and the major political subdivisions.

We have the responsibility for issuing the bonds to finance State, county, and municipal capital improvements. Our ultimate position is that the inclusion of interest on our bonds in the base for limit on tax preference provisions under section 301 of the House bill and the allocation-of-deductions section provisions of 302 can lead to only one result. If enacted, they would increase the share of the cost of government which is borne by persons of modest means, the average worker, the average local taxpayer, and, in addition, in many communities, local services to these same people would have to be cut back.

This, we submit, is not reform but is the very opposite. The goal of reform, as we see it, should be a fair distribution of the costs of government based on the abiiity to pay.

The proposals of this bill are not reform proposals because, when their ultimate effect is traced, they impose greater burdens on those least able to afford them.

The LTP and allocation provisions would impose taxes on the borrowing by which our States, counties, and cities raise the money to build our schools, our playgrounds, our highways, our parks, our sewers and waterworks, and the other State and local capital improvements which are most important to the average citizen.

The antireform effect comes from the inevitable chain reaction, taxes on the bonds lead immediately to higher interest costs to the State and the municipal borrowers. Higher interest costs mean either higher State and local taxes or reduced services or more probably both. Every local citizen is hit in this way no matter how modest his means.

In the total distribution of taxing power the Federal Government is best equipped for progressive taxation. Our local governments have been consigned mostly to the use of regressive taxes which bear most heavily on those with the least ability to pay. Property taxes are still the mainstay of municipalities. Fully 80 percent of local government revenues come from this overworked source.

Sales taxes, which are growing in use, are also regressive, bearing especially heavy on the poor. Even our State tax structures cannot approach the progressive character of the Federal income tax system.

When interest costs are forced up, we shall probably be required to meet the increase principally with higher property taxes, which means that every citizen is penalized. He must bear a higher cost of owning or renting his home. If sales taxes are used, every citizen is penalized by higher cost of purchases of even the bare necessities of everyday life. Those taxes no one can escape.

Higher local costs and higher local taxes are not the whole story. Sometimes municipalities are at the limit of what you can levy in such taxes.

When a community is at the breaking point, what would happen is that more schools would be unbuilt, more hospitals would be deferred, more water purification plants and sewer work would be put off, and so forth.

In some communities where taxes simply cannot be raised, the harsh choice will be faced between forgoing needed schools or other improvements or slashing the regular expense budget to provide less police protection, less street maintenance, larger school classes per teacher, and the like.

Gentlemen, please remember a taxpayer revolt is not limited to Federal income taxes; it has led to the defeat of many local bond issues in popular referendum. The local taxpayers reject referendums at over 6-percent rates because they mean higher property taxes. We cannot pay 7-percent interest rates compelled by the so-called Tax Reform Act.

When traced to their final repressive effects on the average local citizen, we submit that the so-called reform to tax State and municipal bonds backfires badly. It is no reform at all. It is a perfect case of throwing out the baby with the bath water and we don't want to do that.

As we shall show, the Federal gain from these provisions of the bill will be much, much less than State and local losses. But even if this weren't so there would be no excuse for these new taxes on State and local bonds.

Ability to pay is a principle which should govern the distribution of burdens as between the levels of government as well as between individuals.

The Federal Government is a rich member of the federal system, and the local governments are the poorest, with the lowest ability to pay and the lowest ability to distribute their own costs on the basis of their own taxpayers' ability to pay. Thus even if the Federal Government could derive somewhat larger revenues, the States and local governments would lose from these provisions. This would not be reform.

I know millionaires are supposed to be the targets of LTP and the allocation plan. Another panelist will deal with the twin myths that only millionaires hold State and municipal bonds and millionaires hold practically nothing but State and local bonds.

Here I want to note that is not true that only millionaires would be hit by the House bill. A middle-income taxpayer who has very little income from municipal bonds can nevertheless easily be caught under the House bill because the interest is thrown into a common pot with other items. These other items can trigger the additional tax on municipal bondholders of modest means. A physician or small merchant can reach the limit easily by the inclusion of accelerated depreciation, augmented by untaxed capital gains. If he sells a home he has held for 20 years and has a modest success in the stock market he can be paying taxes on any municipal bond interest he receives without having achieved the exalted status of the millionaire.

I would just like to take one-half minute and touch on a situation in Maryland.

I hold in my hand a list of the number of bonds that are authorized by our general assembly in Maryland, and the bonds outstanding as of September 22. As of this date we hrve authorization to sell $1,038 million worth of bonds. We have outstanding $459,180,000 worth. We were supposed to go to the market on July 15. We couldn't get a taker. Our ceiling is 5 percent. The last bonds we sold in Maryland were last February, some $58 million worth. Our bond rate is AAA, they sold for 4.31. We are the second-fastest-growing State east of the Rocky Mountains. Our growth naturally is tied in with the Federal Government. Those who work in Washington have to have a place at night, they can't all sleep in Washington or Virginia. Many come to the land of pleasant living and we are happy to have them in the land of pure sunshine, pure water, and pure air.

Senator McCarthy. You are not talking about Chesapeake Bay?

Mr. Goldstein. Yes, Senator McCarthy, I live on the bay. I wish you could come down home and be my guest and I will show you the finest seafood and purest water in the world, the largest inland sea on the Atlantic seaboard.

Here we have to give these services to all of these wonderful people growing by a hundred thousand people a year and we can't sell our bonds.

Senator Anderson. What interest rate are you offering, 5 percent?

Mr. Goldstein. Our ceiling is 5 percent, Senator Anderson. We now have a case filed in the court this morning to see if we can't use a 5-year bond. We have some State deposits in banks, demand deposits, and they are making a bit of interest on these. I feel some of these banks will probably buy some of these bonds, and some of the big insurance companies that have their base in Maryland, U.S.F. & G., Safe Deposit and Trust, and Fidelity. However, we have to have a test case to determine if we can issue such bonds.

The Chairman. If I understand what you are saying, the 5-percent interest rate which you think you might be able to sell some of those by depositing some money with the bank, or with an insurance company at no interest or at a low interest rate and then in consideration of that they might be in a position to buy some 5-percent bonds from you. Is that what you are saying?

Mr. Goldstein. We have around $25 million in open accounts in big banks and Suburban Trust in Silver Spring; we have that money on hand because I have to have money to pay all the bills because I am revenue commissioner, and I have to pay the bills. We keep that much money on demand deposits. We feel that our doing so would be an inducement to these banks to buy these bonds. Short-term obligations, we feel, would take care of the 6-percent inflation you were talking about this morning.

Senator Anderson. If you are offering these at 5 percent while a building and loan pays 5¼ you wouldn't expect any business?

Mr. Goldstein. These are tax-free bonds; that is the feature to get people to buy, and most of these people are in the 50-percent bracket.

It is the equivalent of getting 10 percent on the money. That is the only inducement we have got to offer them, sir.

Senator McCarthy. Why don't they buy them?

Mr. Goldstein. We have a test case filed in court this morning to see if we can sell 5-year obligations. Our constitution provides for a limitation of 15-year bonds and it is not clear that we can sell a 5-year bond. We want to be sure that what we are doing is legal so that we can't be attacked in the courts after we do it.

Our next panelist is Mr. Daniel B. Goldberg, who will give you a quantitative analysis of the increase in our interest rates because of H.R. 13270 and the prospective Federal gains and losses.

Thank you very much, Mr. Chairman and members of your committee, for the opportunity to appear before you.

In my more than 30 years in public life I can think of no more important endeavor than this effort to allow my fellow panelists to dissuade you from embarking on a course which I feel would be a disaster, a disaster not only to the governmental structure of our federal system, a disaster to the average American, that little man, the workingman whom this bill is supposed to protect. Tax reform should mean more equitable distribution of the taxes of all levels of government, not just the Federal income tax alone.

May I present Mr. Goldberg?

STATEMENT OF DANIEL B. GOLDBERG, COUNSEL, MUNICIPAL FINANCE OFFICERS ASSOCIATION

Mr. Goldberg. Mr. Chairman, Chairman Long, and members of the committee, in the allocation of subjects covered by our panel, my assignment is to quantify the various financial factors involved in the provisions of this bill limiting the value of the municipal bond tax exemption.

The absolutely violent market reaction to the House proposals this year gives a measure of the added municipal interest costs involved.

We have behind me—I hope you can see it—we have behind me a chart of the movement of interest rates over the past 2 years of standard indexes of seasoned long-term municipal bonds of average grade as compared with taxable corporate bonds, the red line at the top. It also shows the rates on Federal Government bonds which is between the other two lines.

You will notice that the State and municipal bonds represented have consistently sold at lower yields than the taxable Federal Government or corporate bonds. The difference between the municipal and corporate bond indexes is a rough measure of the average savings which tax exemption has meant to the average State or municipal issuer.

The important thing to note is that, while all interest rates have been increasing, the gap between tax-exempt municipals on the one hand and taxable Federal and private bonds on the other has been closing since the program to tax our bonds gathered momentum early this year.

We have illustrated this closing of the gap by a separate chart which plots the change in the ratio of tax-exempt bonds to corporate bonds, trying to exclude the general market increase which, of course, has impelled both of them to go up.

This line shows the ratio. Two years ago, when this chart begins, municipal yields in the standard "Bond Buyer 20" index were just about 70 percent of the yields of industrial bonds in the Moody's index. That is to say that States and municipalities were saving some 30 percent, on the average, of what they would have paid at that time on fully taxable bonds if that was the way they had to finance themselves.

This ratio fluctuated until this year between 64 percent, at its low point, and 72 percent.

We think it is fair to say that the traditional ratio has been roughly 65 percent to 70 percent, meaning that the State and municipal saving has therefore averaged 30 percent to 35 percent—and this is our first critical quantity. We want you to have that in mind.

This State and municipal saving is, of course, also the exact measure of the price which the lending bondholder has paid for his expected tax exemption and we emphasize the fact that he hasn't gotten it for nothing, he has paid for it. He has sacrificed 30 to 35 percent of his potential interest.

As the movement to tax our bonds picked up speed early this year the ratio of municipals to industrials leaped from the traditional 65- to 70-percent level.

Where this chart stops at the upper right-hand corner as you face it, at the end of August when this chart was made up, the ratio stood at 83 percent. We are off the chart now at 84 percent. That is where it was by mid-September.

Altogether, between the end of 1968 and mid-September 1969, the ratio of municipal to corporate yields jumped from 71 percent to 84 percent, the difference representing a loss to the States and municipalities of 13 percent of a comparable tax interest rate.

By simple multiplication, 13 percent of the typical taxable interest rate of near 8 percent today produces a loss to the municipal issuers of fully 1 percent, 1.04 is the mathematics of it. We feel we have proven that, after isolating the general market increase, there is a loss of 1 percent that municipal issuers have suffered.

While this loss may be attributed in part to other causes, the principal cause is the House bill. Let us remember, too, that not everyone is convinced that the House bill will be enacted in its present form. Actual enactment, dispelling the last hope of retaining the exemption intact, would produce additional municipal interest losses.

All in all, we judge that the full 1-percent interest rate increase already suffered this year is a quite conservative estimate of the average increase which enactment of the House bill would compel in the present market over what it would be if the provisions relating to municipals were deleted. Of course, the lesser known credits would suffer much more. We heard the gentleman from North Platte making that point. The small school districts and villages and counties where almost the sole attraction in the marketing of their bonds has been their traditional exemption will probably find themselves excluded from the market completely. A 1-percent average interest rate increase is our second critical quantity.

If we apply this increase of 1 percent to next year's anticipated new-issue volume of $15 billion to $20 billion, we find the House bill penalizes State and local government taxpayers by $150 million to $200 million in the first year of operation. Let's say $150 million, and that is our third critical quantity—the first year's loss to State and local government.

As I say, $150 million is only the first year's cost on the first year's issuance. What would be the cost to States and municipalities on this first year's issuance over the entire life of the bonds thus issued in 1970? If we assume a 20-year term with equal annual debt service payments, like a home mortgage, we get an average life per issue of about 13 years, and so our 1970 issue alone would involve at least $2 billion in future added interest costs to States and local government, all contracted for in 1970.

At the back of our filed joint statement, which has been printed in the committee booklet, there is a table distributing this added cost on just 1970 issues among the States. It assumes an aggreate new issuance of $19.5 billion and that each State's proportionate share will be the same as in 1968 when the aggregate was $16.1 billion. If you want a fair approximation of what the House bill would cost your State and its municipalities on only 1970 issues, take a look at that table. By the time new issues replaced the present volume of our bonds outstanding, $130 billion, the aggregate annual—I am back to annual—the aggregate annual cost to State and local Government taxpayers of the 1-percent increment would be 1 percent of the $130 billion or $1.3 billion per year. I ask you to keep that in mind. This is our fourth and most critical quantity. In that year the amount of future payments contracted for would have increased by $17 billion by multiplying out the 13-year average lifetime, the $1.3 billion a year continuing added cost.

Senator BYRD. Mr. Chairman, may I interrupt just a moment? Where is the table to which you referred? Where does one find the table to which you just referred?

Mr. GOLDBERG. Where does one find it? It is printed in the back of the statement in the booklet, I can give you the page later.

Senator BYRD. This one?

Mr. GOLDBERG. Yes. The joint statement that Comptroller Goldstein identified.

The CHAIRMAN. Where is that?

Mr. GOLDBERG. It is reproduced there.

The CHAIRMAN. Just a moment and we will find where it is.

Mr. GOLDBERG. The two charts of which you have seen the large blowups on the easel are on pages 112 and 113 of the booklet, and the breakdown by States is on page 114.

Now that we have these cost figures to State and local government, it is time to compare them with the revenue expectation that the Secretary of the Treasury has given you on September 4.

As against our $1.3 billion of loss every year once we reach present outstanding volume on new issues——

The CHAIRMAN. Let me just try to understand it. I am looking at the table on 114. You are saying this is what you think the cost would be. I am just looking at my own State, Louisiana, on the chart on page 114. Would you mind explaining how I should read that chart, what that means?

Mr. GOLDBERG. Yes, Senator Long.

We took an estimated 1970 volume of new total State and local government bond issues, in this case $19.5 billion. In 1968 it was $16 billion, $16.1 billion. This year the volume is off because of the problems that you have heard about, particularly this bill, and the breaking through of the legal limits. We think realistically that 1970 will be a year of catching up some of that loss and the volume might well go to the figure which we have assumed.

In breaking that down by States we assumed quite arbitrarily that we could apply the same ratio to 1970 that did apply in fact in 1968. I know it isn't going to be right State by State but it is some measure. Then we applied the 1-percent increment over an assumed average life of 13 years which is about right for a 20-year bond.

The CHAIRMAN. This means that in 1970 this proposal would cost Louisiana $6.4 million and over the life of the bonds that were issued it would cost Louisiana only $83 million.

Mr. GOLDBERG. That is correct, Senator Long.

The CHAIRMAN. I can see why the State government would be very much upset about that.

Mr. GOLDBERG. So far we have been talking, as I say, about our costs, and now we should turn to look at what may be expected to go into the Federal Treasury in return for the costs that we would bear.

The Secretary testified that the Treasury would receive a relatively insignificant $80 million against these costs, $80 million a year, $45 million from the allocation of deductions plan which he recommends, and $35 million from the limit on tax preferences which he does not recommend.

Incidentally, if the added $1.3 billion of annual State and local interest costs is translated, as most of it must be, into State and local taxes, these taxes are in turn deductible items on Federal income tax returns. It is going to cost the Treasury something when those deductions are taken on individual income tax returns.

If we assume an average deduction, and only in the 14-percent bracket, the Federal Government stands to lose up to $182 million a year in this way, which would wipe out the $80 million. Even half of it would wipe out the $80 million these provisions are calculated to raise.

This $80 million Federal revenue gain is many years off, if the proposals are restricted to only new issues of municipals. The $80 million would be derived right now from applying the provisions in full immediately, but some people consider that to do so would be a terrible breach of faith in the provisions of the bonds already outstanding. But if restricted to new issues, I would judge that, in 1970, the Federal gain would be something like $9 to $10 million if you scaled it down proportionately. No matter how you figure it, the House bill is bound to cost the State and local governments far, far more than it can produce in revenue for the Federal Government. Actually, we believe the bill would provide no gain at all for the Federal Government but an actual out-of-pocket loss, and particularly, as Governor Kirk said yesterday, if the States were led by the enactment of the bill to retaliate against Federal bonds.

We even think that the tax equity argument for the House bill does not hold good. In the case of maximum application, the LTP plan exacts tax at top bracket rates applicable to half of total income, so-called economic income. That means if an individual who has no municipal bonds is in the 60- or 70-percent bracket the most he is asked to pay is one-half the top bracket rate or 30 to 35 percent. But it will be remembered from our first critical quantity that this 30 to 35 percent is just what every State and municipal bondholder in recent normal markets has already contributed to the cost of the government by accepting that much less interest than he could have received from comparable taxable private bonds.

Since the municipal bondholder, no matter what bracket he is in, is already contributing to the cost of government at the highest rate to be applied to the recipient of other tax preference income, where, we ask, is the argument in tax equity for taxing the municipal bondholder again? Why should he, of all the recipients of so-called tax preference income, be thus subjected to a double exaction for the support of government as the price of his so-called tax preference?

Clearly the bill's attack on municipal bonds would be an unmitigated disaster for all government. It is not justified even by the so-called tax equity arguments applied to recipients of the other so-called tax preferences, and by leading to regressive taxes at the local level it forfeits any claim to furthering tax justice or true reform.

Mr. Chairman, our next panelist is the Honorable John D. Herbert, Ohio State treasurer.

Senator Byrd. Mr. Chairman, may I ask one question just at this point before we leave Mr. Goldberg?

Am I correct in this assumption, jumping from the table on page 114, the localities and the States will be—will have additional interest cost of roughly $200 million yet the Federal Government will only gain $80 million?

Mr. Goldberg. That is exactly right; $200 million if the volume is $20 billion. That is the first year.

Senator Byrd. Thank you.

Senator Anderson. You have to make certain assumptions all the way through.

Mr. Goldberg. The assumptions, I think, are quite reasonable, Senator. The volume in 1968 of new issuances, it is on new issuances that we have to pay the additional interest, no matter what you do to the taxpayers who hold the old ones, the volume was $16 million. You can safely assume that 1970 will not be less than that, which would produce $160 million at the 1-percent figure for all State and local government.

We think it could well be higher because of the shortage, the drop in issuances in 1969 because of the distress factors of which you heard. This table assumed an increase in issuances of 10-percent increments for each of the years 1969 and 1970 yielding a total of $19½ billion in new issuances in 1970. That, on a 1-percent basis, has got to produce nearly $200 million of added costs to State and local governments.

Senator Anderson. I hope they are. We assume this is Wednesday. You assume everything under the sun.

Mr Goldberg. I didn't hear you, Senator.

Senator Anderson. You assume a great many things.

Mr. Goldberg. I have made only two assumptions, one which I think I have proved from these charts that our interest costs will be 1-percent higher than if the provisions, these provisions, were deleted from the bill. That is assumption No. 1. Assumption No. 2 is the volume issuance, and you may argue that the number shouldn't be higher than the 1968 volume of $16 billion, but I don't think, I don't see how you could expect it to be less.

If you want to assume a $16 billion issuance, then the 1-percent figure would produce $160 million. I don't think I have made any assumptions which are unreasonable and I think I have proved the 1-percent increase in interest rates by the charts that we have introduced.

STATEMENT OF HON. JOHN D. HERBERT, STATE TREASURER OF OHIO

Mr. HERBERT. Mr. Chairman, and distinguished members of the Senate Finance Committee, my statement today is made not only as a member of this panel and in support of all else that has been said, and for the National Association of State Auditors, Controllers, and Treasurers of which I am an officer and co-chairman of the committee on tax exemption, but also on behalf of the Governor of Ohio, James A. Rhodes and the other officials of Ohio.

Our concern arises, the specific one I want to discuss, because of the fact that when this bill was presented on the floor of the House a number of Congressmen asked whether it would adversely affect the State and municipal bond market and they were assured that it would not affect municipal bond prices substantially.

At virtually the same time we were issuing a $65 million development bond series in Ohio at a rate of 5.94 percent, nearly 6 percent, when less than a year ago on the exact same kind of issue, the rate was 4.29, or less than 4.3 percent, a difference of over a percent and a half in less than a year.

Certainly, I think those who gave the reassurances were sincere in their representations because they didn't expect the impact that was there. They judged the impact marketwise to be what they assumed the impact taxwise would be.

From the figures submitted by the previous panelist, it must be obvious that the market is reacting to much more than a limited preference tax plan yielding only a $35 million revenue, or an allocation-of-deductions plan yielding only $35 million and applied to only outstanding bonds or even to both plans combined. How can such a small Federal revenue gain produce such market repercussions as to cause State and local govrenment so much more than proponents of these provisions thought?

Quite plainly the investors are not just mathematically appraising the immediate dollar or tax loss to them of these specific new plans. What they are appraising is the consequence of basic constitutional repudiation of the historic concept of tax exemption of State and municipal borrowing. When they are told these plans are small and painless they react as if told that only a small cancer has developed in an otherwise healthy body.

A bond buyer has only one chance to decide how much interest he is willing to surrender in exchange for tax exemption on a bond with a 20- to 30-year life, and that time is when he parts with his money.

At that moment he knows he will receive only the stated coupon rate no matter what Congress will do during those 20 or 30 years.

Until this year that bond buyer had complete faith that Congress would consider it unthinkable to tax these bonds. He has seen such proposals turned back time and time again. He assumed that Congress would consider it immoral to tax outstanding bonds after he had paid for his exemption by accepting 30 to 35 percent less interest than he would receive on corporate issues. And he just could not bring himself to believe that Congress would disregard the kind of pleas which State and local government officials are making to you now.

Right now that faith is badly shaken. The Treasury has not only recommended that the allocation plan be applied to municipals but has even brought itself to urge that the plan be applied to outstanding municipals.

The House has actually passed the bill applying both limited tax preference and allocation to municipals, and limited tax preference to outstanding bonds.

The Ways and Means Committee had tentatively voted this spring to apply a minimum tax to corporate holders of outstanding municipals and an allocation-of-deductions plan to banks.

Against that background an investor would be foolhardy to assume if Congress began by enacting the House bill or even only the Treasury allocation plan the matter would stop there for the whole 20- to 30-year life of his bonds. Being unable to protect himself later he decided to protect himself now when he parts with his money.

He concluded that he has to treat these plans as first steps, cancers if you will, that are bound to spread. If the bond buyer is a bank it is too sophisticated to assume that the so-called "reform zeal" in this field once sanctioned by Congress would not spread to financial institutions and other corporations.

If limited tax preference can be applied so as to tax disallowed tax preferences at one-half their total this year then, he asks himself, why not at three-quarters next year or in full the year after?

If Congress sets a $10,000 leeway figure this year, he reasons, then why not $5,000 next year and no leeway at all the year after?

Can he rely on the 10-year phasing plan to continue? The Treasury already urges you to abandon it. I know that you gentlemen are experts in keeping only the camel's nose under the tent when you have resolved to do so but here the question is not what your psychology is but the market psychology. This market psychology of self-defense explains why Congress cannot even drop pebbles into the hitherto calm waters of unimpaired State and municipal bond tax exemption without causing tidal wave repercussions on State and local governments.

The Treasury argued here on September 4 that the market did not react when it first proposed the allocation plan to the House Ways and Means Committee and, therefore, only limited tax preference and not its plan must be the culprit.

But this overlooks two things. First, even those who understood the plan last March were just not ready to believe that Congress would take it seriously.

The Treasury has been recommending the curtailment of exemption without success for over 30 years.

Second, the seriousness of the plan was just not fully appreciated when it was first advanced.

The market reaction since the Ways and Means Committee acted is so violent that it just cannot be explained in terms of the limited tax preference plan yielding only $35 million a year any more than it can be explained in terms of a combined limited tax preference and allocation plan yielding only $80 million a year. Excising the limited tax preference plan will help very little in restoring market confidence. That confidence can be restored only by eliminating all plans to curtail the value of exemption.

The case for this boomerang reform becomes worse when we consider that there is no evidence of excessive concentrations of municipals in millionaire hands. By now we all know how the Treasury officials overstated the story of the 154 millionaires who pay no tax. Assistant Secretary Cohen had to admit that here on September 4.

He said, "I think there was undue enthusiasm over the category of 154." This outstanding example of misleading propaganda is credited by him as having fueled the taxpayers' revolt which led to this bill.

What became evident but was not stressed in the September 4 testimony, was that, on the record, State and municipal bond interest had absolutely nothing to do with these 154 persons not paying taxes. There is no record knowledge that any of them held tax-exempt bonds.

Their nonpayment of taxes was attributed completely to other circumstances.

Senator ANDERSON. Would you read that last part again?

Mr. HERBERT. What became evident but was not stressed in the September 4 testimony was that, on the record, State and municipal bond interest had absolutely nothing to do with these 154 persons not paying taxes. There is no record knowledge that any of them held tax-exempt bonds. Their nonpayment of taxes was attributed completely to other circumstances, other deductions or what have you.

Senator ANDERSON. I thought the Treasury Department did testify.

Senator WILLIAMS. I think he is correct because the Treasury did not have access to the information as to what extent these 154 individuals may have held State and municipal bonds.

Mr. HERBERT. They may have but there is no record that they held them.

Senator WILLIAMS. I think that is correct. The Treasury did not know to what extent these 154 people were involved in the State and municipal bond.

Senator ANDERSON. Go ahead. Thank you.

Mr. HERBERT. Testimony before the Ways and Means Committee shows that, in the highest adjusted gross income bracket of $315,000 a year and over, fully 35 percent of the taxpayers did not own any municipals at all and only 18 percent of them derived as much as 10 percent of their income from this source, and only 6 percent derived as much as 25 percent from this source.

Nor are millionaires the only investors who hold municipals. Individuals in all brackets hold only about 31.8 percent of the outstanding volume.

Testimony before the Ways and Means Committee shows that municipals were held by 88,000 individuals in the middle-income class, being from $16,400 to $31,000 adjusted gross income, fully 7 percent of all those in this bracket.

There is one documented case pointed to by proponents of the bill of a millionaire old lady in her 90's who has all her wealth in municipals and pays no income taxes. Of course, she has paid the equivalent of 30 to 35 percent tax by accepting lower interest rates but actually she is more to be pitied than envied. She has seen her capital shrink over the last few years by actually 30 percent as municipal bond prices tumbled to offset skyrocketing interest costs. She has therefore lost more in capital from her unique investment program than she received in total interest during those years.

More typical are the 82 percent of the top income class who receive less than 10 percent of their income from municipal bond interest. These individuals had an opportunity over the few years to participate in rising stock market prices and other forms of equity investors, while the 90-year-old lady has had only losses.

One sometimes wonders whether the foibles of this one old eccentric are going to be allowed to produce a breakdown in the legal fabric of American constitutional government.

(The joint statement for the National Association of State Auditors, Comptrollers, and Treasurers, follows:)

Prepared Statement of the National Association of State Auditors, Comptrollers, and Treasurers

Summary

I. The National Association of State Auditors, Comptrollers and Treasurers includes all state finance officers; and the Municipal Finance Officers Association includes the principal municipal finance officers, with ultimate responsibility for issuing the public bonds taxed by H.R. 13270.

II. Our ultimate conclusion is that inclusion of state and municipal bond interest in the bill's tax plans produces in final effect, not reform, but its opposite. This is because the provisions drastically increase state and municipal interest rates and force these governments into curtailing services needed by the average citizen and/or increasing local taxes, principally property and sales taxes, which fall with especial harshness on the persons with the least ability to pay.

III. Charts of recent market movements prove that the House program has caused state and municipal interest rates to skyrocket. The traditional gap between tax exempts and comparable taxable bonds has narrowed—what used to be 65% to 70% ratio (state and municipal savings of 30% to 35% of taxable rates) has jumped this year to 83% for a state and municipal savings of only 17%.

IV. The current market action proves that the enactment of the House Bill would cost fully one percent additional interest rate.

V. On anticipated 1970 new issuance volume of $15 billion to $20 billion, the added dollar cost to state and local governments for the first year's payments on only the first year's issues would be $150 million to $200 million. The full life cost of only the first year's issuance would be at least $2 billion to $2½ billion. The second year's new issuance at the same volume level would double these figures. By the time new issuances had produced a level of post-1969 bonds out-of the Bill, if enacted, would be $1.3 billion, the annual state and municipal cost of the Bill, if enacted, would be $1.3 billion, and if that level were only maintained and not increased, the added cost over the life of those bonds would be some $17 billion.

VI. These enormous extra burdens on state and local governments and their taxpayers would offset many times over the mere $80 million a year which the Treasury concedes is all that would be realized from applying both LTP and the allocation plan to all state and municipal bonds, even those now outstanding.

VII. The enormous discrepancy between federal gain and state and local loss itself makes the bill ludicrous and the opposite of reform.

VIII. The violence of the market reaction contradicts the Treasury assertion that it results only from inclusion in LTP of state and municipal interest, which the Treasury opposes, and not from their inclusion in the allocation plan which

Treasury favors: An LTP plan yielding $35 million a year cannot possibly explain a billion dollar a year interest reaction; even an $80 million revenue a year combined LTP-allocation plan cannot account for the loss.

IX. This enormous discrepancy results from the complete and reasonable loss of investor confidence in continued exemption, even such as survives in this bill, once Congress, for the first time, brings itself to repudiate the basic concept of intact exemption by "gimmick" plans to reduce the value of exemption.

X. Investors regard this bill, if enacted, as introducing a cancer into an otherwise healthy body. They are not persuaded that there can be a small and safe cancer. Investor confidence can be restored only by scrapping all the bill's plans to curtail tax exemption of state and municipal bonds.

XI. There is no evidence of abuse of the exemption. The facts on the famous 154, non-taxpaying millionaires shows no holding of state or municipal bonds by the group.

XII. In the highest bracket, adjusted gross income of $315,000 and over, 38% of the individuals had no municipals at all, only 18% of them derived as much as 10% of their income from this source and only 6% derived as much as 25% from this source.

XIII. Gains from tax exemption in recent years have been more than offset by capital shrinkage of the market price of the bonds as interest rates have risen.

XIV. Municipals are not concentrated in the hands of millionaires. Only 31.8% of all such bonds are held by individuals of all income levels. All levels of income above $10,000 a year include some municipal holdings. Seven percent of those in the middle income bracket of $16,400 to $31,000 adjusted gross income, hold municipals. Such middle income persons can easily be caught by the House bill provisions.

XV. Enactment of the bill is bound to produce state retaliation in the form of LTP and allocation plans made applicable to the $300 billion of federal bonds hitherto exempt from state taxation. Even .015% (1½ basis points) resultant rise in federal interest rates would wipe out the entire revenue gain from applying the allocatiaon plan to muncipals. Only 3/100 of one per cent (3 basis points) of increase would more than wipe out the $80 million which such the LTP and allocation plans would exact from state and municipal bondholders.

XVI. Municipal bondholders already pay 30% to 35% to the cost of government by accepting that much less interest than comparable taxable bonds would yield. Since 30% to 35% is the highest level of tax proposed on other "tax preference" income, there is no argument in equity for exacting it a second time from the holder of municepals.

XVII. State and municipal bond exemption is not a Congressionally created "tax preference" like the other classes of income so labeled. It derives from the constitutional form of our federal system which Congress is not free to change.

XVIII. The House proposals are unconstitutional. They collide with precedent and they fall afoul of the constitutionally interdicting rule that taxes may not be applied to state activities because taxation is, in the words of Justice Black and Douglas, such a powerful "regulatory instrument." An example of abusive regulation of state governmental actlvtity by exercise of the power to tax bond interest already appears in the Revenue Code by last year's overkill mis-definition of industrial development bonds and by the 1968 Act's arbitrary selection for exemption of certain traditional governmental activities and the rejection of others. Correction of this error would be accomplished by Congressman Wilbur Mills' H.R. 12923 or Senator Baker's S. 2280.

XIX. The allocation of deductions plans is not constitutionally cleared by *United States v. Atlas Life Ins. Co.*, as Treasury claims. That case dealt with the unique problems of taxing life insurance companies which, unlike individuals, have the dual charactistics of owner of part of their apparent income and custodian of much the larger share for policyholders for ultimate payment to them as death benefits. Allocation can be reasonable between such dual interests without applying to an individual, who has no such duality.

XX. Inevitable constitutional litigation over the validity of the House Bill would produce market chaos for years, which would cost local taxpayers hundreds of millions of dollars whatever the outcome.

XXI. The provision taxing "arbitrage bond" interest is outrageous. It contains no definition of the term. If properly defined there are no such bonds which can be lawfully issued. The provision is probably aimed at the blameless practice of investing declining balances of municipal bond proceeds until they are applied to the capital improvement for which they were borrowed.

XXII. The "tax-recompense" plan for Title VI is a travesty of a truly optional plan combined with the inclusion of state and municipal bond interest in Sec. 301 (LTP), and 302 (allocation). It is outright coercion. The bill leaves no tax-exempt bonds to opt for. It is frightening to consider the Secretary of the Treasury as the arbiter of what the rate of recompense should be. A 25% floor under the recompense rate threatens a return to the issuers of less than tax exemption has saved them. The plan would leave the states and municipalities helpless if the recompense was withdrawn by a later Congress after the traditional tax-exempt market had withered away. And, finally the dangers of federal control in the plan are exposed by the fact that the bill starts off by making certain bonds ineligible.

The National Association of State Auditors, Comptrollers and Treasurers and the Municipal Finance Officers Association, between them, include the finance officers of all the States and of the major political subdivisions of this country.[1]

It is our members who have the responsibility for issuing the state and local government bonds which finance our country's public capital improvements at the state, county and municipal levels.

REFORM IS THWARTED, NOT AIDED, BY HOUSE BILL

The inclusion of state and municipal bond interest in the base for the "limit on tax preference" provisions of section 301 of the House Bill and the "allocation of deductions" provisions of section 302 can lead to one result—to increase the share of the cost of government which is borne by persons of modest means, the average local taxpayers. This added burden will be compounded in many communities by reduced local services. This, we submit, is not reform, but its very opposite.

Section 301 and 302 would impose taxes on the debt instruments by which our states, counties and cities raise the money to build our schools, our playgrounds, our highways, our parks, our sewers and the myriad of other state and local capital improvements which are closest to the average citizen. These proposed new taxes would produce their anti-reform effect by an obvious chain reaction: taxes on the bonds lead immediately to more interest costs to the state and municipal borrowers; more interest costs mean either higher state and local taxes or reduced services or both.

REGRESSIVE RESULTS

Every local citizen is hit in this way, no matter how modest his means.

Our cities have been consigned mostly to the regressive taxes which bear most heavily on those with the least ability to pay. Property taxes are still the mainstay of municipalities—fully 80% of local government revenues come from this one overworked source. Sales taxes, which are growing in use, are also regressive, bearing especially heavily on the poor. Even our state tax structures can not approach the progressive character of the federal income tax system.

When you force up our interest costs you probably force us to meet the increase principally with higher property taxes. This means that every citizen is penalized by a higher cost of owning or renting a home. If we resort to sales taxes, every citizen is penalized by higher costs of purchasing even the bare necessities of everyday life.

We submit that the House took a short sighted view of the very meaning of "Reform." Tax reform should mean the more equitable distribution of the costs of *all* government, not just the improved symmetry of the federal income tax alone.

STATE AND MUNICIPAL LOSS FAR EXCEEDS FEDERAL GAIN

This would be reason enough for rejecting these taxes on state and municipal borrowing even if the federal government were to gain more than the state and local governments would lose. The federal government is the "rich" member of the federal system. In the overall scheme of tax distribution between levels of government, it is not "reform" to increase federal revenues at the direct expense of state and local government even if the federal increase happened to exceed the state and local loss.

But here the error is compounded. The federal gain would be far less than the state and municipal loss.

[1] Canadian members of Municipal Finance Officers are not here represented.

The Treasury testified here on September 4 that the inclusion of municipal bond interest in the allocation of deductions plan would yield only $45 million a year even if it were applied to the entire *outstanding* $130 billion of state and municipal debt. If the plan is cut back to future issues only then it's hard to see how the first year's new issuance of an estimated $15 billion to $20 billion could produce much more than $5 million to $7 million in federal revenues.

The Treasury also testified that including municipal bonds in the LTP plan, which it opposes, would produce only another $35 million a year, again if applied to all outstanding bonds. If not so applied, the first year's production works out to a paltry $4 million to $5 million.

As against these insignificant federal gains, what would the state and local government losses be?

HOUSE BILL FORCED UP STATE AND MUNICIPAL INTEREST RATES

The violent market reaction to the House proposals gives some measure of the added interest costs involved.

We have charted the movement of interest rates over the past two years for standard indices of seasoned long term municipal bonds of average grade as compared with comparable taxable corporate bonds and federal government bonds. You will notice on the accompanying chart that the state and municipal bonds represented have consistently sold at lower yields than the taxable federal government or corporate bonds. The difference between the municipal and corporate bond indices is a rough measure of the average savings which tax exemption has meant to the average state or municipal issuer. Such a comparison isolates the changing value of tax exemption from other market factors.

The important thing to note is that while all interest rates have been increasing, the *gap* between tax exempt municipals and taxable federal and private bonds has been *closing* since the so-called "reform" program gathered momentum early this year.

We have illustrated this closing of the gap by a separate chart which plots the change in the *ratio* of tax exempt municipal yields to the taxable corporate yields. Two years ago, municipal yields on the standard "Bond Buyers 20" index were just about 70% of the yields of Industrial bonds on the Moody's average. That is to say that states and municipalities were saving some 30%, on the average, of what they would have paid at the time on fully taxable bonds. It is probable that the saving would be more on new issues as compared with the seasoned issues in the index.

At any rate this ratio fluctuated, until this year, between 64% and 72%. We think it is fair to say that the traditional ratio has been roughly 65% to 70%, meaning that the state and municipal saving has therefore average 30% to 35%. This state and municipal saving is, of course, also the exact measure of the cost which the lending bondholder has paid for his expected tax exemption. We will discuss later the "equity" of making the bondholder pay a second 30% to 35% "minimum tax" to the federal government after thus contributing 30% to 35% of his interest potential to state and local government. But here let us trace the impact on state and local government only.

As the so-called "reform" movement gathered momentum early this year, the ratio of municipal to industrial yields leaped from its traditional levels, piercing the 80% mark this July. By mid-September it stood at 84%. The greatest jump occurred in May as the market came to digest the true import of the House Ways and Means Committee announcements. And the market ratio has continued in the same adverse direction to date.

This means that only the threat of the House plan, which is far from enactment, has produced a disastrous increase in the cost of state and municipal borrowing and has stopped many needed projects.

THE MEASURE OF THE INTEREST INCREASE

Between the end of 1968 and mid-September 1969 the ratio of municipal to corporate yields jumped from 71% to 84%, a loss to the states and municipalities of 13% of the taxable interest rates. 13% of the typical taxable interest of over 8% today produces a loss to the municipal issuer of fully 1%. While this loss may be attributed in part to other causes, let us remember that not everyone is convinced the House Bill will be enacted in its present form. Actual enactment, dispelling the last hope of retaining the exemption, would produce much sharper municipal interest losses.

All in all, we judge that one full per cent more interest is a quite conservative estimate of the increase which enactment of the House Bill would compel in the present market. Of course, the lesser known credits would suffer much more, particularly the small school districts and villages and counties whose sole attraction in the distant bond market has been their traditional exemption.

THE DOLLAR COST OF TAXING MUNICIPALS

If we apply this increase of 1% to next year's anticipated new issue volume of $15 billion to $20 billion, we find the House Bill penalizing state and local government taxpayers by $150 million to $200 million in the first year of operation under the "reform" plan. But this is only the *first* year's cost on the *first* year's issuance.

What would be the cost of this first year's issuance over the life of the bonds thus issued in 1970? If we assume a 20-year term with equal annual debt service payments of principal and interest, we get an average life per issue of 13 years. And so our 1970 issues alone would involve some $2 billion to $2½ billion in added interest costs.

We have prepared a chart distributing this added cost on just 1970 issues between the states, assuming an aggregate new issuance of $19.5 billion and that each state's share will be the same as in 1968 when the aggregate was $16.1 billion. (1969 issuances have been so curtailed by adverse conditions that it is reasonable to assume that 1970 will "make-up" part of the 1969 drop from 1968, to average out 1969 and 1970 to the 1968 rate).

And all this is just from the first year's new issuance! If 1971 sees a further volume of new issues between $15 billion and $20 billion, the cost of the House plan to states and municipalities and their taxpayers would be $300 million to $400 million in 1971, and the issuances of 1970 and 1971 would involve, over their life, aggregate increased interest payments of some $4 billion to $5 billion.

And still we have priced out the effect on only two years of issuance, and not those to be issued after 1971.

A BILLION DOLLAR ANNUAL STATE AND MUNICIPAL LOSS VS. $80 MILLION FEDERAL GAIN

By the time new issues had aggregated only the present volume of $130 billion, the annual aggregate cost to local government taxpayers at the 1% increment, would be $1.3 billion dollars (and the amount of future payments contracted for would have increased by some $17 billion dollars, on the assumption of an average 13 years remaining bond life)—to be met for the most part from regressive local taxes.

Now it's time to compare the federal revenue expectation with the resultant local government cost. On the federal side the Treasury estimates $80 million a year, $45 million from allocation of deductions and $35 million from the limit on tax preferences.

In 1970 alone, as we have seen, the Treasury's estimated $80 million in revenue would be accompanied by $150 million to $200 million in costs to the local taxpayers. In 1971 the $80 million federal revenue would involve $300 million to $400 million in added local costs, and with each additional year the gap would increase until the $80 million federal gain would involve $1.3 billion in state and municipal loss in the year when the newly issued municipal debt outstanding was as much as the present volume of $130 billion.

Furthermore, if this $1.3 billion is translated, as it must be, into state and local taxes, these taxes are, in turn, deductible items on federal income tax returns. If we assume an everage deduction in only the 14% bracket, the federal government stands to lose $182 million dollars in this way. Even half this loss would more than wipe out the estimated $80 million revenue gain.

THE DESTRUCTION OF INVESTOR CONFIDENCE—THE CANCER EFFECT

From these figures it must be obvious that far more is involved than the relatively limited application of an LTP plan which would yield the federal government only $35 million a year or an allocation of deductions plan which would bring in only $45 million dollars a year even if applied to presently outstanding bonds. How can such a small federal revenue gain produce such enormous market repercussions as to cost state and local government taxpayers over fifteen times as much as would be paid by the federal taxpayers, who are the targets of the LTP and allocation plans?

The answer is plain to any student of the municipal market. Investors are not just mathematically pricing out the immediate dollar tax loss to them of these specific new plans. They are far more realistic. They are appraising the consequences of a basic Congressional repudiation of the conecpt of tax exemption of state and local government bonds. They are evaluating the consequences of a break in the hitherto impregnable dike which has, till this day protected the states and municipalities and their bondholders. When they are told that these plans are small and painless, they react as if told that only a small cancer has developed in an otherwise healthy body.

We must remember that a bond buyer has only one moment in time to decide how much interest he is willing to surrender in exchange for tax exemption on a bond with a 20 to 30 year life. That is the moment he pays for his bond knowing he will receive only the stated coupon rate no matter what Congress will do during those 20 to 30 years.

Until this year that bondholder had sublime faith that Congress would consider it unthinkable to tax these bonds. He assumed that Congress would consider it immoral to change the rules in the middle of the game and take away all or part of the tax exemption for which he had paid to the state or local government issuer by accepting 30% to 35% less interest than he could have received on a comparable taxable bond. And he considered it implausible that Congress would not heed the plea of state and local government officers not to burden them further when they were beset by the "crisis of the cities" and by the enormous burdens of record high interest costs and almost runaway inflation in the prices of needed capital improvements.

Right now that faith is badly shaken. The Treasury *has* recommended to both the House and this Committee that the allocation of deductions plan be applied and that it be applied even to outstanding state and municipal bonds. The House has passed a bill applying both the LTP and the allocation plans to municipal bonds and applying the LTP plan even to outstanding bonds. The House Ways and Means Committee had tentatively voted to apply a minimum tax plan to corporate holders of outstanding state and municipal bonds and an allocation of deductions plan to banks who, in recent years, have bought for investment fully 80% on the average of all new state and municipal issues.

INVESTORS MUST ANTICIPATE FURTHER INROADS ON EXEMPTION

Against this background an investor would be foolhardy to assume that if Congress began by enacting the House Bill, or even only the Treasury-recommended allocation of deductions plan against individuals, the matter would stop there during the 20 to 30 year life of his bond. Being unable to protect himself later, he must protect himself now, when he parts with his money. He has to treat these plans as first steps, cancers, if you will, that are bound to spread. If LTP and allocation can apply to individuals, he asks himself, why will the next Congress not feel it "only fair" to extend them to corporations? If he is an individual he would suffer because the extension to corporations would hurt the market in which he might have to resell. If the bond buyer is a bank, it is too sophisticated to assume that the "reform zeal," once sanctioned by Congress, would not spread to financial institutions and other corporations. And if LTP can be applied so as to tax "disallowed tax preferences" at one-half their total this year, then why not at three-quarters next year? And if Congress sets a $10,000 leeway figure in both plans this year, then why not $5000 next year, and no leeway at all the year after?

Obviously this necessary market psychology explains why Congress cannot drop even pebbles into the hitherto calm waters of unimpaired state and municipal bond tax exemption without causing tidal wave repercussions on state and local governments and their taxpayers, trapped as they are in their largely regressive tax systems.

THE MARKET RESPONSE WAS NOT LIMITED TO LTP PLAN

This market reaction also contradicts one of the tenets of the Secretary of the Treasury in his testimony here on September 4. The Secretary would have you believe that the acknowledged violent market reaction of recent months is attributable solely to the LTP plan which he opposes and not at all to the allocation of deduction plan which he supports. Perhaps the Treasury feels a need to explain away its failure to heed the warnings of the state and local government officers who predicted to the Ways and Means Committee exactly what has happened.

It would be better if the Treasury faced up to the fact that the market's confidence can be restored in only one way—complete elimination from the bill of *all* plans to curtail the value of exemption. Only then can investors feel secure that the disease has not been implanted and will not spread.

The Secretary argues that the market did not react when he first proposed the allocation plan to the House Ways and Means Committee, and therefore his plan cannot be the culprit. But he overlooks two things. The most important is that even those who understood the plan last March were just not ready to believe that Congress would take it seriously; the Treasury has been recommending the curtailment of exemption without success for over 30 years. Secondly, the seriousness of the plan was not fully appreciated when it was first advanced.

RECOVERY OF MARKET REQUIRES ELIMINATION OF ALL DILUTIONS OF EXEMPTION

The fact is that the market reaction is so violent that it cannot be explained in terms of reaction to an LTP plan yielding only $35 million a year any more than it can be explained in terms of a combined LTP-allocation plan yielding only $80 million a year. Excising the LTP plan will help very little in restoring market confidence. Excising the whole "cancer" is what is needed.

REDUCED SERVICES THREATENED

Increased local costs are not the whole story. The "taxpayers' revolt" is not limited to federal income taxes. It has led to the defeat of many, many local bond issues where popular referenda are required. If the local taxpayers reject school bond issues at 6% interest rates because they mean higher property taxes, must we not expect even more violent reaction to 7% interest rates compelled by a so-called "Tax Reform Act"?

When a community is at the breaking point, what will happen is more schools unbuilt, more hospitals deferred, more water purification plants put off—in short less public service for the average citizen in whose name this "reform" is invoked.

When traced down to their final regressive effects on the average local citizen, we submit that this "reform" to tax state and municipal bonds backfires badly—it is no reform at all. It is a perfect case of throwing out the baby with the bath water.

NO EVIDENCE OF ABUSE OF EXEMPTION HAS BEEN SUBMITTED

The case for this boomerang reform becomes even worse because the damage to be done to state and local government is without any evidence of excessive concentration of municipals in the hands of the wealthy. By now we all know how the previous Secretary of the Treasury overstated the story of the 154 millionaires who paid no tax. This magnificent example of misleading propaganda is credited by many as having fueled the "taxpayers' revolt" which led to this bill. And yet Assistant Secretary Cohen had to admit here on September 4 that "I think there was undue enthusiasm over the category of the 154."

What became evident in the September 4 testimony was that state and municipal bond interest had absolutely nothing to do with these 154 persons not paying taxes. There is absolutely no record knowledge that any of them held tax-exempt bonds. Their non-payment of taxes was attributed completely to other circumstances.

The only testimony before the House Ways and Means Committee on the extent of millionaire holdings of municipal bonds showed only a very small percentage of millionaire income derived from municipal bond interest. The Investment Bankers Association submitted a study showing that in the highest adjusted gross income bracket of $315,000 and over, 35% of the taxpayers did not own any municipals at all; only 18% of them derived as much as 10 per cent of their income from this source and only 6% derived as much as 25% from this source.

CAPITAL SHRINKAGES OFFSET EXEMPTION BENEFITS

There is one documented case of a millionaire old lady in her 90's who has all her wealth in municipals and pays no taxes. Actually she is more to be pitied than envied. Since she bought her municipal bonds more than three years ago she has seen her capital shrink by fully thirty per cent as municipal bond prices plummeted to offset the skyrocketing interest costs which have plagued the economy. She has therefore lost more in capital than she received in total interest let alone the lesser amount she has "saved" by tax exemption.

This phenomenon of capital shrinkage is, unfortunately a general condition, affecting all bondholders. But the more typical investors are exemplified by the 82% of the total highest income class who received less than 10% of their income from municipal bond interest. These individuals had an opportunity to participate in rising stock market prices and increasing prices for real property and other forms of equity investment, while the 90 year old lady has had only losses.

MIDDLE INCOME PERSONS AFFECTED BY LTP AND ALLOCATION PLANS

Millionaires are not the only individuals holding state and municipal bonds. Individuals in all brackets hold only about 31.8% of the outstanding volume, and this percentage has been steadily declining. The Investment Bankers Association testimony before the Ways and Means Committee shows that 7% of the individuals in the middle income class ($16,400 to $31,000 adjusted gross income) hold municipals, and this percentage represented 88.6 thousand individuals.

Nor is it true that only millionaires would be hit by the House bill.

A middle income taxpayer can easily exceed his "limit on tax prefrences" under the House Bill by capital gains. If he sells a home he has held for 20 years and has a modest success in the stock market, he will be paying taxes on any municipal bond interest he receives, without having achieved the exalted status of millionaire.

PROSPECT OF STATE RETALIATION

We have seen no Treasury figures as to how much it would cost the Treasury if the States adopted similar "reforms" in their income tax structures.

We find it inconceivable, if these "reforms" are enacted by Congress, that States will refrain from imposing "limits on tax preferences" and "allocation of deduction" penalties on interest which their citizens receive on federal bonds. We would expect federal interest rates to jump up in response to such moves just as state and municipal rates have. On a $300 billion federal debt, interesc rates would have to increase only a miniscule 1½ basis points (.015%) to ultimately wipe out the estimated $45 million of gain from the Treasury's plan to apply allocation of deduction to state and municipal bond interest. 3 basis points (.03%) on federal debt would more than wipe out the $80 million which both LTP and allocation would produce from this source.

The probability is that retaliation alone would cost the Treasury *far* more than it would hope to realize.

THE MUNICIPAL BONDHOLDER ALREADY PAYS THE EQUIVALENT OF TOP LTP TAX

Even as to the top bracket municipal bondholder the "tax equity" argument for the House bill does not hold good. In the case of maximum application the LTP plan exacts tax at top bracket rates on only half of the excess of "tax preference" income over adjusted gross income. If an individual who has no municipal bonds is in the 60% to 70% brackets, the topmost brackets, then the most he is asked to pay on his "disallowed tax preferences" is one half these rates, or 30% to 35%.

But, it will be remembered, this 30% to 35% is what every state or municipal bondholder in recent normal markets has already contributed to the cost of government by accepting that much less interest than he could have received from comparable taxable private bonds. Since the state or municipal bondholder, no matter what bracket he is in, is already contributing to the cost of government at the highest rates to be applied to the recipients of other "tax preference" income, where is the argument in "tax equity" for taxing the municipal bondholder again? Why should he, of all the recipients of so-called "tax preference" income be thus subjected to a double exaction for the support of government as the price for his so-called "tax-preference?"

We submit that even if you look at the matter from the viewpoint of the municipal bondholder alone and ignore the regressive repercussions on local taxpayers, the House Bill "reform" in his case does "inequity" rather than "equity."

STATE AND MUNICIPAL BOND EXEMPTION IS NOT A CONGRESSIONALLY-CREATED "TAX PREFERENCE"

Frankly, we are disturbed by lumping municipal bond interest with other situations as if they are alike. Each other item labelled a "tax preference" in the House Bill is the creation of the Congress to foster a policy which it was completely free to embrace or reject and which it may, therefore, limit.

But this is not the case with the exemption of municipal bond interest. The policy protected here goes far deeper than Congressional grace. It derives from the unique nature of our federal system which includes sovereign states, constitutionally immune from federal taxation just as the federal government is constitutionally immune from federal taxation by the states and local governments.

When Cordell Hull as the Ways and Means Committee spokesman for the first income tax act in 1913 explained the exemption of municipal bond interest, which appeared intact in that and every successive Revenue Act ever enacted, he stated that it embodied the constitutional doctrine.

Even were that not so, the policy preserved by this exemption goes to the very structure of our government and its ability to survive in its federal form, not wholly centralized and not wholly decentralized. This is not a matter of Congressional preferences, like the treatment of "hobby farm losses" or "accelerated depreciation" or "charitable contribution of appreciated property." It is far more fundamental, bottomed on the constitutional concept of a federal system which Congress is not free to change.

UNCONSTITUTIONALITY OF HOUSE PROVISIONS

From this circumstance flows our judgment that the House Bill provisions to tax municipal bond interest are unconstitutional. The application of the LTP provisions to such interest is admitted by the Treasury to be subject to grave constitutional doubts. We have more than doubts—we are convinced that such application is unconsitutional. The unconstitutionality of taxing municipal bond interest in full was unanimously decided in the only case in which the question could have been raised, *Pollock* v. *Farmers Loan and Trust Co.*, 157 U.S. 429, 158 U.S. 601 (1895). Since Congress embodied this constitutional rule in every revenue act, there has of course been no departure from its holding. When the Treasury tried in the 1940's to break through, the courts turned them back in *Commissioner* v. *Shamberg*, 144 F. 2d 998 (1944), cert. den. 323 U.S. 792 (1945).

It used to be fashionable in the Treasury thirty years ago to argue that the *Pollock* case was out of style because the Supreme Court had come to sanction taxtion of municipal salaries. But the salary case and all the other cases cited as weakening the *Pollock* case themselves distinguished *Pollock*.

THE UNCONSTITUTIONAL REGULATORY EFFECT OF TAXING MUNICIPALS

The distinction is clear. The burden of taxing municipal bonds is direct and immediate upon the states and their local subdivisions. Moreover, the potential for regulation by taxing bonds is enormous and does not exist in the taxation of salaries.

For example, Congress last year added, on a floor amendment rider to the Revenue and Expenditure Control Act of 1968, a provision to tax municipal bonds encompassed by its definition of "industrial development bonds." Many bonds properly so labelled are not true exercises of the municipal borrowing power but pure conduits for private borrowing by industrial tenants of nominal public property. Such bonds were proper objects for federal taxation.

But—and here's the rub—the definition enacted does not limit the tax to these conduit bonds. By a definition which far overshot the normal meaning of the term defined, the act taxes as "industrial development bonds" almost any bonds to finance a governmental facility which would have private occupants. (Some classes of such facilities, like public housing, public markets and public transportation terminals must have private occupants to serve their public purpose.)

But then the 1968 Act set up a category of "certain exempt activities." If the purposes for which the bonds were issued made this "honor roll" of activities preferred by Congress the bonds were made exempt. But if the state cr local government purpose failed to make the "honor roll," they were "black-listed" and the bonds were made taxable. What makes the whole exercise so alarming is the utter irrationality of the statutory classification as between different acknowledged governmental functions.

Thus the bonds are exempt if they are issued to finance a stadium for lease to a professional baseball team but taxable if the facility to be financed and leased is for cultural recreation such as concerts, opera, lectures and Shakespearean drama. The bonds are exempt if the purpose of issuance is to construct public housing for lease but not if the facility financed is a hospital or clinic for lease to doctors practicing their profession for profit. The bonds are exempt if the facility financed is a transportation terminal for aircraft or ships but not if it is a terminal for railroads or buses; and even here there is an exception for rail and bus terminals *wholly* devoted to commuter traffic but no exception for the normal terminal which accommodates both commuter and long haul traffic. Power and water systems can be financed tax exempt under this act if they are for local distribution but not if for regional distribution.

Obviously this was an outright exercise of Federal control of state and local government by the taxing power. If it is not amended as proposed in Congressman Wilbur Mills' pending H.R. 12923 or Senator Baker's pending S. 2280—and that would be a *real* reform—it will undoubtedly be challenged as unconstitutional.

THE VIEWS OF JUSTICES BLACK AND DOUGLAS

But here its importance is to give point to the 1946 opinion of Justice Douglas and Black in *New York* v. *United States*, 326 U.S. 572. They said "A tax is a powerful regulatory instrument. * * * And no more powerful instrument for centralization of government could be devised." There was a reference in this context to the fact that "Tomorrow it (a state) may issue securities," with the obvious meaning that in such issuance a state must be free from taxation in order to escape the unconstitutional application of this "powerful regulatory instrument" and "this powerful instrument for centralization of government."

While this was in a dissent, the majority did not contradict the statement and, what's more, the Justices who wrote those words are the only members of the 1946 court still sitting. Justice Black had voted to tax municipal salaries eight years before and he obviously saw no inconsistency in thus distinguishing a tax on the issuance of securities.

APPLICATION OF LTP TO MUNICIPALS IS UNCONSTITUTIONAL

Is there any distinction in that LTP may tax half and not all of the municipal bond interest? The question practically answers itself. If more is needed we invoke the classic language of *United States* v. *Railroad Co.*, 84 U.S. 322, 327, where the Court said:

> If they may be taxed lightly, they may be taxed heavily; if justly, oppressively. Their operation may be impeded and may be destroyed, if any interference is permitted.

THE VITALITY OF THE CONSTITUTIONAL IMMUNITY

McCulloch v. *Maryland*—4 Wheat, 316 (1819) is the historic case which first announced that ringing truth "the power to tax involves the power to destroy." While it used to be deemed quite smart to mew at this doctrine, it is hard to deny current standing to its force in the light of last year's majority opinion, by Justice Black, in *First Agricultural National Bank* v. *State Tax Commission*, 88 Sup. Ct. 2173.

The case involved the right of a state to impose sales tax on purchases by a privately owned national bank. The statute involved, like the statute exempting municipal bond interest, was shown by its Congressional debate to be based on constitutional principles of governmental immunity. Justice Black quotes the sponsors when they invoked Chief Justice Marshall's statement that "the power to tax involves the power to destroy." The dissenters quoted the minimizers of this doctrine, but they did not prevail.

The 1968 Supreme Court majority does, therefore, stand for this original principle which underlies reciprocal tax immunity.

THE UNCONSTITUTIONALITY OF APPLYING THE ALLOCATION PLAN TO MUNICIPALS

We submit that there is grave doubt, therefore, that an allocation of deduction plan which so dramatically raises the cost of state and municipal borrowing would survive constitutional attack. The Treasury testimony was, we believe, far too cavalier in saying that its plan has been unequivocally cleared by *United States* v. *Atlas Life Insurance Co.*, 381 U.S. 233 (1965).

That case involved what the Treasury brief itself described as the "unique" situation of life insurance companies. Determining the income of these companies has been a constant problem for Congress, resulting in a series of special statutory provisions applicable to them alone. The problem is that so much of the nominal income of a life insurance company is committed in advance to building up the reserves from which policyholders' death benefits are paid.

Congress, in the 1958 Life Insurance Company Tax Act recognized this peculiar situation by requiring the insurance company to allocate each item of income partly to "policyholders' share" and partly to a "company's share", with no tax being charged on the "policyholders' share."

This recognized the practical realities that the company is almost a trustee for policy holders of the major share of 'its" income (85% in *Atlas*' case), and that Congress could therefore prevent it from assigning all its tax exempt income to the company's share.

The difficulty in applying this complex concept to the ordinary individual is that the individual simply doesn't have this dual status of the life insurance company as both owner of its own income and custodian of policyholders' income. He is the absolute and sole owner of all his income in every sense of the world.

In *Atlas* the Court approved allocating *income*, taxable and tax exempt, to different people who had ownership rights to it. What the Treasury proposes is to allocate *expenses* to different kinds of income of the same person where the income and the expenses are utterly unrelated.

CONSTITUTIONAL LITIGATION WOULD PRODUCE MARKET CHAOS

Obviously it would take prolonged litigation to settle this point. Such litigation, whether limited to the allocation plan or covering also the LTP plan, would undoubtedly cause chaos in the municipal market for many years, costing states and local governments millions in additional interest whatever the outcome and postponing thousands of sorely needed public improvements.

ARBITRAGE

One little noticed provision in the House Bill is Section 601(b) removing the exemption of "arbitrage bonds" without a word of definition to inform what such bonds might be.

Nor is there a word in the Ways and Means Committee hearings to give any basis as to why a "reform" is necessary in this area. The Treasury, on September 4th, did not repudiate this section but did admit that a statutory definition was needed,.without offering such a definition.

The only legitimate definition of an arbitrage bond is that it is one issued for the primary purpose of investing the proceeds in other securities at a higher return. Since we know of no state in which such bonds are authorized, we have reason to fear that something far more sinister is intended.

States and municipalities often borrow at one time the total cost of a capital improvement which will take a few years to complete. After all, a bridge, for example, is worthless with the middle hundred feet uncompleted and so both the issuer and bondholders feel more secure knowing that they do not have to depend on a problematic market to sell a second or third issue for completion.

The prudent state or municipal treasurer, of course, invests their bond proceeds pending application to land costs and contractors' bills. If the market is favorable he will try to invest in the highest yielding secure bonds whose maturities match his schedule of money disbursements.

We suspect that the authors of this sleeper tax provision on "arbitrage bonds" are aiming at this blameless practice.

Whatever they meant, we have here another example of how the federal government can, by taxing municipal bonds, embark on the dangerous waters of using the tax as that "powerful regulatory instrument" which Justices Black and Douglas decried.

The effort should be repudiated by the Senate and Section 601(b) should be stricken.

THE "TAX-RECOMPENSE" PLAN

Perhaps a truly optional "tax-recompense" plan would be constitutional whatever other merits or demerits it might have. If Congress truly gave each state an absolutely unfettered option to issue its bonds on either the traditional tax-exempt basis or subject to federal taxes, with agreed upon recompense, we would find no constitutional blemish.

But Title VI of the House Bill is a travesty of such an idea. It must be read with Sections 301 (LTP) and 302 (Allocation) which would destroy traditional exemption. The option offered is to issue taxable bonds under Sections 301 and 302 without federal recompense or taxable bonds under Title VI with some federal recompense. The option to issue tax-exempt bonds is not to be found in the bill.

This LTP-allocation-"subsidy" package is simply not an optional plan. It is transparently an exercise in coercion to compel the states to take whatever they can get. It is therefore utterly unconstitutional and unworthy of Congressional consideration.

Furthermore, the House Bill seeks to give municipal issuers the option to issue taxable bonds. We note that municipalities do not have the constitutional power to trade away an immunity which inheres on the sovereignty of its state and the Congress can not grant that power by itself. It can do so if and only if the State legislature consents in accordance with the State constitution.

The House "tax-recompense" plan leaves it to the Secretary of the Treasury to decide the rate of recompense to issuers opting for taxable bonds. With all due respect to the present Secretary and Assistant Secretary, too many of their predecessors have shown such overt hostility to state and local government in general and to tax exemption in particular as to make the holders of their offices unacceptable as arbiters in this field. By merely proposing such "reforms" as the present, the Treasury can close the market gap between taxable and "tax-exempt" bonds and then invoke the lessened gap to justify cutting the percentage of recompense. We would thus be squeezed between a tax plan that pushes municipal interest rates up and a resultant basis for driving down the percentage of recompense.

Furthermore, the House Bill places a 25% floor under the recompense rate after five years. Under the bill's directions to the Secretary, we must always expect that only the floor percentage would be proclaimed. Why 25%, we ask, when the market percentage has for years run 30% to 35%? Why not 50% when private companies can in effect compel such a Treasury contribution by deducting the bond interest from taxable income at corporate rates? And why less than the 42% which last year's Secretary reported to Congress he could derive by taxing state and local government bond interest?

What defense could the states and cities have, after the tax-exempt market evaporated with universal opting for taxation, if a later Congress had a change of heart and withdrew the offer of recompense?

Then finally, there is the sinister danger of federal controls over matters of local concern. Let no one tell us that this is far from the intent of the proponents. They are contradicted by their very House Bill.

The Bill makes certain bonds ineligible for "tax-recompense" treatment. "Arbitrage bonds", undefined, are one excluded class. And the spuriously defined "industrial development bonds" are another.

As we have shown, this means a baseball stadium bond, for example, can be eligible and a cultural center bond ineligible. When the bill starts its "tax-recompense" plan with such an arbitrary exercise in federal controls of and classification between legitimate governmental functions, states and municipalities are understandably unwilling to see the plan enacted.

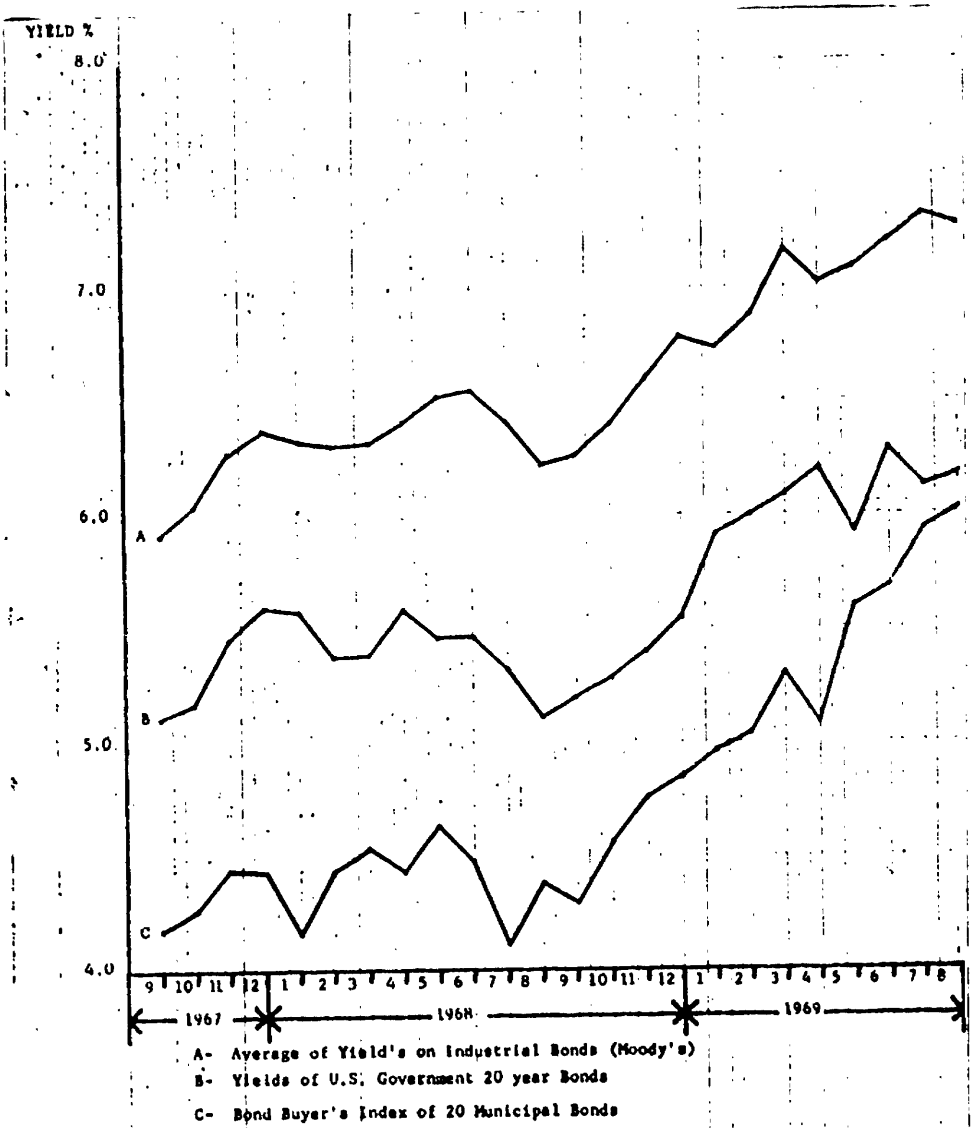
CONCLUSION

We strongly urge that the Senate delete from H.R. 13270 *all* provisions for the impairment of the exemption of state and municipal bond interest. This includes:

(1) Amendment of Section 301(a)(1) by deleting from the new Code Section 84 to be added thereby, subsection (c)(1)(C) and subsection (c)(5);

(2) Amendment of Section 302 by deleting from the new Code Section 277 to be added thereby, subsection (c)(2)(B) and by deleting related technical amendments to Code Sections 265 and 643(a)(6)(A);

(3) Deletion of Title VI in toto, including both the "arbitrage" and the "tax-recompense" provisions.


YIELD %
8.0
7.0
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A
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C
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11
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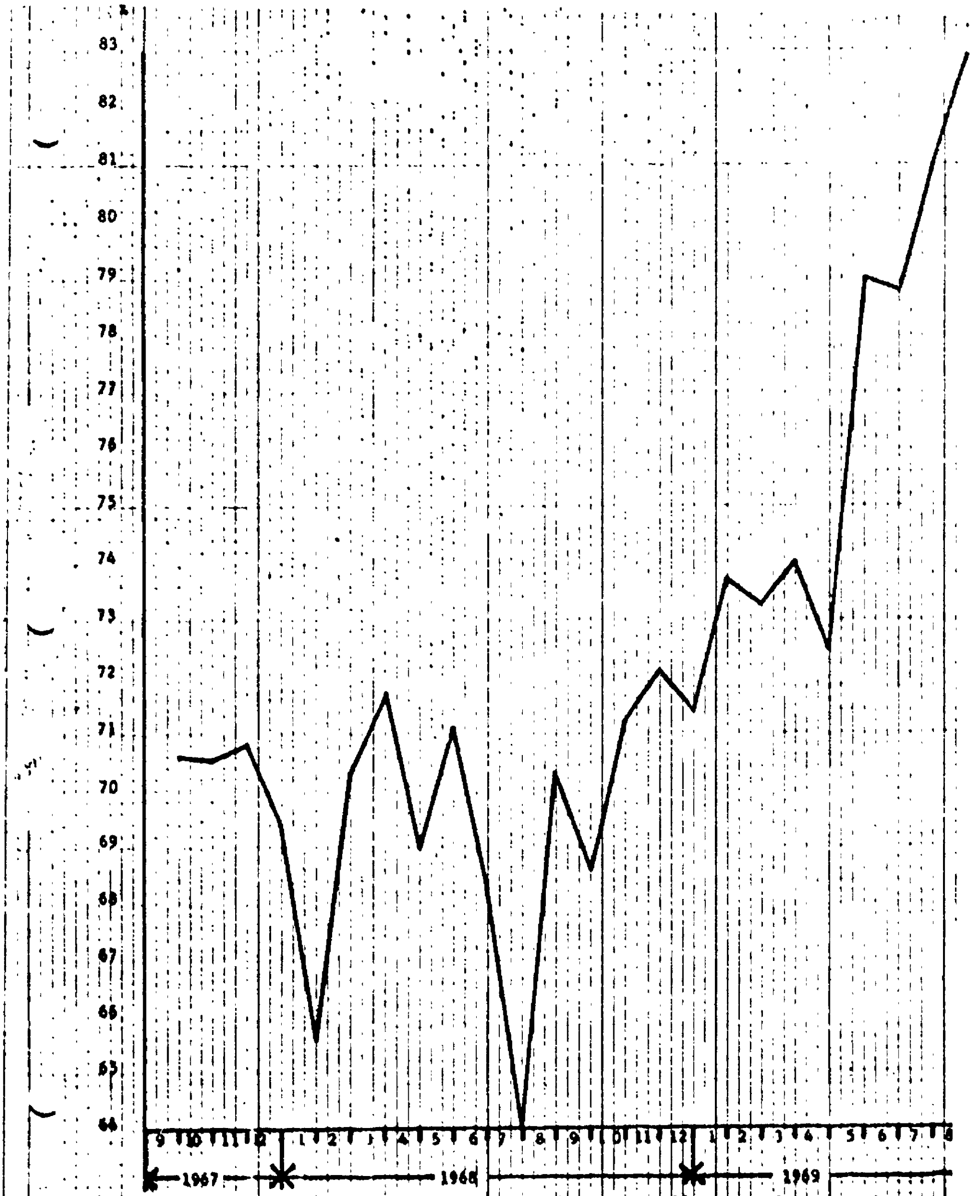
7
8
1967
1968
1969
A- Average of Yield's on Industrial Bonds (Moody's)
B- Yields of U.S. Government 20 year Bonds
C- Bond Buyer's Index of 20 Municipal Bonds



Diiferencial (%) between Bond Buyer's Index of 20 Municipal Bonds and Average of Yields on Industrial Bonds (Moody's)

ANALYSIS OF POTENTIAL COST TO STATE AND LOCAL GOVERNMENT ON 1970 ISSUES DUE TO H.R. 13270

[In millions of dollars]

State	Issuances 1968 (actual)	Issuances 1970 (projected)[1]	Additional interest cost due to tax at 1-percent increment	
			1st year	Life of bond[2]
	(1)	(2)	(3)	(4)
Alabama	299.0	363.0	3.6	46.8
Alaska	69.0	84.0	.8	10.4
Arizona	90.0	109.0	1.1	14.3
Arkansas	36.0	44.0	.4	5.2
California	1.976.0	2,391.0	23.9	310.7
Colorado	72.0	87.0	.9	11.7
Connecticut	266.0	322.0	3.2	41.6
Delaware	61.0	74.0	.7	9.1
Florida	585.0	708.0	7.1	92.3
Georgia	221.0	267.0	2.7	35.1
Hawaii	90.0	109.0	1.1	14.3
Idaho	15.0	19.0	.2	2.6
Illinois	553.0	669.0	6.7	87.1
Indiana	216.0	262.0	2.6	33.8
Iowa	165.0	200.0	2.0	26.0
Kansas	108.0	131.0	1.3	16.9
Kentucky	367.0	444.0	4.4	57.2
Louisiana	531.0	642.0	6.4	83.2
Maine	64.0	77.0	.8	10.4
Maryland	512.0	619.0	6.2	80.6
Massachusetts	369.0	447.0	4.5	58.5
Michigan	694.0	839.0	8.4	109.2
Minnesota	299.0	362.0	3.6	46.8
Mississippi	141.0	171.0	1.7	22.1
Missouri	452.0	547.0	5.5	71.5
Montana	12.0	14.0	.1	1.3
Nebraska	372.0	450.0	4.5	58.5
Nevada	22.0	26.0	.3	3.9
New Hampshire	34.0	41.0	.4	5.2
New Jersey	472.0	571.0	5.7	74.1
New Mexico	50.0	61.0	.6	7.8
New York	2,197.0	2,659.0	26.6	345.8
North Carolina	223.0	270.0	2.7	35.1
North Dakota	9.0	11.0	.1	1.3
Ohio	700.0	847.0	8.5	110.5
Oklahoma	212.0	256.0	2.6	33.8
Oregon	219.0	265.0	2.6	33.8
Pennsylvania	1,187.0	1,437.0	14.4	187.2
Rhode Island	95.0	116.0	1.2	15.6
South Carolina	146.0	177.0	1.8	23.4
South Dakota	13.0	15.0	.1	1.3
Tennessee	212.0	256.0	2.6	33.8
Texas	775.0	938.0	9.4	122.2
Utah	22.0	26.0	.3	3.9
Vermont	54.0	65.0	.6	7.8
Virginia	202.0	244.0	2.4	31.2
Washington	320.0	387.0	3.9	50.7
West Virginia	52.0	63.0	.6	7.8
Wisconsin	237.0	287.0	2.9	37.7
Wyoming	37.0	45.0	.4	5.2
Total	16,125.0	19,514.0	195.1	2,536.3

[1] Assume 10-percent cumulative annual growth.

[2] Assume 13-year average life applicable to 20-year term with equal debt service.

Mr. HERBERT. Our next panel presentation will be given by the Honorable Grady Patterson, State treasurer of South Carolina.

STATEMENT OF GRADY L. PATTERSON, JR., STATE TREASURER OF SOUTH CAROLINA

Mr. PATTERSON. Mr. Chairman and gentlemen of the committee, first I want to express my appreciation to this committee for an opportunity to be heard in opposition to the proposed legislation now pending before this committee dealing with tax-exempt status of interest on State, municipal and political subdivision bonds.

I am appearing on behalf of the State of South Carolina, the Municipal Association of South Carolina, representing approximately 256 municipalities in our State, and the Association of Counties, composed of most county officials in South Carolina.

Let me say at the outset that we vigorously oppose all the provisions in H.R. 13270 dealing with the tax-exempt status of State and municipal bonds, on the constitutional grounds which have been described to the committee, and also on the grounds that these proposals would substantially increase the taxes of almost every local taxpayer in South Carolina and the Nation if they become law.

These provisions of this bill would do significant and irreparable damage to the taxpayers of this country and to the market for public securities. Proof of this fact can be seen today in the chaotic bond market caused by just the threat of such legislation.

By limiting the attractiveness of capital gains the proposed treatment of long-term bond profits will unquestionably restrict the willingness of commercial banks to purchase intermediate and long-term bonds. Bankers all over the State tell me that this, in effect, completely destroys the secondary market in State and municipal bonds.

The interest on outstanding State and local bonds must remain tax exempt. It is unthinkable that the U.S. Government would flagrantly breach the faith with investors who have furnished billions of dollars for State and municipal needs on complete confidence that they were buying tax-exempt bonds.

Furthermore, such proposals strike at the very heart of the sovereignty of the several States, for if the ability of the States to borrow money is impaired, curtailed or destroyed by the Federal Government, the States would be reduced to mere districts in a very short time.

The minimum tax proposal as it applies to the individual taxpayers has a single, very simple and disastrous effect. It destroys the tax-exempt status of State, municipal and political subdivision bonds. If a bond can be taxed in the hands of any investor, it is no longer a tax-exempt security.

Another point that is very important in this matter, Mr. Chairman and gentlemen of the committee, is the secondary bond market.

Investors' confidence in this market is an extremely necessary factor in this whole matter.

In considering this problem, there are two types of securities, and I think this is very important, tax-exempt securities and taxable securities.

If our bonds are liable for $1 of Federal income taxes in the hands of any investor, our bonds are no longer tax-exempt. Simply stated, they are taxable, and when they are sold they will be sold at the taxable rates.

The sale of our securities through the operation of the free enterprise scheme of things has paid big dividends to all the taxpayers of this country. The free enterprise system has worked extremely well for decades. I can see no valid reason for changing it at this time.

I have long felt that if the system is working well, why should we disturb it.

Another thought I wish to share with this committee, which has already been alluded to this morning, concerns the business of tax sharing with the several States.

I would submit to you that one of the best and most direct methods of tax sharing with the several States is to leave the tax-exempt status of State and municipal bonds as we know it under existing law.

In my judgment, the present law provides an excellent means of tax sharing or consideration for the taxpayers of the several States.

Mr. Chairman and gentlemen of the committee, we hear a lot about the States and political subdivisions, the local municipalities meeting their own needs, and doing things for themselves. Well, here we have a wonderful system of meeting our needs through the selling of our bonds, and then the Congress comes along and is attempting to destroy it.

I just do not understand how a piece of legislation like this could get through the Congress. It is frightening that such a piece of legislation could pass the Congress of the United States.

We believe in progress and we believe in tax reform, but we do not believe in increasing the burden of our taxpayers in the process and disrupting the financial stability of the several States.

Most people come up here wanting something. We do not want a thing. All we want is just to be left alone and to leave the law as it now exists in the statute books.

I have heard more criticism of the proposed legislation, in South Carolina, than any other subject in recent history, and not by professionals, not by bankers, not by municipal officials, and not by county officials, but the man in the street, and I think these people are telling us something, Mr. Chairman.

In conclusion, we respectfully urge this committee, the Senate and the Congress, to reject all proposals relating to removing or tampering with the tax-exempt status of interest on State and municipal bonds, and to put an end to this detrimental legislation once and for all.

Thank you, Mr. Chairman.

(Mr. Patterson's prepared statement and a communication received by the committee relative to Mr. Patterson's statement follow:)

STATEMENT BY GRADY L. PATTERSON, JR., STATE TREASURER OF SOUTH CAROLINA

PRINCIPAL POINTS OF STATEMENT

1. Objections to specific provisions of the bill.
2. Substantial increase in tax burden of local taxpayers.
3. Strike at the sovereignty of the State.
4. Tax exempt status destroyed by minimum tax proposal.
5. Allocation of deductions damages tax exempt status.
6. Secondary bond market irreparably damaged.
7. Investor competence seriously jeopardized.
8. Breach of faith by U.S. Government.
9. Basic purpose of tax exempt status.
10. Free enterprise system has worked.
11. A means of tax sharing.
12. Paying tax by accepting lower yield.
13. Big print giveth and small print taketh away.

First, I want to express my appreciation to this Committee for an opportunity to be heard in opposition to the proposed legislation now pending before this Committee dealing with tax exempt status of interest on state, municipal, and political subdivision bonds.

I am appearing on behalf of the State of South Carolina, the Municipal Association of South Carolina, representing approximately 256 municipalities in our State, and the S. C. Association of Counties, composed of most county officials in South Carolina. We are grateful for an opportunity to express to you our profound opposition to these detrimental proposals.

We urge this Committee to delete from H. R. 13270 all proposals that would impair the exempt status of the interest on state and local government bonds, including the following provisions of H.R. 13270:

OBJECTIONS TO SPECIFIC PROVISIONS OF THE BILL

(A) The inclusion of such interest in the base of the limit on tax preferences as proposed by Section 301.

(B) The inclusion of such interest in the base for the allocation of deductions as proposed by Section 302.

(C) The taxation of interest on all "arbitrage bonds" without a statutory definition as proposed by Section 601 (B).

(D) The taxation of the interest on all otherwise exempt obligations in exchange for a preferred "federal subsidy" as proposed by Title IV.

SUBSTANTIAL INCREASE IN TAX BURDEN OF LOCAL TAXPAYERS

Under the guise of reducing taxes for almost every citizen, this so-called tax reform bill written by the House Ways and Means Committee and passed by the U.S. Congress now pending before this Committee will substantially increase the taxes of almost every local taxpayer in South Carolina and the Nation if these proposals become law. These provisions of this bill will do significant and irreparable damage to the taxpayer of this Country and to the market for public securities. Proof of this fact can be seen today in the chaotic bond market caused by just the threat of such legislation.

STRIKE AT THE SOVEREIGNTY OF THE STATE

Furthermore, such proposals strike at the very heart of the sovereignty of the several States, for if the ability of the States to borrow money is impaired, curtailed or destroyed by the Federal Government, the States would be reduced to mere districts in a very short time.

TAX-EXEMPT STATUS DESTROYED BY MINIMUM TAX PROPOSAL

The minimum tax proposal as it applies to the individual taxpayers has a single, very simple and disastrous effect. It destroys the tax exempt status of state, municipal and political subdivision bonds. If this provision is enacted into law, the tax exempt bonds we have issued and now outstanding will become taxable, and any further securities we issue will be taxable. For if a bond can be taxed in the hands of any investor, it is no longer a tax exempt security. The impact this will have on the market for state and local bonds cannot be determined with mathematical preciseness, but it will certainly be severe.

ALLOCATION OF DEDUCTIONS DAMAGES TAX-EXEMPT STATUS

The proposal relating to allocation of deductions between taxable and tax exempt income for individual taxpayers will also damage the sale of our securities. Although the proposed provision applies only to individuals, the principle is very simple. When it has once been applied to individuals, corporate investors are going to be very apprehensive that the same principle will be applied to them. Once the camel's nose is under the tent, it's difficult to stop him. Again, the impact of the proposed provision may not be great, but the real impact is complete destruction of tax exemption and of the tax exempt market and the confidence of investors in our securities.

This provision which proposes changing the tax treatment of realized gains on bank bond portfolios from capital gains to ordinary income cannot be considered separately from these other two provisions. First, if there still are tax exempt securities, this provision would apply to them; and, secondly, since there is a strong possibility that a large share of state and local borrowing will somehow be done in taxable form, we will be very dependent on the market for taxable government securities.

SECONDARY BOND MARKET IRREPARABLY DAMAGED

What will be the effect of this provision on that market?

By limiting the attractiveness of capital gains the proposed treatment of long-term bond profits will unquestionably restrict the willingness of commercial banks to purchase intermediate and long-term bonds. Bankers all over the State tell me that this, in effect, completely destroys the secondary market in state and municipal bonds.

It will make no difference whether the securities are taxable or tax exempt if capital gains are to be taxed as ordinary income. The risk of buying bonds will outweigh the gain, and the gain will not be worth the risk.

The capital gains provision would also impair and curtail the functions of the market by putting an end to tax swapping by commercial banks. I am told that this accounts for perhaps 50% of the volume trading in U.S. Government securities, away from treasury bills and perhaps 40% of the trading in state and municipal bonds. If this amount of activity is removed from the bond market, a substantial amount of capital committed to our securities would be removed. This would reduce the marketability of our securities.

These three proposals must be deleted from this bill if the vitality of the market for our securities is to be preserved.

INVESTOR CONFIDENCE SERIOUSLY JEOPARDIZED

First, the interest on outstanding state and local bonds must remain tax exempt. It is unthinkable that the U.S. Government would flagrantly breach the faith with investors who have furnished billions of dollars for state and municipal needs in complete confidence that they were buying tax exempt bonds. But beyond this, if state and local governments are going to continue to issue securities that offer some tax exemption, the rate of interest we pay on these securities is going to be directly related to the level to which outstanding issues trade in the secondary market. If complete tax exemption is maintained on outstanding state and municipal securities, they will trade in the highest level, and we will be able to sell new issues under most favorable terms in the market place.

BREACH OF FAITH BY U.S. GOVERNMENT

Conversely, if outstanding issues are taxed, investors' confidence will be so heavily damaged that we cannot expect to sell under any favorable terms new issues of state and municipal bonds with whatever amount of tax exemption we may have left. Investors' confidence in this market is an extremely necessary factor in this whole matter. There is no question in my mind that the confidence of the investor is a key factor in this entire scheme of things.

As you gentlemen know, the tax balance is somewhat akin to the balance of nature. One arbitrary action to relieve a so-called tax inequity has a far-reaching effect on many other aspects of the tax spectrum. Thus, by changing the tax laws, these proposals which appear fairly simple on the face, the resulting effect is a substantial increase in local taxes for almost every taxpayer in our State and in this Nation.

In considering this problem, there are two types of securities, tax exempt securities and taxable securities. If our bonds are liable for one dollar of federal income taxes in the hands of any investor, our bonds are no longer tax exempt—simply stated, they are taxable. They will be regarded by all investors as taxable, and when we go to market we will borrow on these securities at taxable rates. If we are going to retain the right to borrow effectively in the tax exempt market, then state and local securities must be exempted from the minimum income tax proposed for individuals in this bill.

BASIC PURPOSE OF TAX-EXEMPT STATUS

I think we should pause for a moment and consider the basic purpose of the tax exempt status of state and municipal bonds in the first place. The purpose of the exemption was to sell these securities at the lowest possible cost to the given political entity, thereby keeping to a minimum the cost to the taxpayers. In order to do this, these securities of necessity had to be attractively priced so as to be saleable and marketable. This arrangement has worked extremely well for decades and I see no valid reason for changing it.

FREE ENTERPRISE SYSTEM HAS WORKED

The sale of our securities to operation of the free enterprise scheme of things has paid big dividends to all the taxpayers of this Country. The fact that it has worked so well seems to upset some officials in high government circles. I have long fe't that if a system is working well, why disturb it. There are plenty of areas in government which need far greater attention than this matter, I would suggest that the government energies be directed toward those areas and leave the tax exempt status of state municipal bonds alone.

A MEANS OF TAX SHARING

Another thought which I would like to share with the Committee concerns tax sharing in the several States. We have seen and read in the news media about the mood of Congress concerning this matter. I would submit to you that one of the best and direct methods of tax sharing with the several States is to leave the tax exempt status of state and municipal bonds as we now know it under existing law. What useful purpose could be accomplished by the Federal Government's subsidizing the cost of issuing taxable bonds? There are many, many reasons which are quite obvious to most people for opposing any federal subsidy arrangement. We know from past experience of all the red tape, unnecessary reports, unwarranted priorities and controls which would result if such a system were adopted. In my judgment, the present law relating to tax exempt status of state and municipal bonds, in effect, provides in a sense a tax sharing consideration for the taxpayers of this Country.

PAYING TAX BY ACCEPTING LOWER YIELD

Moreover, investors who purchase state municipal bonds are, in effect, paying a substantial tax by virtue of accepting a lower yield from investing in these securities. Conversely, these investors could invest the same funds in taxable securities and receive a much higher yield. Thus, it can be argued with considerable merit that by purchasing state and municipal securities, investors are, in effect paying income taxes by accepting the lower yield.

In order to support an alleged need for tax reform in this particular area, some facts should be presented to prove the case. With all the discussion by the news media and others, about 154 persons not paying any income tax on income earned in 1967, not one scintilla of evidence has been shown to prove that one single state or municipal bond was held by any one of these individuals. I submit to you, gentlemen, that no case has been made to justify or warrant any wholesale tampering with or modification of the tax exempt status of state and municipal bonds. The devastating effect this helter-skelter, headlong rush by .the House Ways and Means Committee and the Congress to remove or modify the exemption on interest earned on state and municipal bonds has had on the bond market need not be described in words. One has only to look at the chaotic bond market today for proof of this fact. If this is not satisfactory evidence and proof to you, gentlemen, then I do not know how to prove the case. The confidence of investors in state and municipal bonds has been destroyed, and the only way to restore it is for the Senate and Congress to reject all snippings at the tax exempt status of these securities.

BIG PRINT GIVETH AND SMALL PRINT TAKETH AWAY

This is another case of the big print giveth and the small print taketh away. The big news media headlines giveth tax reductions for almost all citizens, but the small print in the tax bill relating to tax exempt status of interest on state and municipal bonds taketh away with increased tax burdens for local taxpayers.

We respectfully urge this Committee, the Senate and Congress to reject all proposals relating to removing or tampering with the tax exempt status of interest on state and municipal and political subdivision bonds, and to put an end to this detrimental legislation once and for all.

Respectfully submitted,

GRADY L. PATTERSON, Jr.,
State Treasurer, South Carolina.

MUNICIPAL ASSOCIATION OF SOUTH CAROLINA,
Columbia, S.C., September 11, 1969.

CHIEF COUNSEL,
Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SIR: I am enclosing with this letter a copy of the most recent Resolution adopted by the Municipal Association of South Carolina in convention assembled, re "Taxation of Municipal and Local Bond Interest."

Needless to say, we are deeply concerned over the action taken by the House Ways and Means Committee, and later the entire House of Representatives, this year in effect lifting the tax exemption on interest received from state and local government bonds.

We have discussed the matter in detail, and indeed had even considered asking the Chairman of our Federal Legislative Committee, Mayor John Nave, Greenwood, South Carolina, to personally request an appearance before the Senate Finance Committee during the course of its hearings, which I understand are now in progress. However, Governor McNair through his Coordinator for Local Governments, Mr. Woody Brooks, approached us and the South Carolina Association of Counties and asked that we join with State Treasurer Grady L. Patterson, Jr., in presenting our case as a united front against the proposed legislation.

I have discussed this matter at length with our State Treasurer as well as with Mr. James Shipman, Executive Director of the South Carolina Association of Counties. We do desire that both the Municipal Association of South Carolina and the South Carolina Association of Counties go on record as jointly endorsing Mr. Patterson's statement, which will represent all parties concerned in South Carolina.

It is our understanding from the office of the National League of Cities that over 256 individuals have requested to testify on this one point being considered by the Senate Finance Committee, and I think that alone illustrates how concerned the state and local governments find themselves with this proposed legislation as passed by the House of Representatives.

However, we do request that the interest of the Municipal Association of South Carolina joining with the South Carolina Association of Counties and State Government be coordinated and presented in one statement through State Treasurer Grady Patterson, whom I understand is scheduled to appear up there on September 23, 1969.

Thanking you in advance for this consideration, and with best wishes, I am,

Sincerely,

J. N. CALDWELL, Jr.,
Executive Director.

Enclosure.

Whereas, in the past, the House Ways and Means Committee in the National Congress in Washington has received testimony to the effect that legislation should be introduced which would lift the federal tax immunity upon municipal bonds and municipal utility operations; and

Whereas, enactment into law of present proposals to place an income tax on the earnings from such bonds would greatly endanger the sale of municipal bonds on the open market and municipal government operation in general: Now, therefore, be it

Resolved, That the Municipal Association of South Carolina in 29th Convention assembled, once again go on record and emphasize its opposition to any such proposals and that a copy of the Resolution be forwarded to the House Ways and Means Committee Chairman, Wilbur Mills, and to each member of the South Carolina delegation in the National Congress.

Mr. PATTERSON. Now, we will hear from Senator Friday from the State of Florida.

STATEMENT OF HON. ELMER O. FRIDAY, STATE SENATOR FROM FLORIDA

Mr. FRIDAY. Mr. Chairman and members of the Finance Committee, I would like to express my appreciation to you for this opportunity to speak, and to my colleagues on this panel for allowing me to come slightly out of order here because I do have a plane to catch.

I appear before you this morning as vice chairman of the Council of State Governments, as well as a State senator from Florida, to speak with you on recommendations and criticisms as they relate to the State and municipal bond sections of the Tax Reform Act of 1969.

The Council of State Governments, as you know, is a joint agency of the 50 States established for the improvement of interstate relations, Federal-State relations, and the State executive, legislative, and judicial functions of those States.

The Council of State Governments is opposed to the provisions of the bill which drastically alter the tax treatment of municipal bonds. This alteration is wrong in concept and goes far beyond any stated need to attain tax equality. The structure of the bond market has already been disrupted by economic factors and your contemplated action, and it may be many years before it again settled down regardless of the acts taken by this committee and the U.S. Senate as a whole.

On July 30 of this year the Wall Street Journal commented that this was the worst single day in the market's history as far as tax-exempt bonds were concerned.

The communities of Florida, and the other 49 States, are in a time of real financial crisis, and increasing bond interest rates poses a serious threat to their fiscal ability to fulfill the needs of the people of our State and local governments. The course of municipal bond interest rates this year supports that judgment.

This Congress and the agencies of this body have, over the past years, come to a growing awareness of the condition of the health and economy of this Nation by pollution of its air and water. You, and the people of this Nation, are determined to wage war on this implacable foe of society, which spawns it. In Florida, as in the other States, the bulk of this danger springs from the dumping of raw sewage into our waters by our cities and towns. You, at the Federal level, and we at the State level, have pointed to these matters and, we have said, "You can clean it up."

Now, you would take away the only financing available to them. Senators, the citizens of our Nation, should, and, I believe, would, rise up in anger and despair and frustration if this happened. It is reliably estimated that in Florida 60 percent or more of the pollution in Florida's waters is done by the cities and communities of that State, and I am advised through my associates in the Council of State Governments and the National Legislative Conference that this same condition prevails in most other States of the Nation. You have done much. But you have also, and rightly so, pointed to the responsibility of the State and local governments in this field of antipollution activity.

I would like now to address my remarks to you regarding the effects a bill such as H.R. 13270 would have on the State of Florida. Let me hasten to add, however, that its adverse repercussions would be similar for all States and local governments, and only the dollar figures for the affected governmental services would vary. If any new means of taxation affecting these securities is enacted, municipal bond interest rates will rise very significantly.

This will impair the ability of States to borrow money. It will add to the now overburdened taxpayers responsibility. You and I know full well that it takes $1½ to $2 sent to Washington to get $1 worth of service or money back at the local or State level. Under these conditions I believe the States would have to do one of three things to accommodate to this:

One, reduce the financing by bonds, but increase taxes to furnish current services; two, pay the increased interest costs, thus greatly increasing the State debt and cost to taxpayers; or, three, reduce needed and necessary services to the people.

Florida would have been deprived of such projects as the $9 million of bonding for the medical school at the University of South Florida. * * * Under the present system the bonding of this project barely squeaked through.

It would not have been possible to attain the Fort Pierce $5 million water and sewer project, the $13 million Dade County school bond issue and the $19 million Hillsborough County bond issue. It would have placed in serious jeopardy the St. Lucie County beach erosion project—in beach erosion you have exhibited great concern around the Nation and it would have placed and will now place, the $90 million city of Jacksonville sewer project in a nearly impossible category.

Let me add that the sole purpose of this $90 million issue is to clean up the St. John's River. Senators the Federal Establishment has a great interest in that river which is at present a river of raw sewage. There are two major military installations on that river, the Jacksonville Naval Air Facility, and the Mayport Naval Yard.

The interest subsidy will be expensive to administer and could be used to coerce local governmental units to turn even more to Washington. If the rate of subsidy is high, local governments will be forced to abandon the present system entirely.

Mr. Chairman and Senators, bonds are one of our most effective capital outlay sources, and that source must not be damaged. During this past year we have seen Federal cut-off of programed funds to the States—Federal highway grants, and the present cutback on all capital outlays by this administration. Who is to say that this new subsidy would not be wiped out or could not be wiped out by Executive order?

Let me illustrate for a moment the effect of this taxation on Florida. In 1968, we issued $585 million worth of bonds with an average interest rate of 4½ percent and an annual debt service of $4.5 million, with an average maturity period of 20 years. Had there been a tax on municipal bond interest, the rates might save been as high as 6½ percent. This means we would have had to reduce our issuance by approximately 15 percent—or to put it another way, about $78 million worth of projects would not have been built.

To retire the 1968 debt of $585 million will require $900 million in principal and interest payments. The same debt at 6½ percent interest would mean that principal and interest payments would be $1.06 billion over the life of the bonds, costing the taxpayers of that State an additional $106 million.

The other alternatives would be to cut back on much needed projects and services or to raise taxes. I am opposed, as I know you are, to any further tax burden being placed on the people of our States and cities.

An analysis requested by your committee's staff and prepared by the staff of the House-Senate Committee on Internal Revenue Taxation points that this section of the bill "opens the way to complete repeal of the State and local tax exemption."

After House passage of this measure the municipal Bond Buyer's Index soared to a historic high of 6.02 percent, rising 11 points over the previous week, and as of today, I am advised, it has climbed to 6.3 percent.

Reflecting the apathy and uncertainty of the market, the placement ratio dropped to 60.9 percent.

Since early July when the House opened hearings in the Ways and Means Committee, investment yields of new issues of local government "Aa" rated bonds have risen about 70 points, while yields on similar corporate taxable bonds have risen only 5 points.

I think, Senators, it is clear that none of these proposal are acceptable to the States. Our people cannot pay the higher taxes if interest is taxed. It is difficult to finance needed projects from current taxes—almost impossible. Most assuredly, we cannot cut back on necessary services to the people. These services must be provided and they must be financed by bonds at reasonable rates if the States are to be full partners in our federal system.

In an effort to get at a handful of taxpayers who invest heavily in tax-exempt bonds and thus pay little or no tax, you would have to damage the ability of local governments to finance their growing needs without seeking further dole from Washington.

Senators, and my fellow panel members, I apologize for having to leave at this particular stage. I would respond to any questions I might be able to. I have an airplane waiting that I have a problem with, and if there are any questions before I leave, Senators, I would be glad to answer. Thank you very much for your kindness and courtesy, you gentlemen of the panel.

(Senator Elmer O. Friday's prepared statement follows:)

STATEMENT OF SENATOR ELMER O. FRIDAY, STATE OF FLORIDA

Mr. Chairman, Members of the Senate Finance Committee: I am Elmer O. Friday, State Senator from Florida.

I welcome the opportunity to come before you this morning to speak, as Vice-Chairman of the Council of State Governments, on recommendations and criticism as they relate to the state and municipal bond section of the "Tax Reform Act of 1969", (H.R. 13270). The Council is a joint agency of the fifty states established for the improvement of inter-state relations, federal-state relations and the state executive, legislative and judicial functions.

The Council is opposed to the provisions of the bill which drastically alter the tax treatment of municipal bonds. This alteration is wrong in concept and goes far beyond any stated need to attain tax equality. The structure of the bond market has already been disrupted by economic factors and your contemplated action, and it may be many years before it again settles down regardless of the acts taken by this committee and the United States Senate as a whole.

On July 30th of this year the Wall Street Journal commented that this was the worst single day in the market's history as far as tax exempt bonds were concerned.

The communities of Florida, and the other 49 states, are in a time of real financial crisis, and increasing bond interest rates poses a serious threat to the fiscal ability to fulfill the needs of the people by our state and local governments. The course of municipal bond interest rates this year supports this opinion.

This congress and the agencies of this body have, over the past years, come to a growing awareness of the condition of the health and economy of this nation by pollution of its air and water. You, and the people of this Nation, are determined to wage war on this implacable foe of society, which spawns it. In Florida, as in the other states, the bulk of this danger springs from the dumping of raw sewage into our waters by our cities and towns. You, at the federal level, and we at the state level, have pointed to these matters and said "Clean it up!" Now you would take away the only financing available to them. Gentlemen, our citizens should, and would, rise up in anger and despair. It is reliably estimated that 60% or more of the pollution in Florida's waters is done by the cities and communities of that state, and I am advised through my associates in the Council of State Governments and the National Legislative Conference that this same condition prevails in most other states of the nation. You have done much: But you have also, and rightly so, pointed to the responsibility of the state and local governments in this field.

I would now like to address my remarks to you regarding the effects a bill such as H.R. 13270 would have on the state of Florida. Let me hasten to add however, that its adverse repercussions would be similar for all state and local governments, and only the dollar figures for the affected governmental services would vary. If any new means of taxation affecting these securities is enacted, municipal bond interest rates will rise very significantly. This will impair the ability of states to borrow money. It will add to the now overburdened tax-payers responsibility. You and I know full well that it takes one and one-half to two dollars sent to Washington to get one dollar back. I believe the states would have to do one of three things to accommodate: 1. Reduce the financing by bonds, but increase taxes to furnish current financing and service; 2. Pay the increased interest costs, thus greatly increasing the state debt and cost to tax-payers; or 3. Reduce needed and necessary services to the people.

Florida would have been deprived of such projects as the 9 million dollars of bonding for the medical school at the University of South Florida . . . under the present system the bonding of this project barely squeaked through. It would not have been possible to attain the Fort Pierce 5 million dollar water and sewer project, the 13 million dollar Dade County school bond issue and the 19 million dollar Hillsborough County bond issue. It would have placed in serious jeopardy the St. Lucie County Beach Erosion Project and it would place the 90 million dollar City of Jacksonville sewer project in a nearly impossible category.

The interest subsidy will be expensive to administer and could be used to coerce local governmental units to turn even more to Washington. If the rate of subsidy is high, local governments will be forced to abandon the present system entirely. Bonds, Mr. Chairman, are one of our most effective capital outlay sources and we should not damage them. During this past year we have seen federal cut-off of programmed funds to the states—federal highway systems, and the present cutback by this administration. Who is to say that this new subsidy would not be wiped out by Executive Order?

Let me illustrate the effects of taxation on Florida. In 1968 we issued 585 million dollars worth of bonds with an average interest rate of 4½ percent and an annual debt service of 4.5 million dollars, with an average maturity period of twenty years. Had there been a tax on municipal bond interest, the rates might have been as high as 6½ percent. This means we would have had to reduce our issuance by approximately 15 percent . . . or to put it another way, about 78 million dollars worth of projects would not have been built. To retire the 1968 debt of 585 million dollars will require 900 million dollars in principal and interest payments . . . the same debt at 6½ percent interest, principal and interest payments would be 1.06 billion dollars over the life of the bonds, costing the taxpayers an additional 106 million dollars. The other alternative would be to cut back on much needed projects and services or to raise taxes. I am opposed to any further tax burden being placed on the people.

An analysis requested by your committee's staff and prepared by the staff of the House-Senate Committee on Internal Revenue Taxation points that this section of the bill "opens the way to complete repeal of the state and local tax exemption."

After House passage of this measure the municipal bond buyer's index soared to a historical high of 6.02 percent, rising 11 points over the previous week. It has now climbed to 6.20 percent.

Reflecting the apathy and uncertainty of the market, the placement ratio dropped to 60.9 percent.

Since early July when the House opened hearings in the Ways and means Committee, new issues of local government "AA" rated bonds have risen by about 70 points, while yields on similar corporate taxable bonds have risen only 5 points.

I think, Members of this committee, it is quite clear that none of these proposals are acceptable to the states. We cannot pay the higher taxes if interest is taxed. It is difficult to finance needed projects from current taxes. Most assuredly, we cannot cut back on necessary services to the people. These services must be provided and they must be financed by bonds at reasonable rates if the states are to be full partners in our federal system.

In an effort to get at a handful of taxpayers who invest heavily in tax-exempt bonds and thus pay little or no tax, you would have damaged the ability of local governments to finance their growing needs without seeking help from Washington.

Mr. Chairman, Members of the committee, I greatly appreciate your affording me the opportunity to be heard.

Mr. GOLDSTEIN. The next speaker will be Lewis H. Vaden, the distinguished State treasurer of Virginia.

STATEMENT OF LEWIS H. VADEN, TREASURER OF VIRGINIA

Mr. VADEN. Mr. Chairman, members of the committee, I shall be very brief in my remarks today, taking into account that I have filed in detail my thoughts regarding the proposed elimination of the tax exemption in H.R. 13270.

I shall confine my remarks primarily to the distasteful part of the proposed subsidy that is proposed in this bill.

As has been pointed out to you in many instances this morning with figures and charts, and what-have-you, that there would be no savings accruing either to the Federal or local or State governments by way of subsidy. In fact, it would cost the Federal Government a considerable amount of money to have the subsidy program, and nobody since I have been here this morning has brought out the fact of the cost of administering such a program as the subsidy would entail.

In my opinion, it would greatly concentrate government in the Nation's Capital here in Washington, because every State, county, city, town, and hamlet would have to come to Washington on bended knee to get their particular financing worked out, whether it be for a water system, a sewer system, or whether it would be for a schoolhouse or any other public improvement that they may entertain the idea of having. In that fashion the great concentration of all government would be here in the Nation's Capital.

I think that if governmental entities are going to incur debts, that the debt should be as close to the people as it is possible to have it and, as I would visualize a subsidy program and the determination of the financing being done in one central point in the Nation's Capital, this would take this about as far away as one could imagine.

I greatly appreciate this opportunity to come before you and express my opposition to any change in the present laws relative to the tax-exempt features that we now have for State and local bonds.

I also bring a documented statement from our Governor of the Commonwealth of Virginia, the Honorable Mills E. Godwin, Jr. In his statement, he makes it clear that he feels the same way as I feel, that no change should be made relative to the tax-exempt feature of State and local bonds.

Again, let me thank you for the opportunity of appearing. I will attempt to answer any questions that you may wish to propound.

Senator ANDERSON. Your statement will be received in full. Any questions?

Senator BYRD. Thank you, Mr. Chairman. I have no questions. I think this has been a very informative and helpful session in the comments and statements made by the panel.

(The prepared statements of Gov. Mills E. Godwin, Jr., of Virginia, and Mr. Lewis Vaden, treasurer of Virginia, follow:)

STATEMENT OF MILLS E. GODWIN, JR., GOVERNOR, COMMONWEALTH OF VIRGINIA

The changes proposed by H.R. 13270 in the Federal income tax treatment of the interest received on State and local bonds by the holders thereof are matters of grave concern to the Commonwealth of Virginia and its political subdivisions as well as to all other States and their localities throughout the nation.

Specifically, this Statement opposes the following provisions of H.R. 13270:

(a) The provision relating to the election on the part of State and local governments to issue taxable bonds, with certain Federal subsidy payments to the issuers.

(b) The provision to require inclusion of interest received on State and local bonds as an item in the proposed "limit on tax preferences."

(c) The provision to require individuals to include State and local bond interest in allocating deductions between taxable and non-taxable income.

Ever since the Federal income tax law was enacted in 1913, interest on State and local government bonds has been exempt. This exemption finds its justification, not only on constitutional grounds of reciprocal tax immunity, but on other grounds as well. For it is clear that the exemption is provided not for the benefit of the holders of the bonds, but for the benefit of the States and their localities. Therefore, if any valid congressional legislation is enacted to change the existing policy now, or to presage a change in the future, this would constitute a heavy blow to State and local governments by making it more difficult and costly for them to finance needed capital outlays of large proportions.

H.R. 13270, in the provisions above enumerated, does not undertake to do more at this time than to impair the age-old exemption, but there can be no doubt that many investors in State and local bonds would regard this legislation as the first step toward later attempts further to impair the exemption and finally to deny it completely. The present proposals, if enacted, would therefore lessen confidence in the desirability of investing in these bonds and would cause investors to demand considerably higher interest rates than now prevail to compensate them for a reduced net yield under the present proposals, if enacted, and for taking additional potential risks respecting the future status of the bonds.

The election to issue taxable bonds is voluntary on the part of State and local governments under the bill as it now reads, but it is quite difficult to believe that State or local governments would willingly issue such bonds. Moreover, the bill's provisions on subsidy payments out of the Federal treasury to States and their localities would doubtless prove to be quite unworkable as a practical matter, and continuation of these subsidy payments indefinitely might well be open to question.

In a summary of this bill prepared by the staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, dated August 18, 1969, it is said that: "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." This, in essence, is said to be the principal problem.

Assuming the quoted sentence to be correct, it does not follow that this can justify legislation which would be inimical to State and local governments.

It appears that the provisions of the bill hereinabove referred to would produce only a relatively small amount of additional Federal income tax revenue, and that this would probably be more than offset at the State and local levels by the higher interest rates State and local governments would be compelled to pay. The real parties in interest in this matter are the States and their localities and not the investors.

STATEMENT OF LEWIS H. VADEN, TREASURER OF VIRGINIA

SUMMARY

I *The Damage to the $130 Billion Market*

(a) Interest cost highest in history of municipal bond market.

II *State and Local Bonds Are Tax-Exempt as to Income Tax Only*

(a) The issuer, in effect, receives the benefit in the form equivalent to local taxation.

III *Proposed Federal Subsidy to Local Government Financing on Taxable Bonds*

(a) Would result in excessive cost to the Federal Government.

IV *Greater Centralization of Government in Washington*

(a) Proposed bill requiring all State and local financing to be approved in Washington.

STATEMENT

The Damage to the $130 Billion Market

The mere statement of Congressional purpose to infringe the historic tax immunity of the State and local government financing function has inflicted a drastic setback to the going values of State and local government bonds in the market; and, thereby, has brought about a rise of corresponding extent in local government borrowing costs. By one trade estimate, a rise of about $300 million in the borrowing costs to State and local governments over the past four months must be traceable to a large extent to the adverse market implications of the House of Representatives treatment of the issue.

Since early July, when the Ways and Means Committee opened hearings on its final proposals, investment yields on new issues of local government AA-rated bonds have risen by about 75 basis points (from about 5.50 per cent to 6.25 per cent), while yields on similarly-rated corporate taxable bonds have risen by only about 10 basis points (from 7.95 per cent to 8.05 per cent). New York City had to pay from 7.43 to 7.48 per cent in late August to borrow on notes due next February and March. A long-term borrowing cost Baltimore, Maryland 6.35 per cent.

Moreover, the size of the new-issue market in local government financing is shrinking because of the decision of local officials to postpone or cancel bond sales on account of the progressive deterioration of the market.

Displacements of this kind, mostly from municipalities that cannot afford the costs of borrowing forced by the suggested removal of tax-exemption, have soared as high as one-third of a week's total volume—or as much as $127,687,000 in a single week—from a previous average of well below 21 per cent.

With this first adverse impact likely to be compounded by the prospect of prolonged litigation of the tax immunity issue in the courts, the Congressional move can be viewed as the start of a dismantling of market machinery that, since the end of World War II, has succeeded in broadening the outstanding float of local government bonds from $13.7 billion to $130 billion. An endorsement by the Senate of the Lower House's action would be a summary requisition on the bond market to find new buyers for from $10 billion to $20 billion of new local government bonds annually.

As things now stand, the uncertainties abounding in the stricken market are raising questions not so much of price as of what the nature of local government obligations may really be from now on. The investor just does not know what he is asked to buy: Is it something taxable instead of tax-exempt? Something tax-exempt now but taxable later? Something marketable at a price now, but perhaps unmarketable at any price later?

As a result of the above effect on the municipal market, all State and local capital outlay financing has come to an abrupt halt in the Commonwealth of Virginia, as our present statutes do not permit the issuance of State or local bonds having a coupon in excess of 6 per cent. Therefore, with the current market for an A-grade 20 year maturity bond being 6.33% as of September 11, 1969, we are unable to market any of our local bonds.

State and Local Bonds are Tax-Exempt as to Income Tax Only

The purchasers or holders of municipal bonds at the time of purchase elect to receive a lesser yield than they would otherwise receive by procuring non-income tax-exempt securities. The smaller yield to the holder results in a lower debt service cost to the issuer. Therefore, in effect, the purchaser or holder of municipal bonds pays a local tax to the locality issuing income tax-exempt securities. This situation exists for the full life of the bond; that is, from the date of issue to the last date of maturity—so that during the full life of the bond the holder, in accepting a lesser yield, is in effect paying to the local government a local tax.

It is obvious from the above that in the most technical sense, there is no such thing as a completely tax-free municipal security. The present tax exemption applies only to State and Federal income tax and the holders are in effect taxed by accepting a smaller yield.

Proposed Federal Subsidy to Local Government Financing on Taxable Bonds

Buyers of such bonds will have to be found in great part away from the sources of demand supporting the existing market for tax-exempt securities. Commercial banks, a major buyer of local government tax-exempts, would be buyers of local government taxable bonds only in short-term maturities, that is obligations due within a year, or—at the most—two years. Individual investors, having been notified of the Congressional wish to do away with the tax-exempt market altogether, may be buyers of the new local government taxable bonds due in one year or less, but otherwise, their investment money will be attracted to equity securities or to whatever tax shelters may still be around in other fields, such as real estate or oil.

It must be kept in mind that the tax-exempt financing privilege enjoyed by municipal or county governments or their subdivisions cannot be renounced by such entities without the consent of the parent state, and that any unauthorized moves to do so will likely be contested in the courts. The same goes on the state administrative front. No governor or state legislature has the right to waive the right of the state community to borrow money on a tax-exempt basis; the authorization must come from a state constitutional convention. The legal complications attending any waiver of local government tax exemption, therefore, are bound to compound the uncertainties otherwise related to the founding of a new public market capable to absorbing the $10 billion to $20 billion of new local government securities annually.

The long-term borrowing of State and local governments financed through the issuance of municipal bonds amounted to $16 billion during the calendar year 1968.

Under House of Representatives Bill No. 13270, it is proposed that the Federal Government would subsidize the State and localities in an amount equal to 30 to 40 per cent of the interest cost for the first five years and 25 to 40 per cent of the interest cost after five years. Assuming the interest cost required to be paid in accordance with the current municipal market—that is, 6.33 per cent for an A-grade 20 year maturity bond, the interest on $16 billion volume of sales for the calendar year 1968 would amount to $1,012,800,000.

Using the 40 per cent subsidy figure, this would require the Federal Government to pay, in subsidies, $405,120,000, which said figure would not include any administration cost nor the cost to the localities to journey to the Nation's Capitol to present their particular case, and I am to understand that the Secretary of the Treasury estimates that $45,000,000 would be derived from a tax on State and municipal bonds.

It is absurd to think, taking into account the cost of the subsidy program, that any increased amount of revenue could possibly accrue to the Federal treasury.

Greater centralization of Government in Washington

In recent months, there have been many encouraging reports to the effect that Congress is making an effort to decentralize government; however, the proposals in House of Representatives Bill No. 13270, wherein said bill proposes to eliminate income tax exemption on State and local bonds and to subsidize the states and localities as a result of tax exemption elimination would require every state, city, county, town and hamlet in the United States to come to Washington on bended knee for the approval by the Federal Government of its financing for any project such as a water system, sewerage, school house or any public improvement. Therefore, the Federal Government would be in the position to determine the feasibility of any capital improvement contemplated by the localities and would also determine the interest cost or debt service in the event the project was approved by some governmental agency.

I am of the opinion that this would create the greatest centralization of government in the Nation's Capitol than any proposal that has come up in recent times.

It is my firm belief and conviction that if debt is to be incurred in government, it should be kept as close to the people as is possible to do. The proposals as set forth concerning State and local financing in House Bill No. 13270 would take the matter about as far away from the people as one could imagine.

Mr. Goldstein. Our next speaker is the Honorable David P. Buckson, the distinguished attorney general of the first State, Delaware, and who also represents the National Association of Attorneys General.

Mr. Buckson.

STATEMENT OF DAVID P. BUCKSON, ATTORNEY GENERAL OF THE STATE OF DELAWARE

Mr. BUCKSON. Members of the Senate, I appear on behalf of the National Association of Attorneys General, having been a former president of the national association. We are in the role somewhat of the linebacker, in effect. If this legislation should slip through it will be our duty, as the attorneys general of each State, to challenge the legality of the constitutionality of the law, so it is to that aspect of this I will address my remarks.

I will be joined in the oral presentation of the legal side of this by the Honorable Thomas O'Connor, who is president of the National Institute of Municipal Law Officers.

The House Ways and Means Committee report on this bill acknowledged that—

> There is a body of opinion to the effect that it would be unconstitutional for the Federal Government to tax interest from State and local obligations without the consent of the issuing governments.

But it then said—

> This position has been disputed, and many authorities have indicated that the Federal Government does have a constitutional right to tax the interest on State and local securities.

You will note that those who deem such a tax unconstitutional, including 50 State attorneys general, and, we are told, the U.S. Attorney General, are, to the Ways and Means Committee majority, merely a body of opinion, while those who would sanction the tax are called authorities. The identity and qualifications of these authorities are not given, but the report does thus reflect a bias in favoring a legal opinion which, at best, is sharply contested and, at worst, is contradicted by every Supreme Court decision on the subject.

Today's hearing might be a replay of the legal debate before this honorable body 30 years ago but for one enormous difference. Then the contestants on one side were the U.S. Department of Justice and the Treasury Department in their full official capacity and on the other side the State attorneys general and the municipal law officers.

Today the cast is the same on our side, but no present Federal law officer denies us; indeed, the Treasury acknowledges at least grave constitutional doubts and, when pressed, a negative judgment on the constitutionality of taxing our bond interest, even under an LTP plan.

In 1940 it was the State view which prevailed in the Senate, and we hope to prevail again.

It is hard to see why the Ways and Means Committee, almost cavalierly and with no analysis in its report whatsoever, was willing to plunge this great unique federal system of ours into the maelstrom of constitutional conflict, pitting the Federal Government against the States and generating a confrontation which is the opposite of the constructive federalism of which we hear so much.

Make no mistake about it. If sections 301, 302, and title VI were enacted in their present form we, the State attorneys general, will challenge them and resist their enforcement. And we would expect to prevail in the Supreme Court.

I am amazed at the so-called authorities who dogmatically assert the constitutionality of taxing State and municipal bonds without State consent. They acknowledge, as they must, that the U.S. Supreme Court flatly and unanimously held such a tax would be unconstitutional in *Pollock* v. *Farmers Loan & Trust Company*, 157 U.S. 429, 158 U.S. 601. You have already heard Assistant Secretary Cohen explain that the Court split 5 to 4 on other issues in that case, but was unanimous on this point.

These alleged authorities also acknowledge, as they must, that the Supreme Court has never, to this day, challenged that opinion or suggested it was ready for reversal. Even the Court of the late 1930's, the high watermark of critical reexamination of the reciprocal constitutional tax immunity, always carefully preserved in the *Pollock* case and its rule of bond exemption as specifically different from such taxes as it sanctioned on salaries or contractor's profits, as set forth in cases which we have cited.

In the contractor case, the opinion was by Justices Black, Brandeis, Cardozo, Hughes, and Stone, and they too referred to the *Pollock* case. They reaffirmed its validity in words prophetic of the market uproar produced by the House bill. They said:

> That doctrine recognizes the direct effect of a tax which "would operate on the power to borrow before it is exercised"—*Pollock* v. *Farmers Loan & Trust Company, supra*—and which would directly affect the [State] government's obligation as a continuing security.

These judges even went on to say what all the State and local government witnesses are here pleading with you to recognize. The court said:

> Vital considerations are there involved respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit.

Justice Cardozo also cited the *Pollock* case and said:

> By the teaching of the same case an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power such as was condemned in *McCulloch* v. *Maryland*.

McCulloch v. *Maryland*, thus cited, has renewed significance in view of the readoption of its philosophy by the majority of the Supreme Court only last year in *First Agricultural National Bank* v. *State Tax Commission* (392 U.S. 339), *McCulloch* is remembered as the constitutional landmark which first asserted the doctrine of constitutional governmental tax immunity to avoid destruction of our federal system. Its philosophy was expressed in the aphorism, "the power to tax involves the power to destroy."

This should come as no surprise to those who have studied the only case of constitutional significance to this subject which came between the cases of the late thirties and today. This was the case of *New York* v. *United States* (326 U.S. 572), where the Court split three ways in 1946. The tax involved was a Federal excise tax on the sale of bottled mineral waters that the State of New York was engaged in selling. The Court sustained the tax, Justices Black ard Douglas dissenting, and they are the only members of that bench still sitting.

These two justices, while specifically mentioning State issuance of securities, condemned all Federal taxes against the States because, they said, a tax is a powerful regulatory instrument.

To Justices Black and Douglas, according to that opinion of 1946, a Federal system requires coexistence of the Federal and State partners and the kind of coexistence contemplated by the Constitution does not allow for the use by either against the other of such a "powerful regulatory instrument" as a tax.

To these Justices, a Federal system is the opposite of centralization of power in the Federal Government and so they went further in their opinion and said of Federal taxation of the States, "And no more powerful regulatory instrument for centralization of Government could be devised."

You will recognize that this was really only an updated restatement of the century-old pronouncement that "the power to tax involves the power to destroy."

I fail to see where, in this history of the constitutional rule, there is the slightest basis whatever for the constitutional view espoused by the Ways and Means Committee majority report.

As to title VI of H.R. 13270, I hear its plan described as a tax-subsidy plan. I submit this is a most inaccurate label. A subsidy is a gratuity—something paid without exacting repayment. Title VI seeks to exact a very substantial repayment from the States. It requires the waiver of their valuable constitutional immunity, if the Federal Government is to make any payments to the States.

When my friend, Attorney General Burch of Maryland, testified on this subject before the Ways and Means Committee, no bill had yet been drawn. He said:

> If a State consents, Congress may lawfully tax its bonds and those of its municipalities. If, then, the proposals on the Committee's agenda under this subject are unequivocally kept optional for each State, it will avoid the stated constitutional obstacle.

Unfortunately, the bill as passed by the House has not kept its tax proposals unequivocally optional. What we have is a package plan with mandatory LTP and ADR eliminating historic tax exemption and the rebate plan coercively driving the States to take what they can to escape the unacceptable issuance of bonds under LTP and ADR.

In our opinion, the package is, therefore, unconstitutional in all its parts and we, if it does become the law, will be compelled to challenge it in all the courts which are available to us as the legal representatives of each of our States.

(Hon. David Buckson's prepared statement follows:)

Statement of David Buckson, Attorney General of the State of Delaware

I am Attorney General of the State of Delaware, and former President of the National Association of Attorneys General which I represent here. Our Association consists of the chief law officers of each of the 50 States as well as of the Territories.

Our Association is proud that in 1938 it fathered what is now the Conference on Intergovernmental Fiscal Relations, which is the coalition of the national organizations of state and local governments and of the respective executive, fiscal and law officers of the States and local governments. They joined together at our invitation to preserve the exemption of state and local government institutions from federal taxation.

Each time in the past three decades when attempts were made to withdraw the tax exemption of state and local government bond interest, the Attorneys General of the States have appeared here by one of their number and protested. We are here to protest today the inclusion of state and municipal bond interest in the "limit on tax preferences" (LTP) of Sec. 301 of H.R. 13270 and in the "allocation of deductions rule" (ADR) of Sec. 302 of the bill as well as the ill-conceived rebate plan to Title VI and the "arbitrage bond" tax of Sec. 601(b).

We agree with the fiscal and economic objections of the Governors and other state and local government officers appearing at these sessions. But as the chief law officers of the States, our special competence is as to the legal aspects of proposals in this field.

In 1939 the State Attorneys General of that day submitted a brief to this Committee asserting the unconstitutionality of any federal tax on our bond interest without state consent. (Incidentally, former Chief Justice Warren was one of the signatories—he was then Attorney General of California). We commend that brief to you and submit that nothing has happened in the intervening 30 years to change its conclusions.

The House Ways and Means Committee Report on this bill acknowledged that "there is a body of opinion to the effect that it would be unconstitutional for the Federal Government to tax interest from State and local obligations without the consent of the issuing governments." But it then said "this position has been disputed, and many authorities have indicated that the Federal Government does have a constitutional right to tax the interest on State and local securities." (House Report No. 91–413 (Part 1), p. 172).

You will note that those who deem the tax unconstitutional, including 50 State Attorneys General, and, we are told, the United States Attorney General are, to the Ways and Means Committee majority, merely a "body of opinion," while those who would sanction the tax are called "authorities." The identity and qualifications of these "authorities" are not given, but the report does thus reflect a bias in favoring a legal opinion which, at best, is sharply contested and, at worst is contradicted by every Supreme Court decision on the subject.

Today's hearing might be a replay of the legal debate before this honorable body thirty years ago but for one enormous difference. Then the contestants on one side were the United States Department of Justice and the Treasury Department in their full official capacity and on the other side the State Attorneys General and the Municipal Law Officers. And the United States Senate of that time accepted the State and municipal view. Today the cast is the same on our side, but no present federal law officer denies us; indeed the Treasury acknowledges at least grave constitutional doubts and, when pressed, a negative judgment on the constitutionality of taxing our bond interest, even under an LTP plan.

It is hard to see why the Ways and Means Committee, almost cavalierly and with no analysis in its report whatsoever, was willing to plunge this great and unique federal system of ours into the maelstrom of constitutional conflict, pitting the federal government against the states and generating a confrontation which is the opposite of the constructive federalism of which we hear so much.

Make no mistake about it. If sections 301, 302 and Title VI are enacted in their present form, we, the State Attorneys General, will challenge them and resist their enforcement. And we would expect to prevail in the Supreme Court.

Unfortunately, such an ultimate vindication of our opinion will not undo the damage accruing during the years of the judicial contest. The financial status quo cannot be preserved during our legal exercises. New schools will still have to be built and bonds will have to be issued as we seek our final judgment. Investors will have to protect themselves by assuming the worst and our interest rates will stay at taxable levels until the day of victory. But the states and municipalities who couldn't wait for that day will be paying the higher taxable rates on the bonds issued during the years of litigation for 15–20 years after the Supreme Court finally held this legislation unconstitutional.

I am amazed at the "authorities" who dogmatically assert the constitutionality of taxing state and municipal bonds without state consent. They acknowledge, as they must, that the United States Supreme Court flatly and unanimously held such a tax would be unconstitutional in *Pollock* v. *Farmers Loan and Trust Co.*, 157 U.S. 429, 158 U.S. 601. You have already heard Assistant Secretary Cohen explain that the Court split 5–4 on other issues in that case, but was unanimous on this point.

These alleged "authorities" also acknowledge, as they must, that the Supreme Court has never, to this day, challenged that opinion or suggested it was ready for reversal. Even the Court of the late 1930's, the high watermark of critical reexamination of the reciprocal constitutional tax immunity, always carefully preserved in the *Pollock* case and its doctrine as specifically different from such taxes as it sanctioned on salaries (*Helvering* v. *Gerhardt*, 304 U.S. 405) or a contractor's profits (*James* v. *Dravo Contracting Co.*, 302 U.S. 134).

In the salary case, for example, Justice Stone said that immunity was sustained against a statutory effort "to tax income received from state bonds, and thus threaten impairment of the borrowing power of the state (*Pollock* v. *Farmers Loan and Trust Co.*)."

In the contractor case, the opinion was by Justices Black, Brandeis, Cardozo, Hughes and Stone, and they too referred to the *Pollock* case. They reaffirmed its validity in words prophetic of the market uproar produced by the House bill. "That doctrine," they said, "recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (*Pollock* v. *Farmers Loan and Trust Co.*, supra), and which would directly affect the [state] government's obligation as a continuing security."

These judges even went on to say what all the state and local government witnesses are here pleading with you to recognize. "Vital considerations," the court said, "are there involved respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit."

Justice Cardozo, with his flair for the coinage of expressions, referred to *Pollock* in *Hale* v. *Iowa State Board,* 302 U.S. 95, and said, "By the teaching of the same case an income tax, if made to cover the interest on government bonds, is a clog upon the borrowing power such as was condemned in *McCulloch* v. *Maryland.*"

McCulloch v. *Maryland,* 4 Wheat. 316, thus cited, has renewed significance in view of the readoption of its philosophy by the majority of the Supreme Court only last year in *First Agricultural National Bank* v. *State Tax Commission,* 392 U.S. 339. *McCulloch* is remembered as the constitutional landmark which first asserted the doctrine of constitutional governmental tax immunity to avoid destruction of our federal system. Its philosophy was expressed in the aphorism, "the power to tax involves the power to destroy."

The significance of last year's *First Agricultural* case is that the majority and minority locked horns, in final analysis, on the continuing validity, after 150 years, of John Marshall's conviction that the "power to tax involves the power to destroy." The case wasn't even an income tax case; it overturned a state sales tax on a privately-owned national bank. It wasn't technically, even a case of constitutional interpretation, but rather of a statute passed in the light of constitutional doctrine. But the majority opinion cannot be read without dispelling doubts that today's Court still sees intergovernmental taxation as destructive and therefore repugnant to the federal system and the respective federal and state partners in that system.

This should come as no surprise to those who have studied the only case of constitutional significance to this subject which came between the cases of the late '30s and today. This was the case of *New York* v. *United States,* 326 U.S. 572, where the Court split three ways in 1946. The tax involved was a federal excise tax on the sale of bottled mineral waters and it happened that the State of New York was engaged in selling, in the everyday market, bottled Saratoga Springs waters. The Court sustained the tax with Justices Black and Douglas dissenting, and I note that they are the only members of that bench still sitting.

Justices Frankfurter and Rutledge, while voting for the tax, were in another minority, quite obviously willing to scrap the immunity doctrine. The four other judges supported the tax on the conventional ground that a government can lose its immunity when it descends into the market place. That reasoning has no significance to our present inquiry. What is significant is the reasoning of Justices Black and Douglas in arguing the tax was unconstitutional.

In pleading for a reversal of the "market place" exception, these two surviving Justices, after mentioning state issuance of securities, condemned all federal taxes against the states because "A tax is a powerful regulatory instrument."

To Justices Black and Douglas, according to that opinion in 1946, a federal system requires co-existence of the federal and state partners and the kind of co-existence contemplated by the Constitution does not allow for the use by either against the other of such a "powerful regulatory instrument" as a tax. To these Justices, a federal system is the opposite of centralization of power in the federal government and so they went further in their opinion and said of federal taxation of the states, "And no more powerful regulatory instrument for centralization of government could be devised."

You will recognize that this was really only an updated restatement of the century-old pronouncement that "the power to tax involves the power to destroy." Whereas Justices Black and Douglas expressed their judgment alone in *New York* v. *United States,* they formed part of the majority of the 1968 court in *First Agricultural.*

If we repeat the cases which others have cited to you, it is because all "authorities" share the same limited repertory. What I fail to see, however, is where, in this history of the constitutional rule, there is the slightest basis whatever for the constitutional view espoused by the Ways and Means Committee majority report when it recommended taxes, however limited, on state and municipal bond interest.

Certainly the Sixteenth Amendment, which first sanctioned an unapportioned income tax on all income, cannot be the answer. All the cases after *Pollock* that I have cited are also after the Sixteenth Amendment. The history of that Amendment and its judicial interpretation both reject the view that it undid, in any way, the constitutional prohibition against taxing state and municipal bonds.

When in 1910, while the Amendment was awaiting state ratification, the New York Governor suggested that possibility, and recommended against ratification on that sole ground, his suggestion was specifically contradicted by the Senators who were the champions of the Amendment and who had led the successful flight for its adoption by Congress. The states ratified the amendment only after they had been assured in the most solemn way on the floor of the Senate that it did not contain authority to tax their bond interest. (45 Cong. Rec. 1968, 2245–7, 2539).

It is not too much to say that the good faith and credibility of the Senate would be sacrificed if it were ever maintained that the Sixteenth Amendment sanctioned the disputed provisions of H.R. 13270.

While more is not needed, the Supreme Court has held over and over that the Amendment granted no such new power, but merely removed a need for apportionment for income taxes on income from property. *Brushaber* v. *Union P.R.R. Co.*, 240 U.S. 1; *Stanton* v. *Baltic Mining Co.*, 240 U.S. 103; *Peck & Co.* v. *Lowe*, 247 U.S. 165; and *Eisner* v. *Macomber*, 252 U.S. 189. Among the justices in these cases was a former Senator who had been a member while the matter was debated. All the justices were contemporary and fully understood the intent of the Congress and the reassurances to the States which procured ratification.

This chronicle, I submit, leaves no question but that the LTP plan cannot constitutionally include state and municipal bond interest. And it persuades me also that the ADR cannot constitutionally include such interest. The burdensome effect of ADR is at least as direct and serious as in the case of LTP. In fact our finance officers advise that ADR is the more burdensome of the two because it would affect more people, not being limited, as is LTP, to individuals having more "tax preference" income than adjusted gross income. And the Treasury has testified that ADR would produce more revenue than LTP, which tends to confirm that it is more burdensome.

I cannot accept Assistant Secretary Cohen's unqualified statement that all constitutional obstacles to ADR were removed by *U.S.* v. *Atlas Life Ins. Co.*, 381 U.S. 233. The case deals with a unique kind of taxpayer, a life insurance company. The word "unique" is not just mine. The Treasury brief in that case used the same word, "unique," to characterize a life insurance company's peculiar financial structure. It is almost impossible to construct parallels to the ordinary individual who alone is the taxpayer under LTP and ADR in the House bill.

Life insurance companies have never been taxed under the ordinary parts of the Revenue Acts or Codes. They always required a special staute to meet their unique situation.

The fact is that life insurance companies are required by both actuarial necessity and by law to treat by far the larger part of their receipts as "reserves" accrued for the benefit of their policyholders, for ultimate certain distribution on death. Thus, for all practical purposes, what the company receives cannot fairly be taxed to it because so much of it (typically 80%) really belongs to the policyholders from the moment of its receipt.

What Congress did in the 1958 Act was merely to give tax reality to this practical reality. Every item of income was apportioned to a "company's share" on which the company paid taxes and a "policyholder's share" on which it did not. As the Supreme Court saw it, Congress simply forebade the company to assign all its tax exempt income to its own share so as to artificially minimize or extinguish its own tax liability. Rather, it required that the tax exempt income, like all other income, be allocated proportionately to the two respective ownership interests, much as a trustee must do, the Treasury argued, as between trusts he is administering.

Now, when you seek to apply this concept to ADR with regard to individuals, it is obvious that essential elements are missing for any analogy. A life insurance company, for all practical purposes, can be deemed both an owner of its own "company's share" and a quasi-fiduciary for policyholders. But where is the second personality in the case of an ordinary individual? He seems to us one and inseparable. He certainly has no Atlas-type community of interests with the people to whom he makes the payments which produce his itemized deductions: his mortgagee with regard to interest deductions, or his school district with regard to school taxes, or the auto mechanic who repairs his wrecked car, or his church to which he contributes.

The relationship between the company and its allocated income in *Atlas* just doesn't exist between an individual and the allocated expenses under ADR.

All these unique characteristics of life insurance companies were stressed by the *Atlas* court, all of which would have been unnecessary if the court were ready to accept a stark plan like the present ADR under which the exemption of an individual's exemption is devalued by disallowing otherwise allowable and unrelated expense deductions.

Section 601(b) of the House bill seeks to tax certain state and municipal bonds which it calls "arbitrage bonds" without bothering to define the term. If the aim is to tax bonds issued for the purpose of raising money to invest in higher yielding bonds, then the provision is absolutely unnecessary. I don't know of a single state in which bonds could be lawfully issued for that purpose. If the aim is something else, the tax would unconstitutionally violate the basic immunity rule. In any event, the provision of the House bill is clearly an unconstitutional delegation of power to the Secretary of the Treasury to legislate.

As to Title VI of H.R. 13270, I hear its plan described as a "tax-subsidy" plan. I submit this is a most inaccurate label. A subsidy is a gratuity—something paid without exacting repayment. What Title VI seeks is to exact a very substantial repayment from the states in the form of the waiver of their valuable constitutional immunity and to pay the states against their loss and presumably out of the very moneys they would have lost by their waiver.

Whatever else this is, it is not a federal subsidy of the states, although it may be vice versa. I shall call it a rebate plan.

When Attorney General Burch of Maryland testified on this subject before the Ways and Means Committee, no bill had yet been drawn. He said, "if a State consents, Congress may lawfully tax its bonds and those of its municipalities. If, then, the proposals on the Committee's agenda under this subject are unequivocally kept optional for each state, it will avoid the stated constitutional obstacle."

Unfortunately, the bill as passed by the House has not kept its tax proposals unequivocally optional. What we have is a package plan with mandatory LTP and ADR eliminating historic tax exemption and the rebate plan coercively driving the states to take what they can to escape the unacceptable issuance under LTP and ADR. The package is therefore unconstitutional in all its parts.

When Governor Tiemann first opened the possibility of a consensual double-coupon plan before the Ways and Means Committee, he opened a possibility for the practice of true cooperative federalism. The door was opened for negotiations between the state and federal governments, as to ways in which a truly optional plan might be made workable. As Chairman Mills said at that hearing, if the Governors urged and the States really supported a plan, even a constitutional amendment, if needed, could be readily ratified.

But instead of cooperative federalism, the Ways and Means Committee closed itself off from formal communication with the Governors or Attorneys General, retreated to its executive session and concocted this parody of Governor Tiemann's idea, with an inadequate rate of repayment to the States and with the Secretary of the Treasury, of all people, fixing the rate of repayment; with a disqualification of selected bonds, thus boldly asserting the federal power to regulate by this mechanism; with no requirement of state consent for municipal waiver of what is a state immunity; and with no protection against federal pull back or cut down on the provisions for repaying the states. Title VI is not only unconstitutional but thoroughly wrong.

Mr. Buckson. The concluding remarks on this phase of it will be given by the Honorable Thomas O'Connor, president of the National Institute of Municipal Law Officers.

STATEMENT OF THOMAS M. O'CONNOR, PRESIDENT, NATIONAL INSTITUTE OF MUNICIPAL LAW OFFICERS

Mr. O'CONNOR. Mr. Chairman and members of the committee, I am the city attorney of the city of San Francisco, and the president of the National Institute of Municipal Law Officers.

I do not wish to repeat what Mr. Buckson has said except to add that the city attorneys of the country will join the State attorneys general as far as any attack is concerned.

We also believe that the proposal to tax interest on the municipal and State bonds is unconstitutional.

We filed a statement on behalf of our association with the committee, and, rather than summarize it here, I would repeat only that we have had resolutions before NIMLO on a number of occasions, the last in 1965, in which we petitioned the Congress of the United States to reject all measures allowing direct or indirect taxation of municipal bonds.

As I said, I am not going to repeat Mr. Buckson's statements except to say that the major tenet of our legal position is that *McCulloch* v. *Maryland*, and *Pollock* v. *Farmers Loan and Trust Company* are central cases in connection with intergovernmental immunity from taxation, and that the *Pollock* case has never been overruled by the courts to this date—and not only not overruled, but the leading cases of the Supreme Court sustained the validity of the *Pollock* case.

Our statement also points out that, as far as the legislative history of the 16th amendment is concerned, the Congress had no intention to change the *Pollock* rule of municipal bond exemption.

Our statement further points out that the Supreme Court's interpretations of the 16th amendment demonstrate that it did not grant the Federal Government the power to tax municipal bonds.

Lastly, I would like to reiterate that the case of *United States* v. *Atlas Life Insurance Company*, contrary to the statement made to this committee by the Treasury, does not support the constitutionality of the allocation of personal-deduction provisions of the bill. *Atlas* involved only the taxation of insurance companies which are recognized to be unique. It did not involve individuals.

Atlas involved an allocation of income. It did not involve an allocation of deductions by individuals. The history of the 16th amendment, the history of the decisions of the U.S. Supreme Court, in our opinion, demonstrate that it would be unconstitutional for this part of the bill to pass.

It is our hope that this committee and the Senate will reject both on constitutional grounds and sound public policy these provisions of H.R. 13270, which would unconstitutionally impose a clog on the borrowing power of the States and their political subdivisions.

Gentlemen, I thank you for the opportunity to appear.

Senator ANDERSON. Thank you very much.

(Thomas M. O'Connor's prepared statement follows:)

STATEMENT OF THOMAS M. O'CONNOR

SUMMARY

My name is Thomas M. O'Connor, City Attorney of San Francisco and President of the National Institute of Municipal Law Officers (NIMLO).

I have filed a statement on behalf of our association with the Committee and

I ask that it be made a part of the record. Within the time allotted to me, I will summarize the points made in that statement.

The National Institute of Municipal Law Officers composed of 1340 cities acting through their chief legal officer hereby reaffirm their 1965 Resolution petitioning the Congress of the United States to "reject all measures allowing direct or indirect taxation of municipal bonds."

We submit that H.R. 13270 must be rejected for the following reasons:

1. The Bill is unconstitutional because it violates the constitutional doctrine of intergovernmental immunity enunciated in *McCulloch* v. *Maryland*. A specific application of this doctrine resulted in a recognition in *Pollock* v. *Farmers' Loan & Trust Co.* of the immunity of the interest of state and municipal bonds from federal income taxation.

(*a*) The *Pollock* decision rests on the constitutional repugnance to any attempt by one level of government to interfere with another level of government's exercise of its sovereign power.

(*b*) The power to borrow is an essential power of government and any attempt to impose a clog on this power is unconstitutional.

2. The Supreme Court has never retreated from the *Pollock* decision:

(*a*) *Hale* v. *Iowa State Board* (1937), by Cardozo, J.

"By the teaching of the same (*Pollock*) case an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power such as was condemned in *McCulloch* v. *Maryland*."

(*b*) *Helvering* v. *Gerhardt* (1938), by Stone, J.

In *Helvering* v. *Gerhardt*, 304 U.S. 405, 417 (1938), the Court said that State immunity has been sustained where the attempt was "to tax income received by a private investor from state bonds, and thus threaten impairment of the borrowing power of the state (*Pollock* v. *Farmers' Loan & T. Co.* * * *)."

(*c*) *James* v. *Dravo Contracting Co.* (1937), by Hughes, J.

"That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (*Pollock* v. *Farmers' Loan & Trust Co.*, supra), and which would directly affect the government's obligation as a continuing security. Vital considerations are there involved, respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit * * *."

(*d*) *First Agr. Nat. Bank* v. *State Tax Commission* (1938), by Black, J.

Reapplied the principle of *McCulloch* underlying *Pollock*.

3. Adoption of the Sixteenth Amendment did not have any impact on the *Pollock* decision holding municipal bonds tax exempt.

(*a*) The legislative history of the Amendment discloses that Congress had no intention to change the *Pollock* rule on municipal bond exemption.

(*b*) The Supreme Court's interpretations of the Sixteenth Amendment demonstrate that it did not grant the federal government the power to tax municipal bonds.

(1) *Brushaber* v. *Union Pacific Railroad Company*

(2) *Stanton* v. *Baltic Mining Co.*

(3) *Peck and Company* v. *Lowe*

(4) *Eisner* v. *Macomber*

4. *United States* v. *Atlas Life Insurance Co.*, contrary to statement made to this Committee by the Treasury, does not support the constitutionality of the allocation of personal deductions provision of H.R. 13270:

(1) *Atlas* involved only the taxation of insurance companies which are recognized to be unique; it did not involve individuals.

(2) *Atlas* involved an allocation of income; it did not involve an allocation of deductions by individuals.

STATEMENT

My name is Thomas M. O'Connor. I am the City Attorney of the City of San Francisco, California, and President of the National Institute of Municipal Law Officers.

I appear here today to oppose the unconstitutional proposal to impose a federal tax on the income derived from state and municipal bonds.

The National Institute of Municipal Law Officers is an association of 1,340 of the largest cities located in all the states, acting through the heads of their legal departments, the city attorney. These city attorneys and their more than 5,000 assistants participate actively in our organization's work. In Washington, D.C.

we maintain a national headquarters, which we utilize as a clearing house for municipal legal information and from which we send out publications on current developments in the field of municipal law. We also carry out extensive research in this field. Our primary reason for existence is to keep attorneys for cities informed of what other cities have done, are doing, and plan to do, in the legal field, so as to increase the information resources of our member municipalities manyfold. All of our services are supported entirely by appropriations from the tax funds of cities.

In 1965, the National Institute of Municipal Law Officers resolved as follows:

URGING RECIPROCITY OF TAX IMMUNITY BETWEEN FEDERAL AND MUNICIPAL BONDS AND SECURITIES

(Adopted at Annual Conference, October 14, 1965)

Whereas the exemption of municipal bond interest from federal income taxation is critically important in enabling the cities to discharge their mounting burden of responsibility at the lowest cost; and

Whereas suggestion has been made that indirect federal taxation of municipal bond interest be sanctioned by disallowance of a prorated portion of otherwise allowable expense deductions of investors who receive part of their income from municipal bond interest; and

Whereas by Revised Statutes (Section 3701) Congress has expressly prohibited such indirect taxation of federal bond interest by the states and cities; and

Whereas the exemption of public securities—federal obligations from state and local taxes and state and local obligations from federal taxes—has traditionally been and of right ought to be reciprocal: Now, therefore, be it

Resolved by the National Institute of Municipal Law Officers. That the Congress of the United States is urgently petitioned to reject all measures allowing direct or indirect taxation of municipal bonds.

We submit that both the minimum tax and allocation of deduction proposals impose an unconstitutional tax upon political subdivisions of the states. No matter how explained and no matter how clothed in bureaucratic double talk, the legal effect of these proposals is crystal clear. Both proposals clearly violate the Constitution of the United States by violating the constitutional doctrine of intergovernmental immunity.

Furthermore, I submit that no time could be more untimely for the Federal government to attempt to impose such a new and devastating financial burden upon city taxpayers. As it is city tax rates are enormously high. This Bill would cause them to skyrocket. Every Senator who votes for this Bill will be voting to increase city tax rates in nearly every city of his state. The economic experts have estimated that a rise of $300,000,000 in the borrowing costs to state and local governments over the past four months is traceable to the mere threat that the Senate would enact the proposals taxing municipal bond interest which were passed by the House. However, I will not dwell upon the crippling economic impact which H.R. 13270 would have on local governments since it is my understanding that evidence showing the direct economic burden of the proposals will be presented to this Committee by other witnesses. My remarks will be limited to a demonstration that the proposals violate the basic constitutional principles underlying our dual sovereignty form of government.

In considering any legal or constitutional issue it is essential that it be studied in historical perspective. I therefore start with the founding of our Nation and the principles agreed upon and written into our great constitutional charter as they are so clearly stated by Chief Justice Marshall in the famous case of *McCulloch* v. *Maryland*, 4 Wheat. 316 (1819). There, during the very infancy of our Country, the basis for the doctrine of reciprocal sovereign immunity was enunciated in clear and unmistakable language as the keystone for our federal system of government. This doctrine has stood as a rock of Gibraltar against the interference, through taxation, by one level of government with the exercise of essential sovereign powers by another level of government. Indeed, just last year the Supreme Court reapplied the doctrine of the *McCulloch* decision when it struck down an attempt by the state of Massachusetts to impose a sales and use tax on a national bank in *First Nat. Agr. Bank* v. *State Tax Commission*, 88 Sup. Ct. 2173 (1968).

With this reference to the *McCulloch* case, we come now to the famous *Pollock* case, 158 U.S. 601 (1895). In *Pollock*, a specific application of constitutional doctrine of intergovernmental immunity resulted in a recognition of the immunity of the interest on local government bonds from Federal income taxation. The Supreme Court has never retreated from this position.

The *Pollock* case involved three issues:—(a) the power of the Federal Government to levy an income tax without apportionment on income from the source of professions or business, (b) the power of the Federal Government to levy an income tax without apportionment on income from the source of real or personal property, and (c) the power of the Federal Government to levy an income tax on the interest on state and local obligations. The first two questions involved interpretation of Article 1, section 2, clause 3 of the Constitution, which provides that direct taxes shall be apportioned among the several States according to population. It was finally decided that apportionment was necessary for a tax on income derived from the source of real and personal property, but not on income from the source of businesses and professions. This part of the decision led to the adoption of the Sixteenth Amendment permitting a non-apportioned income tax.

The third question, involving the Federal power to tax State and municipal obligations, however, did not concern the manner of levying the tax; it involved no determination as to whether the tax was direct or indirect, from what source it was derived, and whether apportionment was necessary. In the case of a tax on State and municipal obligations, the question was one of power or absence of power to levy the tax at all, whether with or without apportionment. On this third point, the Chief Justice said:

"We have unanimously held in this case that so far as this law operates on the receipts from municipal bonds, it cannot be sustained, because it is a tax on the power of the states, and on their instrumentalities to borrow money and consequently repugnant to the Constitution."

The Supreme Court has often been confronted with proposed extensions of the basic doctrine of reciprocal immunity of State and Federal Governments from taxation, each by the other. Some of these extensions it has sanctioned. Some it has rejected. But the Court has never once wavered from the simple proposition that the Federal Government lacks the power to impose a tax upon State and municipal obligations.

The reasoning of all the Justices on this point in the *Pollock* case was well expressed by Mr. Justice Cardozo for the Court in *Hale* v. *Iowa State Board,* 302 U.S. 95, 107 (1937):

"By the teaching of the same [*Pollock*] case an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power such as was condemned in *McCulloch* v. *Maryland.*"

Similarly, Mr. Justice Stone, in *Helvering* v. *Gerhardt,* 304 U.S. 405, 417 (1938), said that State immunity has been sustained where the attempt was "to tax income received by a private investor from state bonds, and thus threaten impairment of the borrowing power of the state (*Pollock* v. *Farmers' Loan & T. Co.* * * *)."

It will be seen, therefore, that the decision in the *Pollock* case on this point rested upon the conclusion of the Court that a tax on State and municipal bond interest threatens a destructive burden on the exercise of the borrowing power of the States and their agencies. This was a conclusion of fact. The Court took judicial notice of what appeared to it an undeniable fact.

Throughout the three-quarters of a century during which the *Pollock* doctrine has remained in force and been relied upon by State and local governments and investors in their securities, this factual basis of the Court's opinion was never questioned—it was considered unquestionable.

In *James* v. *Dravo Contracting Co.,* 302 U.S. 134, 153, the Court reasserted the *Pollock* rule in the following words:

"That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (*Pollock* v. *Farmers' Loan & Trust Co.,* supra), and which would directly affect the government's obligation as a continuing security. Vital considerations are there involved, respecting the permanent relations of the government to investors in its securities and its ability to maintain its credit * * *."

Adoption of the Sixteenth Amendment had no impact on the portion of the *Pollack* decision which held that the interest on State and municipal bonds was immune from federal taxation. This conclusion is supported by both the legislative history of the Amendment and the case law interpreting it.

To allay the fears of those who believed that adoption of the Sixteenth Amendment would permit the federal government to impose a tax on the interest of State and local government bonds, Senator *Borah* of Idaho made the following statement on the floor of the United States Senate on February 10, 1910:

"The amendment did not deal, does not purport to deal and was not intended to deal with the question of power . . . to construe the proposed amendment so as to enable us to tax the instrumentalities of the state would do violence to the rules laid down by the Supreme Court for a hundred years, wrench the whole Constitution from its harmonious proportions and destroy the object and purpose for which the whole instrument was framed." 45 Cong. Rec. 1698.

On February 23, 1910, Senator *Brown*, the sponsor of the Senate Joint Resolution which eventually became the Sixteenth Amendment, stated:

". . . the proposed amendment will not authorize any additional burden on the several states in the exercise of their sovereign rights guaranteed by the Constitution as it exists today."

And to evidence his desire to overcome only the part of the *Pollock* decision which dealt with apportionment, he repeated:

"The proposed amendment has a single purpose and that is to confer on Congress the undoubted power to tax incomes directly without regard to apportionment."

Later, even more pointedly, he said: "The amendment does not alter or modify the relation today existing between the States and the Federal Government. That relation will remain the same under the amendment as it is today without the amendment. It is conceded by all that the Government cannot under the present Constitution tax state securities or state instrumentalities. Nor can the State lay its taxing finger on Federal bonds or Federal agencies. Each is beyond the reach of the other as far as taxation is concerned. The proposed amendment in no sense seeks nor can it reasonably be argued to suggest any change in the independent or sovereign rights of either sovereignty as enjoyed and defined by the courts ever since the Government was organized." 45 Cong. Rec. 2245–2247.

Shortly afterwards Senator *Elihu Root* of New York stated that:

"The objection made to the amendment is that this will confer upon the National Government the power to tax incomes derived from bonds issued by the states or under the authority of the States and will place the borrowing capacity of the State and its governmental agencies at the mercy of the Federal taxing power. I do not find in the amendment any such meaning or effect." 45 Cong. Rec. 2539.

What clearer expositions of the true sense of the Sixteenth Amendment could be desired? Particularly significant, moreover, is the fact that in *the entire Congressional consideration and debates there is not the slightest suggestion of a contrary opinion.* The judgment of the contemporaries of that day could not have been more overwhelmingly convincing as to the application of the Sixteenth Amendment.

Good faith with the states clearly dictates that since the states ratified the Amendment to aid the Federal government in financing itself on such a clearly expressed understanding, the Federal government should not now attempt to violate the understanding. The nearly sixty years which have elapsed have not eradicated the record of the understanding. It is recorded in such unmistakable language that none can misunderstand.

Assuming that the advocates of the proposals now before this Committee are unwilling to accept the legislative background set forth above as conclusive—although we believe it is—I now examine several of the decisions of the Supreme Court of the United States since the adoption of the Sixteenth Amendment in 1913. Those cases firmly establish that the Sixteenth Amendment did not confer upon the Federal government the power to tax city and state bonds which it concededly did not have before this Amendment went into effect.

The first case coming before the Supreme Court following the adoption of the Sixteenth Amendment involving its interpretation and construction was *Brushaber v. Union Pacific Railroad Company*, 240 U.S. 1 (1916). In this case the Court held that the amendment did not extend the Federal taxing power to new subjects, but merely eliminated the necessity for apportioning direct taxes upon income derived from property.

Following the *Brushaber* case were other decisions which pointed out with equal clarity the fact that the "provisions of the Sixteenth Amendment conferred no new power of taxation" but merely removed all occasion for an apportionment among the states of taxes laid upon income. *Stanton* v. *Baltic Mining Company*, 240 U.S. 103 (1916), *Peck and Company* v. *Lowe*, 247 U.S. 165 (1918), and *Eisner* v. *Macomber*, 252 U.S. 189 (1920), all repeat the view that the Amendment did not go any further than the decision expressed in the *Brushaber* case.

In view of the foregoing it is readily understandable why the Administration, in its testimony before the Senate Finance Committee, readily admitted that the inclusion of municipal bond interest, in a minimum tax calculation posed a grave constitutional question. In fact, when pressed, Secretary Kennedy stated flatly that such a tax would be unconstitutional.

However, with regard to the allocation of personal deductions, the Treasury representatives attempted to convince the Senate Finance Committee that this proposal raised no constitutional question. As support for their conclusion, they cited the Committee to the case of *United States* v. *Atlas Life Insurance Company*, 381 U.S. 233 (1965). This reliance on the *Atlas* case, however, is clearly misplaced. *Atlas* did not involve individuals, it involved insurance companies and *Atlas* did not involve the allocation of deductions, it involved the allocation of income.

The problems involved in the taxation of an insurance company are so different from those involved in the taxation of individuals that a case involving one is of little or no precedential value in a case involving the other. The equitable taxation of an insurance company has always been a troublesome problem for Congress and has resulted in Congress adopting a whole series of special statutory provisions applicable to only insurance companies. Part of the difficulty is caused by the fact that an insurance company is required by law to set aside a very high percentage of its income. This reserve or policyholders' share is allowed as a deduction for purposes of company income taxes. The federal government itself, in its brief to the Supreme Court in the *Atlas* case recognized the *sui generis* nature of the taxation of insurance companies. Thus on page 30 of its brief the government stated that "the policyholders' reserve of a life insurance company is unique."

The Insurance Tax Act which was in question in the *Atlas* case required insurance companies to divide *each type* of income which it received into a policyholder's share (reserve) and a company share (company's income) according to the percentage of total income which was allocated to each.

It was the allocation of income contained in the Insurance Act and that allocation alone which the Supreme Court held not to impose a constitutionally impermissible tax on municipal bond interest income. The Court's decision was based on its belief that to allow insurance companies an arbitrary assignment of tax exempt income to the company share of income would bestow a benefit on insurance companies which is not required by the doctrine of intergovernmental immunity.

CONCLUSION

For reasons of both constitutional law and sound public policy we urge this Committee to reject those provisions of H.R. 13270 which would unconstitutionally impose a clog on the borrowing power of the states and their Political subdivisions.

Mr. GOLDSTEIN. Mr. Chairman, our concluding witness is the Honorable William Summers Johnson, the finance director of the city and county of Honolulu, the 50th State.

STATEMENT OF HON. WILLIAM SUMMERS JOHNSON, DIRECTOR OF FINANCE, CITY AND COUNTY OF HONOLULU, HAWAII

Mr. JOHNSON. Thank you, Mr. Chairman.

I find myself in somewhat of a minority position this morning, and I want to apologize to the other members of the panel for not being able to inform the chairman of the panel that I could not join in the joint statement. The statement was sent to me in Honolulu while I was in New York, but I would like the record to show that I do not subscribe to the joint statement.

I feel that the Ways and Means Committee and, indeed, the House have done a rather good job of protecting the interests of the State and local governments. However, I feel that the formula in the bill is not as definite and as tight as it might be, and I would like to suggest a modification which, I think, will reduce the borrowing costs of the State and local governments, return more revenues to the Treasury and, at the same time, accomplish the equity purposes of including interest income from State and local government bonds in the LTP, the limit on tax preference provision of the bill.

For the record, my name is William Summers Johnson. I am director of finance of the city and county of Honolulu.

I appreciate the opportunity to testify on those features of the tax reform bill (H.R. 13270) which would affect the debt obligations of the State and local governments.

The purpose of the legislation, as I understand it, is to make the tax system more equitable. While I am in full support of this purpose, I have not tried to pass judgment on the questions of equity involved in the individual features of the bill. I have given attention only to what the practical effects would be on the borrowing costs of the State and local governments.

There are several features of the bill which would substantially raise these borrowing costs, relative to other borrowing costs—if there were no other feature of the bill to offset this effect. These are, in the main, four—really five:

1. Limitations on deductions of interest (sec. 221);
2. Increase in standard deduction (sec. 801) and maximum tax on earned income (sec. 802);
3. Limit on tax preferences (sec. 301);
4. Capital gains and losses on bonds held by financial institutions (sec. 443).

I will elaborate on only two of these: The increase in standard deduction, section 801, and the maximum tax on earned income, section 802. These two reduce the maximum tax rate on individuals and reduce the effective tax rates on individuals in all income brackets. Consequently, other things being equal, if you reduce taxes, you will raise the relative borrowing costs of the State and local governments.

Passage of the surtax bill last year lowered those borrowing costs relative to other costs. I am not opposed to the reduction in taxes, however.

In contrast to those features of the bill which would tend to increase State and local government borrowing costs, there is an offsetting feature which is doubtless intended to assure that the State and local government will not incur higher borrowing costs than would be the case if the bill were not passed. This is the feature which authorizes the optional use on the part of the State and local governments of a new type of debt instrument—one which would be fully taxable, but on which the Treasury would pay directly a percentage of the interest cost.

The question is whether, on balance, the State and local governments would be better off or worse off under the bill. The nub of my analysis is that the answer is highly doubtful.

In the first place, the Secretary of the Treasury would be given discretionary authority—within a broad range—to set the percentage of the interest cost which the Treasury would pay, and to change the percentage at the beginning of each quarter year. The range is between 30 percent and 40 percent of the interest cost of a bond issued within the first 5 years after enactment of the bill, and between 25 percent and 40 percent of the interest cost of a bond issued thereafter.

There is no indication as to the purpose of giving the Secretary this discretionary authority and no certainty as to how the Secretary would use it, or for what purposes. If he set the percentage at or near the top of the range, the State and local governments would be better off than in recent past years. If he set the percentage at or near the bottom of the range, these governments would be worse off than they have frequently been in recent years past. This is particularly so when the minimum becomes 25 percent.

Further, there is a possibility that the Secretary of the Treasury, any Secretary of the Treasury might use this discretionary authority for extraneous purposes—such as influencing the level of State and local government borrowing—and this clouds the issue.

It is my belief, however, that this deficiency in the formula for direct sharing of interest costs can be remedied in a way that will be of positive benefit to both the State and local governments and to the Treasury. Furthermore, this remedy will accomplish the purpose of including interest income in the limited tax preference (LTP) provision (sec. 301). It would thus make such inclusion unnecessary—make "taxing" State and local government bonds unnecessary.

The limited tax preference provision is perhaps the most controversial of all the provisions affecting State and local government bonds, and is the one about which all the constitutional and philosophical objections are being raised.

In brief, my suggestion is that the cost-sharing formula be set at 30 percent of the interest cost of the new taxable bonds issued in the first year after they are authorized, at 31 percent in the second year, 32 percent in the third year, and so on, until the 40-percent level is reached 10 years later.

This would gradually reduce borrowing costs of the State and local governments, and it would involve no additional net cost to the Treasury. On the contrary, it would probably bring about a net increase in revenue to the Treasury, especially over the first 10 years.

The benefit of the tax exemption to the State and local governments is never as great as the revenue loss to the Treasury, by reason of the tax exemption. A study made by the Treasury on the basis of the 1965 experience indicated that, for each $1 of benefits which the State and local governments derived from the tax exemption, there was $1.42 loss of revenues to the Treasury, by reason of the exemption. I have made a rough computation of what it would have cost the Treasury, net, if the Treasury had subsidized directly the interest on the State and local government bonds issued in 1965, $11 billion worth, at a rate of 50 percent of their interest cost on fully taxable bonds. The net cost to the Treasury would have been only $14 million annually; and if we applied the same formula, as an illustration, to the whole $130 billion of State and local bonds outstanding, as might be possible 10 years hence, it would cost the Treasury net about $1,000,800,000 a year.

If the costs to the Treasury were the only consideration, it would follow that the Treasury could afford immediately to pay 42 percent of the interest costs of the new taxable bond, not counting any additional administrative expense which the Treasury would incur.

Comparing the Moody's reports, we may find that in 1945 the market yields on triple-A municipals were only about 41 percent of the yields on triple-A corporate bonds. By 1955, the municipal yields had jumped to 71 percent of corporate yields. In other words, the benefit of the tax exemption to the State and local governments had greatly diminished, while the benefit to high-bracket taxpayers had greatly increased.

Since 1963, however, the ratio of municipal to corporate yields has, on a yearly average basis, ranged between about 72 percent and about 68 percent.

Thus, 30 percent seems about the right level to begin the direct payments on the new taxable municipals. This level would mean that State and local government interest costs would be no more than 70 percent of corporate borrowing costs. And, by the same token, yields on nontaxable municipals would not be very far from the 70-percent level.

Since present holders of municipals could expect a declining advantage in holding these bonds, they would tend to unload their holdings, and market yields on nontaxable municipals would tend to rise.

Accordingly, the State and local governments would find it advantageous to issue taxable bonds, rather than more nontaxables, and the supply of nontaxables would disappear from the market about as fast as investors wished to unload them.

This would not mean that nontaxable bonds would completely disappear. Ten years hence, investors in tax brackets above 40 percent would still find it advantageous to buy and hold nontaxables, but the advantage—in terms of tax-preference income—would be greatly diminished.

It could be argued, of course, that my suggestion would not eliminate tax-preference income; but then neither does the limitation in the House bill eliminate tax-preference income. I believe that my suggestion would achieve the purposes of the House bill as well, or better, than the limitation on tax-preference income and, if adopted, would make inclusion of interest income from State and local government bonds within the tax-preference limitation (LTP) unnecessary.

The proposed new taxable municipal bond would, in my judgment, be a good addition to presently available borrowing instruments, whether or not other provisions of the bill are passed. It would be a better instrument with the substitution of an interest-cost sharing formula such as I have suggested. Accordingly, I hope the committee will consider substituting such a formula, without respect to what it may decide concerning the other provisions of the bill.

Thank you, Mr. Chairman.

(Mr. Johnson's prepared statement follows:)

Statement of William Summers Johnson, Director of Finance, City and County of Honolulu, Hawaii

Mr. Chairman, my name is William Summers Johnson. I am Director of Finance of the City and County of Honolulu.

I appreciate the opportunity to testify on those features of the Tax Reform Bill which would affect the financing problems of the state and local governments. My statement is concerned with the problems of these governments generally, rather than the particular problems of Honolulu. Like other cities, Honolulu sells its bonds by competitive bidding in New York, and its interest costs are determined by the general level of interest rates on municipal bonds and the credit rating which the rating services assign to the city's bonds.

Much has been said about the growing financial problems of state and local governments, problems which are sometimes called a financial crisis. The demands upon these governments for public capital improvements have grown enormously over the post World War II years. In the 20 years prior to 1966, these governments had spent some $220 billion for capital outlays, about half of which had been financed by borrowing.[1] Between the end of 1950 and the end of last year, the net debts of the state and local governments increased more than five-fold, growing from about $22 billion to about $130 billion in 18 years.[2] In contrast, the net debt of the Federal Government has increased by only slightly more than one-third this period.

Further, while the Federal budget has achieved a moderate surplus in the fiscal year just ended, the prospects are that the debt burden of state and local governments will grow at even larger increments in the years ahead. Enormous amounts of capital will be required to replace old and obsolete facilities and to expand facilities to provide for a growing population. And to meet these requirements, the public agencies will have to compete for funds against the rising demands for housing and other private needs.

Accordingly, it is hoped that the tax reform legislation as finally passed will not increase the borrowing costs of the state and local governments, or even leave the matter in doubt, but will help to reduce these borrowing costs.

It seems to me the House bill does leave this question in doubt. Thus, at a later point, I would like to suggest some modification of the bill which I believe will serve the three-fold purpose of (1) reducing borrowing costs of the state and local governments, (2) achieving the purpose of the legislation which is to make the tax system more equitable, and (3) avoiding some of the philosophical objections to the bill as it is now written.

ROLE OF TAX-EXEMPT BONDS

The fact that interest income from state and local government debt obligations is not subject to the Federal income taxation is of substantial benefit to these governments. It has meant that such obligations—or what are called "municipals"—could be issued at a lower interest cost than taxable bonds of the same maturity and credit rating—a relationship which carries through to bonds resold in secondary markets.

For example, last December, before market rates were disturbed by this legislation, market yields on triple-A rated municipals were quoted at 4.50%. In contrast, corporate bonds of the same rating and U.S. Government bonds—both taxable—were quoted at yields of 6.45% and 5.65%, respectively.

The differential between interest rates on taxable bonds and nontaxable bonds of like maturity and credit rating at any particular time is a measure of the benefit of the tax exemption to the state and local governments. The greater the differential, the greater the benefit.

It is not, however, the supply of tax-exempt bonds that determines the level of interest rates on these bonds. On the contrary, between 80 and 90 per cent of all new credit instruments being issued are taxable, hence the taxable issues play the dominant role in determining bond rates. Rates on municipal bonds merely adjust to these rates, depending upon the marginal income tax rate of the bond investors.

To illustrate, an investor in the 50% tax bracket finds it advantageous to invest in tax-exempt bonds, rather than in taxable bonds, where the yield on tax-exempts exceeds 50 per cent of the yield on taxable bonds. Similarly, an investor in the 25 per cent tax bracket finds non-taxable bonds more advantageous than taxable bonds only when the yield on the municipals exceeds 75 per cent of the yield on taxable bonds—a point at which the benefit to the state and local governments has greatly diminished and a bonanza has been created for investors in the higher tax brackets.

Changes in the ratio of the yields on the two types of bonds are influenced by several factors, including the supply of tax-exempt bonds outstanding relative

[1] Joint Economic Committee, *State and Local Public Facility Needs*, Vol. 2, December 1966, p. 5.

[2] Appendix A.

to the supply of funds available in the hands of individuals, commercial banks and other institutions that invest in this type of bond.

Changes in effective tax rates are also quite influential in changing the benefits of the tax exemption, both to the investor and to the state and local governments. In the 1900's, there was little if any difference beween the yields on taxable and non-taxable bonds because income tax rates were then so low that there was little advantage in investors' seeking tax-exempt income.

In contrast, passage of the surtax last year served to widen the spread between yields on non-taxable and taxable bonds. On the other hand, consideration of this legislation has had a dramatic opposite effect.

Taking a longer look at the trends over the post World War II years, however, it is evident that the benefit of the tax exemption to the state and local governments has substantially declined. A study prepared for the Joint Economic Committee in 1966 observed that "between 1946 and 1954 the municipal-corporate yield ratio jumped from 40 per cent to 80 per cent and then receded to around 75 per cent, where it has remained since." [3]

The question whether there has been a general tendency for the ratio to decline since 1965 is debatable. There is no precise statistical measure of this subject and the generalized measures have been clouded by several changes in effective tax rates and by two severe cycles in monetary policy which varied the investment capacity of the commercial banks.[4]

GROWING SHORTAGE OF FUNDS FOR MUNICIPAL FINANCING

There have been some dramatic shifts in the flows of institutional funds over the post World War II years which have doubtless influenced the earlier decline in the benefits of the tax exemptions and seem to portend further difficulties for the state and local governments in the future.

While state and local government borrowing has rapidly increased, the great growth of investment funds has taken place in institutions which, because of their special tax status or the nature of their business, find it impractical to invest in tax-exempt bonds. These include the government pension funds—state and local as well as Federal—the private pension funds, the life insurance companies, savings and loan associations, mutual funds and the non-financial corporations.

As of the end of last year, only one of these groups had as much as three per cent of its total financial assets in municipal bonds. These were the state and local governments, presumably those who invested their employees' retirement funds in their own bonds only because they were unable to market the bonds elsewhere.[5]

Among institutional investors, only the commercial banks and the non-life insurance companies are significant investors in tax-exempt securities. The total financial assets of these two groups combined increased by slightly more than 200 per cent between 1947 and 1967, and amounted to $439 billion at the end of the latter year.[6]

More than this, individual investors have added little to their holdings of municipal bonds in recent years. Indeed, this market would appear to have become pretty much saturated. Individual investors held some $40.6 billion of municipals at the end of 1966, increased their holdings by only $0.2 billion during 1967, and, according to preliminary data, actually reduced their holdings by $0.7 billion last year.[7]

Commercial banks, on the other hand, have become the predominant investors in municipal bonds. Last year they increased their holdings in these instruments by $8.1 billion and at the end of the year, held nearly half of all such bonds outstanding. According to preliminary data, state and local government debt obligations outstanding at the end of last year were held as follows:

	Billions
Total	$124.9
Commercial banks	58.1
Individuals	40.1
Nonlife insurance companies	16.4
All others	10.3

[3] Op. Cit., *State and Local Public Facility Needs and Financing*, p. 12.
[4] Appendix C.
[5] Appendix B.
[6] Appendix D.
[7] Appendix E.

No doubt many commercial banks have invested in municipal bonds when it was not particularly profitable for them to do so—in order to advance construction projects in their local communities. However, such heavy reliance on commercial banks as a market for municipal bonds poses some dangers, not the least of which is that this market may become saturated too. Commercial banks are subject to a variety of laws and regulations which limit their investments in particular types of securities, and their investment funds have not been growing as fast as those of other financial institutions.

PROVISIONS OF THE TAX REFORM BILL AFFECTING MUNICIPAL FINANCE

Against this background of the problems of the state and local governments, the provisions of the House bill affecting municipal financies will, I think, be better appraised.

In an effort to make the tax system more equitable, the drafters of the House bill have included several provisions which would make investment in state and local government bonds less attractive, particularly to high income individuals. The effect would be to raise interest costs on future issues of these bonds, relative to the cost of issuing fully taxable bonds.

As an offset, however, the bill provides for a new type of state and local government debt instrument which seems intended to assure that the borrowing costs of these governments will not be higher, relative to other borrowing costs, than in past years.

Coming first to those provisions of the bill which would tend to raise municipal borrowing costs, these are in the main four.

1. Limitations on deductions of interest (*Sec. 221*)

This limits the amount of the deduction which an individual may take for interest paid on funds borrowed to invest in or carry investment assets. An individual would be allowed to deduct such interest payments, on a current basis, only to the extent that the deduction does not exceed his investment income and long-term capital gains by $25,000 ($12,500 in the case of a married individual filing a separate return).

This will limit the advantages that high-income individuals can now enjoy by borrowing funds at a low interest rate, net of the tax deduction, and investing the funds in municipal bonds to receive a tax-free income.

2. Increase in standard deduction (*Sec. 801*) *and maximum tax on earned income* (*Sec. 802*)

The effect of these two sections is to reduce the tax rate on top income individuals and to reduce effective tax rates on individuals in all income groups.

Other things being equal, the effect will also be to raise municipal borrowing costs relative to other borrowing costs. As effective tax rates are reduced, taxpayers find investment in bonds yielding a tax-free income less advantageous.

3. Limit on tax preferences (*Sec. 301*)

This section defines tax preference income as tax-free interest from state and local government bonds, plus several other types of income now taxed at preferential rates or against which preferential deductions may be taken.

Under the bill, an individual will be allowed to claim the exclusions and deductions comprising tax preference income only to the extent that the aggregate of such income does not exceed 50 per cent of his total income (adjusted gross income plus tax preference items).

The excess of 50 per cent will be taxable at the individual's normal tax rate. However, if the individual's aggregate tax preference income does not exceed $10,000, the rule does not apply. Further, the bill provides a formula for bringing interest income from municipal bonds under the formula only gradually. In the first year, one-tenth of such income is to come under the limit; in the second year, two-tenths; and so on until all such income comes under the limit ten years later.

4. Capital gains and losses on bonds held by financial institutions (*Sec. 443*)

Under present law, commercial banks and certain other types of financial institutions are taxed on their capital gains on bond transactions, like other taxpayers, at the capital gains rate. But unlike other taxpayers, however, these institutions are permitted to treat the excess of their capial losses over their capital gains on such transactions as ordinary losses, deductible from ordinary income.

Under the bill, the excess of gains over losses would be treated as ordinary income, taxable at ordinary income tax rates, and the excess of losses over gains would be deductible from ordinary income.

The principal investors in municipal bonds, the commercial banks, will find these bonds less attractive under the bill. In the past, it has been a general practice of commercial banks to increase their holdings of municipal bonds—and other securities—in periods of easy money, then sell these securities in periods of credit stringency, frequently at a capital loss, in order to raise funds to meet their loan demands.

However, this provision of the bill will not place municipal bonds at a disadvantage to other securities. All debt instruments are treated alike.

Furthermore, the commercial banks should find that the tax-exempt interest income available from these bonds will continue to make them quite attractive investments. Commercial banks on a whole have recently been in the 48% marginal tax bracket, and are now thought to be in an even higher bracket. To a firm in the 48 per cent tax bracket, an interest yield of 6.5% on a municipal bond is equivalent to a yield of nearly 12.4% on a taxable security.

THE COST-SHARING MUNICIPAL BOND (SECS. 601 AND 602)

The provisions of the House bill just discovered would, taken alone, have a substantial effect on the borrowing costs of the state and local governments. The effect would be to raise these costs, relative to other borrowing costs.

As an offset, however, the House bill authorizes a new type of debt instrument which the state and local governments may issue at their option. The interest income from this bond would be fully taxable, and would thus require higher interest rates, but the Federal Treasury would directly share the interest costs.

The proposed new bond thus takes advantage of the fact that the tax exempt feature of state and local government bonds is an inefficient means of aiding these governments. That is to say, the tax exemption involves a revenue loss to the Treasury, as compared to taxable bonds, which is much greater than the benefits derived by the state and local governments.

In its general form, the proposed new bonds contains some very attractive features. First, its use is optional on the part of the state or local government, and the governmental unit that issues it does so without giving up its right to issue also the traditional municipal bond.

Second, since the bond is taxable, it will sell at interest yields comparable to other bonds and will thus give the state and local governments access to the investment funds held by institutions that do not now invest in municipal bonds.

Finally, this bond would be marked in the usual way, utilizing the already-existing machinery of private financial services.

However, the formula for the Treasury's sharing in the state and local governments' interest cost is deficient—and needlessly so.

The report of the Ways and Means Committee accompanying its bill states that—

> Historically, the ratio of yields on tax-exempt issues and taxable issues has been as low as 60 per cent, but in recent years has been close to 75 per cent.[3]

Then, for reasons that are not clear, the bill provides a range of direct payments to the issuer, the range being 30% to 40% of the interest cost of bonds issued within the first five years, and from 25% to 40% thereafter. Furthermore, the bill gives the Secretary of the Treasury discretion to set the exact percentage within these ranges at the beginning of each quarter of the year.

Add up the uncertainties which the bill poses for municipal finance and it is easy to see why there has been a certain lack of enthusiasm for these features of the bill.

Giving the Secretary of the Treasury discretion to set the sharing formula within a range is puzzling and suggests

1. That the Secretary is expected to try to equate cost to the issuers of the new taxable municipals with those of ordinary municipals, or

[3] House Report No. 91-413 (Part I) p. 72.

2. That the Secretary is expected to shift the cost advantage one way or the other for the convenience of the Treasury, or

3. That the Secretary might use his flexibility for general economic regulation, reducing the subsidy at times when the Administration wishes to dampen demands on credit markets and the construction industry and increasing the subsidy at other times.

None of these purposes seems desirable. Certainly the purpose should not be to maintain any particular relationship between the supply of the new taxable municipals and the ordinary municipals; the purpose should be to increase the supply of the n< w taxable bonds and thus diminish the tax revenue losses flowing from the ordinary municipals. Nor is it comforting to think that the financing ability of the state and local governments may be modified either for the convenience of the Treasury or for general economic regulations.

COSTS AND BENEFITS OF TAX EXEMPTION

A study made for the Brookings Institution in 1963 developed some advanced techniques for estimating the benefit of the tax exemption to the state and local governments and the revenue loss to the Treasury.

This study concluded that the benefit to the state and local governments amounted to an interest rate savings of between 133 and 186 basis points below the contemporary rate on comparable corporate bonds. A group of experts who reviewed the study reached a conclusion that the more exact differential is 150 basis points.[9]

Further, in 1966, the Treasury updated this study on the basis of the 1965 experience, with these calculations:

1. At the minimum differential of 133 basis points, the benefit of the tax exemption to the state and local governments would amount to $1.9 in savings in interest costs over the life of the bonds, and the Treasury's revenue loss would amount to $2.9 billion.

2. At the maximum differential of 186 basis points, the benefit to the state and local governments would amount to $2.6 billion, and the Treasury's revenue loss would amount to $3.2 billion.[10]

In other words, if the municipal bonds issued in 1965 had not been tax-exempt, each dollar of increased cost to the state and local governments would have resulted in increased revenues to the Treasury of between $1.23 and $1.52. At the concensus differential—150 basis points—each $1 of benefit to the state and local governments costs the Treasury $1.42 in lost revenues.

This suggests that the state and local governments could be given the option of issuing fully taxable bonds on which the Treasury would pay 42 per cent of the interest cost, with no net cost to the Treasury omitting any additional administrative costs.

TAXING MUNICIPAL BONDS UNNECESSARILY

This leads me to suggest the interest-cost sharing formula be modified in two respects. First, that it be made definite and that it provide for gradually increasing cost sharing.

Thus, it would seem appropriate to set the first year rate at 30%, and provide for an increase of one percentage point each year, until the 40% level is reached 10 years hence.

This would accomplish the equity purposes of the limited tax preference provision (LTP), not by taxing the tax-exempt bonds, but by causing them to largely disappear. And at the same time, this formula would be of more certain benefit to the state and local governments.

Additionally, it would bring about an orderly shift from nontaxable to taxable municipals outstanding without serious capital losses. In view of the certain

[9] Op. Cit., State and Local Public Facility Needs, Note 7.
[10] Ibid, p. 332.

rise in the Treasury payments, an investor would tend to shift out of the old municipals and their yields would tend to rise relative to taxable bonds. Accordingly, the state and local government would find it advantageous to refund by the new taxable bond, thus reducing the supply of the non-taxables as these become less desirable to investors.

Finally, this method of accomplishing the purposes would avoid the objections, hotly held, to the indirect tax on state and local government bonds or set out in the LTP provisions.

Mr. Chairman, as one of many municipal finance officers who are being sorely pressed by the recent rise in interest rates on state and local government bonds, may I say that it is most important that the issues involved in the municipal finance features of this legislation be resolved—one way or another—as soon as possible.

Thank you.

APPENDIX A

NET PUBLIC AND PRIVATE DEBT IN THE UNITED STATES

[In billions of dollars]

End of year	Federal Government and agency	State and local governments	Private	Total
1950	217.4	21.7	246.3	485.4
1955	229.6	40.2	391.6	661.4
1960	239.8	63.0	565.7	868.5
1965	266.4	99.9	868.6	1234.9
1968[1]	292.5	129.5	1103.8	1525.8
Percentage of 1950				
1950	100.0	100.0	100.0	100.0
1955	105.6	185.3	159.0	136.2
1960	110.3	290.3	229.7	178.9
1965	122.5	460.4	352.7	254.4
1968[1]	134.5	596.8	448.2	314.3

[1] Preliminary.

Source: Economic Report of the President, January 1969, p. 296.

APPENDIX B

HIGH-GRADE MUNICIPAL AND CORPORATE BOND YIELDS, SELECTED DATES

	State and local governments (Aaa)	Corporates (Aaa)	
Yearly average:			
1945	1.07	2.62	40.8
1955	2.18	3.06	71.2
1963	3.06	4.26	71.8
1964	3.09	4.40	70.2
1965	3.16	4.49	70.3
1966	3.67	5.13	71.5
1967	3.74	5.51	67.9
1968	4.20	6.18	68.0
Monthly average 1969:			
January	4.58	6.59	69.5
April	5.00	6.89	72.6
July	5.60	7.08	79.1

Source: Moody's, as reported in Federal Reserve Bulletins to July 1969.

APPENDIX C

ALL FINANCIAL ASSETS AND STATE AND LOCAL GOVERNMENT OBLIGATIONS HELD BY INSTITUTIONAL INVESTORS, DEC. 31, 1968

[In billions of dollars]

	All financial assets (1)	State and local government obligations (2)	Col. 2 as percent of col. 1
Buyers of tax exempts, total	486.9	74.5	15.3
Commercial banks	438.8	58.1	13.2
Nonlife insurance companies	48.1	16.4	34.1
Nonfinancial corporations	352.3	2.9	.8
Nonbuyers of tax exempts, total	1,388.1	6.9	.5
U.S. Government	189.6		
State and local governments	113.9	3.6	3.2
Life insurance companies	182.4	3.0	1.6
Savings and loan associations	152.8		
Private pension funds	94.7		
Mutual savings banks	71.2	.2	.3
Finance companies	50.7		
Investment companies	47.3		
Credit unions	12.3		
Rest of world[1]	120.9	.1	.1
Memorandum: Households	1,713.5	40.1	2.3

[1] Foreign persons, international agencies, agencies of foreign banks, and U.S. banks in possessions.

Source: Federal Reserve Board, Federal Reserve Bulletin, May 1968, p. A-67.10 et seq. and May 1969, p. A-68, et seq.

APPENDIX D

FINANCIAL ASSETS HELD BY INSTITUTIONS, 1947, 1957, AND 1967

[In billions of dollars]

	1947	1957	1967	1967 as percent of 1947
Buyers of tax exempts, total	145.6	219.1	438.9	301.4
Commercial banks	136.8	197.0	393.9	287.9
Nonlife insurance companies	8.8	22.1	45.0	551.4
Nonbuyers of tax exempts, total	303.6	608.0	1,277.4	420.8
Nonfinancial corporations	83.5	169.3	322.7	386.5
U.S. Government[1]	80.9	110.3	171.3	211.7
State and local governments	17.6	40.1	100.7	572.2
Life insurance companies	50.9	98.3	173.0	339.9
Savings and loan associations	11.7	48.1	143.8	1,229.1
Mutual savings banks	19.7	35.2	66.4	337.1
Credit unions	.5	3.4	11.2	2,240.0
Private pension plans	3.1	22.4	86.9	2,803.2
Finance companies	5.1	19.6	46.6	913.7
Mutual funds[2]	1.4	8.7	44.7	3,192.9
Other[3]	27.4	52.6	110.1	401.8

[1] Includes "monetary authorities."
[2] Open-end investment companies only.
[3] Includes foreign and international agency holders of obligations of U.S. persons and governments, plus brokers and dealers in securities and agencies of foreign banks.

Source: Federal Reserve System, "Flow of Funds Accounts, 1945–67," February 1968.

APPENDIX E

HOLDINGS OF STATE AND LOCAL GOVERNMENT OBLIGATIONS BY INDIVIDUALS AND INSTITUTIONS, END OF SELECTED YEARS, 1945-68

[In billions of dollars]

	1945	1950	1955	1960	1965	1966	1967	1968
Total	15.5	24.7	44.8	68.7	100.0	105.9	117.5	124.9
Individuals	7.2	9.6	18.6	28.7	37.2	40.6	40.8	40.1
Commercial banks	4.1	8.1	12.7	17.6	38.5	40.2	50.0	58.1
Nonlife insurance companies	.2	1.1	4.2	8.1	11.4	12.1	13.7	16.4
Nonfinancial corporations	.3	.5	1.2	2.4	3.6	4.4	5.1	2.9
State and local governments	2.6	3.6	5.1	7.2	5.0	4.6	4.1	3.6
Life insurance companies	.7	1.2	2.0	3.6	3.5	3.1	3.0	3.0
Mutual savings banks	.1	.1	.6	.7	.3	.3	.2	.2
Finance not elsewhere classified	.3	.4	.3	.4	.5	.6	.6	.6

Source: Federal Reserve System, "Flow of Funds Accounts, 1945-67," and Bulletin, May 1969.

Senator WILLIAMS. As I understand it, your proposal for a subsidy, when it eventually got fully implemented, would cost about $1.8 billion a year.

Mr. JOHNSON. No. I gave that only as an illustration. If there were, 10 years from now, outstanding some $130 billion of taxable municipals—that happens to be the amount of the nontaxable securities now outstanding—if 10 years from now you have that many taxable bonds outstanding, then the subsidy would come to a net cost to the Treasury of $1.8 billion.

Senator WILLIAMS. That is correct; if there would be more bonds, it would cost more.

My question is this——

Mr. JOHNSON. Senator Williams, that was at the 50-percent subsidy level. At the 42-percent subsidy level the Treasury would break even, not counting the additional administrative costs, and I am proposing you go only to 40 percent, and let the Treasury have the other 2 percent to cover the additional administrative costs.

Senator WILLIAMS. I understand.

My question is this: There is considerable sentiment here that it may not be wise to start another subsidy program. My question is, if this subsidy provision is eliminated from this bill, do you still stand by the rest of your testimony that the interest on tax-exempt bonds should be included in both the LTP and the allocation for deductions?

Mr. JOHNSON. If we eliminate the subsidy proposal?

Senator WILLIAMS. Yes.

Mr. JOHNSON. I could not take a stand on that, Senator. Obviously, it would raise the borrowing costs of the State and local governments.

Senator WILLIAMS. No question about that.

Mr. JOHNSON. But this is for the Congress to judge, whether the need for creating equity is greater than to help the State and local governments.

Senator WILLIAMS. Assuming for the moment that the Congress decides to reject the subsidy, what I am asking is would your testimony be the same in relation to the tax, to including these in?—that is the important question.

Mr. Johnson. It would raise the borrowing costs of the State and local governments.

Senator Williams. We agree on that. But I ask for your position.

Mr. Johnson. But I cannot imagine the Congress would do that.

Senator Williams. Never be surprised at what Congress does.

But my question is if Congress—what I am trying to establish, Mr. Johnson, is whether you are testifying primarily for the inclusion of tax-exempt interest in these allocations or whether your testimony is directed toward obtaining the subsidy for the States. I want to separate the two because they are two separate questions, and we may reject one and accept the other, and that is what I want to get clear. I think that is the important point, and I would like to know your own position as to where you stand on it.

Mr. Johnson. That seems to me a rather difficult alternative to put to yourself, when you have here the opportunity of helping the State and local governments, increasing revenues to the Treasury and, at the same time, accomplishing the equity purposes of the bill; why would you want to separate these?

Senator Williams. We have the same problem here, and that is why I am asking you to help us solve it, because we will be confronted with that question here in Congress and some future Congress. That is the reason I am asking for your view.

Mr. Johnson. No; I would not want to make a judgment whether it is better to increase equity in the tax system versus having the State and local governments pay higher interest costs. That is a very large judgment I would not wish to make.

Senator Williams. It is a large question, but it is an important part of it, and what I was trying to determine is whether the interest item, in correcting the tax-exempt status of the bonds now, or this other, which you would favor.

I would like to ask a question of either Mr. Buckson or his associates.

In the event that Congress did adopt either the House provision or the Senate provision, and it is tested in the courts, as it has been suggested, suppose the decision is lost in the courts, and the Government decides it is constitutional, would the next question not be whether or not the States would tax the Government interest likewise; would they not go together to a certain extent?

Mr. Buckson. Do unto your brother as has been done unto you, I think. We probably would conclude, Senator Williams, if it is constitutional for the Federal Government to tax the State and municipal bonds, that it certainly would be constitutional for the States to tax the Federal, and I think there would be no question but that would follow.

Senator Williams. That was the point I made.

I have one other question here. The point has been made about the effect that this proposal has had on the marketability of new issues or the price on the outstanding issues.

Is not one of the major factors in the marketplace today, both in new issues and in the old issues, not so much the tax impact of what is proposed in either the House bill or the Treasury's recommendation but rather the uncertainty that is being created in the minds of the investors as to what this Congress or some future Congress may do once we dealt with the principle that we do have the right to tax them? Is there not this uncertainty both as to what this Congress or some other Congress may do that is creating the problem today and will, perhaps, create the problem tomorrow until the issue is settled once and for all?

Mr. HERBERT. Senator Williams, having spoken to that point, I, of course, agree wholeheartedly with that analysis. It is a question of what Congress might do in the future rather than what they might do in this session or with regard to tax law that really 5 years from now, 10 years from now, they can remove it, and this jars the confidence of the market or any prospective purchasers in buying municipals today.

Senator WILLIAMS. I have no further questions.

Senator JORDAN. In order to insure the marketability of low-grade municipals, suggestions have been made to this committee that the Federal Government guarantee the payment of all future municipals that can be issued throughout the country regardless of their grade, and further that the Federal Government subsidize the interest. That has been suggested.

Are any of you gentlemen prepared to support that point of view?

Mr. GOLDSTEIN. In Maryland we would not, sir. We feel that the present system of selling our tax-exempt municipal and State bonds has worked to the benefit of our State and our 23 counties and 116 incorporated towns. In fact, that is a revenue-sharing plan the way it is now established, and we do not have to wait until the Federal Government or the Congress appropriates money to pay us the subsidy you are talking to us about.

The marketplace establishes the rate, and the facilities that are built or requested, needed by the respective citizens. We have built sound State governments, we have built sound county and municipal governments through this Nation, and I would like for the record to show that the statement made by the Honorable William Summers Johnson of the city of Honolulu, Honolulu County, is not backed up by the members of our panel. He made that statement, I think, on his own.

Is that correct, sir?

I would like for the record to show that.

Mr. JOHNSON. Yes. I would like the record to show that I am not a subscrib r to the joint statement.

Senator, you may want to consider that for your very small municipalities, those that do not know how to market their bonds and do not have credit ratings. For the medium-sized, larger cities and counties, I would not see any reason to disturb the present private marketing system for these bonds.

I think—I am not an expert on it—but I have an impression that the present system is a low-cost way of marketing bonds.

I am speaking of the guarantee as to the interest subsidy; yes, I think my statement made clear that I am all in favor of that without respect to anything else, because the State and local governments would gain and the Treasury would gain.

Senator JORDAN. I do not wish the panel to think I am supporting the proposition of the Federal Government supporting municipal bonds. On the contrary, I am opposed to it, but I wanted to get the impression of the panel.

Mr. PATTERSON. If the Senator please, the State of South Carolina would be vigorously opposed to any such arrangement. There would be all sorts of redtape, and like up in Washington to try to get these unsold or try to get this subsidy, there would be all sorts of priorities as to district, and as to a district in South Carolina, a small district, for example, would want to issue a school bond and the Federal Government agency would probably say: "No; some district in California comes before you, so, therefore, you have got to wait."

A district in South Carolina may want to issue, for example, hospital bonds, and the Government would say: "No, we think you ought to issue some sewer bonds instead."

There would be all sorts of redtape and unwarranted delays and we are unalterably opposed to any such arrangement in South Carolina.

Mr. GOLDBERG. Senator, the Municipal Finance Officers Association specifically considered the possibility of guaranteed plans and rejected it for the reasons basically that Mr. Patterson just expressed.

Senator JORDAN. Thank you.

Mr. HERBERT. If I might make one comment, the gentleman from Hawaii was talking about supporting the plan where the Government would pay us 30 percent of interest cost to the State and local government. Well, we have often been comparing municipal tax rates with corporate rates. However, I think certainly in considering anything like this it must be borne in mind that this is artificial, to begin with. We really do not have any idea what, relatively, municipals would sell for as a taxable municipal.

First of all, you would have been rating an entirely new market. I think most experts would be of the opinion that it would be considerably more than comparable in terms of rating, so I think what we are really talking about is substantially more than 30 or 40 percent to issue a taxable municipal security.

Mr. GOLDSTEIN. Senator Jordan, to elaborate on what I said a few minutes ago, in the State of Maryland we have a much better rating than our counties and our municipalities so the State has sold the bonds for the counties, and they, in turn, pay us back under our revenue-sharing plan.

We have done the same thing with hospitals. We sold a $50 million bond issue. The hospitals could not borrow money under 6 or 7 percent, and the average bonds we sold for that $50 million issue were around 3¼, and we lend that money to the hospitals on a 40-percent first mortgage and ⅛ above the percent of cost, so the cities and counties get their hospital facilities, the State is getting its money, and the State does not have the responsibility of running it. It is a very fine plan and it works.

Mr. GOLDBERG. Senator Jordan, that is a growing thing now. We feel that for the poor, relatively unknown, credit which may have trouble marketing that the State really is the solution, as Comptroller Goldstein has mentioned.

The State of North Carolina is doing it, too, and a bill in New Jersey has been introduced to do so, and I would expect if you hold off of any further Federal interference in this field there will be a growing movement in the States to rescue the little-known credit from that problem.

Senator JORDAN. Thank you.

Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

May I commend you, gentlemen? I am certainly in agreement with the philosophy that you have expressed of the independence of the local municipalities and the States, and I think you feel, from what I have heard, that if there is any change made that would place any tax whatsoever on bonds that the constitutionality then would be jeopardized, so I understand the gentleman from South Carolina to say, and this would be a serious question where a contingency would arise any time consideration was made if there was funding for bonds? Is that your position?

Mr. BUCKSON. That is the position, sir, of the National Association of Attorneys General, of which I am a former president, and I appear today on its behalf.

Senator FANNIN. I am sorry. I did not have the benefit of being here, but I have read some of the testimony which is being presented this morning, and I assumed was presented, and I am wondering, I do not know whether this question was asked, it probably was, but how does the allocation of deductions affect the ability of a municipality to finance its capital needs or its interest rates on financing?

The reason I ask that question is through reading some of the testimony I understand you have had a witness here this morning who testified that these factors would not be affected by the proposed legislation, and you have also had witnesses who say that the municipalities would be significantly affected. I wonder what is your view?

Mr. GOLDSTEIN. I think Dan Goldberg ought to answer that question.

Mr. GOLDBERG. Senator, I think I speak for the other members of our panel. I do not know about Mr. Johnson. We have a feeling that if you accept either of the House proposals, and that would be the allocation of deductions as well, that you will start the market down the path that Mr. Herbert has described. You may pull the plug in the bathtub and the water is going to run out. You can tell the water not to run out, but it is going to run out.

The Treasury put a $45 million revenue yield price tag on that part of the proposal, and we just do not see how the kind of market reaction that these charts show which will lead up to over $1 billion a year in State and local government costs, when we have as many new bonds out that we have paid extra interest on as we now have, that is the $130 billion. One percent of that, which is our judgment, will give you $1.3 billion a year from then on. Now, you cannot explain $1.3 billion of added interest costs in terms of a $35 million plan LTP or a $45 million plan which is the allocation of deductions or the combination of $80 million. It is much more serious than that to the investor.

So we think that the allocation plan would do practically as much damage as the combined plan would do.

Senator FANNIN. I do not know whether you heard the controversial testimony this morning, and I am sorry that I did not have a chance to be here to ask questions of the person who testified on that basis. I did not read his testimony.

Mr. GOLDBERG. I did not hear any controversy this morning, Senator.

Senator FANNIN. Of course, I do not know, I was not here, but I do not want to be repetitious.

I certainly appreciate this chance, at least, of asking a couple of questions, and, as I say, I thank you for your position you take. I think it is very realistic.

Mr. GOLDBERG. Could I add just one point there? In talking of that Treasury estimate of what yields, of what they are losing by not taxing our bonds, I have found them most unrealistic because they have always assumed that the present holders or people in the present brackets of those holders would continue to hold them.

Our judgment is that, if the exemption ever went, there would be a massive reshuffling of who the holders would be. I have seen testimony, I think the Investment Bankers put it in the Ways and Means Committee, that if you look at the composition of the holdings of corporate bonds and foreign bonds, which are the principal taxable bonds now on the market, you find half of them are held by people who do not pay any taxes, the foundations and the pension funds and the rest of them, and they averaged up what the yield would be on all taxable, what is now on all taxable bonds, and came up with something like a 15 percent net collection of interest that is paid on those bonds.

I think that is more likely what the Treasury could yield if total exemptions were eliminated than the 42 percent that we have heard.

Senator FANNIN. Thank you.

Mr. PATTERSON. Senator, if I may respond to that question, simply stated you have two types of bonds, you have taxable bonds and tax-exempt bonds, and if you can remove the exemption, no matter how small it may be, and if you can tax the interest on any bonds held by any investor throughout the length and breadth of this Nation, then you destroy the tax-exempt status of these bonds and when you do that these bonds are going to sell as taxable bonds, there is no getting around that point.

Senator FANNIN. I understand. Thank you very much.

Mr. GOLDSTEIN. On behalf of the panel, sir, we say thank you for your courtesy.

Senator JORDAN. Thank you for your testimony.

Mr. Northcutt Ely.

Gentlemen, you have been very patient. We appreciate your sitting through the long morning waiting your turn, and I would ask you to go ahead at your own speed and convenience and present your testimony.

STATEMENT OF NORTHCUTT ELY, GENERAL COUNSEL, AMERICAN PUBLIC POWER ASSOCIATION; ACCOMPANIED BY LARRY HOBART, ASSISTANT GENERAL MANAGER; RICHARD WILSON, CHAIRMAN, COMMITTEE ON TAXATION; AND DON ALLEN, ATTORNEY

Mr. ELY. Thank you, Mr. Chairman.

My name is Northcutt Ely. I am a partner in the law firm of Ely & Duncan of Washington, D.C., general counsel for the American Public Power Association.

This association speaks for about 1,400 local publicly owned power systems in the 47 States and two territories.

I am accompanied by Mr. Larry Hobart on my right, assistant general manager of the association; Mr. Richard D. Wilson, chairman of its committee on taxation, and my associate, Mr. Don Allen.

This bill would create, indeed is now creating, a crisis in intergovernmental relations. This, more than the Federal tax revenue involved, and even more than the demoralization of the municipal bond market, is the true significance of this bill. I shall speak also of the liability that the bill would impose upon the Federal Government to substitute its support of essential public local activities now locally supported.

The demoralization of municipal credit can be very readily documented in a way that I have not heard here otherwise.

February 5, 1969, is the day on which the House Ways and Means Committee published the Johnson administration's proposal to tax municipal bonds. We can identify this, perhaps, as Black Wednesday for the municipal bond market.

If 2 days before that date, February 3, a bank—and I use the word "bank" deliberately and not individual—had bought $1 million worth of the high-grade State and local bonds which compose the Weekly Bond Buyers' municipal bond average, this portfolio would have shrunk in market value to $835,200 on September 4, 1969, the date that Secretary Kennedy testified before you. This was a loss of 16½ percent.

If you picked an earlier date you would have a larger loss, an earlier date of purchase.

The yield on these top-grade municipal bonds had to rise between these two dates of February 3, 1969, and September 4 from 4.91 percent to 6.37 percent, some 146 basis points, to make such issues or new issues like them salable.

By contrast, if the same bank on the same day had bought $1 million worth of high-grade corporate bonds, composing Moody's corporate bond average, that portfolio on September 4 would have dropped in value to $941,000, a loss of only 6 percent.

The yield on corporates had to rise between these two dates from 6.87 percent to 7.44 percent. That is only 57 basis points to make it possible to market corporate bonds of like quality.

The point is simply this: The cost of bond money to municipalities has risen 2½ times as much or 146 basis points as the cost of bond money to corporations—57 basis points—during, and only because of, Congress consideration of proposals to tax municipal bonds.

Such are the consequences of this bill with respect to municipal bonds held by a bank or other corporate holder, even though the bill purports to tax only the interest paid to individuals, and even though individuals have been buying not over 10 percent of new issues in the last 2 or 3 years.

The market has recognized that, if this bill becomes law, no buyer of the municipal bonds hereafter, whether bank, corporation, or individual, will be purchasing a stable contract. If the value of the individual's contract can be impaired retroactively, as this bill does, then, so can a bank's contract with the same issuer in some future bill.

Every buyer, whether individual or corporate, consequently capitalizes the expected tax and adds its consequences to the yield that he demands. The helpless municipality pays the price.

The price reckoned over the life of a bond issue is staggering. State and local governments in 1968 issued just over $16 billion in bonds, tax exempt under the then-existing Federal statutes.

It has been conservatively estimated in the figures submitted here by the Governors that the debt service that the municipalities would have had to pay if this bill had been law at that time would have been increased by more than $223 million annually or by more than $4.4 billion during the life of a 20-year bond.

These are the consequences with respect to the municipal bond offerings of a single year. But municipalities must issue increasingly greater amounts of bonds each year to provide essential services for an expanding population.

Consequently, the total impact is not $4.4 billion but is that large quantity multiplied by whatever number of years you choose to take as those in which this bill would be operative as it is now tendered to you.

By contrast, the Ways and Means Committee estimated that the Treasury would collect added revenues of only $40 million in 1970, and $85 million a year ultimately from all five of the limitations on tax preferences lumped together, with no value at all assigned to the limitation on municipal bond interest. This is burning down the house to kill the cockroaches.

Moreover, it is no longer asserted by the proponents of this bill that tax-exempt interest shelters a single one of the 154 wealthy nontaxpayers who are highly publicized targets of these five limitations on tax preferences. It is almost certain that the wrong house is being burned down.

High interest costs inflated by the loss of the tax exemption result in the inflation of the costs of essential public services not for 1 year or 2, but for the whole life of the bond issue.

The ultimate burden for that protracted period of time is borne by increases in ad valorem taxes and, therefore, in rents or in increases in the cost of public services which the citizen has no option to forgo.

A 2-percent rise in interest rates from 6 to 8 percent, for example, may necessitate a rise of 20 percent or more in rates for water, power, sewerage, and other essential services. This is because these public works are essentially highly capital intensive. A great deal of money—borrowed money—must be invested for each dollar of revenue produced.

Consequently, an increase in the cost of money has a leverage effect upon the rates and charges which must be collected in order to service that inflated debt.

The inflation of the cost of living compelled by the bill will fall most heavily on those of our citizens who are least able to bear it—those to whom the bills for rent, electricity, and water are serious problems.

A Federal tax which directly increases the cost to the States and their political subdivisions of borrowing money, imposing a burden on the borrowing power at the moment of its exercise, "is a tax on the power of the States, and on other instrumentalities to borrow money, and consequently repugnant to the Constitution."

I am quoting from *Pollock* v. *Farmers' Loan and Trust Company*, affirmed on rehearing, 158 U.S. 601 (1895), and the argument is spelled out in the brief which is annexed to my prepared statement.

So tested, both the limitation on tax preferences and the allocation of deductions as applied to municipal bonds are, in my opinion, unconstitutional.

The limitation on tax preferences is a direct, undisguised tax. The allocation of deductions is a more subtle but, in ways, more effective and damaging burden on the States.

Although the Ways and Means Committee, for example, indicates that the collections from the limitation on tax preferences will rise from $40 million to $85 million, and from the allocation of deductions from $260 million to an amount in excess of $400 million, it does not indicate how much of the total is to come from taxation of municipal bonds. However, the Ways and Means Committee does disclose that the increase that comes about is related to making the bill fully operative over a 10-year period. The only item of the five limitation on tax preference items or the six allocation of deductions items which, by the terms of the bill, carries a so-called phaseout, increasing the rate of collection over time, is the one which applies to municipal bond interest.

This, therefore, is a clue of the impact of this bill upon the municipalities.

Now, Senator Fannin asked a question about the allocation of deductions. It works in this way: If a man has taxable income, and he also has exempt income, the higher the amount of his exempt income, the less the amount of deductions he may take from his taxable income.

For example, if a man keeps his capital in cash and all of his income is taxable income, and he now switches from cash to purchasing municipal securities, he will pay a larger amount of tax on each taxable dollar and a larger total amount of tax by virtue of the fact that he is now an owner of exempt securities.

This is the reverse of the effect of the formula in the *Atlas* case which the Supreme Court characterized as meaning that a company which had a higher proportion of nontaxable income would pay less tax on the taxable dollar and a less total tax.

This, for the first time that I am aware of, is a flat-out effort to diminish the deductions, and therefore increase the tax, on each taxable dollar as a result of a man's election to own tax-exempt securities. He would pay a lesser tax if he did not invest in the municipals but kept that money in cash.

It will take years of litigation, much of which will be outside of the control of the States and outside the control of the municipalities, to decide the constitutional issue.

The issues which are sold during this period will have to pay interest rates which are dictated by the buyers' most pessimistic appraisal of the outcome.

The bill proposes a cure for the injury it does to municipal credit in section 601 and section 602. This is the proposal for the subsidy to those municipalities which issue taxable bonds.

The cure is worse in some respects than the disease, which is incubated in sections 301 and 302.

In my prepared statement I spell out four consequences; however, in this summary I shall mention only two.

If the House committee's assurance is sound that "there is no review of the advisability of the local project or of the issuer's ability to pay," then local governing bodies can commit the Federal Treasury to incur long-term debt service obligations, the length of which will be determined by the municipality, without concurrence by the Congress and without review by any Federal agency.

To me, it is totally unsound to invest in local governments the power to appropriate Federal money. Such is the effect of this proposal.

The bill proposes a permanent appropriation of the amount required to meet these obligations, to be effected without Federal control, by local municipalities and States, thus bypassing the Appropriations Committees.

More likely, the House Committee's assurances against Federal review of local projects will not last very long. A taxpayers' revolt would be a certainty if billions were added each year to the long-term Federal debt load by nonreviewable decisions of local governments. I mean billions here because the consequence of the decision by a municipality to issue a 20-year bond is reflected not in the Government's subsidy for 1 year of interest but for 20 years of interest.

My conclusion, gentlemen, very simply stated, is that, to the extent that local governments can and will carry their own burdens, it is in the national interest that they be permitted to do so.

To the extent that their borrowing power is eroded, by Federal taxation or by the threat of attempts at such taxation, whether constitutional or not, local governments are prevented from carrying their own burdens and they are driven to rely upon Federal assistance.

The House bill plainly contemplated this cause and this effect and compels both.

We vehemently disagree. The Nation gets no benefit from disabling any State with attempts to provide essential public services to its own people at its own expense. We all suffer by such a process. This is true not only of the State hospital borrowing power, which may be crippled by Federal taxation or the threat of it, but of the Federal taxpayers who must ultimately pay for a greater share of local projects which are thus priced out of the range of the State's borrowing power.

The Federal Treasury and the Federal taxpayer suffer from the erosion of intergovernmental tax entities, whether Federal or State. This creates a crisis in those intergovernmental tax relationships. This is not tax reform.

Thank you, gentlemen. Annexed to my prepared statement is a brief primarily on the constitutional issue and the text of proposed amendments to restore municipal bonds to the status quo.

Thank you.

Senator JORDAN. Mr. Ely, your full statement and attachments will appear in the record.

Mr. ELY. Thank you.

(Mr. Ely's prepared statement and attachments follow:)

STATEMENT OF NORTHCUTT ELY, ELY & DUNCAN, ATTORNEYS, WASHINGTON, D.C., GENERAL COUNSEL, AMERICAN PUBLIC POWER ASSOCIATION

I. INTRODUCTION: SUMMARY

My name is Northcutt Ely. I am a partner in the law firm of Ely and Duncan of Washington, D.C. My firm is General Counsel for the American Public Power Association. This Association speaks for about 1,400 local publicly owned electric systems in 47 States. I am accompanied by Larry Hobart, Assistant General Manager of the Association, and Richard D. Wilson, Chairman of its Committee on Taxation.

I am here today to testify on H.R. 13270 as passed by the House of Representatives August 7, 1969. I shall discuss three of its provisions which directly and adversely affect State and local governments. These are as follows:

1. Section 301. The Limitation on Tax Preferences contained in Section 301 would have the effect of directly imposing federal income taxes on a portion of the interest paid by States and local governments to their creditors who are individuals—but not, in the present bill, corporate creditors. If a taxpayer receives more than half of his income from municipal bonds, he must pay income tax on that excess. These taxes would apply not only to new issues, but also to bonds outstanding, which were exempted from tax by federal law at the time when they were sold.

2. Section 302. The provisions for allocation of deductions—such as interest paid on a mortgage, or property taxes paid on a house—while continuing to allow these deductions in full in the calculation of the income tax to be paid by any taxpayer who does not own municipal bonds, would deny him a portion of that same deduction if he receives tax exempt interest. The greater his tax exempt income, the greater is the tax he must pay on each dollar of taxable income, and the greater his total tax. The result is that a taxpayer who invests capital in municipal bonds would pay more tax per taxable dollar and more total tax than if he left that same amount of capital idle in his checking account. This provision applies to future bond issues, but not to issues outstanding.

3. Sections 601 and 602. These authorize federal subsidies to induce State and local governments to issue taxable bonds.

We offer amendments, annexed to this statement, to delete all three of these provisions. The effect would be to maintain the current tax-exempt status of municipal bonds, unchanged.

We are against Section 301, the Limitation on Tax Preferences, and Section 302, requiring allocation of deductions, because their combined effect would be to cripple the borrowing power of the States and their municipalities. The resulting increase in the cost of money would impose long-lasting inflation (for 20 years or more, depending on the life of the bond issue) upon the local ad valorem taxes which support such essentials as schools, and upon the cost of essential public services which are supported by rates and charges, such as water, power, and, in some cases, sewerage. This burden will fall with disproportionate effect on poor people, because the increases in the rents they pay, flowing from increases in property taxes, and increases in such unavoidable expenses as electricity and water bills, are substantial factors in their cost of living.

Beyond the policy questions, Sections 301 and 302, in our opinion, are unconstitutional. Protracted uncertainty, with attendant high borrowing costs, would continue to overshadow the financing of all essential local facilities for many years, until such time as the Supreme Court resolves these doubts. The constitutional issue is discussed in our annexed brief.

We are against Sections 601 and 602, the subsidy scheme. Just as Sections 301 and 302 would largely deprive local governments of the power of self-help, Sections 601 and 602 would burden the federal taxpayer with the consequences. The bill would transfer to the back of the federal taxpayer the consequences of local decisions to create debts, on which the bill would require the federal taxpayer to pay interest. The sequel, unavoidably, would be a tax revolt, which would result in the transfer to federal bureaus of the power to make those local decisions.

The combined result of these provisions of the bill will be to create a crisis in intergovernmental relations. This, more than the federal tax revenue involved, is the significance of this bill's demoralization of municipal credit, and its substitution of federal liability for the support of activities that are essential functions of State governments.

II. THE BILL CRIPPLES THE POWER OF THE STATES TO ISSUE AND SELL TAX-EXEMPT BONDS

The devastating effect which the mere consideration and passage of this bill in the House has already had on the borrowing power of local governments is readily documented.

The House Ways and Means Committee published the Johnson Administration's tax reform proposals on February 5, 1969, and suggestions contained in those proposals threw the municipal bond market into a serious decline. If two days before that day a bank—note that I say bank, not individual—had bought $1,000,000 of the high-grade corporate bonds composing Moody's corporate bond average, that portfolio would have been worth on September 4, 1969, $941,200. If the same bank on the same day had bought $1,000,000 worth of high-grade State and local bonds which compose the Weekly Bond Buyer's municipal bond average, this portfolio would have been worth on September 4 only $835,200. The drop in value of corporate bonds reflects the general increase of the cost of money in the market place. The yield on corporates had to rise 57 basis points, which is a way of saying 57 one-hundredths of 1 percent, to make it possible to market new corporate bonds of like quality. But the yield on top-grade municipal bonds had to rise from 4.91 to 6.37, some 146 basis points, or 1.46 percent to make similar new issues salable. The difference between the rate of increase in the yield on corporates and the yield on municipals, during the consideration of this bill during that period, is a fair measure of the market's appraisal of the effect of this pending legislation on the tax exemption of municipal bonds. Cost of money to municipals rose two and a half times as much (146 basis points) as cost of money to corporations on their bonds (57 basis points).

September 4 was selected for analysis because it was on that day that Secretary of the Treasury Kennedy testified before this Committee and recommended *against* application of the Limitation on Tax Preferences to municipal bonds. Since that date the municipal bond market has shown a marked improvement while the corporate market has further deteriorated. The corporate portfolio has dropped another $11,800 in value. The corporate yield has consequently risen 12 more basis points to 7.56, as of September 18, the last date figures were available. Yet the municipal bond portfolio has increased in value by $12,900 since the date of Secretary Kennedy's statement opposing the inclusion of municipal bond interest in LTP, with a resultant drop in yield of 12 basis points to 6.25. These figures indicate alike the sensitivity of municipal financing to the ebb and flow of threats of federal taxation, and the continuing depression in the municipal bond market occasioned by the overall impact of this bill.

Such are the demonstrated consequences of this bill with respect to municipal bonds held by a bank or other corporate holder, even though the bill purports to tax only the interest paid to individuals, and individuals have been buying only about 10 percent of new issues in the last two years. The reason is obvious: The domino effect. The market has recognized that if this bill becomes law, no buyer of municipal bonds hereafter will be purchasing a stable contract. If the value of the individual's contract can be validly impaired retroactively, as this bill does, then so can a bank's contract with the same issuer, in some future bill. The buyer consequently capitalizes the expected tax, and adds its consequences to the yield that he demands. The helpless municipality pays the price.

The price, reckoned over the life of a bond issue, is a staggering, both in the cost to those municipalities which can sell their bonds, and, more ominously, in the consequences to those municipalities which may be unable to sell their bonds.

State and local governments in 1968 issued $16.125 billion in bonds, tax exempt under then existing federal statutes. It has been conservatively estimated that the debt service they would have to pay on an average 20-year bond issue would be increased, if this bill became law, by more than $220 million annually, or by more than $4.4 billion during the whole life of the bond. These are the consequences with respect to the bond offerings of a single year. But the Nation's municipalities, as a group, must sell bonds every year, not just one year, and do so in increasing amounts to maintain essential services to an expanding population. The true consequences of this bill in cost of money to States and local agencies is not just $4.4 billion, but an indefinitely large multiple of the costs attributable to the bond offerings of any single year.

By contrast, the Ways and Means Committee estimated that the Treasury would collect added revenues of only $40 million in 1970, and $85 million a year ultimately, from all five limitations on tax preferences lumped together—State and local bonds, capital gains, appreciations in value of property donated to charity, excess depreciation, excess farm losses—with no value at all assigned to the limitation on municipal bond interest. This is burning down the house to kill the cockroaches. Moreover, it is no longer asserted by the proponents of this bill that tax exempt interest shelters a single one of the 154 wealthy non-taxpayers who are the highly publicized targets of these five limitations on tax preferences. It is almost certain that the wrong house is being burned down.

III. CONSTRAINTS ON TAX-EXEMPT FINANCING OF ESSENTIAL PUBLIC SERVICES RESULT IN PERMANENT INFLATION OF THE COST OF THESE SERVICES, WITH THE BURDEN FALLING DISPROPORTIONATELY ON THE POOR

The construction of public facilities to furnish essential public services—schools, water, sewerage, electric power, fire and police protection, for example—cannot be curtailed below the growth rate of the population, without consequences too obvious and too serious to require argument. Indeed, such construction, and the issuance of bonds to finance it, ought to expand at a rate greater than the rate of population growth, if the standard of living in the underdeveloped segments, the ghettos, of our environment is to be improved.

Consequently, state and local governments must go to market to finance their public works whether they want to or not; they cannot wait indefinitely for the market to improve. High interest costs, that is, costs of money inflated by the loss of tax exemption, result inevitably in the inflation of the costs of essential public services for the whole life of the bond issue. For example, a city which must pay, say $12 million in interest over the 20 year life of a tax-exempt bond issue which it sells to finance schools will have to pay at least $18 million instead if the bond interest is taxable, or if the market, rightly or wrongly, judges that such interest will become taxable in the future. To pay the added $6 million, the city must increase its ad valorem taxes, with a resulting escalation of all living expenses affected by ad valorem taxes—rents, for example. This is a regressive result. If the facilities so built are revenue producing, such as water or power facilities, the city must raise its rates for these services. Note here that power and water works require a large number of dollars of capital investment, that is, of borrowed money, to produce each dollar of revenue. The ratio of investment to annual revenue may be more than ten to one. Consequently an increase in interest from a rate of 6 percent to one of 8 percent, an increase of 2 percent, may require an increase in rates for water or power of 20 percent or more. The ultimate burden of the loss of a municipality's tax exemption on its borrowing is reflected directly in the cost of essential public services which the citizen has no option to forego, and thus falls most heavily on those of its citizens least able to bear it. The inflation of costs of living thereby occasioned is near-permanent, coming into existence when the more costly money is borrowed to build the public works, and lasting the whole 20 to 30 years of the life of the bond.

So much for the more fortunate municipalities which are able to sell their bonds, at a price, even if they lose their exemption in whole or in part. The interest rates they must pay will rise to equal the rate which corporations must pay. Indeed, much of the spread between municipal and corporate rates has already been eroded, commencing when this so-called tax reform scheme was made public early this year. But some public agencies, if forced to issue taxable securities, would find them unsalable at any acceptable price. For example, who is going to buy a taxable bond of an obscure small school district or small town municipal power system, in competition with the corporate bond of a large company, perhaps a debt convertible into equity, except at a price greatly in excess of the corporate rate? Indeed, experts say that many of the annual issues that small public bodies customarily offer will be unsalable at any price if they are made taxable.

IV. THE BILL'S PROPOSED TRANSFER TO THE FEDERAL TAXPAYER OF THE CONSEQUENCES OF THE DESTRUCTION OF LOCAL CREDIT IS BAD PUBLIC POLICY

The bill proposes a cure for the injury it does to municipal credit, in Sections 601 and 602. The cure is worse, in some respects, than the disease incubated in Sections 301 and 302. The remedy offered is a subsidy to be paid by the federal treasury to any municipality which elects to issue taxable bonds. The subsidy is supposed to equal the difference in yield between taxable and non-taxable municipal bonds, fixed as a percentage of yield, within a stated range, the determination to be made by the Secretary of the Treasury. The report of the House Committee on Ways and Means says "there is no review of the advisability of the local project or of the issuer's ability to pay". Availability of the federal money would be assured by a permanent appropriation, avoiding annual review by the appropriation committees.

At least four things are wrong with this idea. In ascending order of importance, they are these:

(1) The "fixed percentage" of the yield constituting the subsidy "is to apply to all issues of taxable obligations" during the quarter of the year covered by the

determination, nationwide. Manifestly, not all issues will fit this single Procrustean bed. What is the upper limit of the new taxable yield? The corporate rate? A small drainage district will have to pay more than that, if its bonds become taxable, for no one will buy them in competition with bonds of, say, U.S. Steel. What is the lower limit, to be subtracted from the upper limit to arrive at the spread which is to be offset by subsidy? Supposedly it is the rate payable on tax-exempts, but whose? Manifestly a subsidy required to make salable top-grade taxable municipals, or even one determined by the average yield of all municipals, calculated as a percentage of the spread between taxable and non-taxable yields, will not be enough to enable the poor and small sisters to sell taxable bonds.

(2) The federal government must raise the money to pay several thousand municipalities many millions of subsidies each year. This federal obligation will continue for the life of the bond issue, a period to be determined by the local government. The effect will be twofold. First, an obligation is to be imposed on the federal treasury which is equivalent to a long-term federal bond, whereas current federal policy is to issue short-term securities. Second, the municipality's taxable bond is expected, by this scheme, to foresake the shelter of the unique tax-exempt market, and to compete in the market for the first time with corporates and federal securities. To the extent that the scheme works, the competition of this new municipal entry may well drive up the interest rates which the federal government and corporations must pay. In six of the last ten years, the net increase in municipal bonds outstanding was greater than the net increase in corporates or in direct federal government securities.

(3) If the House Committee's assurance that "there is no review of the advisability of the local project or of the issuer's ability to pay" really comes true, then the consequence will be that local governing bodies can and will commit the federal treasury to incur long-term debt service obligations, with a consequent increase in burdens on the federal taxpayer, without review or concurrence by Congress or by any federal executive agency. It is totally unsound to vest in local governments the power to appropriate federal money. Such is the effect of this proposal.

(4) More likely, the House committee's assurances against federal review of the advisability of the local project or of the issuer's ability to pay will not last very long. A taxpayers' revolt would be a certainty, if billions were added each year to the long-term federal debt load by non-reviewable decisions of local governments. The alternative would be a super P.W.A. of federal agencies to review the desirability of each of several thousand local projects each year, and the capacity of their sponsors to pay for them. Local decisions, now policed by the marketplace, would become national decisions, controlled by the policies and politics of distant federal administrators.

V. THE BILL'S PROPOSALS FOR LIMITATIONS ON TAX PREFERENCES, AND ALLOCATIONS OF DEDUCTIONS, AS APPLIED TO INTEREST ON MUNICIPAL BONDS, ARE UNCONSTITUTIONAL

The bi''s effect, as demonstrated in Part II of this statement, has been and will be to impair the power of States and municipalities to borrow money, and to increase the cost to local governments of the money that they succeed in borrowing.

It does so in two ways.

The limitation on tax preferences directly subjects to federal taxation the interest paid by local governments on their obligations.

The allocation of taxpayers' deductions burdens the municipality's borrowing power in a more subtle, but equally effective way. The effect is that a taxpayer who owns no municipal bonds may deduct from his gross income, for example, all of the local taxes that he pays on his home and all of the interest that he pays on his mortgage. But if he has income from municipal bonds in excess of a stated amount annually ($5,000 if single, $10,000 if filing a joint return), he may not deduct all of that interest, but only a portion of it corresponding to the ratio between taxable income and total income. In consequence, such a taxpayer would pay more tax if he invested money in municipal bonds than he would pay if he left the same amount of capital idle in his checking account.

The House Committee regards this allocation scheme as producing revenue to the Treasury amounting to $205 million in 1970, rising to $460 million ten years later, but it does not say how much of this relates to municipal bond interest.

To the extent that it does, it constitues an added cost to municipalities which issue tax-exempt bonds, because the bond buyer capitalizes his expectation of taxation and adds that to the yield required to induce him to buy in competition with other taxable bonds.

A federal tax which directly increases the cost to the States and their political subdivisions of borrowing money, imposing a burden on the borrowing power at the amount of its exercise "is a tax on the power of the states, and on other instrumentalities to borrow money, and consequently repugnant to the Constitution" (*Pollack* v. *Farmers' Loan and Trust Co.*, on rehearing, 158 U.S. 601, 630 (1895)). The argument is spelled out in the annexed brief.

So tested, both the limitation on tax preferences and the allocation of deductions, as applied to municipal bonds, are, in my opinion unconstitutional. Secretary Kennedy agrees that there are "constitutional doubts" as to the former, but not the latter. It will take years of litigation, much of it outside the control of the States and their instrumentalities, to decide the constitutional issue if either the limitation on tax preferences or the allocation of deductions includes municipal bonds. For that same period of time all municipal financing will be chaotic. The issues sold during this period will have to pay interest rates which are dictated by the buyers' most pessimistic appraisal of the outcome which indemnify him for taxes he must pay even though the tax is finally declared unconstitutional. The then holder, whoever he may be, will reap a windfall, taxable only at capital gains rates.

VI. CONCLUSION

To the extent that local governments can and will carry their own burdens, it is in the national interest that they be permitted to do so. To the extent that their borrowing power is eroded by Federal taxation, or the threat of attempts at such taxation, whether constitutional or not, local governments are prevented from carrying their own burdens, and are driven to rely upon Federal assistance. This bill plainly contemplates this cause and this effect, and compels both. We vehemently disagree.

The Nation gets no benefit from disabling any State from providing essential public services to its own people at its own expense. We all suffer by such a process. This is true not only of the State whose borrowing power may be crippled by Federal taxation, or the threat of it, but of the Federal taxpayers who must ultimately pay for a greater share of local projects thus priced out of range of the State's borrowing power.

The Federal Treasury and the federal taxpayer suffer from the erosion of intergovernmental tax immunities, whether Federal or State.

This is not tax reform.

Attachments.—Brief: Taxation of the interest paid by States and their instrumentalities upon their obligations, as proposed in the "Tax Reform Act of 1969," would be unconstitutional. Proposed amendments.

BRIEF

1. PROVISIONS OF H.R. 13270, 91ST CONGRESS (THE "TAX REFORM ACT OF 1969") TAXING, DIRECTLY OR INDIRECTLY, THE INTEREST PAID BY STATES AND THEIR INSTRUMENTALITIES ON THEIR OBLIGATIONS

Section 301 directly taxes a portion of the interest paid to individuals by States and their instrumentalities on their obligations. Section 302 does so indirectly.

Limitation on tax preference (LTP)

Section 301 establishes a limit on tax preferences (LTP) which will apply to five items of income (infra). The House Committee Report[1] explains the scheme as follows:[2]

"Under the limit on tax preferences provided by the bill, in the case of individuals, estates, and trusts, a 50 per cent ceiling is to be imposed on the amount of a taxpayer's total income (adjusted gross income plus the tax preference items) which can be excluded from tax. In other words, an individual is to be allowed to claim the exclusions and deductions comprising tax preference income only to the extent that the aggregate amount of these preferences does not exceed one-half of his total income. In order to confine the operation of the pro-

[1] Report of the Committee on Ways and Means of the House of Representatives to accompany H.R. 13270, 91st Congress, 1st Session, a bill to reform the income tax laws: House Report No. 91-413 (Part 1).

[2] Id., pp. 78-79.

vision to individuals with substantial amounts of tax preference income, the limit on tax preferences is not to apply if an individual's total tax preferences for the year do not exceed $10,000 ($5,000 for a married person filing a separate return).

"The application of the limit on tax preferences may be illustrated by the case of a taxpayer with $50,000 of salary and $150,000 of tax preference amounts. Under present law, such an individual is taxed only on his $50,000 of salary. Under the limit on tax preferences, he is to be required to pay tax on $100,000 of income (one-half his total income of $200,000)." [3]

Section 301 designates five tax preference items. The description of item (1) below is quoted from the House Committee report, p. 79. The other four are our summaries:

"(1) Tax-exempt interest on State and local bonds. For the purpose of the limit on tax preferences, however, this tax-exempt interest is to be taken into account gradually over a 10-year transitional period, with one-tenth of such interest taken into account in the first taxable year beginning on or after Jan. 1, 1970, two-tenths in the second taxable year and so on, until 100 per cent of the interest is taken into account. The amount of tax-exempt interest otherwise taken into account for a year is to be reduced by the amount of any deductions allocable to the interest which are disallowed (under Sec. 265(a)(1)) as expenses related to tax-exempt income."

(2) The one-half of net long term capital gains which is excluded from income:

(3) Appreciation in the value of property donated to charity which is deducted as a charitable contribution but which is not included in gross income;

(4) Depreciation claimed for real property in excess of straight line depreciation;

(5) The amount by which farm loss computed under special farm accounting rules exceeds the loss calculated under normal accounting rules.

The Report continues (p. 79):

"The amount a taxpayer is required to include in income is to be considered proportionately derived from each preference item."

The result, insofar as municipal bonds are concerned, is the imposition of a tax upon the interest paid by States and their instrumentalities to individuals, but not that paid to banks or other corporations. Section 301 applies to all outstanding bond issues, not merely to new ones.

The Report states the revenue effect of the Limitations on Tax Preferences as follows: [4]

"It is estimated that the limit on tax preferences will increase tax liability by $40 million in the calendar year 1970 and by $85 million a year when the provision is fully effective. About half of the additional tax liability will come from taxpayers with incomes of $50,000 and over."

The Report makes no allocation of this amount among the five tax preference items, but, as we point out later, it is significant that the only items on which the tax is less in 1970 than "when the provision is fully effective" is tax-exempt interest on State and local bonds, indicating that this item is a substantial contributor to the increase of $45 million, and therefore probably a substantial contributor to the initial $40 million.

Allocation of deductions

Section 302 provides for allocation of deductions between exempt and non-exempt income. The non-taxed items to which allocable deductions are to be apportioned are six in number. They include the same five as the LTP, plus (item 4), intangible drilling expenses, and similar items not involved here. The allocation would include tax exempt interest on bonds issued after July 12, 1969. Under a transition rule one-tenth of such interest would be taken into account for allocation purposes in the first year, two-tenths in the second, and so on, "until 100 percent of the interest on tax exempt bonds issued after July 12, 1969, would be recognized for allocation." [4a] Note that, unlike the limitation on tax preference (Sec. 301), which applies to past as well as future bond issues, the required allocation of deductions (Sec. 302) applies only to new issues after July 12, 1969.

[3] Id., p. 79.
[4] Id., p. 80.
[4a] Id., p. 83.

The Report of the Ways and Means Committee explains the allocation as follows:

"The fact that an individual who receives tax-free income can charge the entire amount of his personal deductions to his taxable income gives him a double tax benefit. He not only excludes these tax preference amounts from his tax base but he also, by allocating his personal deductions only against his adjusted gross income, may reduce his tax payments on this taxable income . . . ." [5]

"To prevent individuals with tax preference amounts from reducing their tax liabilities on their taxable incomes by charging all their personal deductions to their taxable incomes your committee's bill provides that individuals (and estates and trusts) must allocate most of their itemized personal deductions proportionately between their taxable income (adjusted gross income less nonallocable expenses) and their tax preference amounts. Only the part of these personal deductions which is allocated to taxable income is to be allowed as a tax deduction and the personal deductions allocated to the tax preference amounts are to be disallowed. Tax preference amounts are taken into account only to the extent they exceed $10,000 ($5,000 for a married person filing a separate return) . . . ." [6]

*   *   *   *   *   *   *

". . . The bill essentially requires allocation of any itemized deduction where it is reasonable to assume that a portion of the pertinent expense is met out of nontaxable income . . . ." [7]

The coordination between the limitation on tax preferences (Sec. 301) and the required allocation of deductions (Sec. 302) is explained as follows:

"Under the bill, individual taxpayers may be subject to the limit on tax preferences, as well as being required to allocate their deductions. The bill provides in effect that (1) such a taxpayer is to first apply the limit on tax preferences (that is, to add back to taxable income that part of nontaxable income in excess of 50 percent of total income), and (2) he then is to allocate deductions between gross income as modified in step (1) and the allowed tax preference items." [8]

A note to the Committee Report illustrates the last statement as follows:

"For example, suppose the individual has a taxable income of $30,000, a tax exempt income of $70,000, and $30,000 of personal deductions. Applying the limit on tax preferences first results in adding $20,000 to the individual's taxable income increasing the latter to $50,000 and decreasing tax-free income to $50,000. Deductions are then allocated on the basis of a 50–50 split between taxable and nontaxable income, resulting in disallowing $15,000 of the total of $30,000 of deductions. For simplicity, this example omits the effect of the $10,000 floor.[9]

From the foregoing, it is clear that the intended effect of Section 302, read in conjunction with Section 301, is that a portion of the personal deductions which a taxpayer might claim in full against gross income in calculating his taxable income if he received no interest on State of local bonds will be denied him if he does receive such interest. He thus pays a higher tax on his taxable income if he invests money in municipal bonds than he would pay if he kept the amount of that investment idle in his checking account.

The Ways and Means Committee Report calculates the revenue effect of Section 302 as follows:

"It is estimated that the allocation of deductions between taxable income and tax preference amounts will increase revenue by $205 million in the calendar year 1970 and $460 million a year when the provision is fully effective. Almost all of this additional revenue will be collected from taxpayers with adjusted gross income of $20,000 or more." [10]

The Committee gives no breakdown of these amounts among the six nontaxed items to which allocable deductions are to be apportioned, nor does it explain the disparity between these figures and the much more modest amounts of revenue expected from application of tax preference alone, $40 million to $85 million.[11] It is notable, however, that tax exempt bond interest is the only item which is stated on a graduated ten-year scale in either the list of tax preferences (Sec. 301, p. 79 of the Report), or the list of items to which deductions are to be allocated

[5] Id., p. 80.
[6] Id., p. 81.
[7] Id., p. 81.
[8] Id., p. 83.
[9] Id., p. 83.
[10] Id., p. 83.
[11] Id., p. 80.

(Sec. 302, p. 82 of the Report). The inference seems clear, therefore, that revision of tax liabilities occasioned by receipt of interest on State and local bonds is alone accountable for the projected increase in tax revenues (1) via the limitation on tax preferences from $40 million in 1970 to $85 million a year, 10 years later (Report, p. 80), and (2) via the allocation of deductions from $205 million a year in 1970 to $460 million a year 10 years later. It is a fair inference, therefore, that bond interest, hitherto tax exempt, is a substantial component of the tax revenue of $245 million from the combined effect of Sections 301 and 302 in 1970, as well as the total of $545 million 10 years later.

Comments of the Treasury Department

Secretary of the Treasury David M. Kennedy, on September 4, 1969, advised the Senate Finance Committee:

"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 repurcussions 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 phaseout contained in the House bill."

We concur with Secretary Kennedy's conclusion that there are "constitutional doubts"—in our view, doubts of the most serious magnitude—of the validity of the proposal to include tax exempt interest in the Limitations on Tax Preferences. In our opinion, there are equally serious "constitutional doubts" with respect to the validity of including tax exempt interest in the allocation of deductions. The reasons for our conclusion, in both respects, are stated below.

As a preliminary matter, however, it should be observed that, on the House Committee figures, the interest rate which States and municipalities must pay on their bonds will be much more severely burdened by the inclusion of that interest in the proposed allocation of deductions, which Secretary Kennedy favors, than by its inclusion in the limitations on tax preferences, which he disapproves because of constitutional doubts. Moreover, the Secretary would accelerate the impact of the burden attributable to the allocation of deductions, "without the 10-year phaseout contained in the House bill." As to the "possibility of repurcussions in the market for State and local securities," this has passed from possibility to grim reality during, and because of, the pendency of this bill.

2. THE TEST OF CONSTITUTIONALITY OF FEDERAL TAX BURDENS ON STATES AND THEIR INSTRUMENTALITIES

Neither the Federal nor State Governments can constitutionally impair the other's power of the purse, i.e., the other government's powers to raise money by borrowing or by taxation. These powers are essential to a government's existence. Taxation of interest which either government pays on its debts, measurable in the cost of money at the time the debt is incurred, is a direct burden on the power to borrow money, a constriction of the sovereign power of the purse which is as invalid constitutionally as a tax levied against the revenues which that other government receives from its own taxes.

So tested, both the proposed limitation on tax preferences and the proposed allocation of deductions are unconstitutional, because their burden upon the State's borrowing power is directly measurable in the added cost of borrowed money to the State at the instant when that debt is incurred.

The cases which establish this principle are discussed below, as are the cases which limit its application. None of those limitations or exceptions support the taxes proposed here. We are not concerned here with peripheral and remote effects of federal taxation on a state's activities, such as federal taxes on the income of state employees. Nor are we dealing here with federal taxation of capital gains, or with federal estate taxes, which may properly encompass municipal bonds because the effect of such taxation is too remote, in point of time, to be measurable in the cost of money at the moment when the borrowing power is exercised. The taxation proposed here would burden the borrowing power of the State to a readily measurable and extreme degree simultaneously with the attempt at its exercise. Indeed, during the pendency of this proposed legislation the cost of money to States and their political subdivisions has risen two and a half times as much as the increase of cost of money to corporations in the same period. Such is the direct and measurable impact of the proposed tax.

3. THE CASES

The only attempt by the Federal Government to impose a tax on interest paid by States and their political subdivisions was declared unconstitutional nearly 74 years ago, and the case which so decided, *Pollock* v. *Farmers' Loan & Trust Co.*,[1] has been repeatedly cited as good law ever since.[2]

The classic statement of the constitutional basis of the immunity of the States and their municipalities from Federal taxation of their bonds and interest paid thereon, made in the *Pollock* case, was this:

"A municipal corporation is the representative of the State and one of the instrumentalities of the State government. It was long ago determined that the property and revenues of municipal corporations are not subjects of Federal taxation. *Buffington* v. *Day*, 78 U.S. 11 Wall. 115; *United States* v. *Baltimore & O.R. Co.*, 84 U.S. 17 Wall. 322, 332."

*   *   *   *   *   *   *

"* * * It is contended that although the property or revenues of the States or their instrumentalities cannot be taxed, nevertheless the income derived from State, county, and municipal securities can be taxed. But we think the same want of power to tax the property or revenues from the States or their instrumentalities exists in relation to a tax on the income from their securities, and for the same reason, and that reason is given by Chief Justice Marshall in *Weston* v. *Charleston* (27 U.S. 2 Pet. 449, 468), where he said: 'The right to tax the contract to any extent, when made, must operate on the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this power depends on the will of a distinct government. To any extent, however inconsiderable, it is a burden on the operations of government. It may be carried to an extent which shall arrest them entirely. * * * The tax on government stock is thought by this court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently to be repugnant to the Constitution.' Applying this language to these municipal securities, it is obvious that taxation on the interest therefrom would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract, and that the tax in question is a tax on the power of the States and their instrumentalities to borrow money, and consequently repugnant to the Constitution."[3]

And on rehearing in the same case, the Court said:[4]

"We have unanimously held in this case that, so far as this law operates on the receipts from municipal bonds, it cannot be sustained, because it is a tax on the power of the States, and on their instrumentalities to borrow money, and consequently repugnant to the Constitution."

Every case since 1895 which has touched the problem has accepted the *Pollock* case as good law, and this includes cases which have invalidated various claimed immunities of other sorts. Thus:

In *Willcuts* v. *Bunn*,[5] which held a capital gain on the sale of municipal bonds to be subject to Federal taxation, the Court said:

"In the case of obligations of a State or of its political subdivisions, the subject held to be exempt from Federal taxation is the principal and interest of the obligations. [Citing *Pollock*.] These obligations constitute the ccontract made by the State, or by its political agency pursuant to its authority, and a tax upon the

[1] 157 U.S. 429 (1895), affirmed on rehearing, 158 U.S. 601 (1895).

[2] *See Plummer* v. *Coler*, 178 U.S. 115, 117 (1900); *South Carolina* v. *United States*, 199 U.S. 437, 453 (1905); *Farmers & Mechanics Savings Bank* v. *Minnesota*, 232 U.S. 516, 526–527 (1914); *Evans* v. *Gore*, 253 U.S. 245, 255 (1920); *Gillespie* v. *Oklahoma*, 257 U.S 501, 505 (1922), overruled on other grounds in *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376 (1938); *Greiner* v. *Lewellyn*, 258 U.S. 384, 386 (1922); *Metcalf & Eddy* v. *Mitchell*, 269 U.S. 514, 521, 522 (1926); *Willcuts* v. *Bunn*, 282 U.S. 216, 225, 226 (1931); *Indian Motorcycle Co.* v. *United States*, 283 U.S. 570, 577 (1931); *Chooteau* v. *Burnet*, 283 U.S. 691, 696 (1931); *Burnet* v. *Coronado Oil & Gas Co.*, 285 U.S. 393, 400 (1932); overruled on other grounds in *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376 (1938); *Trinityfarm Construction Co.* v. *Grosjean*, 291 U.S. 466, 471 (1934); *Ashton* v. *Cameron County Water Imp. District No. One*, 298 U.S. 513, 570 (1936); *New York ex. rel. Cohn* v. *Graves*, 300 U.S. 308, 315–316 (1937); *Hale* v. *State Board*, 302 U.S. 95, 107 (1937); *James* v. *Dravo Contracting Co.*, 302 U.S. 134, 150, 153, 156 (1937); *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376, 386 (1938); *Helvering* v. *Gerhardt*, 304 U.S. 405, 417 (1938).

[3] 157 U.S. 429, 584, 585–586 (1895).

[4] 158 U.S. 601, 630 (1895).

[5] 282 U.S. 216, 226 (1931).

amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the Government."

In *Helvering* v. *Gerhardt*,[6] which held salaries of employees of the New York Port Authority taxable, the Court said:

"* * * It [the immunity] has been sustained where * * * the function involved was one thought to be essential to the maintenance of a State government: as where the attempt was * * * to tax income received by a private investor from State bonds, and thus threaten impairment of the borrowing power of the State. [Citing *Pollock*.]

* * * * * * *

"The basis upon which constitutional tax immunity of a State has been supported is the protection which it affords to the continued existence of the State."

In *Hale* v. *State Board*,[7] Mr. Justice Cardozo said that the "teaching" of the *Pollock* case was that:

"** * an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power such as was condemned in *M'Culloch* v. *Maryland*. * * *"

In *James* v. *Dravo Contracting Co.*,[8] which upheld a 2-percent tax imposed by the State of West Virginia upon gross receipts received by a contractor for work performed for the Federal Government, Mr. Chief Justice Hughes (for Justices Brandeis, Stone, Cardozo, and Black) said:

"* * * [The doctrine of immunity with respect to Government bonds] recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' [citing *Pollock*] and which would directly affect the Government's obligation as a continuing security. Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit,* * *"

In *New York ex rel. Cohn* v. *Graves*,[9] the Court said:

"It is by a parity of reasoning that the immunity of income-producing instrumentalities of one government, State or National, from taxation by the other, has been extended to the income. It was thought that the tax, whether on the instrumentality or on the income produced by it, would equally burden the operations of government. [Citing *Pollook et al.*]"

In *Helvering* v. *Mountain Producers Corp.*,[10] the Court held that a lessee under an oil and gas lease of State school lands was not entitled to immunity, as a State instrumentality, from Federal taxation in respect of income derived from operations under the lease, overruling earlier cases. But then, citing the *Weston* and *Pollock* cases, the Court said:

"* * * a tax on the interest payable on State and municipal bonds has been held to be invalid as a tax bearing directly upon the exercise of the borrowing power of the Government. * * *"

The cases cited, other than the *Pollock* case, were decided after enactment of the 16th amendment, and, we believe, tacitly reinforce the assurance in *Peck* v. *Lowe*[11] that this amendment does not extend the taxing power to new or excepted subjects."

What accounts for the durability of this doctrine, in a period which has seen what one writer calls a "waning of intergovernmental tax immunities"[12] in other areas?

The reasons are so fundamental as to have passed from the law into everyday speech:

"The Constitution, in all its provisions, looks to an indestructible Union, composed of indestructible States (*Texas* v. *White*)[13]

* * * the power to tax involves the power to destroy (*M'Culloch* v. *Maryland*)."[14]

[6] 304 U.S. 405, 417, 421 (1938).

[7] 302 U.S. 95, 107 (1937).

[8] 302 U.S. 134, 152–158 (1937).

[9] 300 U.S. 308, 315–316 (1937).

[10] 303 U.S. 376, 386 (1938).

[11] 247 U.S. 165, 172 (1918); cf. *National Life Insurance Co.* v. *United States*, 277 U.S. 508, 521 (1928); *Stanton* v. *Baltic Mining Co.*, 240 U.S. 103, 112 (1915).

[12] "* * * The Constitution itself does not change. It is merely occasionally misunderstood, often by lawyers and professors and occasionally even by judges, especially earlier judges." (Powell, "The Waning of Intergovernmental Tax Immunities," 58 Harvard Law Review 633, 642 (1945)).

[13] 7 Wall. (U.S.) 700, 725 (1869).

[14] 4 Wheat. (U.S. 316, 431 (1819).

Although the Constitution contains no limitation upon the power of either the Federal or State Governments to tax the other, such a limitation is necessarily implied, to invalidate any tax of either sovereignty which adversely affects the continued existence of the other. (The immunity may be broader than this, but that does not concern us in the resolution of the present issue.) In Chief Justice Marshall's view, intergovernmental immunity was a constitutional necessity:

"* * * We are relieved, as we ought to be, from clashing sovereignty; from interfering powers; from a repugnancy between a right in one government to pull down what there is an acknowledged right in another to build up; from the incompatibility of a right in one government to destroy what there is a right in another to preserve."[15]

In considering the constitutional power of the Federal Government to tax the interest paid by States and political subdivisions upon their borrowings, we are dealing with a direct obstruction to the power to borrow money, a power essential to their existence. The States' borrowing power is not only "clogged," but may be made absolutely impossible of exercise by increase of interest costs beyond certain points, because many projects' revenues from tolls or local taxes cannot be increased in the ratio required to sustain the inflated debt service resulting from loss of exemption from Federal taxes. The many cases which turned on the question of whether or not the tax burden there involved fell upon a State or upon an individual, or whether, even though it fell directly on a State, it was or was not consequential in amount or did or did not affect an essential governmental function,[16] are all peripheral to the problem now presented. The burden here is direct, its consequences are crushing, the borrowing power thus obstructed is governmental and essential.

[15] Id. at 429–430.

[16] The indirect relation of the tax to any demonstrable burden on the public agency resulted in sustaining taxes on shares of corporations holding Government bonds, in *Van Allen* v. *The Assessors,* 3 Wall. (U.S.) 573 (1866); *National Bank* v. *Commonwealth,* 9 Wall. (U.S. 353 (1870); *Schuylkill Trust Co.* v. *Pennsylvania,* 296 U.S. 113 (1935); taxes on franchises of corporations holding Government bonds or deposits, in *Society for Savings* v. *Coite,* 6 Wall. (U.S.) 594 (1868); *Provident Institution* v. *Massachusetts,* 6 Wall. (U.S.) 611 (1868); *Hamilton Mfg. Co.* v. *Massachusetts,* 6 Wall. (U.S. 632 (1868); *Home Insurance Co.* v. *New York,* 134 U.S. 594 (1890); *Manhattan Co.* v. *Blake,* 148 U.S. 512 (1895); *Flint v. Stone Tracy Co.,* 220 U.S. 107 (1911); estate or inheritance taxes on transfer of Government bonds, in *Plummer* v. *Coler,* 178 U.S. 115 (1900); *Greiner* v. *Lewellyn,* 258 U.S. 384 (1922); *Blodgett* v. *Silberman,* 277 U.S. 1 (1928); taxes on capital gain from sale of Government bonds, in *Willcuts* v. *Bunn,* 282 U.S. 216 (1931). See also *Denman* v. *Slayton,* 282 U.S. 514 (1931). In all these cases, the impact of the tax became perceptible for the first time long after issuance of the bonds, fell on a restricted number of bondowners, and was thus incapable of translation into any calculable direct burden on the public agency at the time its borrowing power was exercised. The essential character of the borrowing power was therefore not in issue.

Logically, the questions of (1) directness of the burden, and (2) essentiality of the function which is burdened, ought to be considered in that order, because if the burden is so indirect as to be inconsequential the question of essentiality is not reached. This was the rationale of *Helvering* v. *Gerhardt,* 304 U.S. 405 (1938) (sustaining a Federal tax on income of employees of the Port of New York Authority), but *Helvering* v. *Powers,* 293 U.S. 214 (1934) (sustaining a Federal tax on salaries of trustees operating a street railway for a municipality), went at it in the opposite order.

In general, the directness of the burden was the issue primarily considered in the following cases; *Helvering* v. *Gerhardt,* 304 U.S. 405 (1938) (supra); *Helvering* v. *Mountain Producers Corp.,* 303 U.S. 376 (1938) (sustaining a Federal income tax on mineral lessee of State school lands, and overruling *Gillespie* v. *Oklahoma,* 257 U.S. 501, *Burnet* v. *Coronado Oil & Gas Co.,* 285 U.S. 393); *Willcuts* v. *Bunn,* 282 U.S. 216 (1931) (sustainign a Federal tax on capital gain resulting from sale of State securities); *Metcalf* v. *Mitchell,* 269 U.S. 514 (1926) (sustaining a Federal income tax on consulting engineers under contract with State); *Greiner* v. *Lewellyn,* 258 U.S. 384 (1922) (State bonds owned by a decedent held properly included in the net value of estate for Federal estate tax purposes); *Flint* v. *Stone Tracy Co.,* 220 U.S. 107 (1911) (held that a Federal franchise tax measured by corporate income may include income from tax-exempt municipal bonds). Similar rulings in the converse situation upholding State taxes levied on Federal employees, contractors, or persons holding Federal property are *United States* v. *Detroit,* 355 U.S. 466 (1958), *Detroit* v. *Murray Corp.,* 355 U.S 489 (1958), *United States* v. *Township of Muskegon,* 355 U.S. 484 (1958), *Alabama* v. *King & Boozer,* 314 U.S. 1 (1941), *James* v. *Dravo Contracting Co.,* 302 U.S 134 (1937) (all upholding various types of State taxes on Federal contractees); *Esso Standard Oil* v. *Evans,* 345 U.S. 495 (1953) (State tax levied on storer of gasoline for Federal Government); *Graves* v. *New York ex rel. O'Keefe,* 306 U.S. 466 (1939) (sustaining a New York State tax on the income of an employee of the Home Owners' Loan Corporation, a Federal instrumentality, overruling or limiting *Collector* v. *Day,* 11 Wall (U.S.) 113, (1871), *New York ex rel Rogers* v. *Graves,* 299 U.S 401 (1937) ("so far as they recognize an implied constitutional immunity from income taxation of the salaries of officers or employees of the National or a State Government or their instrumentalities"), and limiting *Dobbins* v. *Commissioners of Erie County,* 16 Pet. (U.S.) 435 (1842); *Educational Films* v. *Ward,* 282 U.S.

(Footnote continued on following page.)

The proposed allocation of deductions is not saved by the insurance cases which have dealt with formulas for allocation of income and deductions between reserves and shareholders' equity.

The effect of the formula in Section 302 of this bill is that a taxpayer who has both taxable income and tax exempt income from interest on municipal bonds pays a higher income tax than he would if he had kept idle, in his checking account, the capital which he invested in municipal bonds. This is because, if he owned no municipal bonds, he could claim the full amount of his person'.l deductions, such as taxes he pays on his house and interest he pays on his mortgage, theft and casualty losses, charitable contributions, medical expenses, etc., from his gross income in calculating his net taxable income, whereas if he buys municipal bonds and receives interest thereon he can no longer deduct those same expenses, but only a portion of them. The amount of deductions so denied him would be determined by the relative amounts of his taxable income and his nontaxable income. The portion of his expenses on which he is denied a deduction increases as he buys more tax exempts. Since he pays taxes on his taxable income in progressively higher brackets as either (1) his net income increases, or (2) his deductions from a constant gross income decrease, the effect of decreasing his deductions as a consequence of buying municipal bonds is the same to the taxpayer as though a progressively higher income tax were being levied directly against each increment of the interest he receives from municipal bonds.

That this scheme will constitute a substantial tax burden on the buyer of municipal bonds, hence a substantial deterrent to purchase by individuals of municipal bonds is demonstrated by the Ways and Means Committee Report. At p. 83 it projects a tax revenue for 1970 of $205 million annually in consequence of the allocation of deductions, for 1980 a tax revenue from this source of $460 million, the increase of $255 million being due in its entirety, apparently, from the progressively greater denial over a 10-year period of d.ductions in consequence of the income received from interest on municipal bonds.

This presents almost the exact reverse of the case of *United States* v. *Atlas Life Ins. Co.*[17] There a formula which required both taxable and tax exempt income to be allocated between reserves and stockholders' equity was sustained. The Court said (p. 250):

". . . Under the 1954 formula investing in exempt securities results in a lower total tax than investing in taxable securities and the tax rate per taxable dollar does not increase."

At page 251:

". . . In the last analysis Atlas' insistence on both the full reserve and exempt-income exclusions is tantamount to saying that those who purchase exempt se-

(Footnote continued from previous page.)

379 (1931) (State franchise tax based on net income of corporation including income from Federal copyrights upheld); *Plummer* v. *Coler,* 178 U.S. 115, 117 (1900) (State inheritance tax measured by the value of U.. . bonds transmitted upheld). *Snyder* v. *Bettman,* 190 U.S. 249 (1903), and *United States* v. *Perkins,* 163 U.S. 625 (1896), sustained the reciprocal right of the State and Federal Governments to tax legacies to the other.

The essentiality of the function affected was given primary consideration in the following: *New York* v. *United States,* 326 U.S. 572 (1946) (State sale of bottled mineral waters subject to Federal excise tax); *Allen* v. *Regents of the University System,* 304 U.S. (1938) (admission to State athletic contests subject to Federal admissions tax); *Brush* v. *Commissioner,* 300 U.S. 352, 370 (1937) (New York municipal water system an essential State function immune from Federal taxation) *Helvering* v. *Powers,* 293 U.S. 214 (1934) (salaries of trustees appointed by State to operate business enterprise (street railway) subject to Federal income tax); *Ohio* v *Helvering,* 292 U.S. 360 (1934), and *South Carolina* v. *United States,* 199 U.S. 437 (1905) (State owned or operated liquor business subject to Federal excise tax); *Weston* v. *Charleston,* 2 Pet. (U.S.) 449 (1829) (invalidating a city tax upon "stock of the United States"); *United States* v. *Baltimore & O. R. Co.,* 17 Wall. (U.S) 322 (1873) (supra). See also *Commissioner* v. *Shamberg's Estate,* 144 F. 2d 998 (2d Cir. 1944), certiorari denied, 323 U.S. 792 (1945) (dictum that New York Port Authority is essential governmental activity).

Another class involves State taxes which were struck down because of the paramount character of the Federal function which they would have burdened: *Osborn* v. *United States Bank,* 9 Wheat. (U.S. 738 (1824); *M'Culloch* v. *Maryland,* 4 Wheat. (U.S.) 316 (1819) (invalidating a State tax on bank notes issued by a Federal bank).

A class of cases must be recognized in which a Federal tax was sustained as ancillary to a delegated Federal power, for example, relating to foreign commerce or the protection of the national currency, irrespective of the directness of the burden on the State or the essentiality of the function of the State thereby affected: *Trustees of University of Illinois* v. *United States,* 289 U.S. 48 (1933) (denying a State immunity from Federal customs duties on imports); *Veazie Bank* v. *Fenno,* 8 Wall. (U.S.) 533 (1869) (sustaining a prohibitively high tax on State banknotes).

[17] 381 U.S. 233 (1965).

curities instead of taxable ones are constitutionally entitled to reduce their tax liability and to pay less tax per taxable dollar than those owning no such securities. The doctrine of intergovernmental immunity does not require such a benefit to be conferred on the ownership of municipal bonds."

Here, no one contends that one who purchases taxable securities is entitled to pay "less tax per taxable dollar than those owning no such securities." What we find unconstitutional in Section 302 is its requirement that those who purchase exempt securities shall pay *more* tax per taxable dollar than those owning no such securities who receive the same taxable income. Such is the consequence of allowing greater deductions, in calculating the taxable dollar, to those who own no exempt securities than to those who do own exempt securities.

Compare *National Life Ins. Co.* v. *U.S.*,[18] which invalidated a formula which, the Court said in *Atlas*, supra, had the result "that a company shifting its investments from taxable to non-taxable securities would have lowered neither its taxable income nor its total tax." Section 302 would produce an even more drastic result. If it becomes law, an individual shifting his investments from cash to non-taxable securities will increase both his taxable income and his total tax.

Proposed Amendments to H.R. 13270 by Northcutt Ely, Ely & Duncan, General Counsel, American Public Power Association

TITLE III

Explanation of proposed amendments

These amendments delete provisions of section 301, Limit on Tax Preferences for Individuals, Estates, and Trusts, and section 302, Allocation of Deductions which would otherwise include in those sections the interest earned by a taxpayer on bonds issued by state and local governments.

AMENDMENTS TO TITLE III

P. 166, line 24: Strike all commencing with "(C) Interest" through line 12, page 167.

P. 167, line 13: Change "(D)" to "(C)".

P. 167, line 20: Change "(E)" to "(D)".

P. 168, line 22: Strike all commencing with "(5) Transitional" through line 2, page 169.

P. 171, line 9: Change "(D)" to "(C)".

P. 174, line 6: Strike all commencing with "(to" up to but not including the colon on line 7, page 174.

P. 175, line 18: After "(B)" strike the comma and insert "and".

P. 175, line 18: Strike the "and" following "(C),".

P. 175, line 19: Strike "(D),".

P. 175, line 21: Strike all commencing with "(B) Interest" through line 2, page 176.

P. 176, line 3: Change "(C)" to "(B)".

P. 176, line 20: Change "(D)" to "(C)".

P. 178, line 6: Strike "s" making the word "amendments" singular.

P. 178, line 7: Strike all commencing with "(1) Section 265" through line 23, page 179.

P. 179, line 24: Strike "(2)".

TITLE VI

Explanation of proposed amendments

These amendments delete provisions authorizing the Secretary of the Treasury to subsidize interest expenses of state and local governments electing to subject their bond issues to federal taxation. They also delete provisions establishing permanent annual appropriations to finance the deleted federal interest subsidy.

[18] 277 U S. 508 (1928). See also *Missouri Ins. Co.* v. *Gehner*, 281 U.S. 313 (1930), restricted in *Denman* v. *Slayton*, 282 U.S. 514 (1931), and *Helvering* v. *Independent Life Ins. Co.*, 292 U.S. 371 (1934).

AMENDMENTS TO TITLE VI

P. 317, line 19: Strike all commencing with "(a) Election" continuing through line 14, page 318.

P. 318, line 15: Change "(b)" to "(a)".

P. 318, line 22: Change "(c)" to "(b)".

P. 319, line 5: Change "(d)" to "(c)", strike the "s" following "date" making it singular, and strike all commencing with "The amendments" through "section" in line 8, page 319.

P. 319, line 8: Change "(b)" to "(a)".

P. 319, line 10: Strike all commencing with "Sec. 602" and continuing through line 14, page 321.

Senator JORDAN. I want to thank you for a very soundly reasoned presentation. I have heard you before many committees, not this one but other committees, and you always make a good witness, and you have made a good witness today.

Mr. ELY. Thank you.

Senator JORDAN. Let me see if I understand you correctly. Did I understand you to say that in the time that the Congress has been considering changes in municipal bond rates and handling of municipal bonds that there has been a tendency to close the gap between municipals and industrials of the same grade?

Mr. ELY. That is correct, Senator Jordan. Whereas 2 years ago, and historically, there had been a spread on the general order of 2 percent between the municipal yield, or the amount that municipalities had to pay on their bonds, and on the corporate yield, more than half of this spread has now been eroded.

There has been testimony here as to the effect of taxation on the municipal yield. I have heard two figures presented here: one of the order of 2 percent, one of the order of 1 percent.

The higher figure, in my judgment, is more nearly representative because it represented the historic spread before taxation was threatened. One percent more nearly approximates the current disparity after the tax threat has materialized.

Senator JORDAN. Did I understand you to say that over a given period the rate on municipals grew 2½ times as fast as the rate on comparable industrials?

Mr. ELY. The increase in the cost of money?

Senator JORDAN. Yes.

Mr. ELY. This increase was 2½ times greater with respect to municipals than corporates in the period from February 3, 1969, to September 4, 1969.

The statistics are that the yield on municipals had to rise 146 basis points during that time to make top-grade municipals salable. The yield on corporates had to rise only 57 basis points to make those issues salable.

Senator JORDAN. And you identify that February 5 as being coincident with the time that the House committee started getting publicity on this?

Mr. ELY. This is the date on which the House Ways and Means Committee published the Johnson administration's proposals which contained essentially the limitation on tax preferences and allocation of deductions. Our measurement period begins 2 days prior.

I could have picked an earlier date in December, for example, when word of these proposals began to leak, and had I done that, the rise in yield would have been much higher than 146 basis points.

In fairness, if I may, I must add one footnote.

After Secretary Kennedy spoke here on September 4 and opposed the limitation on tax preferences there was a very interesting development. The yield on municipals improved. It dropped 12 points in reaction to the administration's opposition to the limitation on tax preferences.

By contrast, the yield on corporates continued to worsen by 12 points. This indicates the sensitivity of the market to rumors and changes in the threat of taxation, as well as the overall continuing vulnerability of the market to the possible passage of this bill.

Senator JORDAN. Well, that is an interesting comment, that Secretary Kennedy's statement before this committee had the effect of stabilizing municipals even though industrials continued to rise.

Mr. ELY. To some degree and, perhaps, for a short time. But that was the market reaction to the Secretary's testimony.

Senator JORDAN. Now, I was going to ask you, do you think the market has fully discounted the effect that the enactment of this bill would bring about?

Mr. ELY. No, Senator Jordan. I have no crystal ball, obviously, but informed experts with whom I have talked seemed to feel that if the bill became law the situation would be worse than it is now under the threat of the bill being enacted.

So long as there is substantial hope that this committee and the Senate will decisively repel this effort to tax municipal bonds, the battle is not over and the ultimate crisis in prices of municipals has not occurred.

If the protection of municipal credit should collapse and this bill becomes law, I would expect much worse. The yield, they tell me, will come very close to the corporate yield, and more than that, the small municipalities cannot market bonds even at the corporate yield. They would have to offer much higher than that.

Who is going, for example, to buy the taxable bond of a small drainage district in Arizona or an unknown school district in Idaho, the States that you gentlemen are so familiar with, if it is taxable in competition with the bonds of United States Steel or a debenture which is convertible into equity?

There is no true measure of the damage to be done to small municipalities by the destruction of their lending power.

Senator JORDAN. Of course, we have had recommendations, this committee, that the Government guarantee of all municipals would have a tendency to make those low-grade municipals that you have mentioned in that order attractive to bond buyers inasmuch as the Federal Government would be the guarantor.

Also that the Federal Government would subsidize the interest, the difference in interest, and this would give them marketability when they otherwise would not have it, be acceptable.

I think you answered that when you said that this would give local government the power to invest in Federal money on a long-term basis without proper scrutiny from anybody.

Mr. ELY. That is correct. Either that or the alternatives, that you would have two Pentagons full of officials pressing on thousands of municipal bond issues every year.

Senator JORDAN. Thank you.

Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Ely, I want to commend you for a very sound, thoughtful, and impressive statement. I appreciate the information you have given us, and I certainly am in agreement with the chaotic conditions that have been created, with what you say. I do not know whether you were here when the Governors testified or not yesterday.

Mr. ELY. I was unable to be here, I am sorry to say.

Senator FANNIN. They were emphatic in their position that turnabout is fairplay. If the Federal Government decided to tax their State and local bonds that they would have the right or would feel it fair and equitable for them to tax Federal securities. Would you like to comment on that?

Mr. ELY. Well, Senator Fannin, certainly that turnabout would be fairplay.

Senator FANNIN. But disastrous.

Mr. ELY. But, as a lawyer I would have to say I would have to dissent from the constitutional possibility of that coming about. There are Federal statutes which now prohibit State taxation of Federal securities, and I think the supremacy clause of the Constitution would sustain that statute.

Senator FANNIN. I understand that. But also, of course, the position taken by the Governors that from a constitutional standpoint the Federal Government could not tax municipal bonds.

Mr. ELY. Well, I do not like to be the devil's advocate, but I think there is separate constitutional support for a Federal statute that denies powers to the States to tax Federal instrumentalities or Federal securities—the supremacy clause.

I think Congress does have the power to protect by legislation Federal securities from taxation by the State even though a Federal tax on State securities should be held to be constitutional. I would hate to see that result.

Senator FANNIN. I mean, I was just explaining what the Governors stated. I was not taking a position one way or the other because I think this would be disastrous if this had to be fought out in the courts.

Mr. ELY. It might very well be, Senator Fannin, that a determined effort would follow in the Congress by the States to do exactly this, to withdraw the protection against State taxation of Federal bonds. You might have Federal bonds going through the same uncertainty that municipal bonds are now subjected to by the pendency of adverse Federal legislation.

Senator FANNIN. Yes, I understand.

When you brought out about this allocation of deductions, because of my question, the reason I asked that question was because we have had many questions about the allocation of deductions, and also the limit on tax preference, but I understood from reading some of the testimony there might have been a difference of opinion is the reason that I asked the question.

But I know that testimony of others has very much misled the people of this country, that much of the concern today is because, I think, of the erroneous information which has been disseminated throughout the Nation.

For instance, and I recall hearing the argument, that for every $1 saving to local government by these tax-free municipal bonds, that it cost the Federal Government $2. Well, if you just take one particular instance and cite that as an example of what can happen then you are not following down two or three steps to see the overall effect, and that has been brought out very forcefully, especially when we see what the bond market is doing today, but unfortunately we are in the position where timing is so essential. We wish that something could be done to assist. Just like you were talking about what Secretary Kennedy had said, if it meets the approval of the Finance Committee, do you think it will be advantageous if the position were known by the general public or by the bond marketing people what position this committee will take?

Mr. ELY. I think your thought is excellent, Senator Fannin. I think it is essential that the public and the market be reassured by an emphatic rejection by this committee of the proposals to tax municipal bonds, both the limitation on tax preference and the allocation of deductions, and I think it would have a salutary effect in restoring the stability of local government financing if this committee did that.

I think an indecisive, indeterminate result perpetuates the uncertainty. But what is essential is that Congress, particularly the Senate, emphatically reject that, and I must say that I am impressed by the care with which this committee is conducting its hearings.

Unfortunately, in the House, the Ways and Means Committee, with all respect to that great committee, held 1 day of hearings on that subject, and all the discussion after that was behind closed doors in executive session.

This committee is giving to this subject the care it deserves, and I hope you give the answer that it should have.

Senator FANNIN. I certainly agree we are faced with a very dramatic problem; that is, we would like to do that. We would also like to get an answer to the questions that we are facing, that the committee is facing, and facing the Nation in regard to what may be done, and so we are just torn between these two problems. We certainly do not want to rush through and carry through legislation that will be troublesome from this time on, and still we do not want to delay to the point that it is going to create greater problems in the financial market.

So I am just asking that question as to what you thought would be the effect if we could, as we go along, perhaps come to some reasonable conclusion perhaps on municipal bonds.

I am concerned about holding hearings, and giving great study to many problems, many issues and stimulations in this legislation.

Mr. ELY. I think we all want tax reform, and if this committee should announce an interim decision that it had considered the proposals to tax municipal bonds and rejected them and was going on to other, more significant and constructive phases of tax reform proposals, it would be a salutary thing to do without waiting for the final report of the committee, which may be delayed.

Senator FANNIN. I certainly appreciate that, and I agree with you. I do not know exactly what can be done, but I realize the position we are in today so far as municipalities are concerned, and with all the tax-exempt issues under consideration.

I certainly appreciate your testimony, and I would be anxious to read some of the other information that you have furnished to us.

Mr. Ely. Thank you, Senator Fannin.

Senator Fannin. Thank you.

Senator Jordan. Thank you, gentlemen. Thank you, Northcutt Ely. It is good to see you again.

Mr. Ely. Thank you very much.

(The statement of Richard Wilson, referred to previously follows:)

Statement by Richard D. Wilson, General Counsel, Consumers Public Power District of Nebraska on Behalf of the American Public Power Association

Summary

Provisions of H.R. 13270 regarding taxation of municipal bond interest will increase the relative burdens of the lower income individual and will complicate the Federal income tax system. Such provisions will increase the costs of local governments, and those local governments will pass on the increases to their inhabitants. Such services as water, bridges, electricity, toll roads, and other public services will increase in cost. Those costs are significant to the lower income individual, but they are insignificant to the individual with a high income. These increased costs will not be balanced by increased Federal revenues because bond buyers will increase the interest rates based on the possibility of broadened Federal income taxation rather than on the narrow provisions of H.R. 13270.

Many local projects may cease to be feasible and this will increase facilities that must be provided by the Federal Government or hurt the lower income individual by taking away facilities he needs.

The new complications introduced by these provisions are pointed out, and a Federal income tax subsidy is opposed because of the additional Federal controls and regulations which will be required.

Statement

Consumers Public Power District is a political subdivision of the State of Nebraska owning and operating electric generating, transmission and distribution facilities extending to virtually all parts of Nebraska except the Omaha area. In making this statement today, I am also authorized to state that Omaha Public Power District, Loup River Public Power District, Central Nebraska Public Power and Irrigation District and Nebraska Electric Generation and Transmission Cooperative Inc., all public organizations engaged in providing electric service in Nebraska, concur in opposing provisions of H.R. 13270 relating to taxation of interest paid on State and local government obligations. My client, Consumers Public Power District, sold $286,000,000 in revenue bonds to the public last year; Omaha Public Power District, Loup River Public Power District, and Central Nebraska Public Power and Irrigation District have large amounts of revenue bonds outstanding, and the financing of projects required for providing essential public service in Nebraska will require additional bonds to be sold by some or all of them in the future. In connection with this proposed legislation, I am also chairman of a Task Force of American Public Power Association to advise it on provisions relating to interest paid on local government bonds.

Provisions of H.R. 13270 which relate to taxation of interest on State and local government bonds might be summarized as follows:

Title III, Section 301.—Provisions in this Section would result in the payment of income tax on interest received from State and local government bonds in certain cases. This may be referred to as the limited tax preference provision.

Title III, Section 302.—In this Section there are provisions which would require certain individual taxpayers to allocate part of their personal deductions against their income from State and local government bonds so that their receiving such income would result in their paying a higher income tax than if they had not received that income. These provisions are referred to as allocation of deductions.

Title VI, Sections 601 and 602.—There is provision for a State or political subdivision to elect to issue bonds the interest from which will be taxable, and the United States will pay an interest subsidy so as to reduce the interest payments made by the State or a local subdivision. This has been referred to as the interest subsidy provision.

We urge that the provisions for including interest paid on State and local government bonds in the limited tax preference and in the allocation of deductions as well as the provisions for an interest subsidy should be eliminated from this legislation. Why? Because the result of these provisions will not be tax reform, but will be a shifting of the over-all cost of government from those with higher incomes to those with lower incomes and will also be new tax complications rather than simplifications.

There can be no doubt that passage by the Congress of a law that results in placing a Federal income tax on interest from State and local government bonds will substantially increase the interest that will have to be paid by the State and local political subdivisions, and the States and local government subdivisions will, in turn, have to exact more from their local inhabitants. This will raise the cost primarily of services provided by local government, which cost burdens the small taxpayer, not the large. For example, charges for electricity supplied by local governments are an insignificant item to the rich, but they are a much more significant item in the budget of a poor person. These new tax provisions would necessarily increase the charges for electricity made by local political subdivisions. By the same reasoning they would also increase the charges for water, parking, bridges, toll roads, parks, schools, fire departments and other items financed by the issue of bonds. Amounts paid by the lower income taxpayer for such local government services are substantial relative to his income, but they are negligible relative to the income of a rich man. Thus, the poor man is hurt.

Will the lower income taxpayer be helped by increased Federal income tax paid by wealthy holders of local government bonds? No. First of all, the increased revenue to the United States Treasury will be far less than the increased cost to State and local governments. If the United States imposes the taxes now included in H.R. 13270, thereafter every purchaser of State and local government bonds, regardless of whether or not H.R. 13270 taxes him, will require a higher interest rate due to the fact that if the United States has started the income taxation of local government bonds on a narrow basis, it can be expected in the future to broaden the scope of that taxation. Therefore the political subdivision will be paying and passing on to its inhabitants a cost based on the fear of what the United States will do in the future, and the cost will be far larger than any possible increased tax return to the United States.

Second, increased interest rates paid by the State and local government subdivisions can be expected to force the United States to finance and construct some of the facilities which are now provided by local governments so that any increase in Federal income tax will be more than offset by increased Federal construction expenditures. For example, in my own experience, public power districts in Nebraska have financed and constructed a large electric transmission grid extending into all parts of the State, and the United States Bureau of Reclamation uses that transmission grid to deliver electricity from its generating plants rather than having the United States construct its own transmission grid in Nebraska. The feasibility of financing, and therefore the ability to construct, some of these necessary lines can be lost if interest rates must be paid on the basis of interest subject to income taxation. In the same way the feasibility of financing and constructing bridges, roads, other transportation facilities, sewage treatment facilities and public buildings may be lost if interest rates on municipal bonds go up to the rate necessary to sell bonds on which the interest is subject to Federal income taxation. That hurts either the Federal Government, who must step in and supply the necessary facilities, or, if the United States doesn't do it, it hurts the lower income taxpayer who needs and will not have the public facilities.

The foregoing reasons why the limited tax preference with respect to municipal bonds and the allocation of deductions hurt the lower income taxpayer all assume that if Congress taxes municipal bond interest, the penalty to the local government will be only increased costs. However, in many cases the penalty may be the elimination of ability of the local political subdivision to borrow at all. If an investor has a choice between the bonds of an established national corporation and of a local and perhaps small municipality, under the present laws some have chosen the bonds of the local municipality, but if the tax consequences are the same, there is no reason to believe that the investor will buy any local government bonds at feasible interest rates for many of the projects which are now being constructed by political subdivisions.

At least in part, the purpose of a tax reform bill should be to simplify the tax structure. The municipal bond interest provisions contained in this Bill will greatly complicate the tax structure. Take for example the provisions for allocation of deductions. The forms and taxpayer calculations will require these additional determinations and calculations:

1. Does taxpayer have "allocable expenses"?
2. Do the allocable expenses exceed the limits set in H.R. 13270?
3. What is the amount of taxpayer's allowable tax preferences?
4. Are some of the amounts included in 3 excludable as interest from obligations issued before July 12, 1969?
5. What is taxpayer's section 277 fraction?
6. In the particular tax year under consideration, what percentage of the municipal bond interest is to be considered (this varies from 10 to 100 per cent)?

In a similar way, the limited tax preference provisions will add great complications and not simplification to the income tax laws.

It may be asked why local governments should oppose the option to issue taxable bonds and have the Federal Government pay an interest subsidy. First, I would like to point out that even under H.R. 13270 the election by the local government must be made "at such time, in such manner, and subject to such conditions as the Secretary or his delegate by regulation prescribes". Thus, the Federal Government is commencing its control over State and local government financing, and as the States and local governments continually increase Federal costs by increasing their issuance of bonds, it is certainly reasonable to expect increasing control by the Federal Government. No need for a Federal subsidy of local government bonds has been shown, such a subsidy will increase the Federal bureaucracy, and we oppose it. A Federal subsidy will not help the individual with a lower income—it will only increase Federal complications and controls.

For the foregoing reasons, as well as the doubts as to constitutionality and many additional reasons presented by others, we respectfully urge that provisions relating to interest on municipal bonds be eliminated from H.R. 13270.

Senator JORDAN. We are in recess until 9:30 tomorrow, and the hearings will be moved to the hearing room of the Finance Committee.

(Whereupon, at 1:40 p.m. the committee recessed to reconvene at 9:30 a.m., Thursday, Sept. 25, 1969.)

TAX REFORM ACT OF 1969

THURSDAY, SEPTEMBER 25, 1969

UNITED STATES SENATE,
COMMITTEE ON FINANCE,
Washington, D.C.

The committee met, pursuant to recess, at 9:30 a.m., in room 2221, New Senate Office Building, Senator Clinton P. Anderson, presiding.

Present: Senators Long (chairman), Anderson (presiding), Talmadge, McCarthy, Byrd of Virginia, Williams of Delaware, Bennett, Curtis, Miller, Jordan of Idaho, Fannin, and Hansen.

Senator ANDERSON. We will call the meeting to order.

We are honored to have as a witness today, the fine Senator from Nevada, Howard W. Cannon. Senator, proceed as you desire.

STATEMENT OF HON. HOWARD W. CANNON, A U.S. SENATOR FROM THE STATE OF NEVADA

Senator CANNON. Thank you, sir. As a Senator keenly aware of the need for tax reform to correct the inequities that exist in the present system, I am also concerned that in our efforts to improve the system we may—if we are not careful—create worse problems than we are attempting to alleviate.

It is for this reason that I feel compelled to bring to the attention of the committee the inherent dangers and potential folly of weakening the viability of our municipalities by removing the tax-exempt status of municipal bonds.

The crux of the problem is that municipalities simply cannot survive if they are forced to pay the prevailing market interest rate on taxable bonds. The outright elimination of the tax-exemption on interest from municipal bonds would create such a financial burden on the municipalities that they would either become insolvent or be forced to levy huge taxes on their residents.

Let me remind the committee that we are talking about the well-being, even the potential crippling, of such crucial services as police protection, water and sewage requirements, and the education of our citizens. These are the responsibilities that have traditionally, and for good reason, been placed upon local governments, who are most responsive to the needs and wants of the local populace.

To endanger this time-tested theory of government would render chaos to our cities and make a mockery of our tax reform.

Any freshman political science or history student can tell you of the importance of financial power to any governmental organization. Municipal governments are no exception. Caught between soaring interest rates, nationwide anti-inflation measures by the Federal Government, and State statutory restrictions, municipalities are in a fiscal bind.

Many States impose statutory rate ceilings. Making municipal bonds compete with taxable bonds in the area of interest rates offered would either financially destroy the municipal unit, put pressure on States for possibly unwise rate ceiling increases—which would pour fuel to our already overheated economy, or allow States without ceilings to benefit over others.

The sum and substance of the matter is that there is no such thing as freedom without financial independence. No municipality will have truly local government unless it has financial solvency.

With respect to the suggestion that the financial problem could be overcome by a Federal Government subsidy, let us remember the basic purpose of having local municipalities supply their traditional services. Such a subsidy would require local officials to make their decisions in the shadow of decisions made by Federal officials.

While our Government agencies provide a great service in furthering the governmental process, there is no reason to require bureaucrats of the Federal Government to make such decisions with regard to cities. We have trained and knowledgeable city managers, who are responsive to the needs and wants of the people in their area, who can handle the job much better.

It is not only unworkable, unreasonable, and needless, but it would be unduly wasteful to take money from local taxpayers, spend part of it to pay salaries for the bureaucracy to collect and distribute, and then send what is left back to the community as a so-called subsidy.

Another factor which must be considered is the possible excessive increase of Federal expenditures in this area, resulting in the well-organized, progressive, and well-functioning cities being burdened by their taxpayers having to foot the bill for ill-organized and ill-managed cities, thus putting a premium on financial irresponsibility and discouraging fiscal responsibility.

Denying the municipalities the right to issue tax-exempt bonds would eliminate their financial base; without their financial base, they cannot operate independently of the Federal Government. Without the necessary financial independence, our cities, already encumbered by statutory restrictions, would become political ghosts, without body or substance.

I urge this committee to support the fiscal independence of our cities, making them the viable and useful governmental unit they can be, by retaining the tax-exempt status of municipal bonds.

Senator ANDERSON. Thank you, Senator.

Now, I am very happy to welcome back C. Douglas Dillon, former Secretary of the Treasury and a very competent, highly regarded individual. We are very happy to have you.

STATEMENT OF C. DOUGLAS DILLON, FORMER SECRETARY OF THE TREASURY

Mr. DILLON. Mr. Chairman, before commencing, I would simply like to say that I am still a strong believer in the principle of tax reform. I believe that this bill provides an opportunity for major advances which should be made in improving the equity in our overall tax system.

However, in making such changes, I think it is essential that all consequences of each change be carefully considered, and in particular the effects on our general society of changes we may make.

One of the provisions in this bill seems to me to have very serious implications for our whole social structure. This is the allocation of deductions provision insofar as it affects charitable giving.

This provision will, I feel, have a very unfortunate effect on all charitable institutions—schools, universities, hospitals, and cultural institutions such as museums.

I will a little later tell you why the impact is so serious. The law is very complex, and I do not think that these institutions, although they realize it will harm them and have testified against it, yet fully realize how devastating the impact of this provision will be.

Now, it is perfectly all right for Congress to enact such a provision if they wish, but it should not be done without full consideration of the social problems involved. It seems clear to me that this aspect was never considered by the House or by the tax-writing authorities. They looked at this simply from the point of view of tax equity. There is not a mention anywhere in the House report of the effect of this provision on charitable institutions, and in the very excellent summary of the bill, prepared by the staff of the Joint Committee on Internal Revenue Taxation which very fairly sums up the pros and cons of each provision, there is again no mention whatsoever of the impact of this provision on charitable giving and on the institutions which live by such gifts.

So my plea today is basically that this committee and the Senate look very carefully at the social impact of this provision for the allocation of charitable deductions before they decide whether or not they will continue it in this bill. Personally, I think it should be removed from the bill entirely insofar as it affects charitable institutions and charitable giving.

Our country is unique in the world. Largely because of the tax benefit which has been in the law ever since the income tax law was enacted, allowing the full deduction of charitable giving up to some limit which has been 30 percent for the last 15 years, we have built up a series of privately financed, nonprofit institutions such as schools, colleges, hospitals, museums, and symphony orchestras that is simply unparalleled anywhere in the world. Their existence as privately financed institutions without reliance on Government for their funds is a unique source of strength to our country.

The great majority of the privately financed institutions of this nature have to rely on large givers for the bulk of their funds. Any money-raising expert who specializes in helping to raise funds for charity will tell you that 70 or 80 percent of the money raised in large campaigns has to come from large givers in amounts of $10,000 or up.

This situation is compounded today by the fact of the inflation we are going through, the sharp rise in costs which has hit all charitable institutions, and all nonprofit institutions, and which is putting them in a very difficult situation to continue. If at the same time we withdraw a substantial part of the tax benefits from gifts, particularly from large gifts which provide the bulk of their receipts, they will be caught in an impossible squeeze. They will face two choices—either going out of existence gradually and maybe not too gradually, or relying on the

Government to provide the funds that are necessary. These funds could be very substantial, far in excess of amounts that are indicated as any possible revenue pickup from this item.

The effect on givers of removing a substantial tax exemption which has been in the law ever since its inception, is simply equivalent to saying to them that the Congress no longer thinks that private giving to charity is as important as it used to be, that it is substantially less important and, therefore, presumably that the Government is prepared to pick up the difference. This will be very clearly understood by taxpayers, and they are in a position, simply by reducing their gifts to charity, to offset the impact of this provision, as an overall extra burden on them. If these larger givers choose to reduce their gifts as I think the great majority of them will, and many of them in very substantial amounts, they will have no extra burden at all as a result of this provision.

For that reason, the tax reform equity objective of this provision is nowhere near as important as are its adverse social implications.

Now, why are they so bad?

I became interested in this because I devote about half of my time or even a little more to nonprofit institutions. I am on the boards of many. When I heard that this provision was in the bill, I though we ought to get some facts. So I asked Price Waterhouse & Co. to prepare a hypothetical model to see what the impact of this provision for allocating charitable deductions would be on large givers. I told them to prepare this model using roughly my own income and my own charitable gifts as a basis to start from. The model is hypothetical and bears no relation to the figures in my own income return. They cannot be figured out in any way from this model. Nevertheless, the impact of the bill in the model is identical with the impact on me. I only say this to show what the impact of this provision would be on an actual taxpayer.

They have written a letter which is attached to my statement with a lot of tables and so forth in it—they made all the computations which they stand by. These computations show that 40 percent of this model taxpayer's gifts to charity would no longer be deductible under the House bill. That is under the whole House bill.

If you simply look at this one particular provision, some seven-eighths of this problem arises from this one provision. The overall tax to be paid by the model taxpayer would be increased by 24 percent, 21½ percent is due to this one provision allocating charitable gifts.

I then asked them what should be done if the taxpayer felt that he wanted to reduce his giving, as a result of this congressional indication that giving is no longer as important, so that he would be in the same economic position after this tax bill as he would be under the present situation. I was shocked and surprised by the result which came out that he would have to reduce his giving by 87 percent to be in the same position.

I then asked them if they could figure this in any different way to somewhat lessen this impact, and they said, "Well, there is one possibility. If the taxpayer was willing to disregard a substantial increase in his unrealized appreciation and pay his increased taxes out of cash, he would only have to reduce his giving by a little over 40 percent to be in the same position as before. I leave it up to you to imagine the impact on all our charitable institutions throughout the country if between 40 and 87 percent of giving should be halted.

I do not think the figure would be necessarily quite that high because some people will make gifts anyway even if it costs them considerably more. But practically all will reduce their giving by some amount. I would look personally for a reduction in charitable giving by individuals of something in the neighborhood of 35 to 40 percent if this bill goes through and becomes law. And this——

Senator ANDERSON. Mr. Secretary, is that light bothering you?

Mr. DILLON. No; this is all right.

This, I think, would be catastrophic for our present system which relies so heavily on private institutions to set the pace and to provide particularly the cultural strength which we have in this country.

Now, I would like to say one thing about a modification which was suggested by the Treasury. This would remove from the calculations of tax preference income the appreciation on securities given to charity. Certainly this is a step in the right direction, and it is a help. It would reduce the increase in taxes on the model taxpayer from this one provision from 21½ percent to 15 percent.

On the other hand, if one adopted the approach of putting oneself in the same economic position after this bill as before it would actually make no difference at all, and if one was willing to pay the extra tax in cash it would require a reduction of 34.8 percent in giving as against 40 percent, which means that it removes a maximum of only about 13½ percent of the taxpayer's problem.

The point of all this is the real problem is the provision for allocating charitable deductions and not the provision for including capital gains on such gifts, in tax preference income. That is only a minor part of the problem.

This is all I have to say on the subject. I simply plead that this committee carefully examine the impact of this provision on charitable institutions all across the country.

I would just like to say two other relatively minor things. I fully support the Treasury proposal to reduce the tax on foundations to 2 percent from 7½ percent, because the principle of the rest of the provisions regarding foundations, which I support, will insure that they give their money to charity, that they are properly regulated. Therefore there is no reason to have a punitive tax on them.

The extra 5½ percent would simply have to come out of the Government or would again be taken away from charitable institutions.

I also am chairman of the Acquisitions Committee of the Metropolitan Museum of Art in New York. I have seen the tremendous problems that would be caused by the provision denying recognition for the appreciation on works of art given to museums.

There was a problem in the taxation of these gifts and in their valuation when I was in Treasury. I took part in and initiated the idea of setting up a group of art experts that could advise the Internal Revenue Service. That was accomplished a year or two after I left the Treasury, and Assistant Secretary Cohen has stated that this has worked perfectly, and that there is no longer any problem. So I support the Treasury suggestion that this provision be removed from the bill.

Thank you.

The CHAIRMAN (presiding). I entered the room while you were testifying, Mr. Dillon. I am happy to see you here with us again. It seems like old times. You did a fine job for this Government when you made your services available, and we appreciate all you did for our Government during that time.

I would not ask any questions at this time.

Senator Anderson?

Senator ANDERSON. No questions.

The CHAIRMAN. Senator Williams?

Senator WILLIAMS. Mr. Secretary, I will still address you as Mr. Secretary. You realize that under existing law it is mathematically possible for a man making a gift to realize more cash at the end of the year by making the gift than he would if he sold it, paid his taxes and kept the proceeds. Do you think that should be changed?

Mr. DILLON. It is mathematically impossible for someone to make money by giving to charity; is that what you are saying? I recognize that. It should be realized by all concerned that it is not possible to make money by giving something to charity under the 70- and 25-percent capital gain rate or under the 65- and 32½-percent rate in the proposed bill.

There was a time when theoretically, and it exists now, under the surcharge, when if you figure the appreciated securities at zero and add in full capital gain tax on that, that you could figure that one has a tax benefit of more than 100 percent. That will disappear with the end of the surcharge. I am not sure that it is valid anyway, because it assumes the realization of the capital gain profit. Under present law that profit need never be paid and never be taxed if the individual keeps his securities until he dies and passes them along tax free. I think that is one of the leading problems with our tax system, and I believe that that should be corrected at some time in the future, and I understand the Ways and Means Committee said they would address themselves to that question later.

Senator WILLIAMS. Well, it is possible under existing law for——

Mr. DILLON. With the surcharge, I think that is correct.

Senator WILLIAMS. It would be possible without the surcharge.

Mr. DILLON. No. I do not think so. You can gain 70-percent tax reduction and then you can gain 25 percent on your capital gain which is 95 percent, and you lose the other 5 percent. I cannot see how you would gain any.

Senator WILLIAMS. Perhaps in your State you do not have it, but in many of the States we do, including mine—we have a State tax that would run as high as 10 to 12 percent, and that, too, has to be paid. When you add the State tax to the Federal tax, you can actually end up ahead even with the 70-percent bracket today. I am just asking you if you do not think that is a situation that should have been corrected long ago and certainly should be corrected now.

Mr. DILLON. I do not think anyone should make money in giving to charity. I quite agree with you, yes.

Senator WILLIAMS. Do you think they should get the same treatment, or do you think there should be some actual contribution made by the donor?

Mr. DILLON. I think people should pay an equitable share of their taxes, and I favor the elimination of the unlimited charitable deduction which will reduce charitable giving, but I think that in this case the improvements in tax equity outweigh that reduction. I do not think that is the case in this across-the-board allocation of deductions provision.

I also favor the principle of the limit on tax preferences so people will pay a fairer share.

When it comes to an individual, I do not think anyone should make money, and I would not object to a special provision in the law that some costs should apply to every charitable gift. But I do not favor this provision which says that 40 percent of a person's charitable giving would be disallowed. I think that goes too far from the point of view of its social effect.

I do not care to argue on that, the tax equity problem. I think you can make a very strong argument, and it has been made here, about the tax equity, about this sort of a change. But I think you have to weigh this against the social factor in destroying all our privately financed nonprofit institutions. I think that social impact is far worse than any improvement in equity.

Senator WILLIAMS. Do you think they should be permitted to break even, or do you think there should actually be a cash loss to the man who is making the gift?

Mr. DILLON. I think a gift should be a gift, and there should be some tax impact.

Senator WILLIAMS. Yes.

Mr. DILLON. In my State, you are quite right. I probably was insensitive to this because I come from New Jersey where we do not have a State income tax.

Senator WILLIAMS. Now, you referred to a prospective change in the laws and the Ways and Means Committee dealing with it where there are estates passing without any tax. If I recall correctly we have an inheritance tax running up to 75 percent and it starts after the first $60,000. What did you mean when you said we should correct the present practice of where an estate can be passed without taxes? Are you referring to the establishment of a trust, or should they be added to accumulation, or what were you referring to?

Mr. DILLON. No, I was referring to the absence of either the taxation or carryover of basis on capital gains at death which I think should be remedied. Under present law, as you know, there is no taxation of capital gains at death, and the capital gains tax can be entirely avoided if the gains are not realized prior to death.

Senator WILLIAMS. How about capital losses if an estate passes with capital losses? Would you offset the estate tax with the capital loss of the estate or would you just wash those out?

Mr. DILLON. I do not understand that problem. I would think they would probably be on the net basis, capital losses against capital gains; yes.

Senator WILLIAMS. But suppose, just suppose, the question has been raised, you have one estate that is passing on a million dollar estate, and has a capital gains of a half million dollars, but you have another estate passing on a million dollars and it has a cost factor of a million and a half, you have a loss of half a million. How would you treat the two?

Mr. DILLON. Just the same way as treated under present income tax.

Senator WILLIAMS. Under the present law you can carry forward but you cannot carry forward with a dead man.

Mr. DILLON. That is right; I do not think you would give credit for that.

Senator WILLIAMS. You would give no credit for the loss, but you would tax the gain.

Mr. DILLON. That is right.

Senator WILLIAMS. Would you carry forward that same proposal for banks today?

Mr. DILLON. Banks?

Senator WILLIAMS. Yes; if they have capital losses this year they can write off their capital losses against their regular normal income. If a bank, for example, has a million dollars profit, they can establish a million dollar capital loss in their bond sales, they can wash out their taxable income. That is not extended to individuals.

Mr. DILLON. No; that is a special provision for banks.

Senator WILLIAMS. That is right. Do you want to keep that or would you want to change it?

Mr. DILLON. Basically the House bill I think does change that, and although I have a connection with some banks, I do think that in principle that is a good change.

Senator WILLIAMS. You think it should be changed?

Mr. DILLON. Yes, I do.

Senator WILLIAMS. Do you think it should be changed so that they can only write off their capital losses against capital gains?

Mr. DILLON. That is right.

Senator WILLIAMS. You think that should be changed and you would recommend that this bill should be so amended.

Mr. DILLON. I thought that was in this bill.

Senator WILLIAMS. It is not entirely, but it could be put in. Are you recommending it?

Mr. DILLON. I do not feel that I am competent to go into the exact detail of——

Senator WILLIAMS. You underestimate your qualifications.

Mr. DILLON. But I do think that basically the special provisions that have been available to banks have been larger than they should be and should be reduced.

Senator WILLIAMS. To the extent that this bill does not do it, you think it should be so modified.

Mr. DILLON. To the extent it does not do so equitably—this is the detail—as I say, I do not pretend to be a complete tax expert, I do not know all the functions of banks, but I do think they have certain special privileges that go far too far, and I think many bankers would be willing to realize that.

Senator WILLIAMS. No further questions.

The CHAIRMAN. Senator Talmadge?

Senator TALMADGE. Mr. Secretary, it is good to have you back before the committee again.

Mr. DILLON. Thank you, sir.

Senator TALMADGE. As you know, the House-passed bill makes some rather substantial changes in tax treatment of municipal bonds. For the last several days we have had a vast array of Governors, county commissioners, mayors, and other representatives of municipal, county, and State governments who testified I believe unanimously, against those House-passed provisions. They stated that the House bill has already thrown the bond market into a chaotic state of disarray and advanced municipal bonds tremendously in price. In the final analysis the excess cost of the municipals would fall on the taxpayers of the various States and municipal governments and counties, largely in the form of increased taxes on homes and perhaps sales taxes. The increased tax would be far greater than the increased revenue under the House-passed bill.

I believe that you, as Secretary of the Treasury, on March 31, 1965, held a press conference in which you proposed taxing municipal bonds; is that still your view today?

Mr. DILLON. Senator, that is a complex problem. From the point of view of tax equity I do not think there is any case for the exemption of income on municipal or State bonds, and I have always felt that.

But this is a system that is embedded in our economy, it is the way in which our municipalities and States have been able on their own to raise substantial sums of money. Any change in that of any substantial character would have very severe effects on the States and municipalities and force them to turn even more than they are to the Federal Government for funds.

It seems not very consistent, at a time when the Congress is considering some sort of revenue sharing with the States and municipalities to improve their situation, to make it more difficult for them to raise funds.

So, because of this I did oppose any tinkering with this provision while I was Secretary of the Treasury, and I continue to do so today.

However, I would like to say one thing: the suggestion of a subsidy which has been made by some that would be payable by the Federal Government to States and municipalities if they sold fully taxable bonds is a new and interesting one since I made my statement. The proponents of this system say that it might actually benefit the States and cities. They could get their money cheaper. I do not know whether that is true or not. I think the proof of the pudding is in the eating. So I think that under present circumstances I would favor an experiment which would provide a trial of this method, but I would not couple that with provisions which reduce the deductibility of the interest on State and municipal bonds at the same time. I would wait and see if this thing worked as an alternative, a free alternative that they could use, and if it turns out that it is more attractive to States and municipalities, as some say, well then we could think about legislation that would remove the deductibility of interest on future bonds because no one then would care because they had shown that they preferred the other system.

But I certainly would not couple the two, and of course that is what is done in this present bill, which has, as you say, affected the bond market quite seriously. Yesterday I noticed that for the first time municipalities trying to sell public housing bonds, which are tax free and which are guaranteed by, in effect, by the U.S. Government, were unable to sell these bonds because there were no bidders at the ceiling of 6 percent for a tax-free U.S. Government-guaranteed bond—which is something pretty difficult to contemplate.

Senator TALMADGE. Am I to conclude then from your response, Mr. Secretary, that you would recommend to the Senate Finance Committee that we strike the two provisions regarding the municipal bonds, the limited tax preferences area and also the allocation of deductions?

Mr. DILLON. These provisions have affected the bond market, and I would certainly think this is a dangerous thing. It would be bette: not to have them in the bill.

However, I would keep in the bill the alternative of a Treasury subsidy for taxable State and municipal bonds and just see whether this works. If it works as its proponents believe, then and only then would I move on to consideration of the removal of tax exemption on new State and municipal bonds. I do not, when I say keep it in, I do not mean necessarily in the exact form it is presently in. It is a very complex provision and maybe it could be improved in language. This applies to many of the provisions in this bill, which was put together much faster than has ever been the case before.

But I think the idea is worth trying and should be tried.

Senator TALMADGE. Thank you, Mr. Secretary.

The CHAIRMAN. Senator Byrd?

Senator BYRD. Thank you, Mr. Chairman.

Mr. Secretary, you mentioned the interest subsidy to the States on the municipal bonds, State bonds. The Federal Government is now paying in this year's budget $17 billion in interest charges. Do you feel the Federal Government can stand additional interest charges by subsidizing State and local bonds?

Mr. DILLON. Yes, Senator, because, while this would be an extra subsidy, it would only be paid where the State and local bonds that had been issued were fully taxable, and so the new tax revenue would presumably increase by an amount that was roughly equivalent to the subsidy. So there should not be any net drain on the Federal Treasury. This would just be handled in a different manner. That is why I am not sure that this system will work because it sounds a little bit like magic. It does not cost you anything, and you work out this better system and everything is better for the States and cities, it is more equitable taxwise and it does not cost anything, so I would like to see it tried to see if it works. It sounds almost too good to be true, but if it did work it would be, as I say, an improvement.

Senator BYRD. I feel like you. It sounds as if you get something for nothing, and I do not believe you ever get something for nothing.

Now, Mr. Secretary, to get back to your testimony, did I understand you to say that under the proposed legislation that 40 percent of charitable—of a charitable contribution would be disallowed?

Mr. DILLON. For this model taxpayer, which model was created by Price Waterhouse, which, I think, is typical of most large-scale givers, that would be the case, yes.

Senator BYRD. If we might go to another area, could you indicate—you are an outstanding and able businessman, you were an outstanding, thoughtful public official—as to the appropriate depletion allowance for oil?

Mr. DILLON. This is a complex problem. I would just say two things about it. I think that it has become a symbol of tax preference. As such, it probably is almost better for the oil industry, to have this symbol removed or mitigated, this idea that they have this big tax preference.

As to the economic impact of changing the depletion allowance, I think we have got to realize that that impact will be borne largely by the general public. Oil companies today do not make more on their overall capital than other companies, other industries, and so in effect the benefits of 27.5 percent depletion have been passed largely along in the form of lower gasoline prices.

I would think that now that this situation has arisen that it would probably be better all around to reduce the depletion allowance somewhat, maybe not to 20 percent, but to reduce it so it is more in line with other depletion allowances and let the economy adjust, which it probably would through an increase in the price of gasoline to some amount.

But we ought to keep clearly in mind, we are just doing this to achieve a more general posture of tax equity, we are not attacking an industry which is making exorbitant profits because the oil industry is not making such profits as a result of the depletion provision.

Senator BYRD. Your recommendation to the Finance Committee would be that the oil depletion allowance be reduced below the 27.5 percent.

Mr. DILLON. I would take a position which I understand the Treasury has taken, which is that they are prepared to accept such a reduction. They did not enthusiastically recommend it. We never recommended it when I was in the Treasury, although we did recommend the removal of certain specific tax preferences which were not accepted at that time by the Congress.

I do think that there are a number of such preferences that are highly technical that should definitely be changed.

The depletion allowance has become a symbol, and, therefore, it is important even though its economic impact will be primarily charged to the purchasers of the end product.

Senator BYRD. Do you feel the holding period of capital gains should be increased from 6 months to 1 year.

Mr. DILLON. Yes, sir; I do. We proposed that when I was in the Treasury. I still believe it. The opposition to this is that it reduces the liquidity of the general market. I think that may be so to some extent, but the market has been so liquid, and it has had such a tremendous volume that there has been a problem of paperwork keeping up with that. I think the 6 months' holding period has stimulated overactivity of so-called go-go funds looking for very quick capital gains, which is not healthy. All in all I think a 12-month period would do no harm and would improve the health of our economy.

Senator BYRD. Thank you, Mr. Secretary.

The CHAIRMAN. Mr. Secretary, I would like to ask just one or two things about this overall bill which you have not testified to.

You were a big advocate of the investment tax credit during your years as Secretary of the Treasury. The argument was that this would help to stimulate the economy, and, to use John Kennedy's term—you were his Secretary of the Treasury—to get the country moving again, and it undoubtedly did. It stimulated tremendous amounts of investments in new plant, in new equipment, and things of that sort.

Now, we have a recommendation that it be repealed. In addition, the accelerated depreciation advantages are reduced. The charts that undertake to show how class by class they get something on the one hand and lose something on the other just do not reflect the fact that the people who are in the $25,000 and over brackets are, generally speaking, the ones who hold the corporate stock and are going to lose whatever is taxed away from these corporations in terms of investment tax credit and accelerated depreciation.

I am trying to get the facts on that to try to make those charts reflect that, because there were about $4 billion of additional taxes on the investing class of the public which does not really reflect itself in the charts which have been made available to us.

Now, I would like to ask you if we are going to take out all of these incentives to invest, and even increase taxes on some industries such as oil and other natural resource industries, are we not going to need something more than we have in this bill to try to provide some of the incentive that is being removed for people to invest money on the theory they can make something, they can keep some of it?

Mr. DILLON. Mr. Chairman, as far as the investment tax credit is concerned, I am in a minority view. I felt that the investment tax credit was necessary to put our country in a competitive position with other countries around the world. All of them have such a credit. It was needed to help us to modernize our equipment so that we could better compete with them in world markets and in our own markets against imports. I do not see that that situation is changed at all. In fact, because of the inflation, our competitive position in the world is worse today than it was at the time we suggested the investment tax credit. I think that the need for continued modernizing of our plant and equipment so that we can reduce costs is still highly important.

The long run effect of the investment tax credit is encouraging reduction of costs is certainly not inflationary. Quite the contrary. Therefore, when this was put in, I took the position that so far as the Treasury was concerned, this was permanent legislation and should not be changed. I regret very much that that feeling no longer holds. I think we should maintain the investment tax credit. It is very difficult for me to understand the logic of removing the investment tax credit and trying to make up for it by a reduction of a couple of points in the overall tax on corporation income.

I think it would be much preferable to keep the investment tax credit and center the incentives not just on all corporate income but on income that is used to modernize our plant and equipment.

As I say, I am in the minority on this, but I have not changed the view I had at the time it was enacted.

The CHAIRMAN. Now, this bill represents a heavy assault on capital gains, not just this 6-months holding period but it hits capital gains in five different ways. In addition to that, it eliminates the investment tax credit and reduces substantially the advantages of accelerated depreciation.

And of course it also taxes State and local government securities. It appears that the general theory of the bill is that business people will have no choice, that they are going to be taxed heavily on what they do, and that they will have to invest their money somewhere, presumably in the United States. I am well aware of the fact that at least there are some business people who say if you are going to do this to us, we are going to take our money out of this country as fast as we can and put it in Canada where we do not pay a tax on capital gains for example.

Are you concerned at all about the possibility of the flight of capital from this country in the event that taxes do get to the point where business people feel that there is not adequate incentive to invest their money here?

Mr. DILLON. Well, certainly if they should feel that, then this would be a problem.

I do think that the great bulk of people will continue to invest their money in the United States.

As to the increase in capital gains in this bill, again I have mixed feelings. As I said, I am all for the change in the holding period. The increase from the top rate of 25 percent to 32.5 percent and the simplification is involved in removing the alternative way of treating one's income tax is a good simplification. I do not think that it would necessarily have a major impact except for the fact that under our present system, as I have pointed out, one does not need to pay any capital gains tax at all, if one holds securities until the time of death.

This has resulted, even with the 25 percent rate, in a freezing of investment; particularly as individuals get older, they are unwilling to pay that 25-percent tax. They do not sell, and that is obviously not good for the economy.

The increase in the rate to 32.5 percent would obviously make that situation worse. That was the reason that, when we made our recommendations in 1963, we recommended that a tax be imposed on capital gains passing at death and as some compensation for that recommended a reduction in the rate of the capital gains tax, not an increase, with the idea that this would make capital much more fluid because people would know the tax was going to be paid eventually, and so, therefore, would be willing to ignore it in investment decisions.

The Ways and Means Committee was not willing to consider that at the time and thought it should be considered with the estate tax. This was a very logical approach, and therefore nothing was done either way.

The present bill, at least until such time as the estate tax is modified, would decrease the liquidity of the market and, therefore, would be bad from an economic point of view.

However, there are certain tax equity advantages, and personally, taking all these things into account, I would be perfectly satisfied with whatever decision Congress decided to make. I do not feel very strongly one way or another.

The CHAIRMAN. I felt we had to do something in capital gains, but I did not have in mind hitting it five different ways as they do in this bill. I think that is generally your impression about it.

Mr. DILLON. Yes.

The CHAIRMAN. Senator Curtis came into the room while we were interrogating the former Secretary, and I will call on Senator Curtis.

Senator CURTIS. Mr. Dillon, it is good to have you back. I plead guilty to being a little rougher in my questioning of Government witnesses than I am taxpayers. In times gone by I might have been a little rough with you, and so I am delighted that I can ask you a question or two this morning.

As you view the House bill, is it true there will be instances where the tax incentive will be to not give to charity?

Mr. DILLON. Well, I think that is the great——

Senator CURTIS. I mean based strictly on the tax bill.

Mr. DILLON. Yes. Basically that is the thrust of my testimony.

Senator CURTIS. Yes, I understand that.

Mr. DILLON. And I feel that this allocation of deductions provision, as it applies to charitable giving, would be a clear decision by the Congress that it no longer felt that giving to private nonprofit institutions was as important as it has been for the last 50 years. The mere fact of giving does increase one's taxes as this computation shows, the fact of giving increases taxes here by 21.5 percent. People will feel that this is a tax on gifts and, as a result, there would be a very substantial reduction in giving to charity by large-scale givers. This would not apply to little gifts to churches which could still get along all right.

But all these institutions such as universities, colleges, museums, and hospitals that rely on relatively large gifts would be very seriously hurt.

Senator CURTIS. That would be true to perhaps only a lesser degree under the Treasury recommendations, too.

Mr. DILLON. Yes, only moderately lesser. The Treasury recommendations are an improvement and as such I welcome them. But they only handle a very small portion of the problem. The major problem is the allocation provision.

Senator CURTIS. I am very pleased to have you say that, because I am firmly convinced that a broadside attack upon givers and foundations is going to change our way of life in this country. The burden carried by contributors to our cultural institutions, our colleges, universities, our hospitals, and our research centers, is very great, and it has its benefits far beyond the dollar amount.

I will ask you one or two questions about foundations. Do you feel that the Congress has sufficient information that we ought to enact the divestiture provisions of the proposals in the House bill in reference to foundations at this time, especially when it brings in no revenue at all? I am referring to those provisions that would require a foundation to divest ownership in a company if it exceeded a certain percentage.

Mr. DILLON. Well, I think in a good and properly run foundation, that it does not make any difference what proportion they own of a particular business.

However, there are many that have not been run in that way and where some benefit has seemed to inure to the people who originally gave to the foundation through the ability to continue control of a corporation on a tax-free basis. Therefore, as a matter of principles I see no reason not to pass some law limiting the proportion that a foundation may own in a particular business, to some figure and the 20 percent figure in the House bill seems unexceptional.

I have talked to a number of foundations that are affected by it, and they do not seem to object to it, although I know there are a few that object very seriously to it.

Senator CURTIS. What about the foundation that has been run definitely in the public interest, has given substantially all or we might say all of their income to appropriate causes, and has not engaged in any self-dealing or the other abuses but happens to have as its principal asset quite a portion of the donor's company? That is what disturbs me.

Mr. DILLON. I think they are getting penalized for the faults of others, but that has happened before. I do not think the penalty is really too serious on them, so I would be willing to accept it.

There is one thing in the House bill that I do think should be modified in this connection. That is future gifts of securities of this nature, according to the House bill, would have to be divested in a period of 5 years while present holdings could be kept for 10 years. I do not see any logic in that provision. If we are going to encourage large-scale giving to charity, I would think that the 10-year provision should apply in both cases.

Senator CURTIS. I am glad to see that you concur with the Treasury that we do not tax at 7.5 percent but probably go down to say 2 percent. That would enable the Treasury to do a complete auditing of the foundation so after a few years we would have more accurate information to act wisely in this area, will it not, if we do not reach all the problems at one time?

Mr. DILLON. That is certainly true, and I think a more careful and more complete audit is desirable. So this 2 percent figure which would finance that seems proper and, as I understand it, the great bulk of foundations are perfectly willing to pay such a charge. Any additional tax seems very unnecessary, if we are going to make sure that foundations use their funds properly and make sure that they pay out a reasonable amount to charity every year. It seems no sense to add to that what is in effect a punitive level of taxation which simply reduces the amount by which foundations can support other operating nonprofit institutions. It means that those institutions will have to get these funds elsewhere, and there is no elsewhere except the Government in one form or another.

Senator CURTIS. I will not take any more time. I thank you very much.

The CHAIRMAN. Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Good morning, Mr. Dillon. Do you have any comment on the proposal to include appreciated gift property in the limit on tax preferences schedule?

Mr. DILLON. Well, I think that basically the limit on tax preferences is wise. It cuts off at 50 percent, and I do not have any strong feelings on what is done there because, while this would reduce giving to charity somewhat, it would still leave 50 percent, and I do believe that everybody should make a substantial contribution to Government through paying taxes. I do not believe, important as giving to charity is, that that should be a vehicle by which people give nothing to Government, which was the case of the unlimited charitable deduction.

I think the limit on tax preferences just carries that question a little bit further, and I favor the principle of it. I have not looked at exactly how it would work in this case, and that is why I say I favor the principle of it. I am not sure the way it is written in the House bill is the best way. There have been other proposals for handling a limit on tax preference, and there may be better ways of doing it. But I do not object to the principle, and if that means the inclusion of some appreciation of charitable gifts given to charity in that particular computation with 50 percent of it not included, I have no objection to that. I do object to an across-the-board attack on charitable giving or an across-the-board removal of incentives that have been in our system ever since the income tax was enacted.

Senator MILLER. Well, to the extent that the limit on tax preferences approach might impinge upon an occasional large giver, would not or could not that be covered either by a carryover of the unused portion or by some other means?

Mr. DILLON. Certainly it could, and I presume it should be; yes.

Senator MILLER. So you would advocate that as a means of softening the——

Mr. DILLON. Yes; I think if there is no carryover—I have not studied that provision carefully, but certainly if someone wants to make a one-time, very large gift during his life, I think he should be allowed the carryover. I thought there was some such provision in the bill.

Senator MILLER. But you run into the problem of what happens to the person who makes the gift maybe with a very short expectancy of life ahead of him, and then dies the next year or the year after, and then the unused carryover is gone.

Mr. DILLON. I guess that is too bad.

Senator MILLER. Well, some of our educational institutions——

Mr. DILLON. You never like to die.

Senator MILLER. Some of our educational institutions are concerned about that.

Mr. DILLON. Yes; I can see that.

Senator MILLER. But the point you are really making, Mr. Dillon, is if you are going to try to strike a balance so that somebody will be paying some tax——

Mr. DILLON. That is right.

Senator MILLER (continuing). That this would be a preferable way to do it.

Mr. DILLON. That is right.

Senator MILLER. Now, this is not directly related to your testimony, but I think it fits with the general idea on this charitable giving problem.

As you undoubtedly know, the House bill contains an increase in the optional standard deduction from 10 to 15 percent and from a maximum of $1,000 to $2,000.

The Treasury has come over and recommended a 12-percent and $1,400 limit. Would you favor reducing those figures somewhat and allowing both the optional standard deduction and charitable contributions on top? I understand from a number of people involved in charities that increasing the standard deduction will discourage rather than encourage charitable giving, granted that it comes from the lower income brackets, and they would prefer to see the optional standard deduction increase reduced with the trade-off being an allowance for charitable contributions in addition to the optional standard deduction.

Mr. DILLON. It is very difficult, Senator, to figure out the figures on that. I think when the standard deduction was first put in, the same arguments were used. Obviously if people can have a standard deduction that they would take anyway, then they can take it and give nothing away and get the full benefit of it. To that extent in smaller gifts they do not have a tax incentive.

However, I think my basic feeling would be that the simplification involved in increasing the standard deduction is useful and helpful and should not be further complicated. For most of the smaller givers, the tax benefit of a gift is not so very great because their taxable rates are not so very high. So my guess is that the impact of that would not be overly serious, and I think I would favor the simpler approach of the increase in standard deduction.

Senator MILLER. Well, we have to make a decision of whether or not the simplification——

Mr. DILLON. That is right.

Senator MILLER (continuing). Is more important than a little additional work, to have a little schedule instead of a page 2 deduction——

Mr. DILLON. It is always a question of choices and it is very difficult.

Senator MILLER (continuing). For charitable contributions.

Thank you very much.

The CHAIRMAN. Thank you very much.

Senator WILLIAMS. May I have just one question?

Mr. Secretary, I remember when you were Secretary of the Treasury, and Mr. Bell, I think, was the Director of the Budget and you were testifying before the committee, and at that time the chairman and some of us were expressing concern at some of the deficits, and we were given the answer that these deficits were deliberately planned in order to create a planned inflation, but that you could control this inflation, and the plan was to control this inflation, so that it would never exceed 3 percent.

I remember the chairman of the committee commenting that he questioned whether you could have planned inflation and control it any better than you could have planned pregnancy and control that.

Now, in the light of developments since that time, what is your opinion on planned and controlled inflation?

Mr. DILLON. I still feel exactly the same way as I did before. When you are in a position where the economy is operating way below capacity, this is the only way to bring the economy up to capacity. The only problem is that beginning in 1965, the obvious actions that were required by economic reason were not taken, and the inflation went out of control. It had been moderate and up to that point beneficial, and had not shown an increase in prices which were absolutely level during the period 1960 through 1965. The wholesale price index in 1965 and 1966 began to shoot up in an uncontrolled manner. I believe that it is far more difficult to control an inflation once it has started than to stop it before it is begun.

Therefore, I much regret the policy that was followed in that period of 1965 and 1966, which allowed this inflation to gain momentum. I guess I am old fashioned enough to believe that the idea that we can stop inflation and control it without any pain, which has been put forth by a number of economists, is simply not true. While it is vitally important to stop it, that process will be somewhat painful.

Senator WILLIAMS. In other words, the chairman was somewhat right, the abortion would be a little painful.

Mr. DILLON. He was right in his consideration of human nature.

The CHAIRMAN. I do not recall what the chairman had in mind, but it was not me.

Senator WILLIAMS. No, the chairman at that time was the Senator from Virginia.

Mr. DILLON. He was making an observation that was based on his profound knowledge of human nature which turned out to be right because, faced with this problem, neither the administration nor the Congress did the right thing in 1965 and 1966, and we wound up in a very serious inflation.

Senator WILLIAMS. That was the point he was making, when the time came to control it, there would be a reluctance on the part of both the administration and the Congress to take the necessary steps, and by not taking them too late——

Mr. DILLON. There would not have been on my part if I had still been there.

The CHAIRMAN. Thank you very much, Mr. Secretary. We very much appreciate your statement. Each one of us would like to interrogate you at length, but we have Mayor Yorty and others who are to testify this morning, and we very much appreciate your coming here and giving us the benefit of your views.

Mr. DILLON. Thank you, Mr. Chairman.

(Mr. Dillon's prepared statement follows:)

STATEMENT OF THE HONORABLE C. DOUGLAS DILLON

I am here today to testify in opposition to the provision in H.R. 13270 regarding the allocation of charitable deductions. This provision requires that deductions of charitable gifts be allocated proportionately between taxable income and so-called tax preference income. The result would be that charitable deductions would no longer be fully deductible from adjusted gross income as at present.

Our present system of full deductibility for charitable gifts has been in effect for my entire adult life and longer.* It has led to a growth, unknown elsewhere in the world, in privately financed schools, colleges, hospitals, museums, operas and symphony orchestras as well as in other more specialized charitable organizations. This, to me, is one of the unique strengths of our free enterprise system. Over the past two generations it has produced results unparalleled in other countries, where such institutions are almost invariably under the control of governments. If provision for the allocation of charitable deductions contained in H.R. 13270 were to be enacted, it would mean the end of the privately financed aspect of practically all these institutions. Sooner or later they would have to receive the bulk of their support from government or go out of business.

The provision for allocation of charitable deductions contained in H.R. 13270 is actually a major piece of social legislation directed against *all* privately financed charitable institutions. It should be recognized as such, and could well be known as the Death Sentence for privately operated charitable institutions. This is strong language but I mean every word of it, and I feel certain that the facts support my position.

I speak today in my capacity as President of the Board of Overseers of Harvard College, as a Vice President of the Metropolitan Museum of Art, as a Governor of the New York Hospital, as Chairman of the Brookings Institution and as a member of the governing boards of a number of other non-profit institutions. I do not speak as a complaining taxpayer for the impact of this provision can be readily avoided by any individual merely by reducing or eliminating his charitable donations. Thus this provision should not be thought of as tax reform. For it does nothing to spread the tax bu den more evenly. It does not introduce greater equity into our tax system. It will raise little or no revenue, and will not increase the tax burden of the wealthy, all of whom can and most of whom will reduce their charitable contributions as necessary to avoid or minimize any additional burden. As a result its impact on charitable giving is likely to be devastating.

*1917—15% of taxable income computed without regard to charitable contributions.
1942—15% of taxable income computed without regard to charitable contributions and medical expenses.
1944—15% of adjusted gross income.
1952—20% of adjusted gross income.
1954—30% of adjusted gross income.

Certainly it is fully within the prerogatives of the Congress to enact legislation of this nature. The Congress may feel that our social system should be radically revised; that the government should take over the financing of all hospitals, universities and cultural institutions. If this is the opinion of the Congress, then this legislation is appropriate to carry out the Congressional will and should be enacted. If Congress, however, feels, as I most intensely do, that our privately financed, non-profit institutions are a vital source of strength to our society, and should be preserved, this provision for the allocation of charitable deductions should be stricken from the bill. Above all, such a far reaching social change should never be made under the false impression that it is tax reform and therefore good.

In considering this matter, we should always be aware of two things. First, charitable contributions are a voluntary matter, wholly subject to the donor-taxpayer's control. Second, all gifts involve a reduction in the donor's net assets even when taken as a deduction in determining taxable income. Thus, at the present 70% rate on ordinary income and 25% rate on long term capital gains, a gift involves a 70% direct credit against taxes and a minimum of 5% to a maximum of 30% reduction in the donor's net assets if both cash and appreciated securities are given. Under present law, where it is possible to avoid capital gains tax entirely by holding appreciated securities until death, the reduction in the donor's assets for a gift of appreciated securities is likely to be the full 30%. There is simply no way that I know of that a taxpayer can improve his overall financial position by giving to charity.

But this is not the only question involved. There is also the question of fair shares. I firmly believe that all citizens who can do so, should make a fair contribution to the cost of government. So I strongly favor putting an end to the privilege of unlimited charitable deduction, and I also favor the principle of the Limit on Tax Preferences. By measures such as these, we can make certain that all citizens pay a fair share of the costs of government without any major damage to the interests of charitable organizations.

Now a word as to why the provision for the allocation of deductions will have such serious effects on privately financed non-profit institutions. It is a well known fact that, with the exception of churches and a few institutions that rely on numerous small gifts, all large-scale, charitable money raising ventures must obtain at least 70% and often up to 80% of their funds from large givers. It is also a fact that some 70% of the total funds raised by our larger charitable institutions are in the form of gifts of appreciated securities. Clearly anything that shuts off this source of funds from non-profit institutions merits the title of Death Sentence which I have applied to the provision for the allocation of charitable deductions.

In order to illustrate the impact of this provision on large givers I asked a leading auditing firm. Price Waterhouse & Co. to prepare a model tax return for me. In preparing the model I asked them to choose a round figure of adjusted gross income and then to divide the income in the model in accordance with my own tax return. This means that the tax impact on me of H.R. 13270 is exactly the same as that shown in the model. I fully realize that each individual taxpayer would have a different situation, but I feel that the results shown in the case of the model taxpayer would be essentially similar for the great majority of large scale givers to charity. There is attached to this statement a letter from Price Waterhouse & Co. with annexes giving detailed figures and explanations of the working of the model. I will allude here only to the major results of applying the provisions of H.R. 13270 to the model tax return.

First of all, under the provisions of H.R. 13270, the model shows approximately 39% of total income in the form of so-called tax preference income. Of this total 27.3% is tax free interest from holdings of municipal securities, 30.9% is long-term capital gains excluded from income, and 39.3% represents the appreciation of securities given to charitable institutions—none of which were private foundations. The remaining 2.5% represents minor amounts of other tax preference income. If it were not for gifts to charity, total so-called tax preference income would be reduced to 27.7% of total income.

The overall effect of the bill on the model taxpayer would be to increase taxes by 24.2% over present law, provided he continued to make charitable contributions as in the past. Of this increase 88.8% represents the impact of the allocation of charitable deductions together with the classification of appreciation on gifts to charity as tax preference income. The model shows the full 30% of adjusted gross income permitted under the code going to charity. Larger gifts are made in appreciated securities; and make up 85% of the total. Smaller gifts are made in cash and make up the remaining 15% of charitable contributions. The model shows that, under the allocation of deductions provision 40.1% of charitable gifts would no longer be deductible. At the 65% top rate of income tax provided for 1972, and with only 59.9% of each dollar given being deductible, less than 39% of charitable giving would be a direct tax reduction compared to 70% today. In other words, after taking account of the potential capital gains tax not presently due on securities contributed to charity, the cost of making a gift will be increased for the model taxpayer from 8.8% to 48.4%, that is, the cost of each gift will be over five times what it is now.

When I realized the heavy impact of this provision I asked Price Waterhouse & Co. how much contributions would have to be reduced under this bill to leave the taxpayer in an identical financial position to that under present law with 30% of adjusted gross income going to charity. The answer was even more shocking than I had imagined. To be in the same position under H.R. 13270 as at present charitable contributions in the model would have had to be reduced by over 93%.

When this answer was received I attempted to modify the result in every way possible. First I asked that the computation be reworked to eliminate everything except the net impact of the requirement to allocate charitable contributions. The answer came back. To fully offset this one provision, contributions would have to be reduced by 87%.

Let me make it clear that these computations were carried out by the accountants so as to leave the taxpayer in exactly the same position as under present law. This involves raising the funds to pay the increased taxes through the sale of securities that would otherwise have been donated to charity. This process involves the realization of additional capital gains which in turn increases taxes, thus requiring the sale of still more securities.

If the increased taxes were to be paid in cash and the taxpayer were willing to ignore a substantial increase in potential future tax liability on his unrealized capital gains as compared to present law, the required reduction in contributions would be considerably less. However, they still would have to be reduced by 40.1%. I leave it to you to imagine the impact on charitable institutions of a provision that would require a reduction of from 40% to 87% in large contributions in order to offset the effects of a Congressional decision to substantially lessen the incentives to private charitable giving.

I note that the Treasury Department in testimony before your Committee has recommended that appreciation of securities given to charity be eliminated from the classification of tax preference income as defined in H.R. 13270. I welcome this recognition of the problem. Unfortunately, however, the Treasury proposal is far too modest. Its effect would, at least in the model, be minor. The accountants have calculated that, on the basis of the Treasury proposal, there would be an overall increase in tax of 17.8% of which 84.7% would be due to the allocation of charitable contributions. Because of the complexities of the law the reduction in contributions required to fully offset this allocation of charitable gifts would be unchanged from that required by the House bill. However, if the taxpayer were willing to accept an increase in his potential tax liability on unrealized appreciation, the reduction in contributions would be 34.7% as compared to 40.1% in H.R. 13270. In other words, at the best the Treasury proposal would only eliminate 13½% of the problem; at the worst it would be no help at all. This is why I must characterize it as well intentioned but wholly inadequate. What is required is nothing less than the total elimination of the allocation of dedutcions provisions as far as it applies to charitable dedutcions. It must be recognized that solely by reducing the top tax rate from 70% to 65%, the cost of charitable contributions borne by large givers will be increased to a maximum of 35% from the present 30%—an increase of 16⅔%. Because of the benefits from the reduction in rates, this increase in the cost of giving can safely be ignored. But it should not be forgotten.

Finally, I would like to stress what is clear in all of what I have said. Taxpayers can readily offset the burden of the allocation of charitable deductions by reducing their giving. If such legislation is enacted it would be a clear signal that the Congress considers that the national interest is less well served than in the past by the continuation of private financing for our major charitable institutions. Large givers could not fail to draw the conclusion that their giving was no longer as essential as in the past. The result would be sheer catastrophe for our privately financed charities, and a change of epochal importance in our whole social system. When it is realized what is involved it is most difficult for me to see how the Congress can fail to strike this crippling provision from H.R. 13270. I strongly urge you to do just this.

Before I close I have two comments on other matters. First, I very much favor the Treasury proposal to reduce the tax on foundation income from 7½% to 2%. This is enough to pay for an intensive policing of foundation activities. Anything more merely transfers that much of the burden of charitable activities from the private sector to the government budget.

Second, in my capacity as Chairman of the Acquisitions Committee of the Metropolitan Museum of Art in New York, I strongly urge support of the Treasury proposal to strike from H.R. 13270 the provisions which would disallow all appreciation on works of art given to museums. When I served in the Treasury I was instrumental in starting the process which lead to the creation of a special advisory group of art experts to advise the Internal Revenue Service on problems arising in this area. As Assistant Secretary Cohen has stated, this Advisory Group, along with improved audit programs, has substantially eliminated the problems that once existed in this area. Therefore, there is now no need to kill the goose that lays the golden eggs as would certainly be the case for all museums if the provisions of H.R. 13270 on donations of works of art were allowed to stand.

PRICE WATERHOUSE & Co.,
New York, September 18, 1969.

Re: Effect of proposed tax changes on charitable giving

Hon. C. DOUGLAS DILLON,
New York, N.Y.

DEAR SIR: As you requested, we have analyzed the provisions of the proposed Tax Reform Bill of 1969, as passed by the House of Representatives and hereinafter referred to as H.R. 13270, as they would apply to the taxpayer in the accompanying "Taxpayer Model" which we understand is patterned after your own case but in which actual amounts have been proportionately disguised. Based on this analysis we have determined the effect of:

I. H.R. 13270; and

II. H.R. 13270, modified only by the Administration's proposal to eliminate long-term appreciation on contributed property from tax preference income.

on the amount of charitable giving if the taxpayer desired to remain in essentially the same economic position, after taxes and charitable contributions, as he would be in under present tax rules. There are other provisions in the Administration's proposal which have been ignored for this model taxpayer.

On the basis of the information and assumptions stated in the "Taxpayer Model" accompanying this report, we have determined that:

I. Federal income tax would increase by $90,000. (i.e., from $371,600. to $461,600.) as the result of H.R. 13270 if charitable contributions were not altered in response to the proposed changes;

II. Federal income tax would increase by $66,000. (i.e., from $371,600. to $437,600.) as the result of H.R. 13270, modified by the Administration's proposal, if charitable contributions were not altered in response to the proposed changes; and

III. Charitable contributions would be reduced from $300,000. to $20,900., a reduction of $279,100., were the taxpayer to pay the tax increase imposed on him by H.R. 13270 by reducing his gifts of appreciated securities to charitable organizations and, instead, selling sufficient amounts of them to provide funds for such payment. Our calculations show on this basis that this taxpayer could give *no* appreciated securities to charities, and, in fact, would have to also reduce cash gifts. The identical result is also reached under H.R. 13270, modified by the Administration's proposal, due to the differing effect of the allocation of deductions fraction in this instance relative to the H.R. 13270 case alone.

Also included for your information in the accompanying "Taxpayer Model" is, in our opinion, a complete analysis of the proposed tax law changes in comparison with the present tax rules.

Yours very truly,

PRICE WATERHOUSE & Co.

TAXPAYER MODEL

General

Under the present Internal Revenue Code, a married taxpayer has both taxable and tax exempt income. The taxpayer who is in the highest tax bracket normally follows the practice of making charitable contributions to the extent allowable as a deduction for Federal Income Tax purposes.

Being informed of H.R. 13270, the taxpayer realizes that the provisions of H.R. 13270 will result in an increase in tax when such tax is calculated on the same income and deductions under both the present and proposed laws.

Since the tax increase is substantially attributable to the required allocation of charitable contributions and the inclusion of long term appreciation on securities donated to charity in tax preference income, the taxpayer is interested in knowing by what amount he must reduce charitable giving to enable him to maintain the same after-tax financial position.

The taxpayer is also interested in knowing the effect of the Administration's proposal solely with respect to the elimination of long term appreciation on contributed property from tax preference income with respect to the above mentioned contribution reduction.

Maintenance of after-tax financial position

To pay the increased Federal Income Tax through the reduction of contributions, the taxpayer must determine the point where the funds provided by a reduction in contributions equals the increase in Federal Income Tax—

1. As computed under H.R. 13270 over the Federal Income Tax, which he would expect to pay, as computed under the present Internal Revenue Code; and

2. or as compared under H.R. 13270, modified by the Administration's proposal as explained above, over the Federal Income Tax, which he would expect to pay, as computed under the present Internal Revenue Code.

Criteria

To develop the formula required to mathematically calculate the payment of the increased Federal Income Taxes noted above, it was necessary to satisfy certain criteria. They are—

1. The maximum amount of *desired* contributions to be made.
2. The type of recipients of such contributions.
3. The form (cash and/or appreciated property) which the contributions will take.
4. If aprpeciated property is to be given, the character of the gain which would be realized had the taxpayer instead sold the property.
5. Precisely estimated amounts for all elements of income and expense which have a tax consequence.

Assumptions

The above criteria were satisfied by the following assumptions which apply to the taxpayer:

1. The desired maximum amount of contributions to be made by the taxpayer is $300,000. This amount corresponds to 30% of adjusted gross income as calculated under the present Internal Revenue Code and is consistent with the taxpayer's charitable giving practices as established in prior years.

2. The recipients of the gifts will be publicly supported charities which are eligible for the 30% deduction under the present Internal Revenue Code and the 50% deduction under proposed H.R. 13270.

3. The charitable contributions will be in the form of cash and appreciated securities. Since many organizations promote a cause which is worthy of some recognition, the taxpayer wants to make small grants of cash to them. Other organizations are more favored for various reasons and, therefore, large gifts of appreciated securities will be made. The security contributions will be reduced before the cash contributions. Of the $300,000. total desired contributions, the taxpayer expects to make $45,600. in cash and the balance of $254,400. in appreciated securities.

4. The securities donated will be securities which, if sold, would constitute a long term capital transaction. Since the taxpayer's cost basis in the securities to be given is negligible, it is assumed for this model that such securities have no tax basis.

5. The estimated income and expense data, furnished by the taxpayer and detailed on Schedule A, are considered sufficiently accurate estimates on an annual basis.

(a) Except for the level of contributions which is adjusted appropriately in response to the effect of the proposed changes in tax liability and the tax liability itself, all of these other income and deductions are considered to remain constant in amount and composition between a year under present rules and a year under proposed rules.

(b) Certain "transitional" rules contained in H.R. 13270 have ceased to be applicable, and all of its provisions are considered fully in force for the purpose of the tax computations. This affects primarily the treatment of interest on municipal obligations. It is further assumed that all of these bonds owned by the taxpayer were issued after July 11, 1969 and that municipalities have not elected to issue taxable obligations.

(c) The present and proposed tax surcharge is ignored since it is considered a transitory feature.

(d) No effect is given to the changes in any state and local income taxes paid by the taxpayer which are attributable to the proposed federal changes.

Inorease in Federal income tax

Based on the above assumptions, it was possible to compute the Federal Income Tax under the present Internal Revenue Code. This, then, is the amount of tax the taxpayer would expect to pay in the taxable year notwithstanding any revisions in the tax laws. This amount too, then, must remain constant in calculating the point where funds provided through reduction in contributions equal the increase in the tax computed on the proposed bases over the tax computed on the present Code.

The computations of the Federal Income Tax at the maximum desired contribution level of $300,000. with $45,600. in cash and $254,400. in appreciated securities, zero tax basis, and detailed analyses of the effects of the proposals on such tax as compared with the present tax appear on Schedules B through B-7.

Reduction in contributions

The reduction in contributions was calculated on the basis of the assumption that the securities, withheld from charity, were sold to provide money to pay Federal Income Tax in order to allow the taxpayer to remain in the exact same economic position, after taxes and charitable contributions. The validity of this assumption and the substantiation of the resulting reduced contribution level is illustrated in Schedules C through C-4.

The calculation of the charitable contributions which the taxpayer could still make to produce the desired reduction in contributions and corresponding payment of tax required the use of a complicated mathematical formula since the sale of securities to produce cash, in itself, incurs additional direct tax and, further, affects the allowability of the remaining charitable contribution and other allocable deductions under the proposed rules.

The application of this mathematical formula, programmed for computer applications, produced the following *applicable to both H.R. 13270 and H.R. 13270 Modified By Administration's Proposal:*

	Total desired contribution	Required reduction	Balance for contribution	Percentage reduction
Cash	$45,600	$24,702	$20,898	
Appreciated securities	254,400	254,400		
Total	300,000	279,102	20,898	93.03

Computation of reduced contribution level

Scehdule D shows the computer program used to calculate the required contribution reduction and other supplemental information. This program was developed from formulae, which have been reviewed and found reasonable, provided by the taxpayer. *It is understood that this program is primarily applicable to this particular taxpayer since it incorporates the various provisions of the proposed laws only as they apply to such taxpayer.*

However, it illustrates the fact that any particular taxpayer could have his own situation analyzed and formulated to quickly determine the effects of his charitable giving upon his Federal Income Tax even though the proposed provisions are extremely complicated.

Schedule D-1 illustrates the result of applying the computer program in this taxpayer's situation.

Other assumptions with respect to contribution reduction

Schedule E sets forth the required contribution reductions should the taxpayer avail himself of other alternatives available to him in reducing his contributions to offset increased tax.

SCHEDULE A

TAXPAYER MODEL

DETAILS OF INCOME, DEDUCTIONS, AND OTHER FACTORS WHICH ARE ASSUMED TO REMAIN CONSTANT (AS FURNISHED BY TAXPAYER)

I.	Income items		
	Salary	$ 12,800.	
	Ordinary dividends (after exclusions)	822,000.	
	Other interest	600.	
	Partnerships, trusts and small business corporations	(45,900.)	
	Business income	10,500.	
	Total ordinary income		$800,000.
	Fifty percent of total long term capital gain		200,000.
II.	Nonallocable deduction items		
	Nonallocable deductions		45,800.
	Personal exemptions (husband and wife)		1,200.
III.	Allocable deduction items		
	Taxes and noninvestment interest		23,600.
IV.	Tax preference items		
	A - For limit on tax preference		
	Excess of acceleiated over straight line depreciation		1,800.
	Fifty percent of total long term capital gain excluded from income		200,000.
	Net "Tax Exempt" municipal bond interest		176,400.
	B - Additional items for allocation of deductions		
	Excess of intangible drilling and development costs over deductions allowable if capitalized		14,600.
	Statutory allowance		(10,000.)

TAXPAYER MODEL

SCHEDULE B

COMPUTATION OF FEDERAL INCOME TAX AT MAXIMUM DESIRED ($300,000) CONTRIBUTION LEVEL

	Present Internal Revenue Code		H. R. 13270*		H. R. 13270 modified by administration's proposal**	
INCOME						
Ordinary income	$ 800,000.		$ 800,000.		$ 800,000.	
Fifty percent of total long-term capital gain	200,000.		200,000.		200,000.	
Adjusted gross income computed without regard to disallowed tax preference provision	1,000,000.		1,000,000.		1,000,000.	
Disallowed tax preferences from Schedule B1	Not applicable		None		None	
Adjusted gross income		$1,000,000.		$1,000,000.		$1,000,000.
Itemized deductions						
Allocable:						
Contributions	300,000.		300,000.		300,000.	
Other	23,600.		23,600.		23,600.	
Total allocable	Not applicable		323,600.		323,600.	
Nonallocable	45,800.		45,800.		45,800.	
Total itemized deductions		(369,400.)		(369,400.)		(369,400.)
		630,600.		630,600.		630,600.
Exemptions		(1,200.)		(1,200.)		(1,200.)
Taxable income without allocation		629,400.		629,400.		629,400.
Disallowed allocable deductions		Not applicable		129,667.		92,744.
Taxable income		629,400.		759,067.		722,144.
Fifty percent of total long-term capital gain		(200,000.)		Not applicable		Not applicable
Ordinary taxable income		$ 429,400.		$ 759,067.		$ 722,144.
Tax per married taxpayers filing joint return						
Rate table on ordinary taxable income						
$110,980. plus 70% of excess over $200,000.		$271,560.		Not applicable		Not applicable
$228,180. plus 65% of excess over $400,000.		Not applicable		$ 461,574.		$ 437,574.
Fifty percent of 50% of long-term capital gain		100,000.		Not applicable		Not applicable
Total tax liability (without tax surcharge)		$ 371,560.		$ 461,574.		$ 437,574.
Increase over tax prepared on basis of present internal revenue code				$ 90,014.		$ 66,014.
Percentage increase over tax prepared on basis of present internal revenue code				24.23%		17.77%

* The computations under H. R. 13270 assume that all provisions are fully effective and that municipalities have not elected to issue taxable bonds.

** The computations under H. R. 13270 modified by administration's proposal are identical to those under H. R. 13270 except that long-term appreciation on securities given to charity are not included in "Items of Tax Preference."

SCHEDULE B1

TAXPAYER MODEL

COMPUTATION OF DISALLOWED TAX PREFERENCES AT MAXIMUM DESIRED ($300,000.) CONTRIBUTION LEVEL

	H.R.13270	H.R.13270 modified by administration's proposal
Items of tax preference		
Long term appreciation on securities donated to publicly supported charities	$ 254,400.	Not applicable
Excess of accelerated depreciation over straight line depreciation	1,800.	$ 1,800.
Fifty percent of total long term capital gain excluded from income	200,000.	200,000.
Net municipal bond interest	176,400.	176,400.
Total tax preferences	632,600.	378,200.
Adjusted gross income computed without regard to disallowed tax preference provision from Schedule B	1,000,000.	1,000,000.
Total	$1,632,600.	$1,378,200.
Limit on tax preferences - greater of $10,000. or 50% of above total	$ 816,300.	$ 689,100.
Disallowed tax preferences		
Excess of total tax preferences	$ 632,600.	$ 378,200.
Over limit on tax preferences	816,300.	689,100.
Which is	None	None

SCHEDULE B2

TAXPAYER MODEL

CONTRIBUTIONS AT MAXIMUM DESIRED ($300,000.) CONTRIBUTION LEVEL

	Present Internal Revenue Code	H.R.13270	H.R.13270 modified by administration's proposal
Contribution base			
Adjusted gross income from Schedule B.	$1,000,000.	$1,000,000.	$1,000,000.
Allowable tax preferences from Schedule B1		632,600.	378,200.
Excess of intangible drilling and development costs over alternative of capitalizing such costs and using straight line depreciation		14,600.	14,600.
Statutory deduction		(10,000.)	(10,000.)
Total tax preferences as defined for this section and for allocation of deductions		637,200.	382,800.
Contribution base	$1,000,000.	$1,637,200.	$1,382,800.
Limitations on contributions deduction			
Publicly supported charities:			
At 30% of contribution base	$ 300,000.		
At 50% of contribution base		$ 818,600.	$ 691,400.
At 30% of contribution base on gifts of appreciated securities which, if sold, would result in long term capital gain		$ 491,160.	$ 414,840.
Contributions to publicly supported charitable organizations			
Appreciated securities which, if sold, would result in long term capital gain	$ 254,400.	$ 254,400.	$ 254,400.
Cash	45,600.	45,600.	45,600.
Total contributions	$ 300,000.	$ 300,000.	$ 300,000.

SCHEDULE B3

TAXPAYER MODEL

ALLOCATION OF DEDUCTIONS AT MAXIMUM DESIRED ($300,000.) CONTRIBUTION LEVEL

	H.R.13270	H.R.13270 modified by administration's proposal
Computation of "Section 277 Fraction" (Disallowance Factor)		
Allowable tax preferences as defined for this provision (ATP) from Schedule B2	$ 637,200.	$ 382,800.
Modified adjusted gross income:		
Taxable income determined without regard to this provision from Schedule B	629,400.	629,400.
Allocable deductions from Schedule B	323,600.	323,600.
Total modified adjusted gross income (MAGI)	953,000.	953,000.
Total ATP and MAGI	$1,590,200.	$1,335,800.
$\frac{\text{ATP}}{\text{ATP + MAGI}}$ =	.4007	.2866
Computation of disallowed deductions		
The lesser of allowable tax preferences	$ 637,200.	$ 382,800.
or the		
Allocable deductions of $323,600. multiplied by the "Section 277 Fraction"	$ 129,667.	$ 92,744.

Analysis of disallowed deductions - H.R.13270

	Gross allocable deductions		
	Percent of total	Amount	Amount disallowed
Contributions	92.707%	$300,000.	$120,210.
Other	7.293%	23,600.	9,457.
	100.000%	$323,600.	$129,667.

Contributions disallowed as a percent of total contributions - 40.07%

Analysis of disallowed deductions - H.R.13270 modified by administration's proposal

	Gross allocable deductions		
	Percent of total	Amount	Amount disallowed
Contributions	92.707%	$300,000.	$85,980.
Other	7.293%	23,600.	6,764.
	100.000%	$323,600.	$92,744.

Contributions disallowed as a percent of total contributions - 28.66%

SCHEDULE B4

TAXPAYER MODEL

ANALYSIS OF INCREASE IN FEDERAL INCOME TAX H.R.13270 AT MAXIMUM DESIRED ($300,000.) CONTRIBUTION LEVEL

	Increase (Decrease)	
	Amount	Percent
Federal income tax computed under H.R.13270 from Schedule B	$461,574.	
Federal income tax computed under present Internal Revenue Code from Schedule B	371,560.	
Total increase	$ 90,014.	24.23%*
Analysis of increase ***		
Allocation of deductions between taxable and tax preference income:		
Cash contributions at base "Section 277 Fraction" ($13,069. at 70%)	$ 9,148.	10.163%
Appreciated security contributions at base "Section 277 Fraction" ($72,911. at 70%)	51,038.	56.700
	60,186.**	66.863%
Additional disallowance of cash contributions by reason of giving appreciated securities ($5,203. at 70%)	3,642.	4.046%
Disallowance of appreciated security contributions from base "Section 277 Fraction" to actual "Section 277 Fraction" ($29,027. at 70%)	20,319.	22.573
	23,961.	26.619%
Other allocable deductions at base "Section 277 Fraction" ($6,764. at 70%)	4,735.**	5.260%
Additional disallowance of other allocable deductions by reason of giving appreciated securities ($2,693 at 70%)	1,885.	2.094%
Elimination of alternative capital gains tax rate ($200,000. at 20%)	40,000.	44.438%
Reduction in individual tax rate schedules:		
Without regard to other proposed changes (on ordinary taxable income of $429,400.)	(24,270.)**	(26.962%)
Coupled with:		
Elimination of alternative capital gains tax rate ($200,000. at 5%)	(10,000.)**	(11.109%)
Allocation of deductions:		
Cash contributions at base "Section 277 Fraction" ($13,069. at 5%)	(653.)	(0.726%)
Appreciated security contributions at base "Section 277 Fraction" ($72,911. at 5%)	(3,646.)	(4.050)
	(4,299.)**	(4.776%)

SCHEDULE B4 (Cont'd)

	Increase (Decrease)	
	Amount	Percent
Allocation of deductions (cont'd):		
Additional disallowance of cash contributions by reason of giving appreciated securities ($5,203. at 5%)	(260.)	(0.289%)
Disallowance of appreciated security contributions from base "Section 277 Fraction" tc actual "Section 277 Fraction" ($29,027. at 5%)	(1,451.)	(1.612%)
	(1,711.)	(1.901%)
Other allocable deductions at base "Section 277 Fraction" ($6,764. at 5%)	(338.)**	(0.376%)
Additional disallowance of other allocable deductions by reason of giving appreciated securities ($2,693. at 5%)	(135.)	(0.150%)
Totals	$ 90,014.	100.000%

* The net increase in tax resulting from the requirement to allocate contributions between taxable and tax preference and to include appreciation on securities given to charity in tax preference income is $79,887. Of the total increase in tax, this represents 88.75%. The increase over the present tax with respect to the aforementioned provisions alone is 23.15% and together with the rate reduction is 21.50%.

** The total of these items equals the increase in tax under H.R. 13270 modified by administration's proposal. In addition each individual subtotal may be agreed to their equivalent increases under each proposal on Schedule B5.

*** In this analysis, the phrase "base 'Section 277 Fraction" refers to the disallowance factor at zero level of contributions; as cash is given to charities, this value remains constant. The phrases "Disallowance .... from base 'Section 277 Fraction' to actual 'Section 277 Fraction" or the "additional disallowance... by reason of giving appreciated securities" means the additional disallowance of allocable expenditures resulting from an increase in the disallowance factor at zero (or cash) contributions to the disallowance factor at the $300,000. contriuution level which results from giving $254,400., zero tax basis, of appreciated securities in this model.

SCHEDULE B5

TAXPAYER MODEL

ANALYSIS OF INCREASE IN FEDERAL INCOME TAX
H.R.13270 MODIFIED BY ADMINISTRATION'S PROPOSAL
AT MAXIMUM DESIRED ($300,000.) CONTRIBUTION LEVEL

	Increase (Decrease)	
	Amount	Percent
Federal income tax computed under H.R.13270 modified by administration's proposal from Schedule B	$437,574.	
Federal income tax computed under present Internal Revenue Code from Schedule B	371,560.	
Total increase	$ 66,014.	17.77% (*)
Analysis of in:rease **		
Allocation of deductions between taxable and tax preference income:		
Contributions at base "Section 277 Fraction" ($85,980. at 70%)	$ 60,186.	91.172%
Other base "Section 277 Fraction" ($6,764. at 70%)	4,735.	7.172
Elimination of alternative capital gains tax rate ($200,000. at 20%)	40,000.	60.593
Reduction in individual tax rate schedules:		
Without regard to other propoaed changes (on ordinary taxable income of $429,400.)	(24,270.)	(36.765)
Coupled with:		
Elimination of alternative capital gains tax rate ($200,000. at 5%)	(10,000.)	(15.148)
Allocation of deductions:		
Contributions at base "Section 277 Fraction" ($85,980. at 5%)	(4,299.)	(6.512)
Other at base "Section 277 Fraction" ($6,764. at 5%)	(338.)	(0.512)
Totals	$ 66,014.	100.000%

(*) The net increase in tax resulting from the requirement to allocate contributions between taxable and tax preference income is $55,887. Of the total increase in tax, this represents 84.659%. The increase over the present tax with respect to the allocation of contributions alone is 16.198% and together with the rate reduction is 15.041%.

** The term "base Section 277 Fraction" referes to the disallowance factor at zero contributions. Under this proposal, such factor remains constant at all levels of contributions regardless of form.

SCHEDULE B6

TAXPAYER MODEL

ANALYSIS OF INCOME AT MAXIMUM DESIRED ($300,000) CONTRIBUTION LEVEL

	As defined by:					
	H. R. 13270			H. R. 13270 modified by administration's proposal		
	Amount	Percent of total income	Percent of total tax preference income	Amount	Percent of total income	Percent of total tax preference income
Adjust.d gross taxable income from Schedule B	$1,000,000.	61.08%	-	$1,000,000.	72.32%	-
Tax preference income (for allocation of itemized deductions)						
Long-term appreciation on securities donated to publicly supported charities	254,400.	15.54%	39.93%	-	-	-
Fifty percent of total long-term capital gain excluded from income	200,000.	12.22	31.39	200,000.	14.46	52.25
Net municipal bond interest	176,400.	10.77	27.68	176,400.	12.75	46.08
Excess of intangible drilling and development costs over alternative of capitalizing such costs and using straight-line depreciation	14,600.	0.89	2.29	14,600.	1.06	3.81
Excess of accelerated depreciation over straight-line depreciation	1,800.	0.11	0.28	1,800.	0.13	0.47
Statutory deduction	(10,000.)	(0.61)	(1.57)	(10,000.)	(0.72)	(2.61)
Total tax preference income, as defined	637,200.	38.92%	100.00%	382,800.	27.68%	100.00%
Total income	$1,637,200.	100.00%		$1,382,800.	100.00%	

Total tax preference income	$ 637,200.	
Less long-term appreciation on securities donated to publicly supported charities	254,400.	
Total tax preference income without appreciation on charitable gifts	382,800.	27.68%
Adjusted gross taxable income	1,000,000.	72.32
	$1,382,800.	100.00%

TAXPAYER MODEL

COST OF GIVING COMPARISON
AT MAXIMUM DESIRED ($300,000) CONTRIBUTION LEVEL

Present Internal Revenue Code

Form of gift	Total gift	Direct reduction in federal income tax at 70%	Capital gains tax saved at 25%	Net cost	Net cost as a percentage of total gift
Cash	$ 45,600	($ 31,920.)	-	$13,680.	30.000%
Appreciated securities	254,400.	(178,080.)	($63,600.)	12,720.	5.000%
Total	$300,000.	($210,000.)	($63,600.)	$26,400.	8.800%

H. R. 13270

				Disallowances by operation of "Section 277 Fraction"					
Form of gift	Total gift	Direct reduction in federal income tax at 65%	Capital gains tax saved at 32-1/2%	Cash contribution only at .2866*	Appreciated security contribution only at .4007**	Add'l. cash contribution at .1141***	Add'l. other deductions of $23,600. at .1141***	Net cost	Net cost as a percentage of total gift
Cash	$ 45,600.	($ 29,640.)	-	$13,069.	-	-	-	$ 29,029.	63.660%
Appreciated securities	254,400	(165,360.)	($82,680.)	-	$101,938.	$5,203.	$2,693.	116,194.	45.674
Total	$300,000.	($195,000.)	($82,680.)	$13,069.	$101,938.	$5,203.	$2,693.	$145,223.	48 408%

	Present Internal Revenue Code	H. R. 13270	Increase	Percentage increase
Net cost as a percentage of total gift	8.800%	48.408%	39.608%	450.09%

H. R. 13270 modified by administration's proposal

Form of gift	Total gift	Direct reduction in federal income tax at 65%	Capital gains tax saved at 32-1/2%	Disallowance by operation of "Section 277 Fraction" - Contributions at .2866*	Net cost	Net cost as a percentage of total gift
Cash	$ 45,600.	($ 29,640.)	-	$13,069.	$ 29,029.	63.660%
Appreciated securities	254,400.	(165,360.)	($82,680.)	72,911.	79,271.	31.160
Total	$300,000	($195,000.)	($82,680.)	$85,980	$108,300.	36.100%

	Present Internal Revenue Code	H. R. 13270 modified by administration's proposal	Increase	Percentage increase
Net cost as a percentage of total gift	8.800%	36.100%	27.300%	310.227%

*Base "Section 277 Fraction" (Disallowance Factor at zero level of contributions) - In H. R. 13270 modified by administration's proposal, this remains constant at all levels of contributions regardless of form.

**"Section 277 Fraction" at $300,000. level of contributions.

***Difference between above "Section 277 Fraction" values.

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SCHEDULE C

TAXPAYER MODEL

PROOF OF REDUCED CONTRIBUTION TO $20,898

	Present code		H. R. 13270		H. R. 13270 modified by administration's proposal	
	Account					
	Cash	Security	Cash	Security	Cash	Security
Balance - beginning of year at market	-	$254,400.	-	$254,400.	-	$254,400.
Transactions during year						
Adjusted gross income	$1,000,000.		$1,127,200.	($127,200.)	$1,127,200.	($127,200.)
Municipal bond interest	176,400.		176,400.		176,400.	
50% long-term capital gain excluded from income	200,000.		327,200.	(127,200.)	327,200.	(127,200.)
Totals	$1,376,400.	$254,400.	$1,630,800.	($254,400.)	$1,630,800.	($254,400.)
Contributions	($ 45,600.)	($254,400.)	($ 20,898.)		($ 20,898.)	
Nonallocable deductions	(45,800.)		(45,800.)		(45,800.)	
Base allocable deduction:	(23,600.)		(23,600.)		(23,600.)	
Federal income tax	(371,560.)		(650,662.)		(650,662.)	
Totals	($ 486,560.)	($254,400.)	($ 740,960.)	-	($ 740,960.)	-
Balance - end of year	$ 889,840.	$ -	$ 889,840.	$ -	$ 889,840.	$ -

SCHEDULE C1

TAXPAYER MODEL

COMPUTATION OF FEDERAL INCOME TAX AT REDUCED CONTRIBUTION LEVEL OF $20,898

	H. R. 13270		H. R. 13270 modified by administration's proposal	
INCOME				
Ordinary income	$ 800,000.		$ 800,000.	
Fifty percent of long-term capital gain:				
Original amount	200,000.		200,000.	
On sale of securities previously given to charity	127,200.		127,200.	
Adjusted gross income computed without regard to disallowed tax preference provision	$1,127,200.		$1,127,200.	
Disallowed tax preferences	None		None	
Adjusted gross income		$1,127,200.		$1,127,200.
Itemized deductions				
Allocable:				
Contributions	$ 20,898.		$ 20,898.	
Other	23,600.		23,600.	
Total allocable	$ 44,498.		$ 44,498.	
Nonallocable	45,800.		45,800.	
Total itemized deductions		(90,298.)		(90,298.)
		$1,036,902.		$1,036,902.
Exemptions		(1,200.)		(1,200.)
Taxable income without allocation		$1,035,702.		$1,035,702.
Disallowed allocable deductions		14,270.		14,270.
Taxable income		$1,049,972.		$1,049,972.
Tax per married taxpayers filing joint return rate table on ordinary taxable income				
$228,180. plus 65% of excess over $400,000.		$ 650,662.		$ 650,662.

SCHEDULE C2

TAXPAYER MODEL

COMPUTATION OF DISALLOWED TAX PREFERENCES AT REDUCED CONTRIBUTION LEVEL OF $20,898

	H.R.13270	H.R.13270 modified by administration's proposal
Items of tax preference		
Excess of accelerated depreciation over straight line depreciation	$ 1,800.	$ 1,800.
Fifty percent of total long term capital gain excluded from income:		
Original amount	200,000.	200,000.
On sale of securities previously given to charity	127,200.	127,200.
Net municipal bond interest	176,400.	176,400.
Total tax preferences	505,400.	505,400.
Adjusted gross income computed without regard to disallowed tax preference provision	1,127,200.	1,127,200.
Total	$1,632,600.	$1,632,600.
Limit on tax preferences - greater of $10,000. or 50% of above total	$ 816,300.	$ 816,300.
Disallowed tax preferences		
Excess of total tax preferences	$ 505,400.	$ 505,400.
Over limit on tax preferences	816,300.	816,300.
Which is	None	None

SCHEDULE C3

TAXPAYER MODEL

CONTRIBUTIONS AT REDUCED CONTRIBUTION LEVEL OF $20,898.

	H.R.13270	H.R.13270 modified by administration's proposal
Contribution base		
Adjusted gross income	$1,127,200.	$1,127,200.
Allowable tax preferences	505,400.	505,400.
Ex:ess of intangible drilling and development costs over alternative of capitalizing such costs and using straight line depreciation	14,600.	14,600.
Statutory deduction	(10,000.)	(10,000.)
Total tax preferences as defined for this section and for allocation of deductions	510,000.	510,000.
Contribution base	$1,637,200.	$1,637,200.
Limitations on contributions deduction		
Publicly supported charities:		
At 50% of contribution base	$ 818,600.	$ 818,600.
At 30% of contribution base on gifts of appreciated securities which, if sold, would result in long term capital gain	$ 491,160.	$ 491,160.

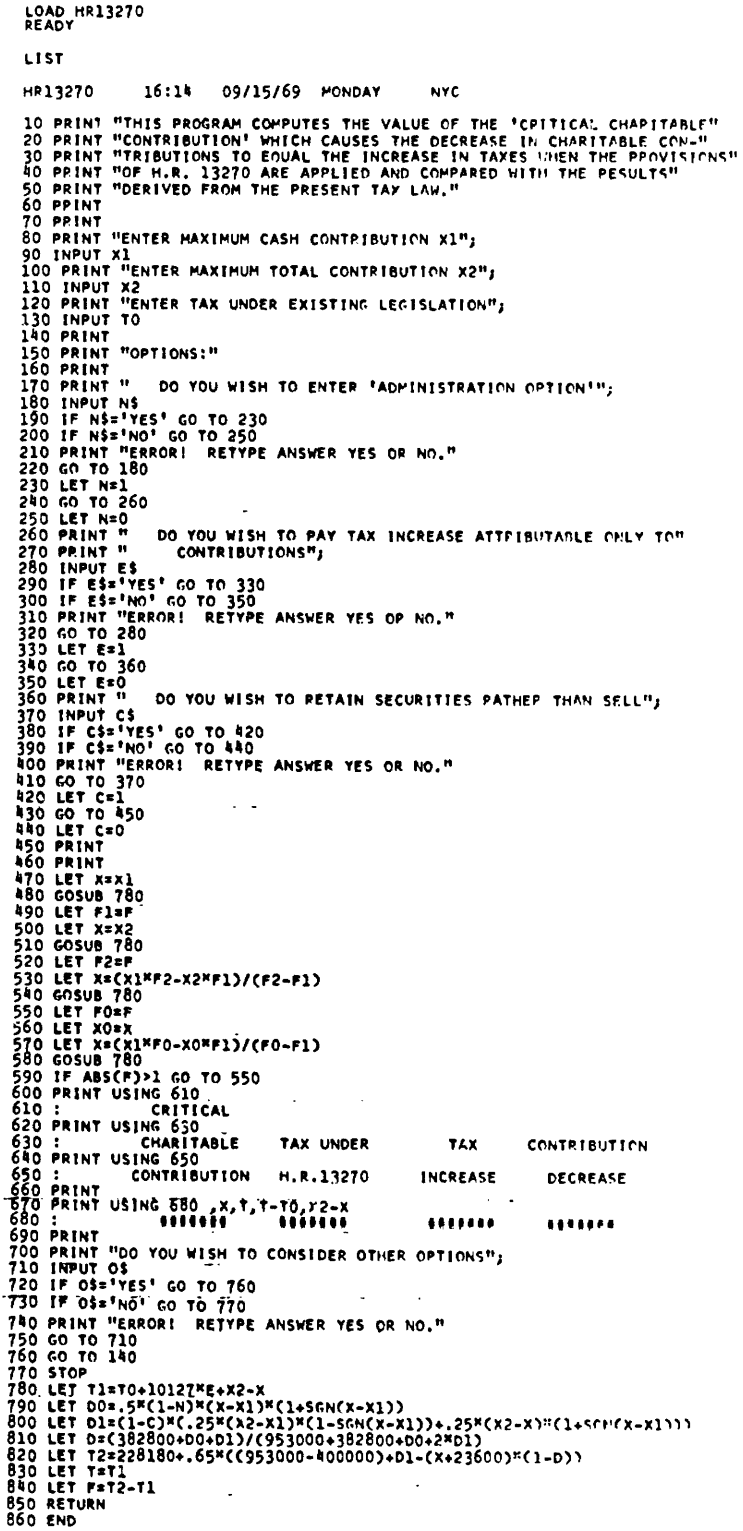
SCHEDULE C4

TAXPAYER MODEL

ALLOCATION OF DEDUCTIONS AT REDUCED CONTRIBUTION LEVEL OF $20,898.

	H.R.13270	H.R.13270 modified by administration's proposal
Computation of "Section 277 fraction"		
Allowable tax preferences as defined for this section (ATP)	$ 510,000.	$ 510,000.
Modified adjusted gross income:		
Taxable income determined without regard to this provision	1,035,703.	1,035,703.
Allocable deductions	44,498.	44,498.
Total modified adjusted gross income (MAGI)	1,080,201.	1,080,201.
Total ATP and MAGI	$1,590,201.	$1,590,201.
$\frac{\text{ATP}}{\text{ATP + MAGI}}$	.3207	.3207
Computation of disallowed deductions		
The lesser of allowable tax preferences	$ 510,000.	$ 510,000.
or the		
Allocable deductions of $44,497. multiplied by the "Section 277 fraction"	$ 14,270.	$ 14,270.

SCHEDULE D



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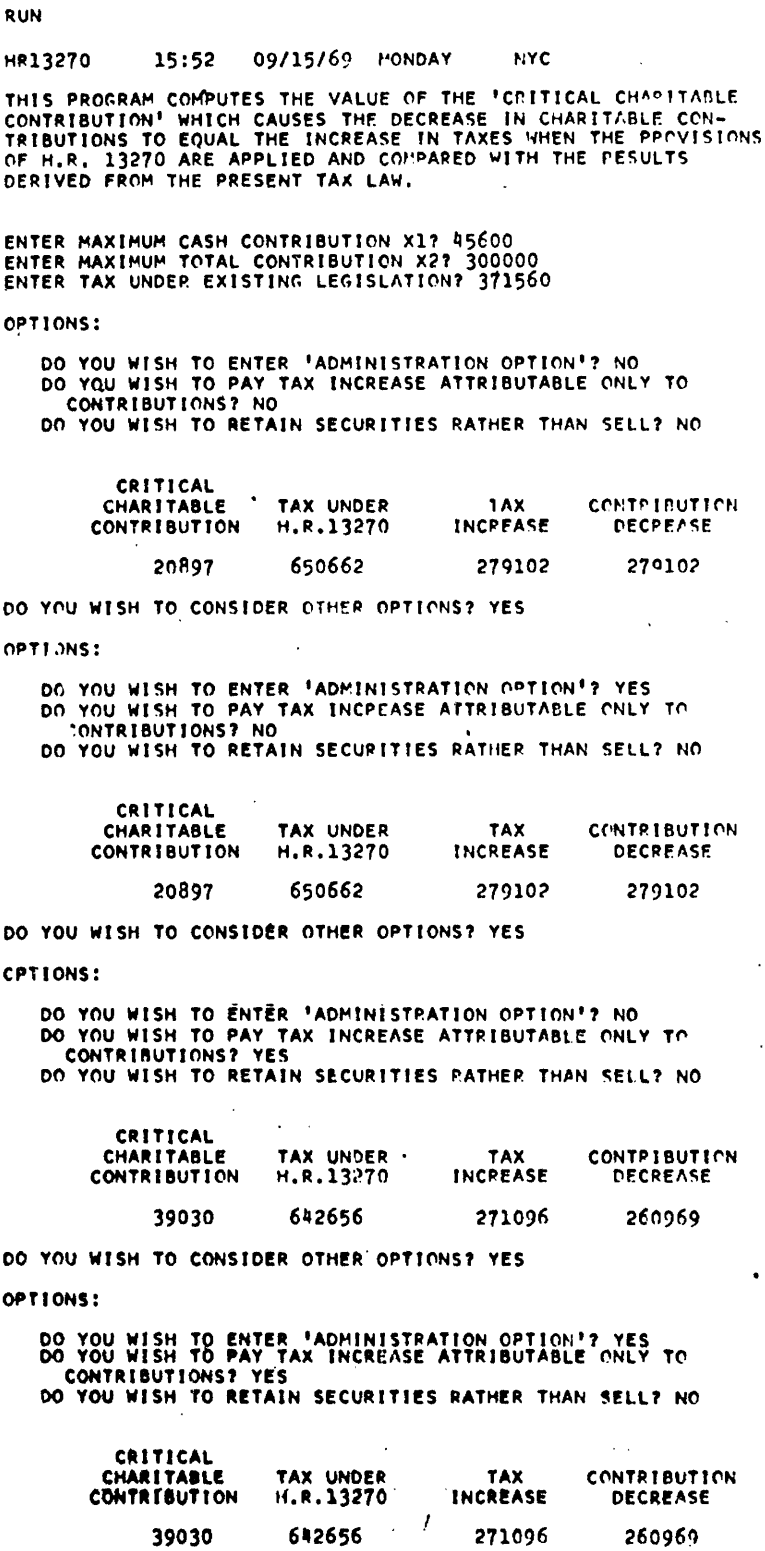
LOAD HR13270
READY

LIST

HR13270     16:14   09/15/69  MONDAY     NYC

10 PRINT "THIS PROGRAM COMPUTES THE VALUE OF THE 'CPITICAL CHAPITABLE"
20 PRINT "CONTRIBUTION' WHICH CAUSES THE DECREASE IN CHARITABLE CON-"
30 PRINT "TRIBUTIONS TO EOUAL THE INCREASE IN TAXES WHEN THE PPOVISIONS"
40 PRINT "OF H.R. 13270 ARE APPLIED AND COMPARED WITH THE PESULTS"
50 PRINT "DERIVED FROM THE PRESENT TAY LAW."
60 PPINT
70 PRINT
80 PRINT "ENTER MAXIMUM CASH CONTRIBUTION X1";
90 INPUT X1
100 PRINT "ENTER MAXIMUM TOTAL CONTRIBUTION X2";
110 INPUT X2
120 PRINT "ENTER TAX UNDER EXISTING LEGISLATION";
130 INPUT TO
140 PRINT
150 PRINT "OPTIONS:"
160 PRINT
170 PRINT "   DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'";
180 INPUT N$
190 IF N$='YES' GO TO 230
200 IF N$='NO' GO TO 250
210 PRINT "ERROR!  RETYPE ANSWER YES OR NO."
220 GO TO 180
230 LET N=1
240 GO TO 260
250 LET N=0
260 PRINT "   DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO"
270 PRINT "      CONTRIBUTIONS";
280 INPUT E$
290 IF E$='YES' GO TO 330
300 IF E$='NO' GO TO 350
310 PRINT "ERROR!  RETYPE ANSWER YES OP NO."
320 GO TO 280
330 LET E=1
340 GO TO 360
350 LET E=0
360 PRINT "   DO YOU WISH TO RETAIN SECURITIES PATHEP THAN SELL";
370 INPUT C$
380 IF C$='YES' GO TO 420
390 IF C$='NO' GO TO 440
400 PRINT "ERROR!  RETYPE ANSWER YES OR NO."
410 GO TO 370
420 LET C=1
430 GO TO 450
440 LET C=0
450 PRINT
460 PRINT
470 LET X=X1
480 GOSUB 780
490 LET F1=F
500 LET X=X2
510 GOSUB 780
520 LET F2=F
530 LET X=(X1*F2-X2*F1)/(F2-F1)
540 GOSUB 780
550 LET F0=F
560 LET X0=X
570 LET X=(X1*F0-X0*F1)/(F0-F1)
580 GOSUB 780
590 IF ABS(F)>1 GO TO 550
600 PRINT USING 610
610 :           CRITICAL
620 PRINT USING 630
630 :         CHARITABLE    TAX UNDER         TAX     CONTRIBUTION
640 PRINT USING 650
650 :        CONTRIBUTION   H.R.13270     INCREASE     DECREASE
660 PRINT
670 PRINT USING 680 ,X,T,T-T0,X2-X
680 :             #######     #######        #######     #######
690 PRINT
700 PRINT "DO YOU WISH TO CONSIDER OTHER OPTIONS";
710 INPUT O$
720 IF O$='YES' GO TO 760
730 IF O$='NO' GO TO 770
740 PRINT "ERROR!  RETYPE ANSWER YES OR NO."
750 GO TO 710
760 GO TO 140
770 STOP
780 LET T1=T0+10127*E+X2-X
790 LET D0=.5*(1-N)*(X-X1)*(1+SGN(X-X1))
800 LET D1=(1-C)*(.25*(X2-X1)*(1-SGN(X-X1))+.25*(X2-X)*(1+SGN(X-X1)))
810 LET D=(382800+D0+D1)/(953000+382800+D0+2*D1)
820 LET T2=228180+.65*((953000-400000)+D1-(X+23600)*(1-D))
830 LET T=T1
840 LET F=T2-T1
850 RETURN
860 END
```

SCHEDULE D-1



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RUN

HR13270     15:52   09/15/69  MONDAY     NYC

THIS PROGRAM COMPUTES THE VALUE OF THE 'CRITICAL CHARITABLE
CONTRIBUTION' WHICH CAUSES THE DECREASE IN CHARITABLE CON-
TRIBUTIONS TO EQUAL THE INCREASE IN TAXES WHEN THE PROVISIONS
OF H.R. 13270 ARE APPLIED AND COMPARED WITH THE RESULTS
DERIVED FROM THE PRESENT TAX LAW.


ENTER MAXIMUM CASH CONTRIBUTION X1? 45600
ENTER MAXIMUM TOTAL CONTRIBUTION X2? 300000
ENTER TAX UNDER EXISTING LEGISLATION? 371560

OPTIONS:

   DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? NO
   DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO
     CONTRIBUTIONS? NO
   DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? NO


          CRITICAL
         CHARITABLE    TAX UNDER        TAX      CONTRIBUTION
        CONTRIBUTION   H.R.13270     INCREASE      DECREASE

             20897       650662        279102       279102

DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

   DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? YES
   DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO
     CONTRIBUTIONS? NO
   DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? NO


          CRITICAL
         CHARITABLE    TAX UNDER        TAX      CONTRIBUTION
        CONTRIBUTION   H.R.13270     INCREASE      DECREASE

             20897       650662        279102       279102

DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

   DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? NO
   DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO
     CONTRIBUTIONS? YES
   DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? NO


          CRITICAL
         CHARITABLE    TAX UNDER        TAX      CONTRIBUTION
        CONTRIBUTION   H.R.13270     INCREASE      DECREASE

             39030       642656        271096       260969

DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

   DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? YES
   DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO
     CONTRIBUTIONS? YES
   DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? NO


          CRITICAL
         CHARITABLE    TAX UNDER        TAX      CONTRIBUTION
        CONTRIBUTION   H.R.13270     INCREASE      DECREASE

             39030       642656        271096       260969
```

SCHEDULE D-1 (cont.)

```
DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

   DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? NO
   DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO
     CONTRIBUTIONS? NO
   DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? YES

          CRITICAL
         CHARITABLE      TAX UNDEP         TAX       CONTPIBUTION
        CONTRIBUTION     H.R.13270      INCREASE       DECPEASE

            163750        507809         136249         136249

DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

   DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? YES
   DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO
     CONTRIBUTIONS? NO
   DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? YES

          CRITICAL
         CHARITABLE      TAX UNDER         TAX       CONTPIBUTION
        CONTRIBUTION     H.R.13270      INCREASE       DECREASE

            176914        494646         123085         123085

DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

   DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? NO
   DO YOU WISH TO PAY TAX INCREASE ATTPIBUTABLE ONLY TO
     CONTRIBUTIONS? YES
   DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? YES

          CRITICAL
         CHARITABLE      TAX UNDER         TAX       CONTPIBUTION
        CONTRIBUTION     H.R.13270      INCREASE       DECREASE

            179752        501934         130374         120247


DO YOU WISH TO CONSIDER OTHER OPTIONS? YES

OPTIONS:

   DO YOU WISH TO ENTER 'ADMINISTRATION OPTION'? YES
   DO YOU WISH TO PAY TAX INCREASE ATTRIBUTABLE ONLY TO
     CONTRIBUTIONS? YES
   DO YOU WISH TO RETAIN SECURITIES RATHER THAN SELL? YES

          CRITICAL
         CHARITABLE      TAX UNDER         TAX       CONTPIBUTION
        CONTRIBUTIO      H.R.13270      INCREASE       DECREASE

            195798        485888         114328         104201

DO YOU WISH TO CONSIDER OTHER OPTIONS? NO

TIME     0 MINS.    1 SECS.
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SCHEDULE E

TAXPAYER MODEL

SUPPLEMENTAL INFORMATION

Assumptions	Total desired contribution	Required contribution reduction	Balance for contribution	Percentage contribution reduction	Federal income tax at balance for contribution
Pay increase in Federal Income Tax resulting solely from the requirement to allocate charitable contributions and assuming sale of securities withheld from charity (H.R. 13270 and H.R. 13270 Modified by Administration's Proposal)	$300,000	$260,969	$ 39,031	86.99%	$642,656
Pay full increase in Federal Income Tax resulting from proposed changes but without sale of securities withheld from charity:					
H.R. 13270	300,000	136,250	163,750	45.42%	507,809
H.R. 13270 Modified by Administration's Proposal	300,000	123,086	176,914	41.03%	494,645
Pay increase in Federal Income Tax resulting solely from the requirement to allocate charitable contributions and without sale of securities withheld from charity:					
H.R. 13270	300,000	120,248	179,752	40.08%	501,934
H.R. 13270 Modified by Administration's Proposal	300,000	104,202	195,798	34.73%	485,888

The CHAIRMAN. Now, the next witness is Mayor Sam Yorty, whom we are pleased to welcome back here, a former member of the House of Representatives. We recall you from those days, Mr. Mayor, and some of us have followed the very fine record you have made as mayor of the city of Los Angeles. We think you have done a fine job.

Senator CURTIS. Mr. Chairman, may I also point out that Mr. Yorty is a native of Lincoln, Nebr., and has a family back there. The people from Lincoln never cease to remind folks as to who is the mayor of Los Angeles.

The CHAIRMAN. I understand, Mr. Mayor, that you are scheduled to appear before another committee at 11 o'clock. I was at least so informed. If that is the case we will try to ask questions after you have explained your views.

STATEMENT OF HON. SAM YORTY, MAYOR OF THE CITY OF LOS ANGELES

Mayor YORTY. Mr. Chairman, I understand my friend Senator Anderson likes to time the eggs there and I don't like hardboiled eggs so if he wants to turn on the timer it is all right with me.

First of all, Senators, I want to thank you for this time and the courtesy of inviting me, the city of Los Angeles, to express its views.

I won't presume to take up your time by reading the statement which is already in the committee print anyway, at page 153. It begins, it is not a very long statement, but I would like to point out to you that our department of water and power in Los Angeles pioneered the revenue bond system financing improvements for the future of our city.

As the circumstances stand now, we have planned that for the 5-year period 1969 to 1974, and this is page 156 of the committee print facilities amounted to $1,650 million depending upon the current law and our ability to finance these improvements with tax-exempt bonds, and we don't feel that it would be either wise or fair to interfere with our ability to finance our own projects as we have been doing for a long time in this type of project by now even threatening to change the rules of the game, and I can tell you that already the very threat of this legislation has had a very serious effect on our ability to go forward with our projects by marketing bonds.

When you add this threat to the tight money and high interest rates we have very great difficulties, and so we would like, of course, to see this legislation put not on a back burner but clear off the burners, and we would like very much to see it done as expeditiously as possible, because the uncertainty is going to hover over us until this great committee and the Senate makes its final decision.

The CHAIRMAN. Well, you know, Mr. Mayor, just because we on this committee vote against such a proposal and, may I say, that a completely devastating case against the House provision on this subject has been made by your associates as mayors of great cities, by the Governors of 50 States, by all of the local officials, the county commissioners, the school boards, so far as I determine there is not an elected official in America who represents anyone at the State or local level who is for this thing and they are all adamantly opposed to this.

In addition to that all the banks are very much opposed to it, and it is amazing to me that it has gotten this far. It is difficult to see how the measure could have gained as much support as it seemed to have gained, except the House has a closed rule as you are familiar.

Mayor YORTY. Yes; very familiar.

The CHAIRMAN. You have to take it or leave it on the whole thing, and someone says there is tax reform so you must vote for it. But we can't give you any final answer on this until we hold a conference with the House.

Governor Kirk raised that point, couldn't we take a stand on this thing as early as possible but even if we do there is no certainty what Congress will do until we pass a bill and meet with the House, and there is no sure conclusion on that.

Mayor YORTY. I am certain of that. I just hope it would happen soon. We wish somebody in the House would decide they had better reconsider this provision separately and get this threat away from over our heads so the cities can go ahead with their projects.

And speaking for the city of Los Angeles, I can tell you this is very true with us. As you know, we are definitely opening a great airport system which will serve the whole Western part of the United States, as Senator Anderson well knows. It is really a great regional airport system, and all of this is being held up partly by the threat of this legislation.

The CHAIRMAN. Well, you are in a position now that you can't sell your bonds, I would assume. Many mayors have so testified.

Mayor YORTY. That is right. It is very difficult.

The CHAIRMAN. Do you have a ceiling on the interest rate you can pay on the new obligations, new issues?

Mayor YORTY. Well, when I first became mayor we were selling our AA water and power bonds for about 2.9, and now it is up around 6 percent for these AA bonds, which our water and power department has that rating so it is almost impossible to market them now even without the legislation because of the high rate, but the legislation on top of the high rate makes it impossible.

The CHAIRMAN. Senator Anderson.

Senator ANDERSON. I am very happy to greet the mayor again. What he stresses is completely right. The rates are so high that nobody can afford to sell them.

Senator WILLIAMS. I have no questions, Mayor Yorty, except the chairman stated the situation accurately, and all we can do is pledge we will get the answer for you as rapidly as possible, but we can't do it until we get a conference with the House and get the final decision.

Mayor YORTY. Thank you, Senator.

The CHAIRMAN. Senator Talmadge.

Senator Curtis.

Senator CURTIS. Mr. Mayor, we are delighted that you are here. We have a long list of witnesses and I will waive questions.

Mayor YORTY. I must say, Senator, you gave us a pretty rough time down at Lincoln a week ago, USC versus Nebraska.

Senator CURTIS. I am sorry I couldn't be there.

Senator BYRD. No questions, Mr. Chairman.

Mayor YORTY. I was down in your State yesterday, Senator.

Senator BYRD. I am delighted.

The CHAIRMAN. We are very pleased to have you back.

Mayor YORTY. Thank you, Mr. Chairman.

(Hon. Sam Yorty's prepared statement follows:)

STATEMENT BY THE HONORABLE SAM YORTY, MAYOR OF THE CITY OF LOS ANGELES, CALIF.

Provisions under Titles III and VI of HR 13270, which affect the tax-exempt status of municipal bonds, present a most serious financial threat to the City of Los Angeles, and I strongly urge this Committee to reject these proposals. These proposals constitute an unwarranted interference with the functioning of local government which has been given a constantly expanding role in serving the people of this nation. Furthermore, they come at a time when the larger urban centers are confronted with unprecedented demands for financing essential capital projects.

I am well aware that the motivation for this legislation was an attempt to provide a more equitable Federal income tax structure, but if such legislation will result, as I firmly believe it will, in enlarging the local tax burden of the people of Los Angeles and of depriving them of needed public facilities, then I must oppose it.

I will not attempt to cover all of the general and constitutional arguments against the adoption of these measures since these points have been or will be ably presented to you by others. My remarks will be directed at the effect of these proposals on the nearly three million people of Los Angeles (and the more than eight million for whom Los Angeles serves as the urban core and nerve center). Hopefully this view from Los Angeles will be relatable to other major population centers in the nation.

By way of background, let me state briefly that the City of Los Angeles has relied heavily on the municipal bond market in its rapid development since the close of World War II, and has issued over one billion dollars in general obligation and revenue bonds in just the past twenty years. With the assistance provided by this source of financing, the City of Los Angeles has built the nation's largest municipally owned utility providing the total water and electricity needs of the City, a new jet age airport—now the second busiest in the nation, the nation's foremost man-made harbor, a modern sanitation system, a world famous zoo, and many other significant public facilities.

How important has the tax-exempt feature of municipal bonds been to these developments? In the case of several projects, lower interest costs available through municipal bond financing provided the economic feasibility for projects which otherwise would not have qualified.

Lower interest costs on outstanding debt are the only obvious break the local property taxpayer receives. Local property taxes in Los Angeles have already reached a level where we are constantly seeking alternatives to reduce the burden.

Notwithstanding the volume of municipal bond financing the City has engaged in for development purposes, the practice has not been abused. The City's bonds by virtue of sound financial management have earned the confident support of bond rating agencies and are considered a prime credit in the municipal bond market.

I have seen statements emanating from Congressional and Treasury sources that indicate that the legislation now before you will not significantly affect the municipal bond market or raise interest rates on new issues. This is simply not true. As a matter of fact, the mere announcement by Chairman Mills early this year that his committee was going to consider legislation in this area, proved severely disruptive to the municipal bond market. The uncertainty this generated as to the course Congress might follow in this field, caused all outstanding bonds in the municipal market to be discounted in value and drove many potential investors for future municipal issues from the market place.

Indices of interest rates on corporate bonds and municipal bonds, which historically tend to track one another, suddenly diverged. Acknowledging the difficult money market conditions that have existed this year, we still observed that the rate of increase in municipal interest rates has been more than 3½ times that in the corporate sector. The increase in municipal borrowing costs in the first nine months of this year, as reflected in the indices, has been 26.3%, while costs of corporate borrowing moved up 7.4%. One announcement by the committee chairman, in the course of the committee's hearings, resulted in an historic 25 basis point rise in the municipal bond index in one day. On a $30 million issue of the City's water bonds such a rise in the bond index, equivalent to ¼% on the interest rate, would have raised borrowing costs on the issue by more than a million dollars.

As further evidence of disruption in the municipal bond market, interest rates have now risen beyond statutory interest rate limits for several classes of the City's bonds. As a consequence, we have been unable to issue any airport bonds this year, when it had been our intention to issue approximately $170 million to finance necessary expansion of airport facilities. Millions of dollars in vital local improvement projects in the City have had to be postponed as a result of the effect this legislation has had on interest rates. The Department of Water and Power, which does not have a statutory interest rate limitation, has witnessed interest costs on its bonds increase 20% in the past nine months and interest costs on its short-term borrowing jump almost 50% in the same period. Rates for water and electrical service to the Department's 1,600,000 customers must eventually reflect these higher interest expenses.

Looking to the future, our capital programs in Los Angeles were planned with a heavy reliance on the municipal bond market to provide needed funds. In the five-year period 1969–1974, the amount contemplated to be raised through municipal bond issues totals more than $1,600,000,000, broken down as follows:

	Million
Airport facilities	$710
Water and power facilities	535
Recreation and parks facilities	140
Library facilities	35
Sewer facilities	91
Parking facilities	20
Harbor facilities	14
Fire, police and general administrative facilities	35
District improvement projects	70
Total	1,650

Increased interest costs on municipal bonds, which would be brought about by legislative changes governing the treatment of tax-exempt income in the Federal income tax structure, would obviously run into the hundreds of millions of dollars for the City of Los Angeles alone. This result, repeated in large cities throughout the nation would, if totaled, provide a clear perspective on the crushing burden to be added to the local taxpayer were the legislative proposals in Title III of H.R. 13270 to be enacted.

The City of Los Angeles must get on with the indispensable developmental programs that are required to provide a liveable environment for its burgeoning population. Title VI of H.R. 13270 purports to offer an offset to cities for loss of the advantages of issuing tax-exempt bonds should the cities elect to accept a Federal interest cost subsidy for issuing fully taxable bonds. Gentlemen, I have spent some time as a member of Congress and know well the requirements to hold hearings, to examine evidence, to deliberate, and finally, to make a judgment on the worthiness of capital projects before granting approval for the expenditure of Federal funds. This proposal is simply not workable when consideration is given to the staggering volume of municipal projects which are needed and needed now. Decisions on what city projects are to be built in Los Angeles, in what priority and how financed, are decisions that must be made in Los Angeles, not in Washington, D.C. This proposal runs counter to a growing awareness throughout the nation that government must decentralize in order to become truly responsive to the needs of its citizens.

The municipal bond market has been thrown into an almost chaotic state by Congressional actions relating to the treatment of tax-exempt bonds since the opening of this 91st Congress. The restoration of traditional investor confidence in municipal securities, will require a resounding rejection of the proposals before you. To quietly vote these proposals down or to refer them for further study, will leave the municipal bond market in the shroud that it has worn throughout this year.

The contention that proposals for legislation against the tax-exempt status of municipal bonds are an appropriate response to taxpayers' demand for tax reform will, I assure you, not set well with the people of Los Angeles; not when the people are made aware that the proposals advanced will significantly add to their own local tax burden and set up roadblocks to the progressive development of their City.

The CHAIRMAN. Next we will call the Honorable Stanley S. Surrey, former Assistant Secretary of the Treasury for Tax Policy.

Mr. Surrey, we are pleased to have you here, and I suppose that, for lack of a better name, we might call this the Surrey bill, and we are interested in knowing your views on it. [Laughter.]

Senator WILLIAMS. Did you say Surrey or sorry? [Laughter.]

STATEMENT OF STANLEY S. SURREY, PROFESSOR OF LAW, HARVARD LAW SCHOOL

Mr. SURREY. Mr. Chairman, I am pleased to be here and also pleased to be here on the same day that my former boss, Secretary Dillon, is here.

I have a long statement. I am just going to summarize certain parts of it, Mr. Chairman.

As you would expect, from what you said, I think the bill before you is a very significant step forward in the accomplishment of the task of tax reform. It certainly is not the end of the road by any means, but it is a major beginning. In the annals of tax reform a major beginning is a major event and, therefore, I am here really to expresss strong support for the House bill.

Now, I will cover certain portions of the bill only.

One, very briefly, the treatment of low-income taxpayers. I think the House approach to that treatment with its increased minimum standard deduction or low-income allowance of $1,100 is the right approach. It both removes the income tax from people who are below the poverty line—I see no reason why they should pay taxes—and substantially reduces the burdens of the people just above the poverty line.

Parenthetically, I would say that the Treasury recommendations in that area to phase out that allowance are on the wrong track. They do have the effect of relieving a person from tax, say, a single person at the poverty level of $1,700, a single person. The Treasury proposal would relieve that fellow from tax.

But then as soon as he has any money above $1,700 the Treasury proposal places a high tax on him, higher in effect than the starting rates of tax.

For example, just to show what is the result of a phaseout policy, under the House bill for the first year of phaseout the starting rates of tax for people just above the poverty line are increased 50 percent. While everybody thinks that the starting rate will be 14 percent—and that is the rate you find when you look at the income tax scale, the actual rate of tax on a fellow who earns a dollar of income above $1,700 is 21 percent. It is 50 percent higher than the regular rate.

Now, it seems to me really outrageous to have a high rate of tax, 21 percent, on a person who is just above the poverty line. Under the Treasury phaseout, when the regular tax rates are 13 percent, a person just above the exempt level, a person who is earning above $1,700, will really be paying a rate of 16¼ percent. These are high rates to place on people in those brackets. Yet the phaseout recommendation has that result, because for every dollar he earns under the Treasury recommendation he has to pay tax on $1.25, and, quite obviously, that increases his tax rate by 25 percent.

So I think the House bill when it finally finishes in 1971 by completely giving a flat $1,100 minimum standard deduction is the right approach.

On the question of the middle-income taxpayers, in connection with Senator Miller's question, I would agree with Secretary Dillon that the House approach of increasing the standard deduction on grounds of simplicity and fairness is the best approach and it should be around 15 percent and $2,000.

When you get to the upper-income groups you really have a basic problem of tax fairness. There is absolutely no question that there has been a complete breakdown of the fairness of the income tax in the upper income grounds. With some people paying no tax despite great amounts of wealth and income, with others paying very small taxes despite great amounts of wealth and income, no one can say that the income tax has not broken down in these brackets. Whether you are in the poverty level or whether you are a man in the $20,000, or $30,000 or $40,000 group, you have cause to complain about the people with great income and great wealth simply not paying taxes.

Any changes in this situation are going to affect some things in the United States, because once you start asking people to pay their fair share of taxes there are going to be consequences in the United States.

One has to tolerate those consequences. You have been told that in certain areas those consequences are too severe. But they may not turn out to be too severe. There is no one so pessimistic in this world about the future of the country or the future of anything as the taxpayer or industry about to lose its tax preference. That is really what has been said to this committee. There has been a wave of pessimism portrayed to you by the people who stand to gain from their pessimistic predictions, because they say their pessimism can only be countered by keeping all the preferences we have today.

I think the wiser course would be to follow the path of tax reform and then see if there are particular areas in which there really are problems, if so, then see what has to be done in those areas by direct Government assistance.

Now, let me illustrate, for example, by this matter of tax-exempt securities. It is very difficult for me to sit here and talk about it, Mr. Chairman, when you just said a devastating case has been made against the House bill. But really, I think, there has been a devastating amount of misinformation on the House bill.

The Chairman. Might I just say this, Mr. Surrey: If you have to be elected from a State and you find that every elected official down there is against what you are asked to vote for, you would be inclined to recognize the facts of life and not only do they make a logical argument, they have the power to take you out of office if you cannot appreciate it.

Mr. Surrey. I cannot deal with that aspect of the matter, Mr. Chairman. Let me deal only with, say, the logic of the matter apart from that. I talked recently to a very large group of local tax officials in

Massachusetts about this matter. One heard there the question, "Our taxes have to go up because our interest cost has to go up," and all the like.

But let us look at this House bill. The House bill does provide, as Secretary Dillon indicated, that in the future if State and local governments issue taxable bonds the Secretary of the Treasury can pay 40 percent of the interest on those bonds.

Let us assume tomorrow that the Secretary of the Treasury starts paying 40 percent of the interest on State and local bonds. Bonds would then go out at a lower cost to municipalities. The Secretary of the Treasury could in fact pay close to 50 percent of the interest on State and local bonds and the Federal Government wouldn't lose anything on the matter. It would be made up by the revenue collections on bonds that are taxable which used to be tax-exempt.

Let us assume then that this system is in effect and are over the difficult period of transition that we are in now. We are in this turmoil now. You are told it is due to the House bill. But a very large part of it is due to the interest market and the fact that the banks are net sellers of securities, which is not due to the tax bill. Banks are not subject to tax on this interest under the House bill. But let us say we get through this period, and taxable bonds are issued and there is this Federal payment of part of the interest cost. When things settle down States and localities will have lower interest costs than they have today and I do not then see how their taxes go up and how their interest costs go up.

Let me carry this a step further. Let us assume we enter into a period in which many future issues, the majority of future issues, are taxable issues. What happens to the values of existing tax-exempt securities. They become very valuable, because they will come to be a scarce commodity. The holders of tax-exempt securities would thus stand to have windfall gains if future issues are going out on a taxable basis.

Now, to a considerable extent subjecting their interest on existing securities to the minimum tax and to allocations is an offset. Subjecting that interest to the limit on preferences and to allocation may indeed be at best only a mild offset to the windfall gains that are involved if tax-exempt securities tend to be smaller and smaller in proportion to the volume of taxables outstanding. That could well be the case—it should be the case—if this House bill proposal on taxable bonds works.

Now, I haven't heard people tell you that it won't work. All I have heard is that this is the first step down the road to Federal control.

But there is nothing in the House bill that involves any Federal control. It is an automatic provision. The Secretary of the Treasury simply sends a check with no questions asked to any mayor who elects to issue a taxable bond.

Senator WILLIAMS. Could I ask a question at that point? Would that check be sent to the issuer of the bonds regardless of their rating?

Mr. SURREY. Absolutely no questions. Just as it is in effect today, Senator, through the exemption.

Senator WILLIAMS. Even if we have a community that is just incorporated for a new bond issue?

Mr. SURREY. That is right.

Senator WILLIAMS. And it is not solid, the Government still guarantees it?

Mr. SURREY. No; I didn't say guarantee it. No; no guarantee.

Senator WILLIAMS. Guarantee the interest?

Mr. SURREY. No guarantee of interest, just as happens today. The States and localities have a blank check today on the Treasury in the form of issuing a tax-exempt bond. The check that the Secretary of the Treasury would send under the House bill—an actual check will be worth more than the blank check that they have today. There will be no questions asked. It is automatic and it is permanent. Investors have the same protection as to this amount as they have if they buy a Federal bond.

Senator WILLIAMS. If the Government can get all of its money back by paying 50 percent of the interest, suppose we advance it to a hundred percent and pay it out, how much will we get?

Mr. SURREY. No; it is not that. As Senator Byrd says it looks like magic. But it isn't if you look at the figures. If these bonds were taxable that came out in the past, the Federal Government annually would have gained about $2.6 or $2.7 billion—if the bonds had gone out in the past as taxable bonds. The interest saving on tax-exempt securities to State and local governments that occurred in the past as against issuing taxable securities is only about $1.8 billion. There is thus a tremendous wastage in this mechanism because the interest rates have to be tailored to people lower than those in the top brackets.

So the Federal Government could simply take this difference today between what it would get if the bonds were taxable, and the lower rates of interest that the States now get, and pay that additional amount to State and local governments and could still break even. That is why the Federal Government doesn't lose money and that is the answer to Senator Byrd, with respect to paying this subsidy. It is just taking away the commission that is paid today to high-income people and the banks when they purchase these bonds. It is taking that commission and it is handing it over to State and local government. Why State and local government should not want this additional advantage nobody has answered in any testimony before ycu.

I must say when I made this statement before the officials in Massachusetts, a great many of them had never heard the case presented that way. They had been subjected to a barrage of, I think, misinformation, frankly, on this bill and that is one of the problems that your committee faces.

Now, to move on, I do favor the proposals in the House bill that deal directly with the problems of the high-income groups, the elimination of unlimited charitable deduction, the treatment of capital gains, the cutback on real estate preferences—I think it could go further—and a number of other matters.

I also favor the general backup provisions—which are the minimum tax or limit on preferences and the allocation of deductions—to take care of those situations where the other preferences have not been handled directly.

I would like to say one word on farm losses. I think on that matter the House bill does a very poor job. Again, there is a lot of misinformation on farm losses. A person uses the term farm losses and it sounds like people are losing a lot of money. They are not losing money. They are investing money in farms which the tax system today calls a current expense, and that current expense is so large, because it represents initial investment, that it exceeds the current income.

So what do you do with that "loss"? You take that loss and you apply it against your other income, not from farms, whether it is dividends or brokerage commissions or anything else, and you don't pay tax on that other income.

The net result is that for wealthy people the Government is in effect paying them to have the farm by eliminating their tax on the nonfarm income, and the wealthier you are and the higher bracket you are in the more you get paid for having a farm.

The House bill fundamentally does not correct that. Its revenue gain in this area is about $20 million whereas an appropriate revenue gain would be $150 million to $200 million. Senator Metcalf's bill is along the right track. But no one should get misled by this use of the word "losses." It is investments that are being written off against other income. The result is a huge negative income tax for people with nonfarm income who choose to own a farm.

Another weakness in the House bill is the 50-percent top rate on earned income.

Now, it seems to me there are two problems with that proposal. It is said that the limit is necessary in order to discourage people with large amounts of earned income from looking around for tax shelters. The difficulty with this is that you can have your 50-percent limit and still have your tax shelter. There is nothing in this bill that closes down all the tax shelters. Consequently, an executive will still have ways to roam around and have his tax shelter and still have this limit put on earned income.

Secretary Dillon pointed out the enormous tax shelter of holding appreciated securities until you die. There is nothing that keeps an executive from holding his appreciated securities until he dies, with that appreciation year after year escaping tax, and still having a 50-percent limit on his salary.

The only way really to do this, if you wanted to do it, is the way Senator Long approached it. There are two differences between his approach and the House bill. One, his approach was an effective rate of 50 percent, not a marginal rate as in the House bill but an effective rate of 50 percent. In other words, it was the rate on total income and not just the top rate. And, secondly, he applied the 50-percent rate to all of a person's income. What he said essentially was that looking at all of the income of a person he shouldn't pay more than 50 percent of all that income to the Government. If you are going to have any limits, that is the right approach. The House approach which says we will look at one segment of his income, put a marginal rate of 50 percent on that, disregard what other income he may have that is untaxed, is completely wrong. Therefore, it seems to me it is a serious defect in the House bill.

We are a long ways from starting in that fashion to seriously reduce the progression of the tax until we do more than the House bill does about closing up the preferences.

My time is running out and let me just mention one or two other places where I think the House bill is weaker—where other people will not tell you it is weaker so, therefore, I would like to say this.

The House bill has the unfortunate effect of spending about a billion dollars through tax incentives. What does it do? It has got a 5-year amortization provision for pollution control facilities. It is going to cost a lot of money, about $400 million. It has got a 7-year amortization provision for railroad cars. It has got a 5-year amortization for rehabilitation of Federal housing. Put all those together and you have about a billion dollars. I don't think there is a word in the House committee report that says there is anything to show that this expenditure—that is what it is, an expenditure of Government money—has anything to back it up in the form of any studies people have made.

There is nobody who has said, so far as I know, that if the Federal Government is suddenly to spend $400 million for pollution control, that the $400 million should be spent in this way of amortization for industrial facilities. If the States and municipalities are looking for assistance—and they really need assistance in pollution control—here is $400 million that ought to be going to them. Yet without any study, without any question of what the priorities are, in 1 minute the House adds $400 million of Government funds to pollution control without any regard to what is going on with regard to the rest of the pollution problem.

The same way with rehabilitation housing. There is no study that shows we should be spending as a top priority $300 million to $400 million on the rehabilitation of old houses. My guess is, if you ask housing experts if they were suddenly given $300 million to $400 million to spend what is the top priority, it would not be in rehabilitation of old housing.

So if you are looking for places to cut in this bill and to save money, and not have an unbalanced bill, there is about a billion dollars in the incentives in the House bill with no studies in back of it.

Finally, one word on the rate reduction. The rate reduction in the House bill is large. I think they go about the priorities correctly. The first priority is the low-income groups, the second priority the middle-income groups with the standard deduction.

Then they do make overall rate reductions which I think are probably on the excessive side. I think the House bill perhaps was a better bill before it was revised on the last day. But I think the Treasury approach, which is to say that the across-the-board rate reductions have the highest priority and that the relief of the lower-income groups and the relief of those in the middle-income groups not using itemized deductions have a lower priority is to put this thing backward.

I also think it is wrong at this time to start cutting the corporate tax on the ground that we may need incentives to investments.

Secretary Dillon indicated that the investment credit was adopted as an incentive to investment. The Treasury feels apparently, and I suppose most economists feel today, that at this time we don't need such incentives to investment. It may be we may well need them a few years from now, and then I think the question will be what is the appropriate way of achieving that. But at this time I would not suddenly decide that the most appropriate way is to cut the corporate tax. I think in the final analysis the more appropriate way would be, as Secretary Dillon says, to use the investment credit. But I think it is too early now to start cutting the corporate tax, especially at the expense of the low-income taxpayers in the country and the middle-income taxpayers in the country.

I did want to mention something on charitable contributions in view of Secretary Dillon's testimony, but my time is out and maybe it will be covered in questions.

Thank you.

The CHAIRMAN. Why don't you go ahead and say what you want to say about charitable contributions?

Mr. SURREY. Well, I am in a difficult position testifying with regard to Secretary Dillon's testimony. He pointed out in that testimony that he is the president of the Board of Overseers of Harvard College. I am only a professor at Harvard College. [Laughter.]

And there is an interesting difference.

The CHAIRMAN. But you are entitled to academic freedom so you can express yourself without fear of retribution.

Mr. SURREY. Secondly, he is my former boss and I have learned from long experience he has a very good batting average for being right.

I think he is not the best witness for his position—this is just an aside—because I think he would not, knowing that man, not cut his charitable contributions to the extent he indicates is involved in that case.

But I think what he is saying to you is that others may not act so rationally and they may look at this allocation provision and see that it centers in their mind on charitable contributions. That, in a sense, to them causes the problem—the charitable contributions are allocated to the other income and, therefore, the tax goes up—and they may look on that and say, "That is the thing we have got to do. We have got to do something about cutting down our charitable contributions because that has caused our tax to come up."

Secretary Dillon is saying they thus may look at the charitable contributions as the only variable in the allocation problem.

The witnesses before your committee take a different view. If you are a mayor or a local governor, you look at the allocation provision and you say it is going to hit tax-exempt interest, and people will stop buying tax-exempt bonds. They don't say people will cut their charity to get out of this problem; they say they will stop buying tax-exempt bonds. An oil man will say drilling will stop, and a farm man will say there will be problems for farmers. Each points to what is his interest and each says that that is the thing that will be hurt under this allocation.

Now, they can't all be right. What really would be the general effect is that it will be spread all over, over all of these matters and not concentrated on charity, as Secretary Dillon indicates, and not concentrated on these other matters.

Also in Secretary Dillon's example people could meet the problem by using other assets. They do not have to cut their charitable contributions. He says to cover the tax increase they might have to cut charitable contributions by 80 percent or so. They could cover the increase by using other assets or cash if they still wanted to contribute to charity. It is a question of degree.

He points out essentially that the charities have a vested interest in the continuation of our present tax system that has a large number of tax preferences. I am sure they would have the same problem before you if you suddenly closed all the preferences directly and increased their taxes—they would have that same problem. They would also have the same problem if you said, "Well, let's take out the preferences, and reduce the tax rates." Charitable giving isn't then worth as much and they would have the same problem as they present to you today.

In other words, the problem arises out of the fact that people are able today to have large preferences, but then to take their charitable contributions and allocate it against their taxable income.

Secretary Dillon said he thought, and he was quite right on this, there should be some cost in giving to charity, and people with substantial incomes should make substantial taxpayments. Without this allocation provision however there will be people with large incomes who will not make substantial taxpayments, because they will have their preference income, on the one hand, and that is excluded, and then they have their taxable income and they allocate their charitable contributions to taxable income and escape tax. The limit on tax preferences will not reach those people, only allocation will.

It is wrong to say that the person who has a lot of tax-free income needs some further relief to give to charity. You gave him the relief when you gave him the tax-exempt income, so to speak. He shouldn't have everything in this world. His charitable deductions should be allocated between the two.

Charities used to object to eliminating the unlimited charitable deduction. They no longer do that. Largely most of them now see it is morally wrong that people should contribute all to charity and nothing to the Federal Government. And in a sense that is what is happening here, when a person does make these charitable contributions he is making a decision to pay his tax to charity and not the Government.

The CHAIRMAN. If I do say, Mr. Surrey, what irritates me is a situation where the people didn't really give it to charity themselves at all. They gave it to themselves. They will take it out of one account and put it in another account. It is like John Jones finds we would owe the Government some money, he would owe the Government taxes on $200,000, so he takes $200,000 worth of stock out of a John Jones bank account or John Jones personal account and he transfers that over to the John Jones Foundation, he is still voting it. He still has control of it, he gave it to himself and, therefore, he owes the Government no taxes. Those are the kinds of things that make people look upon this unlimited charitable deduction as a complete farce. And, as you so well know, the whole thing started with that Philadelphia nun up there, and since that time every wealthy man in America has tried to figure out how can he be taxed like that Philadelphia nun. She was actually giving her resources and her income to charity but these other people have been giving it to themselves, and that is what, I think, has caused everybody to say, "Well, this unlimited charitable deduction by those who are using it are in large measure, at least in most cases, a tax device." We haven't had another Philadelphia nun to so qualify since the original case, have we?

Mr. SURREY. Not so far as I know.

That completes what I have to say, Senator.

The CHAIRMAN. Senator Anderson.

Senator ANDERSON. No questions.

The CHAIRMAN. Senator Williams.

Senator WILLIAMS. Mr. Surrey, I have been interested in your testimony. You started out and you said that the Tax Reform Act of 1969 is a very significant step forward in the accomplishment of the vital task of reform of the Federal tax structure, and you gave it your enthusiastic endorsement.

Then I noticed in your testimony you made a rather devastating attack on the inadequacies of that bill and I am going to direct a question to see if you like something in that bill.

Mr. SURREY. No, Senator, don't misunderstand me. I wanted to single out inadequacies in the bill because I think others are unlikely to single them out. But I said the bill was a good bill overall.

Senator WILLIAMS. Yes; I want to single out some in which I am sure we are in complete agreement, at least I hope so.

Now, the bill proposes to roll the oil depletion allowances back to around 20 percent; do you support those recommendations?

Mr. SURREY. Yes.

Senator WILLIAMS. I am delighted; I thought you did because for 7 years while you were Assistant Secretary I couldn't get your endorsement, and I welcome it today. I am glad I got it before I got out of office, anyway.

One other question: The House proopses to extend the surcharge for 6 months beginnnig January 1 at 5 percent. Do you endorse that?

Mr. SURREY. I think if everything else comes out all right——

Senator WILLIAMS. Well, we are sure it will.

Mr. SURREY. I wish I were as sure. I probably would put a much higher premium on tax reform than the extension of the surcharge.

Senator WILLIAMS. I think that you will agree that based upon the questions that I asked you many times when you were Under Secretary——

Mr. SURREY. Assistant Secretary.

Senator WILLIAMS. Assistant Secretary, that I would go about as far on tax reform as most of the rest because I have been pleading with the Treasury Department trying to get some support for many of these proposals for years, and I am delighted that we are getting a little support on some of those points now, even though it is rather late. But I am asking, So you would support the surcharge provision?

Mr. SURREY. That is right.

Senator WILLIAMS. How about the section dealing with the repeal of the investment tax credit?

Mr. SURREY. It is a difficult problem, Senator.

Senator WILLIAMS. They are all difficult.

Mr. SURREY. That is right.

I think probably at this period of full employment the investment tax credit may well become too costly from the standpoint of economics. Now that is really only to say to you at this time that we probably have to learn more about handling investment incentives, given our different changes in the economy. I don't think the investment credit is a bad thing. Quite the contrary, and I think it has its place, and I think it might well be wise soon to restore it.

I would have preferred some suspension of the investment credit if that rationally could have been worked out.

Senator WILLIAMS. Well, it was suspended once and then reinstated last year, as you know and, of course, we have had quite an inflationary spiral since. Do you think there was a mistake made when it was reinstated last year, looking back?

Mr. SURREY. You can't say these things are mistakes. You have to act on your best forecast of where the economy is going. On the forecasts that were then made the action was wise. Now presumably people underestimated at that time the basic strength of the economy, and more importanly, money became—credit became too liberal at the wrong time, which was again an underestimate of the strength of the economy.

But given what one knew at that time in the sense of what people were saying, I think the action was wise. In retrospect many of these things may turn out to be wrong because the forecasts have been wrong.

Senator WILLIAMS. But the point is it was reinstated last year, and I understand you are concurring in the repeal.

Mr. SURREY. This was in 1967, wasn't it?

Senator WILLIAMS. Well, it was almost 1968.

Mr. SURREY. 1967.

Senator BYRD. 1967.

Mr. SURREY. It was suspended in 1966 and reinstated in 1967.

Senator WILLIAMS. Yes.

Mr. SURREY. Yes.

Mr. SURREY. At that time it probably was the wise action.

Senator WILLIAMS. At the time that it was in effect there was an effort made to extend the investment credit by treaties on American investments in foreign countries and had that been approved by the Congress we would have a situation where we would not be able even to rescind the investment tax credit.

Mr. SURREY. No. My recollection is, Senator, as a result of your position, the position you now state, and the words of admonition you gave back then, that the treaties that were before you did contain a provision in them wherever whenever the credit was suspended or repealed in the United States it would be ipso facto suspended or repealed in the treaty.

Senator WILLIAMS. That is correct.

Mr. SURREY. You brought that up.

Senator WILLIAMS. If it were suspended or repealed it would have been an embarrassing situation.

Mr. SURREY. You are speaking if such a clause were not in the treaty, yes, sir.

Senator WILLIAMS. You said on farm losses the House bill did not quite properly deal with it. What is your proposition: to just repeal the capital gains provision so far as livestock is concerned?

Do you think that would make a major step toward correcting it? I think it was you who pointed out the mathematical possibility of a man operating a farm by converting his income over into capital gains could even convert a losing proposition into a monetary gain, and I am just wondering what is your position toward repeal of that provision entirely. Wouldn't that be a major step toward really correcting the situation?

Mr. SURREY. Yes, to an extent, but I would have to go through the mathematics. I have the impression it wouldn't do the job because the basic problem here, is not only what happens at the end of the road but what happens at the beginning.

For example, the problem at the beginning is that these investments, which instead of being capitalized which they should be, are treated as expenses and at that point they offset other income, so at that point the taxpayer is saving money.

Senator WILLIAMS. I understand——

Mr. SURREY. I think the damage is done there, and that is what I am indicating, Senator. The damage is done not at the end of the road primarily. The damage starts at the beginning of the road and, therefore, the proposal just to tax the sale as ordinary income would not completely do the job, because it would mean a deferral of tax for a rather long period of time in many cases, and that deferral is worth a great deal of money.

Senator WILLIAMS. I am not suggesting that the repeal of the capital gains would do it entirely.

Mr. SURREY. No.

Senator WILLIAMS. But you are speaking of the beginning of the road and the end. I am speaking of it while we are going down this road.

Mr. SURREY. Yes.

Senator WILLIAMS. What is your position toward the retention of the capital gains provision on livestock?

Mr. SURREY. Well, to the extent that the livestock are just assets used in business and sold as such they should be treated like other inventory and be taxable as ordinary income.

Senator WILLIAMS. What other type of livestock is there that should be subject to capital gains than that? I mean what other types are there?

Mr. SURREY. There may be some isolated sales or such. I think on the whole they are more ordinary income assets than capital assets the way you indicate, yes.

Senator WILLIAMS. I am not quite clear, do you support the repeal of the provision or not, because I don't know how we can do it halfway.

Mr. SURREY. I would support it but I want to go further on the treatment of the initial capitalization.

Senator WILLIAMS. I understand that. But I mean as far as the repeal of the capital gains——

Mr. SURREY. Let me put it this way.

Senator WILLIAMS. That is what I was trying to get at.

Mr. SURREY. If all you gave me as a choice was ordinary income treatment and Senator Metcalf's bill, I would prefer Senator Metcalf's bill.

Sena'or WILLIAMS. I was not suggesting this as a choice but suggesting this as an isolated case with the other suggestion.

Mr. SURREY. Then I would, I think, go along your line. I would like to think about it a little bit.

Senator WILLIAMS. Your suggestion on capital gains is that there is a loophole there. I didn't quite understand your testimony on a gift to a university of appreciable assets. Would you suggest the donor be taxed on these gifts that are being made at that time?

Mr. SURREY. The recommendations that we set up when I was in the Treasury did not go that far.

Senator WILLIAMS. I know that they didn't, but I am asking you now that you are out of the Treasury, because that is when we got the most of your recommendations. We didn't get any while you were there, we got those after so I am asking your position now.

Mr. SURREY. I don't want to take the time to debate that point with you, Senator.

I find it hard to answer because we have a very peculiar result today. In other words, we say to people, "If you give cash you essentially get a deduction of 100 percent of the gift. If you give appreciated property you can essentially deduct 135 percent of what you give," and in any rational treatment you would not have that result. In a rational tax world, you would tax the appreciation in property. So from a tax standpoint I would have to answer you "Yes," it is rational to tax the appreciation of property.

I think what influenced the recommendations that we made were that the other provisions would have presumably some impact on charitable giving and it might be the part of wisdom here in balancing off the two problems to take this one step now, and see what happens. For that reason that recommendation was not made, and I think that is where I would be today. But if you ask me strictly from a tax standpoint I would have to agree with you that the tax logic would be to tax the appreciation.

Senator WILLIAMS. It is not necessary to agree with me. I am trying to get your opinion.

Mr. SURREY. In tax logic you would have to tax the appreciation. I would not do it in the context of this bill.

Senator WIILIAMS. You would not do it in this bill but you are for it.

Mr. SURREY. I would be for it over time. We would move in that direction.

Senator WILLIAMS. Suppose an individual dies and leaves a sizable part of his estate or all of it for charity. Would you tax it at capital gains before it is turned over to charity?

Mr. SURREY. My recollection is that the proposal we sent up to you did not do that.

Senator WILLIAMS. Well, what would be your independent recommendation now?

Mr. SURREY. Let me put it this way: The treatment of capital gains at death is probably the most important tax reform that can be made. The treatment of capital gains at death by individuals is the most important change you can make in restoring fairness to the system.

I think it is extremely difficult to accomplish that result. I think it would be very difficult, probably impossible to accomplish it, if at the same time you were to tax those gifts to charity. I think the most important thing is to get that first step of taxing gains at death and, therefore, I would start with that only.

Senator WILLIAMS. Do I understand from you, if a man dies and leaves two-thirds of his estate to his wife and part of it to charity you would tax that part which goes to his wife more than you would to the charity?

Mr. SURREY. No.

Senator WILLIAMS. The capital gains or make it more expensive?

Mr. SURREY. No.

Senator WILLIAMS. What did you say? I understood you to say if he leaves all of it to his family you would tax it at capital gains on appreciable assets.

Mr. SURREY. Not to the wife, Senator.

Senator WILLIAMS. To his children?

Mr. SURREY. Yes, to his children.

Senator WILLIAMS. To his estate.

Mr. SURREY. To his estate.

Senator WILLIAMS. Yes, but half of it is taxable to his wife now.

Mr. SURREY. What was said there, Senator, was that in a system under which you had decided to tax under the income tax the appreciation in value of property, and under a system in which it was also suggested there would be no estate tax at the time of the transfer between husband and wife, there should also be no income tax on the appreciation in the case of a transfer between husband and wife. Rather it was thought it would be better not to impose either the estate tax or any tax on appreciation on transfers between husband and wife, but let the final tally be made on both of these at the time the assets pass to the next generation.

Senator WILLIAMS. To the children.

Mr. SURREY. To the children, that is right.

Senator WILLIAMS. But you would tax the children?

Mr. SURREY. Tax the estate.

Senator WILLIAMS. Tax the estate on that portion which goes to the children at a different rate than you would if it goes to a university?

Mr. SURREY. Under that proposal, right.

Senator WILLIAMS. I expect that is going to be a little hard to explain that to a family man if we try to implement it.

Mr. SURREY. That is right, but I have also a feeling in this world we live in without that being done nothing will be done and we will be in the same situation we are in today.

Senator WILLIAMS. But if it goes to a foundation or to a university you think they are entitled to preferential treatment over the man's family?

Mr. SURREY. Well, it is going out of the family. You have to remember that. It is no longer wealth that this family has and there is that difference. The crucial question in all of this is should a person give this money to the Federal Government or give it to charity.

Now we have a system today that says you can in many cases decide not to pay your tax but to contribute that same amount to charity at really no cost to you, or as you demonstrated with Secretary Dillon at even some advantage to you. That is the choice people have, and it is that question that we are really debating when we talk about charity.

Now, in this family situation, the person's choice would be to pay his tax to the Government or to reduce it by giving those same funds away to charity. He is giving it away. The family will no longer control this wealth except in the foundation situation.

Senator WILLIAMS. I find most of the representatives of the universities agree with you but the unfortunate part of it is when we proposed that tax we find most all of them have excellent suggestions to raise revenue except on something they are connected with.

Mr. SURREY. I agree.

Senator WILLIAMS. And if we eliminate what each witness is personally interested in we don't have much left.

Mr. SURREY. I agree.

Senator WILLIAMS. I have no further questions.

Senator TALMADGE. Mr. Secretary, welcome back. It seems like old times to have you here.

I do want to explore one thing with you and I want to make it as brief as possible.

How many municipal bonds are issued in the United States Annually? By that I mean all tax-exempt bonds, States, authorities, counties, cities, and so on.

Mr. SURREY. I have an impression it is around $10 billion of $11 billion net.

Senator TALMADGE. I think it was $11 billion last year.

Mr. SURREY. Yes, that is right.

Senator TALMADGE. And they anticipate that would increase each year and certainly with the const of construction going up, the demands for services, I think that seems logical.

Let us assume next year that these tax-exempt bonds are issued at the rate of $16 billion. At a subsidy of 40 percent it would amount to $640 million annually; is that not correct?

Mr. SURREY. I am lost in arithmetic. That $16 billion is the capital cost of the bonds, not the interest costs. That $16 billion figure is the capital cost of bonds, not the annual interest cost on the bonds.

Senator TALMADGE. I am using the 4-percent factor.

Mr. SURREY. You took——

Senator TALMADGE. That would be the capital cost; yes. Four percent of $16 billion would be $640 million, but don't you pay the—you pay the interest rate annually.

Mr. SURREY. You pay the subsidy annually. You don't pay it in one lump sum to the State and local government.

Senator TALMADGE. What would it be, get the pencil and compute it. You are very good in arithmetic.

Mr. SURREY. Let us assume they got out at, forget this present high market, let us say it went out a 6 percent.

Senator TALMADGE. Let us use the present market, that is what we have got to deal with.

Mr. SURREY. Eight percent.

Senator TALMADGE. Washington Gas Light Co. had to pay about 8.80.

Mr. SURREY. Let us say 8 percent.

Senator TALMADGE. This year.

Mr. SURREY. Eight percent times $12 billion is what—about $960 million.

Senator TALMADGE. How much would the subsidy be on that?

Mr. SURREY. Let us say the Secretary puts it at 40 percent.

Senator TALMADGE. That would be only $400 million.

Mr. SURREY. But those bonds are going out as taxable bonds.

Senator TALMADGE. Yes.

Mr. SURREY. And the subsidy really represents the tax money that the Treasury is getting on those bonds which they otherwise wouldn't get. They are simply taking it and handing it over.

Senator TALMADGE. I want to explore that with you. Now, that $400 million would be due the next year on the same bonds, wouldn't it?

Mr. SURREY. That is right.

Senator TALMADGE. And assuming they issued another $18 billion the second year, you would have an $800 million subsidy then, wouldn't you?

Mr. SURREY. That is right.

Senator TALMADGE. By the 10th year then it would build up well in excess of $4 billion a year, wouldn't it?

Mr. SURREY. The Federal Government is paying this subsidy today except we don't see it in our accounts.

Senator TALMADGE. That is what I want to get at now. I am trying to get to the point in just a moment. This subsidy would pyramid year after year to reach a phenomenal sum in 10 or 12 years, wouldn't it?

Mr. SURREY. Yes——

Senator TALMADGE. But in excess of $4 billion or $5 billion. You would agree with that, wouldn't you?

Mr. SURREY. I don't know about the arithmetic. Right today we have about $124 billion or $125 billion of outstanding State and local bonds. Each year on that State and local governments save about $1.8 billion. That is the subsidy the Federal Government is paying today, $1.8 billion, a year, to them. We lose however about $2.6 billion in revenue today. So right today——

Senator TALMADGE. You are assuming by that conclusion that every dollar of those bonds would be taxable, aren't you?

Mr. SURREY. I am assuming they were taxable bonds.

Senator TALMADGE. All right. You are getting to my point now.

Don't you think if these municipal bonds were issued on a taxable basis that they would also reach the level and sometimes exceed the level of corporate bonds?

Mr. SURREY. I think it is hard to say, Senator. Some may, some may not.

Senator TALMADGE. A little village with limited resources is trying to put in a water system, and the Government isn't guaranteeing their bonds. All they are doing is paying the subsidy so that bond might reach an extremely high rate, may it not?

Mr. SURREY. You are saying reach an extremely high rate because of people's doubts as to the security of the——

Senator TALMADGE. Lack of resources and so on. You are familiar, of course with the rating of bonds; some of them high ratings and some of them low.

Mr. SURREY. Yes, that same——

Senator TALMADGE. The price range depends on the rating doesn't it?

Mr. SURREY. To some extent that would be true of their present interest rate. Their present interest rate would be higher than the normal run of tax-exempts.

Senator TALMADGE. What is going to happen? You are calculating that every dollar of this bond issue would be taxable to the Federal Government. Don't you think the pension funds and tax-exempt funds, retirement for State and local employees, city and county governments are going to come in and start buying up a lot of these bonds and your taxable theory then is going to evaporate.

Mr. SURREY. No, if they start buying those bonds, they have got to stop buying corporate bonds. Somebody else is then going to start buying the corporate bonds.

Senator TALMADGE. You figure the displacement value then would make up for it?

Mr. SURREY. I am only giving you the calculations that others more expert in this than I have given. The Treasury's calculations in this area estimated roughly about, as I recall, a 40-percent tax rate applicable on the average to these bonds. If you just went through the arithmetic, the calculations would show that today, if all the outstanding bonds had been taxable—and they assumed a certain rate of interest—the Treasury would have been collecting about $2.6 or $2.7 billion in revenue. If you look at the actual difference in interest rates to the States, they only received $1.8 billion. There is thus a commission being paid here. I would like to see this commission given to State and local governments directly. I would like to see this waste that goes on, this high commission we hand to the banks, and this high commission we give to wealthy people to buy these bonds—and we do give a commission to them to do it because the tax-exempt rate is not pitched to the 70-percent taxpayer, it is pitched at around the 30- or 40-percent taxpayer. The 70-percent fellow is getting a real windfall. I would like to take this commission and give it to State and local governments and that is what this 40-percent subsidy is. The Federal Government would break even.

Senator TALMADGE. You are dealing with a theory there.

Mr. SURREY. No.

Senator TALMADGE. As a fact I can see where the Federal Government would be paying a subsidy here at a minimum of $4 billion a year in about 10 years and if these bonds have 20-year average life, most of them are longer than that, I can see where the subsidy can reach $8 billion a year, and then if these bonds start going into the hands of pension funds, which are increasing astronomically year by year, you are getting them into hands where you can't tax them and you might wind up with a huge deficit by using this theory.

Mr. SURREY. Yes. But the only way a pension fund can buy these bonds, Senator, is by not buying corporate bonds and somebody else is buying corporate bonds.

Senator TALMADGE. Right now they are not buying any municipals and the reason they are not buying municipals is because the tax on them is exempt and the pension funds don't have to worry about taxes because they are all exempt. They will start buying whatever pays them the highest return.

Mr. SURREY. That is right.

Senator TALMADGE. And if you get a municipal bond which is taxable up into a very high bracket you are going to get a great many of them in nontaxable hands in the pension funds.

Mr. SURREY. Let us assure the pension fund had only one bond for the sake of argument, and it is a taxable bond because there is no point in its owning a tax-exempt bond today. All right, there is not particular reason for the fund to displace that bond. It has a taxable corporate bond today. There is no reason for it suddenly to throw that away and buy another State and local bond. It might decide to buy the State or local bond and because it may look more attractive, and it may want to diversify my risk or it may do so because of its expanding funds, this widens the market for State and local bonds. But if it does not buy corporate bonds, somebody else, will then buy corporate bonds.

Banks will. Today they buy tax exempts. They have to do something with their money. If the tax exempts are not there they are going to have to buy taxables.

There will be this very large subsidy amount piling up. I don't disagree with you but it will not be a loss to the Federal Government. It will be offset and balanced by the increased taxes the Federal Government gets when tax exemution goes out and taxability goes in. The studies that people have made, these are studies of people who have worked in this field, would show you could nearly go up to 45 percent as a subsidy, somewhere between 45 and 50 percent and end up with no net loss to the Federal Government.

Senator TALMADGE. I am not so sure those conclusions are correct. Because I think a large part of that, with high premium bonds, would wind up in funds that still were not paying the tax.

Mr. SURREY. Let me say, Senator, the inquiry and debate and discussion should be along the lines of these questions of facing up directly to what would be the impact of this new method. Let us think that through very carefully before we come to the conclusion that I think the mayors and localities have done without even considering

Senator TALMADGE. Thank you, Mr. Surrey.

what would be the consequences.

Thank you, Mr. Chairman.

Senator BENNETT. I was not here when Mr. Surrey testified so I have no basis for questions.

The CHAIRMAN. Senator Miller.

Senator MILLER. Mr. Surrey, I have known you for a long time, and you enjoy a reputation of being not only an outstanding tax authority but a leader in tax reform, albeit sometimes a little controversial.

Now——

Mr. SURREY. The two go together.

Senator MILLER. I realize that you were over with the administration for 8 years, and I understand further that a good many of the provisions in the pending bill represent recommendations and ideas that you had for a long time.

Now that you are no longer affiliated with the Government, I am very curious to know why after your 8 years over there it was not until after you left the Government that all of a sudden we have this, these recommendations before us. Where did this thing stop? Why didn't we get these recommendations before us 8 years ago instead of today. As I understand it you felt very strongly about some of these tax reforms, and what I can't understand is why they took 8 years and after you had left the Government service before we had these before us?

Mr. SURREY. Well, that is not hard to answer, Senator Miller. A number of the recommendations that you are dealing with are recommendations that were made in 1963 and simply not adopted by Congress. There were recommendations in 1963 dealing with the unlimited charitable deduction, dealing with the depreciation on real estate, dealing with farm tax losses and the like. They were sent up here. The Congress of the United States at that time chose not to adopt these recommendations.

Senator MILLER. Well, now you mean the Congress or the committee?

Mr. SURREY. The tax committees.

Senator MILLER. In other words, the Ways and Means or Finance Committees did not see fit to report them out but you made the recommendations?

Mr. SURREY. That is right.

Senator MILLER. On behalf of the administration?

Mr. SURREY. That is right. A lot of these recommendations were made in 1963.

Now, we get educated as we go along. Let us go on now, on to 1967 and 1968. It was very clear that the Treasury was going to come up with another tax reform recommendation in, hopefully in 1967. It was expected that it would follow upon the enactment of the 10-percent surcharge. It was thought undesirable to push those two together because the surcharge was needed immediately.

It was said that there would be a tax reform bill after the surcharge and all the present material that had been made available early this year was in the process of study at that time.

The timetable just got completely out of control. I think if that timetable had not gotten out of control these recommendations could have come up to the Congress much earlier than they did. I am sorry that that was the result. But the recommendations were being prepared. Secretary Fowler said repeatedly in those years that there will be tax reform recommendations to come up as soon as the stabilization aspect, the 10-percent surcharge, was passed, and that these would be in the legislative process.

I would add another thing. After the 1963 and 1964 recommendations were not followed, we commenced in the Treasury an intensive study of the tax returns of high-income taxpayers and an intensive study of the corporate tax system to see essentially where the tax slippage was. In other words, what are the reasons, the basic reasons, why people don't pay their fair share 'n taxes. I think that study was a good job and I think it has helped to explain more to the American people and Congress just where the problems are. I think that is something which has helped the present interest in tax reform. I am sorry it wasn't done earlier.

Senator MILLER. You began the study in 1963?

Mr. SURREY. Beg pardon?

Senator MILLER. You began the study in 1963?

Mr. SURREY. We began it essentially when, we saw we were unable to convince the Congress in 1963 and 1964 of the need for some of these reforms and we had to go back and really see what was lacking in our presentation.

Senator MILLER. And you didn't complete it until when?

Mr. SURREY. It was largely completed in the course of 1967 and so on when we thought we were coming up at that time with a tax reform bill.

Senator MILLER. There was another study on foundations, and my recollection is that that was a very comprehensive study that was completed in 1965.

Mr. SURREY. I think that is correct; yes that date is correct.

Senator MILLER. And it contained numerous abuses in the foundation area. Why wasn't that acted on?

Mr. SURREY. Well, I wish I knew. That was sent up and it was urged that there be action on it.

Senator MILLER. Recommendations from the Treasury Department that there be action?

Mr. SURREY. Yes; the Treasury wanted action on that. I might add that there was a bill, for example, introduced dealing with charities, churches and others, borrowing money to buy businesses. The Treasury strongly supported that bill. It was introduced, I think, in late 1966 or 1967 but it didn't move in the committees.

Senator MILLER. By the committee you mean the Ways and Means Committee?

Mr. SURREY. Way and Means Committee. The material on the foundations was sent to both tax committees. I think at that time the interest of the Congress lay in some of the other problems in the tax field. It lay in the economic stabilization problems, and there wasn't this dramatic interest in tax reform. I had hoped that the foundation recommendation would have been acted on much earlier.

Senator MILLER. Thank you very much.

Now, do I understand in your response to Senator Williams' questions that you would draw no distinction between breeding and dairy livestock and ordinary livestock held in inventory and sale in the ordinary course of farming and ranching?

Mr. SURREY. No; I did say I wanted to think about that, Senator Miller, and I haven't really thought enough about the direct approach.

What I was saying is that where you have inventory cattle and cattle essentially being sold off currently year after year as a business, it seems to me that is ordinary gain, and that——

Senator MILLER. You are talking now about a rancher who sells off his young stock year after year, a certain number of them for feeding purposes, and you are not talking about the rancher who sells off his breeding bulls as they get older?

Mr. SURREY. You know much more about this business than I do. That was the part I wanted to think about.

Senator MILLER. Well, I hope you will consult with ranchers in Massachusetts before you reach a conclusion. [Laughter.]

Mr. SURREY. That is a part I wanted to think about. But I really do feel, as I indicated to Senator Williams, that the crucial thing in this is, what Senator Metcalf is aiming at with respect to deduction of capital expenditures.

Senator MILLER. Now granted this proposal to have tax-exempt municipals with a Federal subsidy——

Mr. SURREY. Taxable municipals.

Senator MILLER. Made taxable, with a Federal subsidy.

Mr. SURREY. Yes.

Senator MILLER. Is an optional provision in the House-passed bill, even though a municipality should elect that option, would the taxation be constitutional?

Mr. SURREY. Well, I am one who has not had any problem with the constitutional aspect of taxation of State and municipal securities. I therefore think certainly on an optional it would be constitutional. I see no problem there.

Senator MILLER. I don't know. I am just asking.

Mr. SURREY. I see none.

Senator MILLER. Has that been researched out?

Mr. SURREY. I would put the answer this way: There are in the record books opinions of the Department of Justice and opinions of the Treasury Department of long standing that it would be constitutional to tax the interest on State and local bonds. I have seen no governmental opinion by the Federal Government that it would be unconstitutional.

Senator MILLER. There was an interesting point raised by one of the Governors the other day, and that was that if, for example, we should seek to use the allocation of deductions approach or the limit on tax preferences approach with respect to State and local bond interest, that those States having income taxes, and most of them do, could turn around and revise their State income tax laws to include a limit on tax preferences and allocation of deductions approach to Federal bonds. That could be done, could it not?

Mr. SURREY. I would have to think about that, Senator. Without the consent of the Federal Government its bonds could not be taxed directly by the States. Whether an allocation approach would cut across that I would like to reserve judgment.

Senator MILLER. Would you care to furnish the committee with a comment on that a little later on?

Mr. SURREY. Yes, I would like to think about it.

Senator MILLER. We would value your opinion on it.

Mr. SURREY. Of course in the final analysis, if we had this subsidy and State and local bonds took the taxable route, I think it would be wise for the Federal Government to consent to the taxation of its bond interest by State and localities.

Senator MILLER. Now, in your comments you merely draw attention to the action of the House bill on percentage depletion, indicating that it roughly represents a 25-percent reduction. If I know you very well, you have never favored a meat-ax approach in handling tax matters. Doesn't this flat reduction of 25 percent across the board up and down the line, according to various resources, doesn't that represent a rather meat-ax approach without getting at the real abuses that exist?

Mr. SURREY. Well, the difficulty, I suppose, is that any action taken in the depletion areas has a meat-ax aspect because it is essentially compromising among a lot of contending forces.

I happen to be in this position: The preferences as to depletion stand along with all the other tax preferences in this light. The Government is spending a lot of tax money in this area. To my mind the question always is what is it getting in return for having spent this money. When I was in the Treasury I really sought an answer to that question and tried to get the best econometric judgments I could. Our studies were made available to the committees and they show that for one reason or another, whatever it may be, the Government was spending large amounts here and was not getting anywhere near commensurate returns. Now that seems wasteful, and I would like to see it ended—just as I think we are spending large amounts of money in the real estate area and not getting commensurate returns in the kind of housing we really need.

Senator MILLER. When you say "we"——

Mr. SURREY. I mean the people of the United States.

Senator MILLER. I take it you are talking about the people of the United States.

Mr. SURREY. The people of the United States.

Now, in the case of depletion, I suppose if similar studies were made of other industries we would find the same thing. The problem is thus, a tremendous amount of wastage in these areas and the funds could be spent directly to far better purposes. However, having erected this structure in the past, if one is to reduce it, whether it should be done scientifically or not, is very hard to accomplish.

I think all things being considered while the House approach, 25-percent reduction across the board has the meat ax aspect you indicate, still it is using a rough and ready meat ax in an area where there is no basic logic behind the existing percentages. No one has ever carefully indicated why one percentage is at one level and another is at another level. The whole area has been treated in the past that way. The House approach is thus in keeping with what you have to do when you have a set of arbitrary numbers that have no basic study or rationality behind them.

Senator MILLER. Yes, but in line with your policy of looking at this to see what is the benefit we receive from it, I am concerned about a meat ax approach which could result in an increase in the cost to consumers of all of the products involved in these various categories of percentage depletion, and you may recall that Vice President Humphrey in the Presidential campaign, and President Nixon, were opposed to the meat ax approach, and Vice President Humphrey called attention to the concern over the increased cost to the consumers, and it seems to me this fits in with your policy and that a meat ax approach is one to be avoided as distinguished from a more sophisticated approach in looking at where the abuses really are.

Let me give you one last example because I know my time is up.

Take two corporations. Let us just take petroleum corporations. Each of them has a million dollars resulting from percentage depletion. Corporation A takes its million dollars and plows it back into exploration, development and drilling which is calculated to provide more resources for the people of the country.

Corporation B doesn't do that. Corporation B takes the million dollars and pays it out in dividends to the stockholders.

Do you think they should be treated alike?

Mr. SURREY. I would let their initial basic tax consequences be the same. Then presumably one corporation that engages in drilling will constructively move forward with perhaps a wiser investment of its funds than the corporation that decides not to engage in constructive drilling——

Senator MILLER. Your answer is that you would treat them exactly alike from a tax standpoint?

Mr. SURREY. Except to the extent that I would allow deductions over time for the expenses of drilling. That is the difference between them and I would treat those drilling expenses in an appropriate way.

Senator MILLER. But they both are entitled to intangible drilling development costs now?

Mr. SURREY. Yes; but one is apparently drilling more than the other.

Senator MILLER. One doesn't drill at all.

Mr. SURREY. That is right.

Senator MILLER. The other pays it out to the stockholders.

Mr. SURREY. I say the one who doesn't drill at all wouldn't have any drilling expenses under my approach. The one that does drill would have expenses to amortize. That tax difference would recognize the appropriate difference between those two companies.

Senator MILLER. Thank you. My time is up.

The CHAIRMAN. Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Surrey, when President George Meany of the AFL-CIO was before us, he made a recommendation that municipal bonds should not only be guaranteed by the Federal Government but that the interest be subsidized, and when asked a question as to what would happen when they promiscuously issued bonds that would be guaranteed and, therefore, salable on projects which would not be feasible, he said well, that the Federal Government would decide that issue so they would be in control.

What would your position be, first, on whether or not these bonds should be guaranteed by the Federal Government and, second, what control would you advocate?

Mr. SURREY. I do not think that I would guarantee the bonds of State and local governments because that would involve at this stage elements of Federal control.

As I see the virtue of the present system from the standpoint of mayors and Governors, it is that they have full freedom to draw on the Treasury Department without any questions asked.

When they issue a bond, it goes out tax exempt, regardless of the character of the bond or the nature of the municipality, and the Federal Government supports it through tax exemption. These Governors and mayors and localities see that as a positive virtue and I would not differ with them on that in our Federal-State system.

So consequently I favor the House bill which does not involve any element of control, because there is no guarantee. It is just correspondence between the mayor and the Secretary of the Treasury. The mayor says, "Our bond issue is going out tomorrow, the interest rate is so much, we would like to have your check for 40 percent of it," whatever the figure is. That is all it is. I would favor that.

Guarantees will get you into the aspect of control and I think that would upset the picture. There may well be avenues of further assistance such as an urban development bank which can go further and, if it wants, lend moneys even at better advantages to State and local governments on those projects that the bank approves. But I would leave open to State and local governments the avenue of being able to issue their bonds without the Federal control and with the subsidy in the House bill. So I don't think I would be in favor of guaranteeing the bonds.

Senator FANNIN. Thank you, Mr. Surrey. But the problem the Governors expressed is they started out with subsidizing the interest, the differential, then what is the next step, and that is their fear. Of course we do not take into consideration the constitutionality but, as you probably know, "If you are going to tax our bonds, State and local municipalities, then we will tax Federal securities."

I know we don't want to get something started on that.

Mr. SURREY. I said earlier I wouldn't object to State and local governments taxing Federal securities. If State and local government bonds go out on a taxable basis, I think the Federal Government ought to consent to States and localities taxing its bonds.

Senator FANNIN. I know of course it is a constitutional question which I won't get into but I know the Governors felt turn about is fair play.

Mr. SURREY. Yes; I think so, too.

Senator FANNIN. One item you know in your testimony, you talk about as to high-income taxpayers in that paragraph, the extension of the 6 months holding period to a year, you recommend that, and we have had a variance in testimony, we have had one professor who stated he did not think this would have over a 1 percent effect on a number of transactions. We have had others testify that they though that it would have a great effect in that it would reduce the revenue to the Federal Government. There would be so many that would not decide to go into an issue where—or would not go—yes, go into an investment where they would have to depend on a year where they would as to 6 months. What is your opinion?

Mr. SURREY. I think my opinion is the same as Secretary Dillon had before you this morning, that this would not have a material effect on investment. It is a sound change from the tax standpoint since 6 months is far too short. I was certainly reinforced in my judgment when Secretary Dillon, who is far more experienced in these matters, thought it wouldn't make any difference at all as respects investment.

Senator FANNIN. On the municipal bond issue you commented, you talked about what would happen in the House bill if we went along with it.

This is an important question because already we have had a tremendous effect, by the testimony given us, on the bond market. I realize other factors may be involved, higher interest rates. But the $140 billion of municipal bonds outstanding that were tax-exempt it was estimated that these securities have depreciated anywhere from 20 to 30 percent. Do you feel that is a fact?

Mr. SURREY. Obviously there has been a depreciation in existing tax-exempt securities. But that has equally been true whether it is tax-exempts or corporates or U.S. obligations previously held. They have all depreciated because interest rates have gone up. It isn't limited to State and local government bonds. Everybody with a fixed investment has had a depreciation in the value of his obligation.

Senator FANNIN. That is one factor. Previously there hasn't been that radical change in municipal bonds as compared to industrial bonds, corporate bond, because they were tax-exempt. Hasn't that always been a factor?

Mr. SURREY. No, their rates have been rising relative to corporate bonds over the last few years.

Senator FANNIN. Until recently there hasn't been that differential.

Mr. SURREY. But, you see what nobody asks is this, and this is what we have to get to. Let us assume this legislation passed tomorrow. We are going through a transition period. But let us assume it passes tomorrow. The interest rate on the issuance on future obligations will be controlled not by a question whether tax-exempts are taxable or not.

It will really be controlled by the fact they will be taxable bonds, and the net cost to the municipality will be controlled by the amount of the subsidy that is paid. That will be the crucial thing.

Senator FANNIN. Yes, you are taking into consideration the subsidy will apply.

Mr. SURREY. Yes, and then you will find also that if the $11 billion or $12 billion of bonds previously issued annually as tax-exempt were to go out as taxable bonds, the value of the outstanding tax-exempts will rise and many people who have suffered losses in this period will start finding their values restored.

Senator FANNIN. Well, one problem: Do you feel that the municipal bonds have been greatly—that is more—affected by the possibility that this legislation will be approved than corporate bonds, industrial bonds? In other words, we have had a big change.

Mr. SURREY. Statistically I have not gone back and looked at that. I think to the extent it has, part of it is the misinformation with respect to the existing House bill and its consequences.

Senator FANNIN. Well, it has worked a great hardship already because they have not been able to sell their bonds, as we have had reports in the last few days, that they have even tried to pull back the issues that had been contemplated.

Mr. SURREY. But again, let us assume this bill were to pass at the end of this year, make that assumption. Every one of these people who wanted to issue new bonds would, on a taxable basis, get immediately 40 percent of that interest paid by the Federal Government.

Senator FANNIN. Well, I realize that.

Mr. SURREY. Then they would be able to issue them.

Senator FANNIN. This was one of the factors that was involved in the dispute that they felt that this was a first step and what would follow, and of course they stated that they did not feel that the Federal Government should have control, should not guarantee municipal bonds. Of course others are advocating that that procedure be followed.

Mr. SURREY. I agree there should be no control.

Senator FANNIN. One last item, we have a great problem as far as the competitive position of our industries with the other industries of the world with some of the foreign countries, and some of the countries are getting incentives. For instance, no capital gains tax in Canada and many other countries, and the elimination of the investment tax credit is a factor involved. I asked Secretary Kennedy about this matter, and he state the Treasury is studying a program, perhaps increasing depreciation or some factor, that would be involved for the encouragement of the investment in new machinery, modernizing of equipment. Do you have any suggestion, he said for a rifle approach rather than a shotgun approach, for investment credit?

Mr. SURREY. I didn't get that, I am sorry.

Senator FANNIN. He said a rifle approach, as I remember it, rather than a shotgun approach as the investment tax credit.

Mr. SURREY. If we come to the conclusion that after we pass through this present inflationary period our economy and our tax structure will require some affirmative incentives to investments, my general belief would be the same as Secretary Dillon's that the investment credit is the most efficient way to do it and that other methods such as depreciation and the like are unlikely to do it as effectively or as efficiently as the investment credit. I would still keep that number one on my list of appropriate encouragements to investment.

Senator FANNIN. And you would want that to be across the board?

Mr. SURREY. I think, all things being considered, I would want it to be across the board.

Senator FANNIN. In other words, that is your recommendation, but do you think it is wise for an on and off basis on investment tax credit? Isn't it very difficult for firms to make, to do their planning, programing if they cannot depend on one method or another?

Mr. SURREY. That is a very difficult matter you have put your finger on. That will be true, I think, of any incentive to investment that we work out. If we come to periods where the economy is starting to run away with us, whether its incentive is depreciation or anything else, I think you will find economists will recommend let us start drawing back at that particular time.

Now, unfortunately we have not yet worked out in this country some method of handling the accommodation of these investment incentives to periods where investment is too strong. I think that is the task we all have, whatever the nature of the investment incentive is.

I see yet no clear answer to it but I think it would equally be true whatever the character of the incentive.

To some extent business has those problems of adjustment because of changes in interest rates. When we use interest rate changes as a factor everybody has to adjust because things have to change if there is going to be stabilization of the economy in this country.

In a sense taxes therefore will have to be in some way or another put on the same basis and we will have to work our way through and learn to do better there, as equally we have to learn to do better with handling interest changes.

Senator FANNIN. I think the question was whether or not this stands out as an easy way to make a change, so that the investment tax credit has been, the history of the process to date, that it can be changed, it just shines out just like the 27½ percent depletion allowance, and so it seems to be a target, and certainly it has been a target as far as the House bill is concerned and it has been a target in the Congress, you know, constantly. So I was just wondering if we might devise a system whereby industry could make their plans ahead and go ahead and have the confidence that they can expend the money necessary to modernize equipment to compete with other industries of the world, because we are certainly losing our competitive position if we consider the total dollar volume of the world business and the percentage that we are receiving today.

Mr. SURREY. Yes, but I think the difficulty is that our competitive position is much more hurt today by our high cost as the result of the inflationary situation. If that could be controlled then we would be in a much better competitive position and then we would, I think, again face the problem you indicated, what is the general relationship of our tax system to systems of other countries.

Senator FANNIN. Yes, you touched on one of the great problems, that we have had an increase in labor costs, without much increase in productivity and it is a very serious problem and, of course, that gets us into the question if we are going to try to correct the tax inequities what do you feel should be done as far as the investment money that—the return on investment that unions receive that are tax-exempt? I mean on unrelated income they pay tax but when you get into investments, as I understand it they do not pay tax.

Mr. SURREY. That is correct. They are put in the same category as other nonprofit organizations that happen to have investments.

Senator FANNIN. But we are changing, for instance, on foundations, and other organizations or other types of entities, why isn't this a factor involved in tax inequity today, tax preference?

Mr. SURREY. No, I think there is a difference. In the foundation situation I would agree with Secretary Dillon, that it would be unwise to tax the investment income of foundations—just as it would be unwise to tax the investment income of universities—if, and let me add this big if, if all the basic abuses in the foundation area are corrected. I would put as one of the many serious abuses the control of businesses by foundations. But if foundations clean their house, and are no longer under the tax cloud and the general cloud that they are today—if they get out from under that cloud largely as a result of many of the provisions in the Treasury recommendations that have found their way into the House bill—then I see no reason to levy a 7½-percent tax on their income. In that sense they and the labor unions and other nonprofit organizations which have investment funds would pay no tax.

I think we should take a look at all of the nonprofit organizations again, the whole list that we have in the Internal Revenue Code, go through them again and see if they all should be on that nontaxable basis. Without making judgments on any one of them at this time, I think the whole list should be looked at.

Senator FANNIN. I agree with that. But when you look at the labor unions, the giant unions, the international unions and all, and their income, and I think we must go these other steps along the line to determine what is done with that money and how it is utilized in many ways that I think certainly are detrimental to our whole system of government.

Mr. SURREY. If you look at them, my guess is they show no net income for the year because of their outlays, and you have the very difficult problem when you decide to tax investment income, do you take account of the expenditures.

This bill on foundations overlooks all that and levies a flat tax on investment income.

Senator FANNIN. But you think we should follow it down the line with other steps to see just exactly what is the end result.

Mr. SURREY. No; I have a feeling that it would not be profitable to follow down along the lines you are suggesting in most of our major nonprofit organizations.

Senator FANNIN. I am talking about unions.

Mr. SURREY. No; I don't think it would be profitable to follow that line, I really don't.

Senator FANNIN. You don't think that that revenue——

Mr. SURREY. I don't think so. I would have to disagree.

Senator FANNIN. Thank you.

Senator ANDERSON. Senator Byrd.

Senator BYRD. Thank you, Mr. Chairman.

Nice to see you again, Mr. Surrey.

Mr. SURREY. Thank you, Senator.

Senator BYRD. You are certainly able and knowledgeable in the field of taxation and I am delighted you are here.

I noticed your comment a moment ago about the possible need in the future for investment incentives, with particular reference to the investment tax credit.

I would like to state for the record some history in regard to this.

I am taking it from memory but I believe it is accurate.

When this proposal was first enacted I opposed it on philosophical grounds because it appeared to me that it was going in the opposite direction to tax reform.

I think it worked out well in practice and I think it helped business to modernize itself, but from a philosophical point of view it seems to me it goes in the opposite direction from tax reform because it gives a special tax benefit to one particular group.

Now, in March of 1966 Senator Gore introduced an amendment in the Senate to repeal or suspend the investment tax credit, and the Treasury Department vigorously opposed that. I was persuaded by the Treasury Department that Senator Gore's amendment should be defeated and I voted against it and the majority of the Senate sustained the Treasury.

Then we come 6 months later in October and the Treasury Department then says now this has got to be repealed, it has got to be suspended, it must be suspended. But I had been so persuaded in March I wasn't going to change my mind 6 months later. But the Senate did follow the Treasury again and suspended investment credit for 9 months. Then another 4 months passes and the Treasury Department says no, we have got to put that back now. We don't want it to continue in suspension for the full 9 months. So we put it back in February of 1967, or thereabouts, approximately February of 1967.

Frankly, I couldn't keep up with the gyrations of the Johnson administration on this investment tax credit. But what it dramatized to me is that we are trying to run this great big country out of Washington, and although we have tremendous able men in Government, I don't think that anybody is able enough or any combination of men here in Washington is able enough to attempt by these changes in the tax laws from month to month to keep our country on the right course. So I am willing to vote to eliminate the investment tax credit, but I would think it would be very unwise to vacillate back and forth such as we did during 1966 and 1967.

Now, let me get to this question of subsidy to the States on tax-exempt bonds.

The Chesapeake Bay Bridge Tunnel bonds are now almost to the point where the interest will be defaulted on those bonds at 5¾ tax exempt but the money is about to run out to pay the interest on those bonds.

Now, under your proposal, would the Federal Government subsidize the interest?

Mr. SURREY. Under the proposal in the House bill, which I have favored, as I understand its mechanics on a future issue of a bond, let us say if a bond goes out at a 7-percent interest rate, taxable rate, the Federal Government has entered into a contract to pay the locality which issues that bond, let us say 40 percent of that interest. That would be paid as each coupon falls due regardless of what the locality itself did, even if it defaulted. It would seem to me there was a contract with respect to that 40-percent payment and that that must be paid.

Senator BYRD. So then the bondholder of, just to take as an example the Chesapeake——

Mr. SURREY. If that were a new issue.

Senator BYRD. If it were a new issue, the Chesapeake Bridge Tunnel bonds, the bondholders would have their interest up to 40 percent at least guaranteed by the Federal Government at the time the bond is issued; is that the way it would work?

Mr. SURREY. That is the way I understand it. It is a flat call on the Federal Government, no questions asked, for 40 percent of the bond interest if the Secretary fixed the subsidy at that level.

Senator BYRD. Well, in the present budget the taxpayers are paying $17 billion in interest. That is what the Congress will be called upon to vote for interest charges in this current fiscal year. If this proposal goes through, it seems to me that the interest charges to the Federal Government will go up very, very substantially, and the only place that that money can come from is out of the pockets of the wage earners, and the middle-economic group mostly, because the middle-economic group, those under $20,000, pay two-thirds of all the individual income taxes that are paid into the Federal Government.

Mr. SURREY. I really don't think so, Senator. I think I have the same feeling as you do, that the taxes should not be raised on low- and middle-income groups, but I don't think that would be the case here.

In nearly total part as I indicated, in discussion with Senator Talmadge, the money to pay this interest subsidy is going to come from higher taxation of people in the upper brackets and banks. It is not going to come out of the wage earners. It is in a sense the commission we are paying today to people because they buy tax-exempt bonds instead of taxable bonds.

Senator BYRD. But if it increases the cost of the Federal Government, it is going to come out of the pocket of the individual citizen and out of the pockets of the wage earner.

Mr. SURREY. But it is going to come out of increased taxes of people who presently largely are holding tax-exempt bonds and they are going to have to switch to taxable bonds. The average rate of tax that the Treasury applies in its calculations as to the revenue it will obtain from taxable municipals is a 40-percent rate of tax. In other words, it assumes that these taxable bonds will go out and on the average, counting corporate and individual taxation, be taxed at roughly 40 percent. That is not the bracket of the low-income and the middle-income people. And it is from that 40-percent-bracket area that the Federal Government is going to recoup the commission it pays today to those who buy tax-exempt bonds.

I would share your concern if this were simply a question of, let us say, tax sharing by the Federal Government with the State and local government. That is an added expenditure for the Federal Government. It has got to be met by some device if you are going to do it.

This bond subsidy is not, because this carries with it a recoupment in regaining funds that are lost through tax exemption today, and lost in the brackets that I say average around 40 percent.

I have your genuine basic concern, and I share that with you on not having the low-income, middle-income people have higher burdens. But as I have indicated the burden will be lower.

Senator BYRD. The burden can't be lower because the burden is going up.

Mr. SURREY. It can on an allocation in the cost of government. This bill has some allocations in the cost of government. It is a major allocation in the cost of government.

Senator BYRD. I can't forget this figure, that is, two-thirds of all of the individual income taxes are paid by those who earn $20,000 or less. So when we increase the cost of government, however we do it, by military expenditures, by welfare expenditures, by whatever expenditures we make, we increase the burden mostly on the middle economic group, because there are simply more people in that group.

Mr. SURREY. Yes, but look, however, at the figures in the House bill on the impact of this bill, and you will see that starting with the very lowest income there is a major reduction in their taxes, and that extends all through the middle-income groups. There is an increase in the upper-income groups, and there largely is an increase in the corporate tax.

But looking at this bill alone, this bill alone, and all the costs that it involves, the shift is in the direction I indicated and not adverse to the groups that you are concerned about.

Now, on future costs of government, future costs, that is a different issue how they are going to be met. There your general figures are correct. You are correct on those future costs.

Senator BYRD. Yes.

Mr. SURREY. But not on the particular cost of this bill.

Senator BYRD. Let us just change the subject for a moment here. Could I get your view on this: Do you feel that there should be a termination date on foundations, that is, should they be perpetual or should they be cut off 50 years, 75 years, a hundred years?

Mr. SURREY. I do not feel that there should be a termination date. I do feel, however, and this is indicated in the recommendations of the Treasury report, that after a reasonable period of time there should be a change in the character of the people who are controlling the foundation. If a foundation wants to exist in perpetuity it should have a group in control that is not so closely associated with the dominant interests that formed the foundation as we do have today. These are philanthropic funds for the use of the public, and I would rather see boards that are not donor-dominated. Therefore, our recommendation was that after a period of years the donor's position on the board and those associated with him should be a distinctly minority position. Under those circumstances I think the foundations should continue.

I feel that a well-run foundation without all the abuses we have today, without its involvement in controlling business and the like, is a useful philanthropic institution in the United States.

Senator BYRD. From your experience in the Treasury Department, do you feel that there are adequate laws today to see that these foundations operate as they are supposed to operate? Is it lack of manpower that prevents closer scrutiny of them?

Mr. SURREY. No, it is the undesirable present substantive rule, it isn't lack of manpower. All the manpower in the world, I don't think, would reach the abuses that exist today.

Senator BYRD. How do we get at the abuses?

Mr. SURREY. How do we get at them?

Senator BYRD. How do we get at the abuses?

Mr. SURREY. Well, the House bill goes a long way in doing that, Senator Byrd. Because the House bill—let us just take a minute—the House bill says that a foundation cannot accumulate its wealth and give nothing to charity. It cannot invest in growth stocks or in land that is appreciating with no income from it and nothing going to charity. The House bill ends that substantively by saying the foundation has to pay out its income or 5 percent of its assets.

Today many foundations serve two purposes in the United States. One, the money may go to charity, but, two, and often the more fundamental purpose, is to protect the business that is put into the foundation—either protest the business with respect to the family controlling it or to see that this business is not gobbled up by another business in a merger or something. That is not the function of philanthropy. It is not a philanthropic function to protect businesses in this country.

Senator BYRD. I agree; how do we get at it?

Mr. SURREY. The House bill would say that foundations cannot have more than 20-odd percent of the stock of any business. In other words, they cannot be put there to control that business. This present control of business is a substantive abuse that no manpower will reach. You have to make a basic change in that and the House bill does. There are other provisions with respect to self-dealing, provisions saying that the donor cannot use the foundation as his pocketbook. Those are good provisions and they were recommended earlier, as Senator Miller indicated. When that has been done, I think you will see far less of abuses because foundations will be devoting themselves to philanthropy and not to the other things which they are being used for today.

Senator BYRD. I think those provisions you mention, many of them, are good ones and should be considered and utilized. But that doesn't get to the other abuses as to the misuse of these tax-exempt funds for political purposes and other purposes.

Mr. SURREY. Yes.

Now let me come to that. That, I think, is in part a question of manpower. I don't think the instances are large. I think it may need a rewriting of some of the ground rules. I think the general rewriting in the House bill on voter registration, for example, is in the right direction. I think reiterating that foundation funds are not to be used for political purposes or for lobbying, reiterating that and emphasizing that, is useful although I think some of the language and mechanisms in the House bill could stand clarity in that regard. But I think it would be helpful just to reiterate as the House bill does that they must confine themselves to essentially philanthropic functions.

I would not mean by that that they couldn't have useful experimentation in social and other activities because that is their real usefulness. But such matters as the voter registration change I think are useful changes.

Senator BYRD. One final question: As I understand it you oppose the House provision that sets a 50-percent limit on taxation, tax limit on earned income. I am not clear as to your position, whether you would favor a 50-percent limit, tax limit, on total income.

Mr. SURREY. The recommendations that I worked on and were sent up to the Congress early this year, said that if all the reforms were made, including, and this is really one of the biggest ifs, including taxation of capital gains at death, then consideration could be given to an overall effective rate of 50 percent of total income. By effective rate, I mean to say that if a person had a million dollars of total income the Federal Government would take no more than 50 percent of that. The House bill doesn't do that because 50 percent is just the top marginal rate after a lot of lower rates.

Senator BYRD. Yes.

Mr. SURREY. And that recommendation was of a maximum effective rate of 50 percent on all income—all income, exempt and nonexempt—and with taxation of capital gains at death. That recommendation was made, but I would not come to that unless all these other if's were done as it said in that Treasury Report.

Senator BYRD. The House bill taxes above 50 percent. It taxes unearned income at a rate higher than 50 percent.

Mr. SURREY. Yes, but the trouble is——

Senator BYRD. But you are assuming that this tax-exempt income involved may be for some individuals and not for other individuals.

Mr. SURREY. That is right. This amount of his taxable income may be taxed up to 70 percent rates but this much higher pile in many cases of exempt income is not taxed at all. Also year in, year out, his capital assets are appreciating and that is not taxed at all. So that if one just looks at that 70 percent rate for the well-to-do in our country, it is applied only to a very small amount of their income year in, year out. That is the reason, if you look at the effective rate of tax, what he is actually paying to the Government—taking account of the 70 percent rate and everything else—what is he actually paying in tax in relation to his income for that year in the upper brackets, many people are at zero and the average effective rate is generally around 30 percent. If you counted appreciation in value of assets, the average effective rate is around 11 percent a year. So this 70 percent is very misleading when you look at that in the tax table.

Senator BYRD. Thank you, Mr. Chairman, Mr. Surrey.

Senator Bennett?

Senator BENNETT. We are not going to ask any more. Senator Byrd. Senator Miller.

Senator MILLER. Yes, briefly.

You advocate the 6 months holding period or 12 months holding period?

Mr. SURREY. Yes, Senator.

Senator MILLER. The way the House bill provides it?

Mr. SURREY. Yes.

Senator MILLER. And the Treasury has come back and recommending going back to 6. I am sure you have given a lot of thought to this. Why would you be opposed or why would you advocate a little more sophistication in this holding period, for example, 6 months holding would give a certain benefit, 12 months would give more or perhaps all or maybe even 2 years, so that you have a scaling down.

You know this has been talked about down through the years a lot so that we have maybe three stages of holding periods with maybe one-third of the benefit for the first and lowest and shortest holding period, maybe two-thirds for the second, maybe all of it were held for the maximum length of the period of investment. Do you have any thoughts on this?

Mr. SURREY. Well, I think that a sliding downward scale of holding periods is inadvisable. Secretary Dillon indicated today that we have that in a rough way because now after the 6 months holding period we take 50 percent of the gain, and then when a person dies we take zero. So we have a graduated holding period in that regard, and he indicated the serious inadvisability of that graduated holding period. It tends to lock people in, which is one problem.

The other problem is that many people do hold their assets for a considerable period of time and you have a major question of equity as to what is the rate of tax that is going to be applied to capital gains which are a very large source of wealth.

A graduated holding period that decreased the tax on capital gains as it went along would end up with far lower rates of tax on capital gains than we have today which I think, would be a serious inequity.

Senator MILLER. On that point I am not suggesting lower rates, please get me straight.

Mr. SURREY. I am sorry, I didn't get it then.

Senator MILLER. Well, let us say that if you want, just for example, to get the maximum capital gains benefit of 50 percent on unrecognized income you would have to hold the asset for 2 years. If you only hold if for 1 year, then maybe 40 percent can be unrecognized. Then if you hold it for 6 months then 30 percent may be unrecognized.

Mr. SURREY. I have a feeling that would end up too complicated. I don't think the complications are worth it.

Senator MILLER. I am not suggesting we get terribly complicated. We are just drawing a dividing line between 6 months and everything else.

Mr. SURREY. I think the House did once try that. I would have to go back and check, Senator Miller, in 1963 or so when they had several so-called baskets and I think it did get pretty difficult when you worked through that method.

Senator MILLER. Even if you made two holding periods instead of one you would worry about complexity?

Mr. SURREY. Well, it is a question of degree. You are adding two where I would be satisfied with one. But it is a minor question.

Senator MILLER. You get into the same argument, I suppose over why we don't have more than one change in rates in the corporate tax structure.

Mr. SURREY. Yes.

Senator MILLER. Now, we received some very persuasive testimony, I must tell you, from the horse breeders indicating if one gets into the horse breeding business ordinarily you can't expect to make a profit any sooner than 3 years. As you know, under the Metcalf bill, there is a provision that farm losses can be carried back 3 years and carried over for 5 years to apply against farm income.

However, if a person starts into let us say a horse breeding business and has not previously been in the farm business even, of course, the 3-year carryback is of no benefit to him at all.

Would it not seem feasible in a case like that to give him an 8-year carryover to be applied against farm income?

Mr. SURREY. To be applied against farm income?

Senator MILLER. That is right. And these are real losses. We are talking about losses which are outside of the spectrum of drought and disease and pestilence and abnormal situations or maybe even outside of the area of sales which result in lower income due to market conditions.

Mr. SURREY. But are these losses due to the tax expensing of otherwise capital expenditures?

Senator MILLER. Well, it wouldn't be capital. We are talking about a cash basis farmer who may just simply have had very few sales or probably not been in the horse breeding business for 3 years, and he has, in the meantime, his expenses of feed, of property taxes.

Mr. SURREY. Let me ask you, just for my information, just to get your question. If this were commercial accounting, if this were a regular corporate business, would the expenses be capitalized or written off annually?

Senator MILLER. Annually.

Mr. SURREY. Let us talk then about expenses under proper commercial accounting, annual expenses. I see no real objection to a carry forward, I see no objection to that approach.

Senator MILLER. But you would limit your application of those to farm income?

Mr. SURREY. I think probably it would be safer here until I knew more about the expenses; yes.

Senator MILLER. Now, you apparently are indicating approval of the overall House approach to increasing the income taxes paid by commercial banks, savings and loans and mutual savings banks and the like.

Mr. SURREY. That is right.

Senator MILLER. I have the feeling that if such an increase as the House bill encompasses went into effect, that inevitably the interest rates paid by their customers would increase. What bothers me so much is I think the timing is terrible on that. If we were in a normal interest situation that would be one thing. But here we are today with the highest interest rates in the history of the country and we come along with a package which is going to have an effect on those interest rates. Don't you think it would be prudent either to cut back some of the impact of the House bill on these various institutions or perhaps not take any action on them at this time and hold them in abeyance until we have a much better climate for this?

Mr. SURREY. I am afraid I would have to answer the other way around. In other words, it is very difficult to get improvements in the tax system. The House has taken a step in the commercial bank area and the like ending what is completely unwarranted tax favoritism to these institutions. I would end that favoritism and then see what happens. My guess is that the amounts involved in tax are really so minor in relation to the economy as a whole that they will have a very little impact on interest rates.

Senator MILLER. Well, I am not guessing on one case that was brought into my office. This involved not a particularly large savings and loan institution. I thought that a very persuasive argument was made showing me how much the officers' salaries are and how much the cost of operation is and how much of a tax impact there would be, and there is no place to go except to pass it on to the mortgage borrowers.

Mr. SURREY. Well, it may be in that bank that is so. But in the general level of all depositors through the United States, I would think the amounts involved are so small in this bill in relation to our total amount of deposits and interest, I would think it would have a very minor effect. I would rather take my chances on that than putting off the day when they come under fair tax treatment.

Senator MILLER. I have no further questions, although off the record if I could have a moment of your time in the back I would appreciate it.

Mr. SURREY. Thank you.

Senator MILLER. Thank you.

Senator BYRD. Thank you, Mr. Surrey.

(Mr. Surrey's prepared statement follows:)

STATEMENT BY STANLEY S. SURREY

I appreciate the opportunity to appear before this Committee in the Hearing on the Tax Reform Act of 1969.

The Tax Reform Act of 1969 is a very significant step forward in the accomplishment of the vital task of reform of the Federal tax structure. It is not the end of the road, but it is a major beginning that takes us a considerable way forward. In the area of tax reform, major beginnings are certainly major events.

Major tax bills are bulky, complex documents replete with technical language. It is often difficult to obtain an overall perspective regarding the basic aspects of such a bill—the significant changes that are involved, the degree of progress or retrogression in improvement of the tax structure, the swing of the pendulum toward tax simplicity or tax complexity. I believe it would be helpful in obtaining perspective on the effectiveness of this bill in achieving tax reform to consider first the dimensions of tax reform—that is, what are the problems or issues of tax reform—and then to see what the bill actually does in meeting those problems and issues.

INDIVIDUAL INCOME TAX

I will start first with the individual income tax. A consideration of the dimensions of tax reform under the individual income tax indicates that several distinct factors are involved. Some factors are paramount for one group of taxpayers, while other factors predominate for the remaining groups. These different factors, of course, call for different approaches. Hence, I will separate these considerations into three broad taxpayer classes—low income, middle income and high income—and discuss the factors that are relevant to each group and the pertinent provisions of the House Bill.

Low-income taxpayers

The significant factor regarding low-income taxpayers is that the individual income tax is imposed on people whose incomes fall below the poverty line, and also bears heavily on those close to the line. Since that line is intended to measure the levels of income, by family size, which are barely sufficient to provide the necessities of life, there is justification for concluding that the income tax should not reach down below those levels. While poverty line definitions are to some extent arbitrary, so also is any cut-off utilized under the income tax, and the poverty line classification can well be used as a presumptive point for fixing the line of exemption from the income tax. The present income tax exemption levels, based on the combination of the $600 per person exemption and the minimum standard deduction, are considerably below the poverty line levels, especially for single persons and married persons with no or few children. Thus, a single person with income above $900 is subject to income tax, and yet the poverty line for single persons is around $1700; a married couple pays tax if their income is above $1600, whereas the poverty line is about $2200. There are about 2.2 million families in poverty who are now subject to tax.

The income tax change best designed to relieve this situation is to increase the present minimum standard deduction. Revision in the amount of that deduction will concentrate the revenue involved in the lowest income group and among single persons and married persons with small families, where, as stated above, we find the widest disparities between the present income tax exemption levels and the poverty line. No other tax change—increase in personal exemption, decreases in tax rates, etc.—will accomplish this purpose with the same effectiveness. The revenue cost depends on the amount of increase that is made in that deduction and the manner of its application.

The House Bill fully meets this problem of tax reform for the low-income taxpayers. It raises the present minimum standard deduction from $200 (plus $100 for each personal exemption) to $1100 per taxpayer, effective in 1971. (The name is changed from "minimum standard deduction" to "low income allowance.") The effect of the change is to place the start of the income tax at essentially the poverty level—thus fully exempting those below that level—and to give substantial tax relief to low-income families in the area above the poverty level.

This approach is far preferable to that contained in the earlier version of the low-income allowance (H.R. 12290) which involved a scaling-down of that allowance, so that it eventually disappeared and only the present minimum standard deduction remained. Such a scaling-down is retained in the current House Bill for 1970 and a modified permanent scaling-down has been recommended to your Committee by the Treasury Department. But a scaling-down approach is decidedly undesirable in meeting the problems of low-income taxpayers. While the initial allowance does exclude those below the poverty level from the income tax, the scaling-down has the effect of providing less relief to those low-income families above the poverty levels and far less overall relief to the lowest brackets than does the undiluted approach taken in the House Bill for 1971. Thus, that Bill achieves $2.6 billion of tax relief for these low-income families as compared with only $625 million under the scaling-down approach in 1970 (the original Treasury approach) and only $920 million under the latest Treasury scaling-down proposal.

The scaling-down approach also has the decided disadvantage and unfortunate effect of providing a high rate of tax for all low-income taxpayers who remain subject to tax. Thus, in 1970, under the general rate scale in the House Bill (which is the same as present law) the first bracket rate on income above the exempt level is 14% on the first $500, 15% on the second $500, 16% on the next $500, and so on. Under the scaling-down approach in the Bill, however, the rates in effect for 1970 are much higher—for example, the starting rate really becomes 21% instead of 14%. Thus, under the new table for that year, a single person is exempt if his income is below $1700. As he earns income in excess of $1700 his tax rate is 21% on the first $500 earned, 22½% on the next $500, and 24% on the next $500. The same effect exists for married persons. This is because the taxpayer not only pays tax on each dollar he earns, but each such dollar also adds $.50 more to his taxable income because his low-income allowance is sliced $.50 for each $1 of income. These high rates do not show up in the law or tax returns because the tax is stated only in table form—nor are they discussed in the House Committee's Report or the Treasury proposals. But the disadvantage of very high marginal rates for these brackets exists under the scaling-down approach. Fortunately, the House Bill in 1971 eliminates the scaling-down and thus eliminates these high marginal rates for that year and thereafter.

However, under the permanent scaling-down approach now recommended by the Treasury, the aspect of high marginal rates would persist. The scaling-down is slower—the low-income allowance would be sliced $.25 for each $1 of income—and the marginal rates would not be as high as in 1970, but they would be high. Thus, in 1971, when the general rates are stated to be 13% on the first $500, a low-income person subject to tax would under the Treasury approach actually have a rate of 10¼% on *his* first $500 of taxable income; when the general rate is 14% on the next $500, the low-income person would actually have a rate of 17½% and so on. Thus, for low-income taxpayers, the tax tables under the Treasury scaling-down really involve actual tax rates 25% higher than the rates used in the general rate tables and which people presumably think are the rates applicable.

It is right to exempt from tax completely those persons whose incomes are below the poverty level. It is not rigth—as the Treasury would do—to tax at high rates those persons whose incomes are just above the poverty levels. The House Bill in rejecting a permanent scaling-down is thus distinctly preferable to the Treasury recommendation to use that device.

Middle-income taxpayers

In 1944 the Congress took a major step to improve the simplicity and fairness of the individual income tax when it adopted the standard deduction—at 10% of gross income up to a maximum deduction of $1000. This standard deduction was then used on about 82% of the tax returns. This action had two consequences: From the standpoint of simplicity, for the great mass of taxpayers the computation and record keeping under the income tax were greatly simplified. From the standpoint of fairness, for this group variations in deductions for personal expenses would not affect tax liabilities so that the tax burden was the same within the range of the average for these deductions. Only those taxpayers with personal expenses above the average could affect their tax liabilities through those expenses.

Since 1944, however, these important gains in simplicity and equity have steadily eroded away. In 1969, it is estimated that only 57% of tax returns will utilize the standard deduction. In the intervening years, average deductions have risen, making the 10% figure inappropriate, and incomes have also risen, making the $1000 limit inappropriate; yet those two aspects of the standard deduction have remained unchanged. The result is increased complexity for taxpayers, and a greater spread of actual tax liabilities for taxpayers largely similarly situated.

It must be remembered that many taxpayers who actually bear the burdens of these personal expenses cannot obtain the itemized deuctions for those expenses since they do not directly pay the items, such as tenants who in their rent bear the costs of property taxes and interest. In these cases, the purpose of the standard deduction is to prevent serious unfair distinctions in tax burdens. And even where there are actual variations in personal expenses, the precise reflection of those variations in many cases would produce only small tax differences, whose reflection in tax liability is out of all proportion to the complexity involved in keeping track of the items. This is especially so where the deductible personal expenses themselves raise qualitative judgments on which people differ. In these cases, the standard deduction serves to prevent taxpayers from being involved in excessive costs to obtain at best miner equity advantages.

As a result, our goals of simplicity and fairnesss point in the case of this group of taxpayers—those with incomes from about $7000 to $25,000—to a revision which would restore, as far as possible, the effectiveness of the *standard deduction*. This step requires both an increase in the 10% figure and the $1000 limit, and the revenue cost involved depends on the extent to which these amounts are increased.

The House Bill here also meets the problem of tax reform for this group of taxpayers. It increases the standard deduction to 15% by 1972 and raises the limit to $2000. The effect, in combination with other changes in the Bill, would be that about 80% of returns would again be using the standard deduction. This is clearly a major gain in both tax fairness and tax simplification.

The Treasury recommendation to your Committee to increase the standard deduction only to 12% and $1400 is a decidedly inferior approach and should not be adopted.

A word as to revenue costs and the priorities for tax reduction may be appropriate here. The $1100 uniform minimum standard deduction or low-income allowance with no scaling-down costs $2.7 billion under the House Bill. The 15%—$2000 standard deduction costs $1.3 billion. The revenue is well spent, however, and goes to the persons under the individual income tax who held the top priority for tax relief when revenues for that relief became available, as they do under this Bill. These are the people who are first in line for tax relief, for they are treated unfairly and less favorably than other taxpayers under the present law—the low-income groups who can least afford the income tax burden and the middle-income groups who do not benefit from itemized deductions.

The Treasury, however, seems to have an upside-down view of the priorities for tax relief. It gives top priority to the across-the-board rate reduction under the House Bill in the individual tax of $4.5 billion, stating that it "represents reasonable, equitable tax relief" because it "does not discriminate between itemizers and non-itemizers, between homeowners and tenants" and so on—"it provides even-handed non-discriminatory relief."

But the task of tax reform and tax revision—when taxes are being reduced—is to see whether the present treatment is fair or unfair and to correct injustices first rather than simply uniformly to change tax rates. Such a uniform adjustment is appropriate in a temporary measure adopted for economic stabilization reasons—a 10% surcharge (though even here the lowest brackets were exempted) or a 10% reduction to avoid a recession. There the task is not to change existing relationships and not to consider basic tax policy issues—these are to be left to permanent tax revision. But now we are engaged in just such a revision where the task is that of examining just who is treated more favorably and who less favorably under the tax system. To approach such a fundamental revision by saying, as does the Treasury, that the first tax priority is across-the-board rate reduction would mean we would never really ever deal with the basic issues in an adequate way. The Treasury approach is thus a misstating of priorities and a negation of the essential task of tax revision. The House Bill approaches the matter properly by giving full relief to those first in line for it.

Several additional matters not in the House Bill may be mentioned with respect to the middle-income groups. Another step that can achieve simplicity, and also is in keeping with tax fairness, would be to eliminate the deduction *for state gasoline taxes* where the item is a personal and not a business expense. Like the non-deductible federal gasoline tax, the state gasoline tax is essentially a charge for the use of highway facilities and, therefore, should not be deductible. This step is now recommended by the Treasury.

Simplification and fairness for this group also call for a complete revision in the *tax treatment for the elderly*. The present rules are a maze of complexity adding up to a full page on the tax return. They also involve unjustifiable discriminations among the elderly through differing tax treatment for different sources of income, here bearing adversely on those elderly who need to continue working after reaching age 65. Further, they provide unneeded tax relief for those elderly who are well-to-do. The February Treasury Proposals involved a complete revision of present rules, with a revenue cost of $80 million.[1]

High-income group

Breakdown in fairness.—The problem presented in the high-income group is a complete breakdown in the fairness of the individual income tax. A few examples will illustrate this:

In 1967 there were 155 tax returns with adjusted gross income above $200,000 on which no income tax was paid, including 21 returns with incomes above $1 million.

But these figures do not measure the full degree of tax escape at this level. If *actual* incomes were used rather than *adjusted gross income*—so that items such

[1] Another desirable change, recommended in the February Treasury Proposals, was in the *charitable deduction,* under which that deduction would be allowed outside the standard deduction (i.e. allowed together with the standard deduction), but would be available only where the contributions exceeded 3% of adjusted gross income. This threshold would apply to taxpayers using either the standard deduction or itemized deductions. These changes in the charitable deduction, combined with the standard deduction changes, would reduce significantly the number of returns requiring record keeping and audit for personal items, while maintaining for all taxpayers, even those using the standard deduction, an incentive for charitable gifts above routine giving. The charitable organizations apparently oppose such changes. But they presumably overlook or misjudge its advantages. Under the House Bill, with its increase in the standard deduction, and no other change as respects charitable contributions, only about 15 million returns would be left to use itemized deductions and to claim a charitable deduction. Under the above proposals, however, with the ability to claim a charitable deduction whether other deductions are itemized or not, even with a 3% threshold about 26 million returns would claim a charitable deduction. These proposals would thus provide a wider base for charitable support than simply changing the standard deduction.

as tax-exempt interest, full capital gains, excess percentage depletion, farm "tax losses", excess real estate depreciation, and intangible drilling expense deductions were included in the total amount of income—the number of individuals with incomes above $200,000 and $1 million who are paying no tax would be higher. This figure would provide a more accurate description of the escape from tax in this group. Thus, some individuals who now show up in Statistics of Incmoe below $200,000 and even in the $0–$3000 bracket or with a loss, and who are paying no tax, would—if these excluded items were added to their adjusted gross income—be in the above $200,000 group and even above $1 million—and still, of course, be paying no tax. Present data, however, presumably do not permit a statistical reclassification on this basis.

For those who pay tax, in the group with over $1 million of *actual income* (before personal expense deductions), the effective rate of tax for about 75% of the group clusters in the area between 20% and 30%.[2] This may be compared with taxpayers in the group between $20,000 and $50,000 of actual income, where about 60%[3] cluster in the same effective rate area between 20% and 30%, yet the $1 million and over group per taxpayer have probably over 50 times as much income.

For taxpayers up to the level of $50,000 of *actual income*, although there is dispersion within each group, the central range of effective rates moves upwards as income rises; for groups above $50,000, this upward movement in effective rates begin to flatten; and above $100,000 the central range of effective rate moves backwards to produce the results described for the $1 million and over group.

The obvious departure from the ability to pay concept and from elementary standards of fairness is self-evident in these statistics. Whether a person is below the poverty line, whether he is in the group between $20,000 and $50,000, or whether he is in-between, he is certainly warranted in feeling that the income tax is not working fairly.

Causes of Unfairness.—I would like to turn from these overall evidences of unfairness to the causes of high incomes showing these low rates or complete absence of tax, since the causes will point the way to possible approaches for correction.

In overall effect, the causes lie in a combination of *excluded income items* and the *method of applying itemized deductions.*

As to the *excluded items,* looking at the significant ones, the list covers:

The excluded half of realized capital gains.
Interest on state and local bonds.
Accelerated depreciation largely on buildings.
Deduction for unlimited charitable contributions (almost entirely of appreciated securities whose gain is not taxed).
Farm "tax losses".
Excess of percentage depletion over cost of investment.
Intangible drilling expenses of oil wells.

For many persons, these items singly or in combination bring the tax to zero. Thus, for somewhere around 50 to 75 persons, the unlimited charitable deduction benefit simply eliminates tax.[4]

For others, percentage depletion of intangible drilling expenses[5]; real estate deductions, mainly accelerated depreciation[6]; or farm "tax losses"[7] are the factors that produce a zero tax.

For a large group, the effect of these items while not completely eliminating tax is to reduce the taxable income considerably below the actual income. Then another factor enters—these persons usually have *large personal expense deductions* which they itemize. These itemized deductions are offset against the remaining *taxable income*, and in no way are allocated to the *excluded income,* although excluded as well as taxable items are a source for the itemized deduc-

[2] 36.6% in the range 20%–25%, and 37.8% in the range 25%–30%. The $500,000–$1 million group reflects a similar cluster, 64.7%. Even these figures are an understatement, since the actual or total income data do not include excess real estate depreciation, farm "tax losses," and intangible drilling expenses.

[3] 45.8% in the range 20%–25%, and 13.5% in the range 25%–30%. 27.9% are in the range 15%–20%.

[4] See specific cases 1–4 in the February Treasury Proposals, pp. 90–91, involving persons with actual incomes of $10 million, $6 million, $8 million, and $8.5 million.

[5] See specific cases 8 and 9, p. 93, involving persons with $1 million and $1.3 million.

[6] See specific case 10, p. 94, involving a person with $1.4 million, and table 1, p. 452.

[7] See specific case 11, p. 94, involving a person with $700,000.

tions. Hence, the full force of the *itemized deductions* is concentrated against the *taxable income* and the result is a very low or even zero tax.[8]

The interest deduction, usually arising from loans to carry capital assets which result in excluded income or no current income, is here an important factor. So also is the general charitable contributions deduction, which for this group usually involves not cash gifts but gifts of securities whose appreciation is not taxed though the appreciated value measures the deduction.

This steady deterioration of income taxation in the case of high-income individuals has been hastened by the "institutionalization" of tax escapes. The "packaging of tax shelters" by investment houses, brokerage organizations, and others has made these shelters readily available to those with incomes high enough to utilize their attractions. Just as in the case of the stock market, geography is not a factor—the possessor of a tax shelter can live thousands of miles away from his cattle or his oil well or his orchard or his post office and in fact may never see them at all. It is clear that whatever may have been the origin of these shelters, it was no one's intent—in the executive branch or in the Congress—that this supermarket era of tax shelters was to be the end result.

These are the causes of unfairness—what are the solutions adopted in the House Bill?

House Bill solutions—Matters dealt with directly

Some of the items permitting escape from tax are dealt with directly in the House Bill.

Unlimited Charitable Deduction.—The House Bill would, and properly so, eliminate the unlimited charitable deduction after a transitional period. While superficially this deduction may seem to have a certain appeal when loosely described—a person must give away 90% of his income—in actual effect the individual is not giving away income or assets but giving away his tax. The assets actually contributed are nearly always appreciated securities whose gain is untaxed and the income made tax-free is generally dividend income otherwise subject to a rate around 70%. I see no reason why one group of persons is permitted to give their tax to any charity they choose while others are required to pay their tax to the Federal Government. If all of us could choose either to pay our income tax to the Government or give it to our favorite charity we would have tax anarchy. This being so, no special group should be permitted this choice. The question of how large a tax subsidy should be given to charitable organizations under the income tax is one to be decided by the Congress. For most everyone this is controlled through the limit, now 30% of adjusted gross income, on the charitable deduction. This limit can be changed; the House Bill uses 50%. But the limit should apply across the board. All who have ability to pay should pay some tax to the Federal government, rather than be permitted to select a charity to the exclusion of the Federal government. Certainly, if only for the reason of tax morality, this should be true for our wealthiest persons. The House Bill properly ends the unlimited charitable deduction.

Capital Gains.—The House Bill would reduce the tax preference for capital gains by lengthening the holding period from six months to a year and eliminating the 25% alternative rate. These changes are proper improvements in the treatment of capital gains and their justification in terms of tax equity is clear. Most economists have for years urged at least changes along these lines. Equally, most economists who have studied the matter would find unconvincing the assertion that such moderate changes would have the calamitous effects on investment that critics of the changes usually charge.

The Treasury's objection to these changes is also cast in terms of effects on investment: "These changes . . . 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." But these dire forebodings are strange indeed when placed alongside its actual recommendations. For the Treasury is obviously aware that the capital gain preference is the single most important factor in permitting high income persons greatly to reduce their effective rate of tax, so that the equity and fairness of the tax system are markedly reduced. Hence, it recommends a complex limitation on

[8] See specific cases 5, 6, and 7, pp. 92–93, involving persons with $5.3 million, $935,000 and $1.3 million.

the use of the 25% alternative rate which is in effect a special minimum tax applicable to capital gains. Under this approach the revenue gain in the capital gain and loss area would be $425 million—or about 66% of the House Bill gain of $635 million. It is hard to see how this $210 million additional gain under the House Bill—less than 1% of the present yield from capital gains taxation of individuals—can have the adverse effects on investment painted by the Treasury. In this light, the House Bill approach, which is direct and far simpler, is to be preferred.[9]

We should recognize that the most serious aspect of our present capital gains policy is the permanent escape from tax of appreciation in assets transferred at death. Correction of this defect remains a matter of top priority. The House Committee Report states that reform measures relating to revision of the estate and gift tax laws and the related problem of the tax treatment of property passing at death will be studied as soon as possible, with a bill to be reported in this Congress. The accomplishment of this objective will move us considerably further along the road of meaningful tax reform.

State and Local Bond Interest.—The House Bill begins to come to grips with the difficult matter of state and local bond interest—difficult because of its history and its place in federal-state relationships. The issue is clear: The present exemption for interest on state and local bonds has the general effect of a blanket, no strings attached, federal grant-in-aid to the issuing governments. It is achieved by giving tax favoritism to high-bracket individuals with conservative investment instincts, to commercial banks, and in lesser degree to some other financial institutions. The state and local governments clearly desire the general effect to continue. Those interested in the federal tax structure deplore the method of achieving this effect because of both the tax favoritism and the inefficiency or wastage involved in resorting to the technique of favoritism, in that more federal tax revenue is lost than the local governments obtain in aid. The federal revenue lost annually through the exemption is about $2.63 billion. The aid annually obtained by the states and local governments—the amount saved through the lower interest rates on tax-exempt bonds—is about $1.9 billion. (Parenthetically, to put this form of federal aid in perspective, the total amount of grant aid to states and localities is about $25 billion.)

The state and local governments carry no brief as such for the federal tax windfalls and the wastage. Up to now, however, they have not seen any other mechanism which can achieve for them the general effect that the tax exemption produces. But the future heavy financial demands on state and local governments will diminish for them the amount of the grant-in-aid that the tax exemption mechanism produces. The restraint on the scope of the market for their bonds that tax exemption involves will cause their interest rates to rise. At the same time, the tax favoritism perversely is increased.

The inefficiency inherent in the use of the tax exemption mechanism to achieve the grant-in-aid will thus hurt all the governments involved. They now have a common interest in finding a better path to the grant-in-aid.

The House Bill provides the solution of taxable bonds issued on an optional basis by state and local governments. The federal taxation of these bonds would remove the present tax unfairness. Since the interest costs on taxable bonds would be higher than on tax-exempt issues, the Bill continues the aid to the states and localities by authorizing the Treasury to pay from 30% to 40% of the interest cost (25% to 40% after 1975). The payments would be to the issuing governments periodically as interest falls due. The payments would be automatic, with no strings attached. Hence, the automatic non-Federal control of the present aid would continue. The issuance of taxable bonds would be optional, so that the privilege still to issue tax-exempt bonds would remain.

It is difficult to see how states and localities can lose under this arrangement. On the contrary, depending on the level of the Treasury's interest payments, they could readily gain much through actual interest costs on their part becoming less for most localities than the interest costs on their existing tax-exempt bonds. The Treasury could even make its payments around 45% or 50% of the interest without losing any money. It would then simply be turning over fully to states

[9] The definitional changes in the House Bill in the capital gain area—as to collections of letters, papers, and memoranda; the treatment of lump sum pension distributions (still inadequate as to appreciated property); franchises; casualty gains and losses; and sales of life estates (why is the income still considered capital gain?) are improvements over present law, as are the changes in the capital loss rules.

and localities the amount that today goes wasted—the difference between the earlier figures of $2.63 billion federal revenue lost and $1.9 billion state and local interest savings annually.

There can be improvements in the provision, perhaps fixing on a definite percentage of aid rather than letting the Secretary vary the figure. There can be problems of transition and adjustment. These are inevitable and all should work together to meet them. Also the present difficulties plaguing bond issuers, growing out of the unusually high interest levels reflecting inflationary forces and counter measures, should not cause us to lose perspective on the long-run aspects. Further, while there may well be shifts in the traditional patterns of investment dealer relationships and mechanisms, these shifts are hardly a matter on which to base policy objectives. There can be other alternatives to pursue, such as an Urban Development Bank. But these alternatives need not be competitors, but complementary solutions.

The matter must be kept in perspective. The House Bill offers a present, rational approach regarding future issues of state and local bonds. It should be accepted in this light and efforts made to perfect it rather than seek to tear it apart and strike it down. A solution of this character would both materially lessen the federal tax unfairness as future issues go out on a taxable rather than a tax-exempt basis and provide greater interest savings to states and localities without any federal control of their debt obligations.

Farm "Tax Losses".—The House Bill unfortunately falters severely when it comes to the matter of farm tax losses. The abuses in this area have been well publicized. Essentially, Treasury regulations permit farmers to expense items which are capital items and so treated under commercial accounting principles—items such as the costs of raising livestock and the costs involved in the pre-operation stage of orchards and ranches. (There are other departures from financial accounting, such as the ability to use the cash method through inventories are involved). The ability to expense items that are capital in nature gives rise to current deductions that are in excess of the current income from the cattle or orchard or other activity. These excess deductions—"tax losses"—are quite valuable when other non-farm income is present, since the farm 'losses" can then shelter that non-farm income from tax and thus leave the non-farm income—be it executive salary, investment house or brokerage commissions, dividends and so on—free of tax. The tax picture is made all the sweeter by the statutory treatment of the sale of the products involved—the cattle or the orchard—as a capital gain transaction, so that the end of the road can be 25% tax rates and not ordinary income rates. And the main road of tax shelter need have no end—one herd of cattle can be sold and another started, one orchard sold and another planted.

Wealthy non-farmers have been made increasingly aware of the wonders of this tax system, under which the Government actually pays the non-farmer money just to own the cattle or orchard and the wealthier he is the more it pays him. These farm rules are thus a "negative income tax" for well-to-do non-farmers. The absurdity of the present rules is disclosed by data that show that as people rise in the income scale they would appear to have a remarkable propensity to run their farm operations at a loss—the greater the income from non-farm sources, the greater the loss from farm operations. Since the data also indicates that people with high incomes do not show losses on other business ventures, we can hardly conclude that when they go into farming they uniformly stumble around and actually lose money due to mismanagement or bad investment decisions. Rather, when we observe the extensive literature which explains how wealthy people can save after-tax dollars through showing "tax losses" on farm operations, which really involve an actual net investment in the farm, and then shielding other income with those "losses," it is obvious that the prevalence of these "losses" is evidence of extensive use of a tax abuse.

The House Bill essentially does very little about this—it raises $20 million when an adequate approach would produce at least $150 million. Its defects are two-fold: It continues to allow these artificial farm "tax losses" to be used *currently* but then would recapture them (the "excess deduction account") on any later sale of the assets by treating the gain on sale as ordinary gain rather than capital gain to the extent of the prior losses. The House Bill, by allowing artificial losses *currently* to be offset against and thus shelter non-farm income, permits the tax on that income to be deferred until a later date. For people in the upper brackets, tax deferral by itself is a valuable asset—the Government in effect makes an interest-free loan of the tax amount and such loans in these days of 9% and 10% money are quite beneficial. In addition to this basic defect of structure in its solution, the House Bill imposes severe limits on the use of the solution: the farm loss must exceed $25,000 and the non-farm income exceed $50,000.

In contrast, Senator Metcalf and others have suggested a far better approach. This approach would not allow these artificial "tax losses" to be used currently, so that there would be no shelter of non-farm income. On any sale of the farm assets, the losses could then be used to offset any gain on that sale. His bill uses a limit of $15,000 of non-farm income, and this exclusion is phased out.[10]

The proper course in the farm is to reject the House Bill approach and follow Senator Metcalf's approach.[11]

Real Estate.—In many respects the real estate area is like the farm area, except that "real estate tax losses" are used as the shelter rather than "farm tax losses." The present tax laws grant excessively favorable accelerated depreciation to buildings, which provides far more rapid write-offs than straight-line depreciation. This excessive depreciation deduction, on top of the other expense deductions for interest and taxes, not only relieves real estate rentals from tax, but is so large that it spills over and shelters non-real estate income tax.

The investor is in many cases not interested in "cash flow" from the building but in "tax flow"—how much by way of deductions for interest on the mortgage, real estate taxes, and accelerated depreciation will the building generate so that the resulting "tax losses" (deductions in excess of rental income) can offset dividend income, profession fees, salaries, etc., and thus "shelter" the latter from tax. The real estate shelter is especially attractive because all these deductions belong to the equity investor. Generally the equity investor can obtain a high leverage effect. Further, through deductions of interest and taxes during the construction of a building, he can often recover his equity investment before the rental lease even starts, so that the deductions available during the lease are all a return on investment. The rental under the lease will take care of the mortgage and real estate taxes.

For these reasons, the real estate shelter—office buildings, motels, shopping centers, post offices, high rise apartment houses, industrial buildings and so on—has had a broad attraction. Thus the announcement of the Government's decision to build a major post office is also a major event in the halls of those institutions that package tax shelters. Post Offices are privately owned and leased to the Government, thus making the real estate shelter available to the syndicate members who own the facility. The data, though not as complete as one would like, point to a far wider—and still rapidly widening—use of the real estate shelter than is generally realized. In fact, the use of this escape route may rank just after the capital gain factor in magnitude.

The House Bill makes a start on attacking this problem. It reduces accelerated depreciation on all new buildings, except new rental housing, to 150% declining balance depreciation instead of 200% declining balance and it limits used buildings to straight-line depreciation. It also applies the present recapture rules of personal property to real property, so that depreciation in excess of straight-line depreciation is recaptured on sale, by converting capital gain to ordinary income to the extent of the excess.

The allowance under the House Bill of 150% declining balance depreciation for new buildings is still on the over-generous side, and straight-line depreciation is more appropriate. Another desirable step would be to require the capitalization of interest and taxes paid during construction. The present option to expense these costs is at variance with proper accounting procedures and operates to accentuate the real estate shelter. The current deduction of these capital costs often returns to the investor nearly all of his equity investment

[10] Senator Metcalf's bill could be strengthened by offsetting the disallowed losses against the full gain on any sale, before the application of the 50% capital gain deduction rather than after that application, as the bill now appears to provide.

[11] The House Bill provides for recapture of any excess depreciation deduction that may show up on a sale, as is done under present law with other tangible property generally, and this change is desirable. The Bill also strengthens the "hobby loss" provision (the Treasury suggestion of including anticipated increase in the value of the property as an indication of a non-hobby would seem a weakening of the House Bill). But these provisions are not substitutes for an adequate solution to the main problem; they are desirable complements to Senator Metcalf's approach to the main problem.

at the outset. With nothing in effect at risk, the benefits of excessive depreciation are pure tax profit to him.

The House Bill does not change the depreciation provisions applicable to rental housing, though no reason for the exception is advanced. The Government does have an interest in encouraging rental housing. Government non-tax programs to aid such housing, however, do not indiscriminately apply to all housing, but focus instead on housing for low and middle income families. The House Committee Report itself criticizes the use of tax benefits for luxury housing:

"In the housing field the tax stimuli are more effective for luxury- and moderate-income rental housing where profitability and appreciation prospects relative to risk are inherently more attractive than in lower-income housing. The "trickle down" supply effect for the lower income rental housing market is slow and uncertain in a growing general housing market.

Capital and other resource demands engendered by the existing tax stimuli tend to expand luxury housing, commercial, office, motel, shopping center, and other forms of investment, squeezing out lower income housing."

And yet the Bill retains tax benefits for all housing, including luxury housing. There is no Government expenditure policy to aid luxury, high cost housing. Why, therefore, should we have a tax policy that in effect spends Government funds for such housing instead of concentrating Government financial assistance where it is needed. At the least, the benefits of accelerated depreciation should be retained only for the type of rental housing that is assisted under direct expenditure programs.

Even as to such housing it would be desirable to phase out the tax assistance and allow the funds which that assistance represents to be used directly by HUD in its programs. A termination date should therefore be put on this tax incentive for such housing, and arrangements explored to achieve a transfer of the funds involved at that date from the "tax expenditure budget" to the regular Budget for housing.

The House Bill introduces a distinctly unwise tax policy when it provides for five-year amortization of certain costs incurred in the rehabilitation of low-cost rental housing. This is an expensive tax incentive—the revenue cost is put at $330 million. There is no discussion in the House Report, and no study referred to, indicating that if the Government is suddenly to spend $330 million more on housing, it should be spent in this fashion. There is no indication that rehabilitation of low-cost buildings has this high a priority or that this type of program and assistance is the most effective that can be devised. Because of the difficulties involved in rehabilitation, HUD up to now seems to have given it a low priority. Scarce funds must be allocated over many needs and apparently the economics of rehabilitation are such that the money is better spent in new construction. If HUD and the Congressional Committees concerned with housing have come to this conclusion, it would seem irrational for the Treasury and the Ways and Means Committee suddenly to start spending Government funds on a different basis. Surely with other established housing programs not fully funded, a better use for this $330 million exists. It is one thing for HUD to accept money from any source and not turn down such gifts, but this is hardly a wise use of scarce Government resources.

The Treasury itself seems to have reservations on tax incentives in the housing area, for it states:

"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."

Given this concern, it is difficult to perceive the wisdom of suddenly launching a new tax incentive with no study behind it and in an area that seemingly has been regarded by housing experts as having a low priority when it comes to spending Federal funds.

Together with the continued accelerated depreciation assistance for all rental housing, we presumably will be spending over a half-billion dollars through the tax system on such housing. It would be far wiser to turn these funds over to the non-tax expenditure programs of Government.

Natural Resources.—I will discuss the matter of percentage depletion and other natural resources tax changes in connection with consideration of the corporate tax.

Other Items.—The House Bill in a number of areas has desirable corrective provisions that will strengthen the equity of the individual income tax, which I will here merely list:

The requirement that corporate earnings and profits be computed on the basis of straight-line depreciation, thereby ending the present system of creating tax-free dividends to shareholders, especially in the public utility area, through computing earnings and profits on the basis of accelerated depreciation.

The taxing of distributions to beneficiaries of accumulation trusts and multiple trusts at the tax brackets applicable to those beneficiaries rather than, as at present, at the lower tax rates applicable to the trusts.

The tightening of the rules regarding restricted stock compensation plans.

The tightening of the rules regarding the treatment of stock dividends when two classes of stock exist and the rules regarding stock dividends on preferred stock, the changes in effect largely embodying existing regulations in the statute.

The revision of the treatment of employee deferred compensation so as to allocate its consequences for tax purposes to the years in which the compensation was earned.

House Bill Solutions—Overall Approaches

In addition to the above direct approaches, the House Bill has two overall approaches, or back-up provisions, designed to increase the fairness of the tax. These two approaches are a *minimum individual income tax* or *limit on tax preferences*, and *the allocation of deductions.*

Limit on Tax Preferences.—The limit on tax preferences—or minimum income tax—is premised on the position that whatever may be the merits of the major tax preferences that are retained, of overriding importance is the principle that every individual with substantial income should pay a minimum tax toward the cost of Government that itself bears a relationship to the economic income involved. To achieve this, under the House Bill a 50% ceiling is imposed on the amount of a taxpayer's total income (taxable items plus tax preference items) that can be excluded from tax. In other words, speaking generally, if the tax preferences exceed 50% of total income, the excess becomes taxable.[13]

The tax preferences covered by the House Bill are state and local bond interest (included gradually over 10 years); one-half of capital gains; appreciation in value of property contributed to charity; excess depreciation on real estate; and farm tax losses.

Two important items are missing from this list: percentage depletion and intangible drilling expenses. These omissions are serious aspects, since for those engaged in natural resources activities, the effect of the limit on tax preferences is fully negated. There is no reason to omit these items. The theory of a minimum tax—or a limit on tax preferences—is not to pass judgment on any particular tax preference. The theory instead accepts the view that for one reason or another the particular preference is to remain. But the theory asserts an overriding concept of tax equity that there must be scope for the principle that each individual with significant amounts of income must pay some tax to the Government. Any preference, no matter how meritorious it is considered by its adherents, must make accommodation to this competing principle of tax equity. In this light, percentage depletion in excess of capital investment and intangible drilling expenses should be covered as preference items. The Treasury so suggests, though it would still exclude intangible drilling expenses of individuals whose principal business is exploraton for oil and gas. Obviously such an exception is at variance with the principle of the limit on tax preferences and is unadvisable.

The Treasury suggests three additions to the list of tax preferences: interest and taxes paid during the period of construction of a building; excess depreciation in the case of a lease of equipment and other personal property; and the new five-year amortization of rehabilitation outlays for low-cost housing. The first two additions are desirable assuming the matters are not dealt with directly, which would be preferable—the interest and taxes should be capitalized as stated earlier; the lease abuse could be handled, even administratively, by a better delineation between what is really a sale by the purported lessor accom-

[13] The technique is similar to Senator Harris' minimum tax bill, except that Senator Harris' bill would apply the regular tax rates to any part of the 50% of capital gain that is reached by the minimum tax, thus not making the 25% alternative rate applicable to that part. This was the effect of the February Treasury Proposal for a minimum tax. The House Bill version does not alter the 25% alternative rate. This is done under the direct changes in capital gains.

panied by a loan, since many of these leases are essentially financing arrangements, and what is a real lease. The third addition indicates the error of embarking at all on the new tax preference for rehabilitation.[13]

Allocation of Deductions.—As stated earlier, income excluded because of tax preferences provides in effect a double benefit—the income is excluded and the taxpayer is then permitted to reduce his remaining income by the *full* amount of his itemized deductions. To eliminate this double benefit, the House Bill contains an *allocation of deductions* requirement. Under this provision itemized deductions must be allocated between taxable income and excluded income. The portion allocable to the excluded income would not be allowed as a tax deduction.

The proposal is clearly appropriate. The policy issue involved is the content of the tax preferences that are taken into account in determining the excluded income. The House Bill parallels the limit on tax preferences proposal by covering the same preferences, with two exceptions. It here does cover percentage depletion and intangible drilling expenses, which is proper (and with which the Treasury agrees, without any of the exceptions as to intangible drilling expenses of those engaged in the oil business). It here excludes, however, interest on *existing* state and local obligations, which is wrong. The Treasury here recommends existing obligations be covered, without any ten-year phase-in. The Treasury here also recommends the additional three matters mentioned under the limit on tax preferences.

The proper course is to make the two provisions, allocation of deductions and limit on tax preferences, parallel in scope. Moreover the two provisions should be given a wide scope, in keeping with their back-up objective to maintain a degree of tax equity despite the various factors which require the continuation of some tax preferences. Hence the proper course is to provide a parallel treatment by including the wider coverage in each case where there is a difference in the House Bill.

A word should be added as to two items. In the case of *state and local bond interest*, the Treasury urges that the interest not be covered under the limit on tax preferences because of doubts as to the constitutional validity of that step. No legal opinion has been provided by the Treasury or the Department of Justice stating that the inclusion would be unconstitutional. Moreover, both Departments in the past have published opinions affirming the constitutionality of the taxation of such interest. It would appear to be the proper course on this record to at least allow the Supreme Court to render its judgment. Others have urged that under both LTP and Allocation that interest on *existing* obligations not be covered (and the House Bill so provides as to Allocation), presumably so as not to defeat expectations of existing holders. This argument goes too far, for it would sanction the assertion of a vested interest in a tax preference and in a situation even where full taxation is not involved.

Moreover, the argument overlooks the effect of the provision under the House Bill for subsidized future issues of taxable state and local obligations. Under that provision, if a significant amount of such taxable bonds are issued—and there is no reason why this should not result—tax-exempt bonds will begin to become a relatively scarcer commodity and the value of existing obligations will accordingly rise. Thus a windfall benefit would be granted to existing holders. The inclusion of existing obligations under the LTP and the Allocation provisions is thus but an offset—and not too strong an offset—to this windfall benefit. It is hard in this light to see any ground for complaint by existing holders. There is also no reason for any slow phase-in, as under the House Bill. Further, the coverage of existing bonds cannot as such affect state and local governments, for the bonds have been issued. The rates they must pay on their future issues will be determined far more by the effect of the taxable bond option than by inclusion of obligations, existing or future, under LTP and Allocation.

A second aspect concerns *appreciated property given as a charitable contribution*. The House Bill treats the non-inclusion in taxable income of the appreciation as a tax preference—which it is—and therefore covers such appreciation under the LTP and Allocation proposals. The Treasury now suggests that this coverage be deleted because it believes it would unduly restrict public support of charitable institutions. Such exclusion, however, would clash with the basic

[13] The House Bill applies a five-year carryover rule to the limit on tax preferences. This seems unwise and to improperly dilute the application of the limit.

rationale underlying these two back-up provisions, for their operation as stated earlier is not dependent on the reasons for the tax preference. In the final analysis, all tax preferences exist because the Congress decides that financial assistance is to be given through the tax system to the activities involved. The LTP and Allocation proposals set up a balancing principle, that the financial assistance be tempered by some adherence to the principles of tax equity. This balancing principle is applicable to appreciated property given to charity as well as to the other tax preferences.

Moreover, there is no reason why donors of appreciated property should have a greater opportunity to place Government resources at the disposal of charities—which is the effect of the tax benefits given to gifts of appreciated property—than donors of cash. I very much doubt that the Congress would provide directly that if a person contributed $100,000 in fully appreciated property he could deduct say 135% of the gift but if he contributed $100,00 in cash, he could deduct only 100% of the gift—yet such a discriminatory result is the general effect of our present rules. The existing law does discriminate in favor of the donors of appreciated property and their value judgments as to which institutions and charitable functions to support. The issue is a troublesome one, not because of its tax aspects because the tax answer is clear, but because of the values we ascribe to our charitable institutions. But one can well fear that an exception on this ground can lead to other exceptions in favor of those who will argue—and they will—that their tax preferences also serve worthwhile purposes, and soon the LTP and Allocation provisions would be eroded away.

Other Provisions in House Bill

Limitation on Interest Deduction.—The House Bill contains a limitation on the deduction of personal interest on funds borrowed for investment purposes. The limit would be that of investment income including capital gains plus a $25,000 floor. The limit would not extend to interest on funds borrowed for business purposes or for a home mortgage.

Studies of the tax returns of high-income individuals underscore the importance that the interest reduction plays in permitting these individuals to achieve low or non-existent tax liabilities. Long ago it was recognized that the interplay between deductible interest on borrowed funds and favorable tax treatment of the activity in which the funds were invested would play havoc with the fairness of the individual income tax. Present law thus disallows the deduction of interest when it is connected with tax-exempt bonds. But to confine the restraint on the interplay to this narrow area is obviously inadequate to meet present day tax-escape sophistication. The House Bill approach is especially important in the case of growth stocks and other assets which appreciate over time without a current cash flow. Our present law does not tax current appreciation in value until it is realized by sale, and this deferment of tax is in itself valuable. The denial of a current interest deduction would thus match the deferment of the inclusion in income of the appreciation. Further, if the asset is retained until death, the appreciation entirely escapes income tax.

The Treasury argument that the provision discriminates against the person with earned income, no investment income, but borrowings invested in growth assets is hardly an adequate reason to drop the provision. In a sense, in terms of the ratio of borrowings to tax-sheltered property, such a person has the highest ratio, 100%, and in that sense is maximizing the use of the interest deduction. Nor would such a person be hampered by the Allocation of Deductions proposal. In the case of the interest deduction, it has become clear that a direct limitation is needed, in addition to the Allocation provision, and the House Bill provides this strengthening.

Earned Income Maximum Rate.—The House Bill provides that the tax rate on earned income shall not exceed 50%, so that this figure becomes the maximum marginal rate for earned income. I believe this provision to be unwise and the wrong approach to setting limits on the progression of the income tax.

A principal reason advanced for its support is that it will cause executives and self-employed persons to be satisfied with the lower tax result on their earnings and not seek tax shelters. This does seem a peculiar way to reward the past pursuit of tax shelters. Moreover, the top rate of 50% would remain even if these individuals continue to pursue tax shelters. Under the House Bill, for example, an executive can have his lower tax on earned income and also his tax shelter of depletion and intangible drilling expenses, which are not covered by LTP, or of interest on existing state and local bonds under the Treasury approach. More important, the executive or self-employed person can have his lower tax on earned income and also have securities which are appreciating in value and which appreciation will not be taxed at his death.

If we are to set limits on the progression of the individual income tax, we should at least follow two principles: one, the limit should be in terms not of a marginal rate but an overall effective rate of tax; two, the effective rate should be in terms of an individual's total economic income and not just in terms of taxable income without regard to his untaxed income. Nor should we rush into limits on progression until we have really covered all the serious avenues of tax escape, and that of appreciated securities transferred at death remains wide open. We may when the serious escape avenues are closed be ready for a properly tailored maximum effective rate on all income. But we are still a long way from the point where we should so seriously blunt the progression of the tax as does the House Bill and the Treasury proposal respecting earned income.

Summary as to Individual Income Tax

The House Bill is a major step forward in beginning to meet the problems of tax reform under the individual income tax:

As to *low-income taxpayers*, the Bill fully meets the problem of the present system, that of taxing those below the poverty level and placing unfair burdens on those low-income families above that level.

As to *middle-income taxpayers*, the Bill meets the major goal of restoring tax simplicity and tax equity in the case of the personal deductions by significantly increasing the standard deduction. The Bill could be improved by revising the tax treatment of the elderly, setting a threshold for charitable contributions and allowing them outside the standard deduction, and disallowing the gasoline tax deduction.

As to *high-income taxpayers*, the Bill commences in a significant way to restore tax fairness through its elimination of the unlimited charitable contributions deduction; its removal of the alternative rate on capital gains and the extension of the six months holding period to a year; its provision for future issues of taxable state and local bonds; its partial cut-back on the tax preferences accorded real estate—a cut-back which should be pushed further, and a number of other special matters. Its adoption of the minimum tax or limit on tax preferences and allocation of deductions provisions provides a partial offset to the remaining preferences that will, if properly implemented, serve to prevent the gross escapes from tax that are now prevalent. But these two provisions as presently structured have serious omissions which should be corrected.

The Bill *falters seriously* in its treatment of farm tax losses and embarks on an unwise approach in placing a 50 percent limit on the top marginal rate applicable to earned income. It also unwisely introduces a new tax incentive in the five-year amortization of certain rental housing rehabilitation expenditures.

THE CORPORATE INCOME TAX

The corporate income tax presents a different set of problems. We are not dealing with a progressive tax and the ability to pay concept that underlies such a tax. Nor, in the large, are the pressures for simplification so intense, though the less complex the tax, the better. The goal under the corporate tax should be to apply its rate as uniformly as possible to all business net income. Departures from this uniformity will have the effect of pushing resources into the favored areas. We should at all times be aware of these departures and the revenue costs involved, so that we can determine whether the resulting allocation of resources is in the direction we want and, if so, it is being achieved effectively with the least expenditure of Federal funds. For, as has been pointed out many times, revenues lost through tax preferences for certain activities are expenditures which should at least meet all the tests applied to direct budget expenditures.

Departures from Uniformity

We can approach the question of the extent and nature of departures from uniformity under the corporate income tax through an examination of effective tax rates. The corporate income tax can generally be regarded as requiring corporations to pay tax at a 48% rate (apart from the 10% surcharge) on their total net income as net income is usually defined for business purposes. This is what *would happen* if there were no surtax exemption (under which the first $25,000 of income is taxed at 22%), no investment credit, no special capital gain rate, and no special deductions or exclusions. Without these items, the effective rate under the corporate tax would be 48%. The actual effective rate for all industries on total net income, however, is only 37.5%. The question is, therefore, what factors reduce the actual effective rate from 48% to 37.5%?

Looking at all industries together, if we consider only the effect of the surtax exemption and the investment credit—matters of general application—the expected effective rate would be lowered to 43.4%. For manufacturing, generally, the expected effective rate would be 44.9%. The actual effective rate on total income for manufacturing is 43.3%. This is so close to the expected rate of 44.9% that, as a general proposition, we can say that the tax applies with reasonable uniformity to manufacturing activities. The cause of the reduction from the *expected rate of 43.4%* for *all industries* to the *actual rate of 37.5%* must, therefore, lie in lower effective rates on certain types of activitiy. The data show this to be the situation.

The effective rates for those activites that vary most significantly from their expected rates are:

[In percent]

	Expected effective rate	Actual effective rate
Natural resources:		
Petroleum	44.8	21.1
Other mineral industries	42.7	24.3
Lumber	41.2	29.5
Financial institutions:		
Commercial banks	43.4	24.4
Mutual savings banks	42.4	5.3
Savings and loan associations	40.4	14.5

The major aspects of unevenness of the corporate tax are thus primarily a matter of the tax preferences applicable to two industries—natural resources and financial institutions.

House Bill Solutions

Financial Institutions.—The House Bill takes important steps in cutting back on the tax preferences accorded financial institutions. It would eliminate the existing excessively generous and artificial bad debt reserve granted by Internal Revenue Service rulings to commercial banks and instead apply the rule of actual experience, which governs all other business activities. It would also eliminate the present treatment of the losses of banks on bond sales as ordinary losses while the gain are regarded as capital gains, by making both losses and gains ordinary in character.

The Bill, however, still permits commercial banks to have full exemption from tax of the interest on state and local bonds while also allowing full deduction of the expenses involved in obtaining that interest. The retention of this tax preference will permit commercial banks still to enjoy tax rates below those applicable to business generally.

There is no persuasive reason why commercial banking should have a lower tax rate than other business activities. Certainly the arguments of banks that they must have excessive bad debt reserves to meet a possible serious decline in the economy are without merit. Their pessimistic outlook for the future should not be rewarded by tax favoritism. There are mechanisms at hand to allow full scope to that pessimism without its providing tax benefits for bank shareholders year after year. Thus the Bill provides a ten-year carryback of bad debt losses. The banks say that this is not a current asset for financial purposes. The answer then for this problem is to use the provision Congress adopted in 1967 to solve a similar assertion by the mortgage reinsurance companies (Code Section 832(e)). The present law here allows the deduction of a larger reserve than experience would dictate but requires that the tax benefit of that deduction be invested in special Federal Government "tax and loss" bonds that are non-interest bearing. These bonds would be redeemable and the reserve restored to income in ten years and then taxed (unless it were earlier required to use the reserve). In this fashion, an asset—the Government bond—is available as an asset on the balance sheet to meet the pessimistic possibilities seen in the future, but that pessimism is not rewarded with a tax benefit.

The Bill reduces the over generous and artificial statutory bad debt reserve deductions accorded to mutual savings banks and savings and loan associations, though leaving the deductions higher than those permitted commercial banks. It gears these higher deductions to investments in certain types of assets, principally residential real estate. Here it unduly favors mutual savings banks through a lower investment requirement (72%)—the difference in treatment is not justified and the mutual savings banks should be placed at the level of the savings and loan associations (82%). Moreover, it would be appropriate for tax purposes to place both institutions on the same bad debt actual experience reserve approach applied in the House Bill to commercial banks. Studies in 1961 showed this to be the proper course. Any requirements as to investment could then be handled in non-tax legislaton. And any assistance deemed needed for residential and multi-unit housing could equally be handled through the non-tax measures.

The Treasury recommends that all these institutions should equally be limited to a bad debt reserve based on actual experience. But it couples its suggestion with a recommendation for a special deduction of 5% of the gross income obtained from certain loans, including residential real property loans and student loans. Here also, this resort to special tax incentives for special purposes is unwise. If these loans are to be assisted by Government funds, it should be done outright—as in the example of student loans where the Government directly meets part of the interest cost. (Any aspect of high risk on certain loans is adequately met through a bad debt reserve based on actual experience). The Treasury recommendation is really the start of a percentage depletion system for financial institutions and has all the potentiality for the development that has marked such an approach in the natural resources area.[11]

Natural Resources.—In the natural resources area the House Bill reduces by about 25% the present rates of percentage depletion. It eliminates the tax abuses possible through the use of mineral production payments and ABC transactions. It tightens the rules applicable to mining exploration expenditures. It does not, however, change the present liberal treatment of intangible drilling expenses for oil and gas wells. And it does not deal with the capital gains tax preferences granted to timber, except as it increases the capital gain rate generally for corporations from 25% to 30%.

This Committee has before it the results of a study prepared for the Treasury Department, the Consad study, relating to the effectiveness of the present tax treatment for oil and gas. One would suspect that the results of that study—which concludes that the present tax mechanism for assistance to these activities, if assistance is needed, is quite wasteful—would be duplicated in the case of the percentage depletion accorded to other minerals.

The Treasury recommends a recapture rule on the transfer of an oil or gas well under which any gain on the transfer would be ordinary income to the extent of intangible drilling expenses previously deducted, and this recommendation is appropriate. It also disagrees with the provision in the House Bill extending the cut-off point for percentage depletion on oil shale to include non-mining process. This disagreement is well taken. Tax history has shown that persistent efforts to extend the cut-off points for the various minerals receiving percentage depletion have been quietly effective in amplifying the depletion advantage, and often more effective than any likely upward change in the depletion rates themselves. A Treasury report to this Committee on the varying cut-off points applicable today, and the differences in value (to which the depletion rates apply) between those points and cut-off points more consistent with an effort to stop at the mine would be quite constructive.

[11] There are other problems with the proposal. Thus, it would mean both lower taxes and less assistance to housing in the use of the savings and loan associations. It would also permit stock savings and loan associations to pay out the tax benefits to their shareholders, which is not permitted today in the case of the artificial bad debt reserve deductions. Also, the amount of the deduction—and hence the assistance to the borrower—depends on the extent to which the institution has certain tax shelters, such as tax exempt bonds. But if the borrower needs assistance, why should he be denied the assistance because the bank has a tax shelter—it is a curious system that would deny a needy student a loan because the bank has bought tax-exempt securities. Of course, tax equity explains the connection But the result underscores the undesirability of resorting to the tax system at all as a mechanism to assist borrowers.

The Bill changes the rules applicable to the treatment of foreign minerals, some of the changes occurring through changes in the foreign tax credit rules. The thrust of the changes is to insure that U.S. companies do not, through deductions for the development of mineral interests abroad and through excess foreign tax credits arising in the foreign mineral operations, reduce the U.S. tax on their U.S. income or the U.S. tax appropriate to other foreign income. The Treasury has suggested improvements in the foreign tax credit provision, which would make the determination of the excess credit turn on the effect of the availability of the depletion deduction under U.S. law.[15]

Multiple Corporations.—The House Bill would end, over an eight year transition period, the present tax favoritism granted to those businesses which operate through the use of multiple corporations rather than a single corporate unit. The result is sound, and long delayed. Whatever may be the reason why a business chooses to use multiple corporations, be it tradition, business reasons, state laws, or pure tax avoidance, there is no tax justification for providing it with a lower tax than an enterprise with similar total income but fewer corporate units. The efforts to rationalize this tax preference, which efforts often are a tribute to the imagination and resourcefulness of the legal and accounting professions, have over the years reached new heights in the defense of this provision—a provision which in reality has no sound argument for it at all. One would think the beneficiaries of the provision would feel grateful that it has been kept alive so long. Moreover, the House Bill is exceedingly generous in allowing a phase-in of the intercorporate dividend deduction and pre-consolidated return loss benefits during the phase-out of the multiple corporation benefit; it would be more appropriate to deny these benefits until the multiple corporation benefits end.

New Tax Incentives.—When one looks at the House Bill overall, one sees that most of the reform efforts are directed at reducing the impact of the various tax incentives that have entered our tax law gradually over time, either through statutory provision or administrative action. There are relatively few provisions in the Bill directed at remedying mistakes in tax structure, that is mistakes in which there was no intention deliberately to confer a tax benefit for incentive or other reasons but rather matters in which the technical tax structure just didn't work correctly. Examples in the Bill of such structural repair are the corrective rules applicable to multiple corporations, accumulation trusts and multiple trusts, mineral production payments, restricted stock, tax free dividends, deferred compensation and stock dividends.

The major part of the Bill, in substantive scope and revenue impact, relates to tax provisions which, whatever their origins, are supported by their adherents on tax incentive grounds. The fact that the task of tax reform today really consists of a scaling-back of all these tax incentive provisions—because of their ineffectiveness, their waste of Government resources, their misallocation of Government resources, and their effect on tax equity—is underscored by the House Bill. Its major provisions relate to existing tax incentives for real estate, financial institutions, natural resources, investment, state and local government assistance, farm activities, and so on. These Senate Finance Committee Hearings indicate that once a tax incentive takes root in the tax law it is a very difficult matter to restrict or eliminate it, especially if it has the prospective coloration of being cast in a traditional jargon and structure indistinguishable to most persons from the jargon and structure that mark most of our Internal Revenue Code.

All this being so, it is indeed unfortunate that the House Bill opens up three new tax incentives, and that the Treasury would also seek to adopt others. The House Bill provides five-year amortization for pollution control facilities; five-year amortization for rehabilitation expenditures on housing; and seven-year amortization for railroad cars. It appears that "amortization" is now the magic word and we may be witnessing the beginning of a wide schedule of amortization periods for various businesses and activities akin to the schedule of percentage depletion rates.

The Treasury deplores the railroad car amortization, probably doesn't want the pollution facility amortization and would certainly cut it back in scope, and

[15] These recommendations are similar to those made by the Treasury in 1963. The Treasury in its suggestion does not include the availability of the deduction for intangible drilling expenses or other development costs in the determination of the excess credit. It would seem this should be covered unless the interplay with the recapture provision applicable to such expenditures provides sufficient protection.

seems responsible for the rehabilitation amortization. As stated earlier, it would introduce a new type of tax incentive for certain loans by financial institutions.

In all, the House Bill in its amortization incentives has a revenue cost of $830 million. If to this is added the retained excessive depreciation for housing, especially luxury and high cost housing, the Bill involves over $1 billion of tax incentive expenditures. If one is seeking to reduce the net revenue cost of this Bill, these are areas in which one could properly start. If funds of this magnitude are to be spent for social and other programs, they ought to be spent directly as Government expenditures and in accordance with carefully selected priorities in the various programs.

I have previously discussed the weaknesses of the housing rehabilitation provision. The Treasury has described the weaknesses of the railroad car provision. As to the pollution facilities provision, which will cost $400 million, the Treasury has described some of its weaknesses in urging that it be cut back. But more can clearly here be said.

Legislative committes have struggled long and hard to find the most efficient ways to expand Government resources in the battle against pollution. There are many claimants for Government dollars and those concerned about combating pollution have found it difficult to secure the funds they desire. Interested legislators speak of scrounging a few more dollars here or there to add to an inadequate Budget figure. Yet, now, at one stroke, the Ways and Means Committee decides to spend $400 million (by 1974) in the pollution control area by allowing five-year tax amortization of the cost of installing pollution control facilities. But the Committee does not refer to any study which indicates that—if the Government is to allocate an additional $400 million to pollution control—the particular device and particular approach chosen by the Ways and Means Committee would have top priority. Instead, $400 million is allocated to this purpose without any coordination with other planning or expenditures in the pollution control area and without regard to what are the priority needs once it is decided to add $400 million to pollution control expenditures. It is quite likely that the top priority lies in assistance to municipalities and not to industry.

If these tax incentive provisions are to remain, they should at least have a definite termination date and, as suggested earlier, arrangements made to transfer funds involved to the direct expenditure programs of the agencies concerned.

Foundations and Tax Exempt Organizations.—The House Bill contains extensive changes in the treatment of foundations. A number of the provisions deal with abuses that have been documented earlier by the Treasury Department—self-dealing; failure to make adequate current distributions; ownership of businesses; utilization of the foundation by the donor as an instrument to facilitate control of a business; and speculative investment of assets. Provisions correcting these abuses are sorely needed. They would be of material assistance in rescuing private foundations from the cloud that now hangs over them.

The financial assistance given foundations through the tax system can be justified only if their sole purpose is to function as genuine philanthropic institutions. If the foundations want to serve other purposes beside philanthropy, then they should not receive that assistance and should not complain if the Congress and the public regard them with unfriendly suspicion. Thus those who urge that foundations are useful institutions to perpetuate family business or to keep particular businesses from being absorbed in merger investments, may perhaps be wisely serving the businesses involved, but they are not wisely serving either the foundation as an institution or the purposes of philanthropy. These purposes of protecting businesses are not the functions of philanthropy. Our colleges and our other charitable institutions do not concern themselves with these non-philanthropic goals. If our foundations wish to merit and fulfill a useful institutional role in our society, they should and can do so only by functioning solely as philanthropic institutions.

For these reasons the House Bill provisions concerning these matters should not be weakened as many are urging. Nor should there be special exceptions for any foundation, such as the provision in the House Bill allowing the Kellogg Foundation to own over 50% of the Kellogg Company.

Other provisions of the House Bill in the foundation area deal with different matters. One, the 7½ tax on investment income, is unadvisable, if the provisions countering abuses are strong enough to insure that foundations are functioning solely as philanthropic institutions. If it is determined that there should be a modest fee to meet the cost of administration, it should be based either on asset value or income distribution (including the 5% minimum)—to use only net investment income would favor the foundation that invests in non-income producing assets.

Other provisions deal with the operational activities of foundations and are designed to maintain a philanthropic posture as contrasted with political activities, lobbying activities and the like. These provisions require careful articulation and drafting lest the pursuit of the goals involved, which in general purpose are appropriate, does not in the day-to-day operation of the provisions hamper the basic philanthropic functions of these institutions.

The provisions in the House Bill relating to other tax-exempt organization problems, such as the strengthening of the unrelated business income tax and the taxing of the investment income of social, fraternal and similar organization, are all improvements.

Summary as to Corporate Tax

The House Bill is a significant step forward in beginning to meet the problems of tax reform under the corporate tax:

With respect to the industries with the present lowest effective rates:

As to *financial institutions*, the Bill brings the effective tax rates of the commercial bank, mutual savings banks and savings and loan associations closer to those paid by business generally, and also reduces the range differences within these institutions themselves.

As to *natural resources*, the Bill reduces the percentage depletion rates by about 25% and ends the abuses associated with mineral production payments. But it fails to deal with the aspect of intangible drilling expenses in the oil industry and the tax preference accorded to timber.

With respect to *other preferences:*

The Bill ends the tax escape now provided for multiple corporation.

The Bill cuts back on the tax preferences accorded to real estate.

The Bill strengthens the rules governing foundations and other tax-exempt organizations.

But the Bill has a *serious weakness* in the addition of new tax incentives:

The five-year amortization for pollution control facilities.

The five-year amortization for housing rehabilitation expenditures.

The seven-year amortization for railroad cars.

A WORD ON PESSIMISM AND TAX BENEFITS

There is no one so pessimistic about the future of the country as an industry or taxpayer faced with losing a tax preference. These Hearings seem replete with industries and taxpayers who can see only gloom ahead. The correlation between pessimism and tax benefits is indeed high, for these prophets of gloom assert that their pessimism for the future should be reflected in continued or increased tax preferences.

Thus, the Stock Exchange sees a pessimistic future for investment and asserts that its pessimism be met by keeping the preferences unchanged for capital gains. The financial institutions are pessimistic about a possible depression and therefore seek higher bad debt reserves—and higher tax benefits—to match that pessimism. The mutual savings banks and savings and loan associations are pessimistic about the future of housing and seek tax benefits that reflect that pessimism. Wealthy non-farmers worry about the future for cattle and horses and orchards, and seek to retain farm "tax loss" shelters to house their pessimism. The natural resources industry is alternatively pessimistic about national security and the price consumers of gasoline will have to pay, and seeks tax benefits to dispel that pessimism. And so it goes as to almost every provision in the House Bill, even as to the "small businesses" housed in the multiple corporations of an enormous multi-state enterprise.

Most of the pessimism is self-assertion, for there are few studies, if any, that document the beliefs. No one wants to see if his view of the future is wrong, for that course means the loss of tax preferences. All would prefer to be gloomier, for that course could mean increased benefits if their view of the tax system is accepted. For all see the tax system as a device to pour out financial assistance to industries and activities that do not want to trust to the marketplace. The accent is not on private enterprise, but on private enterprise plus tax assistance None is willing to pull back on the preferences so we can see if the pessimism is really warranted and to see if Government assistance is really needed. And then, if the assistance is really needed, to see it provided through direct expenditure programs.

It should be clear by now that this tax incentive rationalization, this infusion now of social goals into tax provisions adopted long ago without any thought of incentive or social programs or the like, can only be destructive of an equitable tax system and an efficient use of Government resources. It is the proper course now to cut back these tax incentives and await the future. The House Bill is a good start and should be pushed forward, not stripped back.

RATES OF TAX AND REVENUE COST

My principal purpose is to discuss the structural tax reform provisions of the House Bill and hence I wish to say only a few words regarding the rate structure.

As stated earlier, those first in line for tax relief when reduction is considered feasible, are the low-income taxpayers. Those next in line are the middle-income taxpayers not itemizing deductions for personal expenses. The House Bill fully meets those two claims for relief. It then goes on to reduce tax rates throughout the rate schedule. The result is a total long-run revenue loss of $2.4 billion.

Looking ahead to 1979, such a loss is hardly significant, considering the hazards of revenue estimates. In all likelihood such a tax reform bill cannot provide a net revenue gain, even though an appraisal of national priorities would put more emphasis on expenditure programs than such a large tax reduction. The House Bill before the last round of tax reduction added after the Bill was reported, was in this respect a better balanced bill—from the expenditure-tax reduction aspect—than the Bill as it finally passed the House. And even the Committee Bill could be regarded as too generous in some of its rate reduction in the brackets above the middle. But aside from these thoughts, the margin for concern about the revenue aspects, i.e. the $2.4 billion loss in 1979 considered as an absolute matter, is small. The Treasury appears to recognize this, for its changes would leave a revenue loss of $1.3 billion—the difference of $1 billion is hardly cause for major economic judgments.

The important matter is the composition of the tax reductions. The Treasury approach to the House Bill, as described earlier, is to make the across-the-board individual reduction paramount and then to strip back the relief for low and middle income families.[16]

As a consequence, the tax liability reduction under the Treasury approach shows a large reduction in the $0–$3000 bracket and then proceeds to a relatively flat decline from $5000 on to $100,000. In contrast, the House Bill shows significantly larger reductions up to the $20,000 bracket than the Treasury approach, and the slope of the tax reduction is far from flat. There is no question but that the House Bill has a fairer distribution of the tax reduction.

The Treasury approach, after cutting back the reductions in the low and middle-income brackets, is then to use the revenue so obtained to reduce the corporate tax rates by two points. Such a change is not defensible on tax equity grounds or on economic stabilization grounds. The Treasury desire to remove the investment credit was based on the ground that capital formation was at a high level now and no general investment incentive was needed. From a stabilization standpoint there is no point in substituting a corporate rate reduction for the investment credit.

As to future growth and the relative balance between consumption and investment, we can afford to wait a bit until the present inflationary pace really wears away to see if capital formation will then lag. If it does, a resort again to an investment credit can be more meaningful than corporate rate reduction. There is no point now in choosing weaker devices on the assumption that capital formation may later need strengthening.

One could point out that if the various new tax incentive devices in the Bill are not to be scrapped in favor of a resort to direct expenditures in the

[16] The House Bill has a considerable revenue loss—$650 million—through a change in the treatment of single persons. I would not give this matter such a high priority, especially since the relief for lower- and middle-income taxpayers will to a very large extent meet the problems of single persons in these brackets. If we are to give further relief to single persons, the Treasury suggestion in this area is an improvement over the House Bill.

areas involved, then a preferable course is to drop those devices and use the revenue to lower the corporate rate. Such a step, together with a further cut-back of accelerated depreciation for real estate and more tightening of the remaining corporate tax preferences, would readily produce the revenue to support two-point reduction in the corporate rate.

CONCLUSION

The Ways and Means Committee and the House have taken a significant step forward to the goal of a fairer and simpler Federal income tax. It is now up to this Committee and the Senate to make that step a decisive one. The House Bill is a fine structure to build upon. It can be strengthened in a number of ways and these weaknesses should be corrected. But its many, many strengths should be retained.

Senator BYRD. The committee will stand in adjournment until 2:30.

(Whereupon, 12:45 p.m. the committee recessed to reconvene at 2:30 p.m. of the same day.)

AFTERNOON SESSION

The CHAIRMAN. Gentlemen, I would like to remind you that we have everyone's printed statement, which is available to all members of the committee. We also have a summary prepared by our staff.

The next witness is Mr. David N. Mills, of Detroit, Mich.

Please summarize your prepared statement.

STATEMENT OF DAVID N. MILLS, DETROIT, MICH.

Mr. MILLS. I am a practicing attorney in Detroit, specializing in tax matters.

Unlike the witnesses who will follow me, I am not here in behalf of any client or organization. I am interested solely in the fairness, workability, and simplicity in the law, and not on its economic impact on an industry or any group.

My concern is entirely with what I regard as an unfairness of section 302. That is the allocation of deductions section which Mr. Dillon spoke of this morning.

Section 302 was, of course, intended as a companion to section 301, the section establishing the so-called 50-percent income limit on tax preferences.

While section 301 could only apply to these very rare individuals only half of whose income is from preferential sources, some of whom, as Mr. Surrey pointed out pay no taxes at all, section 302, on the other hand, would apply to every taxpayer in any year with $10,000 or more preferential exempt income regardless of his total income on which he is paying taxes.

So the section is going to have a very enormous impact on a lot of people. It is going to apply to every year to at least tens of thousands of taxpayers and possibly hundreds of thousands of taxpayers.

Now, the rationale behind section 302 is, of course, the personal deductions should be allocated pro rata between exempt and taxable income, and that thus allocated exempt income should be disallowed on the theory that they were paid out of the exempt income.

Gentlemen, the basic defect in this approach is that about half the classes of tax preferences which section 302 applies to, they do not represent cash or property receipts at all, so that personal deductions could never have been paid out of these items.

For example, this is true of the farm loss items Mr. Surrey spoke of this morning. It is true of accelerated depreciation, it is true of intangible drilling expenses on oil and gas. These items represent payments, they are not receipts on which a man could pay his deductions. They are regarded as tax preferences, but that is only because the law permits them to be written off all at once or at some accelerated rate rather than through straight line depreciation but, to in effect, part of it from ever being deductions at all, which is exactly what section 302, in my judgment, would be terribly unfair.

Take as an example a building. During the overall life of a building the total depreciation will, of course, be exactly the same whether a man uses the accelerated method or straight-line method. In other words, under the accelerated method he receives a larger deduction in the earlier years and, correspondingly, a smaller one in the later years.

I submit there is absolutely no reason at all to impose a section 302 tax penalty during certain years on a man using accelerated depreciation whereas no such penalty will be required in any year for another taxpayer with the same building and with the same depreciable life, depreciating on a straight line method and giving him the same exact amount of total depreciation over the years.

If accelerated depreciation and these other tax preferences are wrong, and maybe they are, then I would agree they should be removed. But, if this is done it should be done directly, it should not be done by the back door method of penalizing the recipient of such exempt preferences by disallowing perfectly legitimate deductions for charitable contributions and medical expenses, and so one, which are allowed in full to other taxpayers who do not have to—do not happen to have preferential income.

Now, direct taxation of exempt income would also treat equally differently taxpayers with the same amount of such income or preferences whereas the section 302 approach makes instead this amount of indirect tax on the preferential income depend instead on the amount of a man's preferential deductions.

Take another example. Take two taxpayers each with the same amount of, exactly same amount of taxable income, each with the same amount of income with preferences. I can frankly see no reason at all why one of them has got to pay a substantial 302 tax penalty because he has substantial deductions to itemize, whereas the other one with exactly the same income and preferences must pay no tax penalty at all because he uses the standard deduction instead of itemizing his deductions.

The two things are entirely unrelated.

I think that the allocation of deductions section also unfairly discriminates between different types of taxpayers.

For example, it does not apply to preparations at all the way the House worded the bill. In other words, no matter how much exemption, or preferences a corporation has got, it will still be permitted to deduct in full its charitable contributions, its mortgage interest, its property taxes and its other investment expenses.

On the other hand, an individual can take such contributions and investment expenses only as personal deductions so that he will be subject to this section 302 disallowance.

Now, Secretary Dillon pointed out this morning the great hardship which he felt section 302 would work on the fund-raising activities of charitable and educational organizations, and he pointed out that the section is particularly unfair as applied to charitable gifts of appreciated property.

Now, I would like to add to his statement that, as applied to these items of gifts of appreciated securities, it, in effect, provides a double penalty.

First, the unrealized appreciation itself is treated as one of the tax preference items that requires section 302 allocation. But, in addition, the appreciation is, of course, part of the gift itself, which itself is one of the personal deductions that is subject to the section 302 allocation.

I would guess that the administration recognized the unfairness of this when it recommended narrowing the scope of section 302 by removing unrealized appreciation of charitable gifts from a list of tax preferences subject to allocation which Mr. Dillon recommended this morning.

Now, Mr. Surrey——

The CHAIRMAN. Let me ask you if this is not true, and I imagine you would probably agree with this statement. Is it not true that to the extent that you are collecting a substantial amount of taxes on income which is being directed toward charitable and educational purposes, you are going to reduce substantially the amount of contributions that people contribute to those things?

Mr. MILLS. No question about it, Senator.

The CHAIRMAN. In other words, when someone can go to a man and say, "What you contribute to education, to charity, is wholly deductible," that person is accustomed to the fact that he can deduct this——

Mr. MILLS. No question about it.

The CHAIRMAN (continuing). Once you start making it only partially deductible that is going to cause him to retrench some on what he gives, is he not?

Mr. MILLS. I think there is no question about it.

Now, Mr. Surrey sort of sloughed this off this morning when he said, "Well, this man can, instead of giving appreciated property or securities, he can give cash."

But, as Mr. Dillon pointed out, he still is going to give less when he gives cash, and he is also going to give less not only because of the tax effect but because he will still be subject to section 302.

He will not be subjected to a double penalty, but he will be subjected to a single penalty because his gift will still be subject to allocation if he has other exempt income.

The CHAIRMAN. Well, after you work over a period of time to get some person up to a certain level of giving, once you get him on that basis, your chances are pretty good that you can keep him contributing until some disturbing factor comes into the picture.

But when you start taxing him, that gives a man an excuse to back off and take another look at the whole situation and not contribute or only contribute half, something like that.

Mr. Mills. I think this provision would have such an effect.

None of us, I do not think, really, would object to denying a personal deduction for expenses that are really attributable to tax-exempt income. But we have already got sections that do this, that is, sections 264 and 265 do, they disallow the deduction of interest and other expenses that are attributable to tax-exempt income.

Maybe these sections ought to be expanded, but when the personal deduction is not in any way related to tax-exempt income this section 302 is arbitrary, an arbitrary pro rata assumption. To the contrary, I think it is terribly unfair.

For example, it does not even make an exemption in the case of personal deductions that are specifically attributable or paid out of identifiable items of taxable income like interest expense, mortgage interest, and other investment expense paid on money borrowed for specific purposes of investing in securities or other properties producing taxable income.

I just cannot see any reason for this kind of allocation. In closing, the last thing I wish to say is this: I would like to point out that we who prepare returns are going to have a terrible burden. It will be a terrible time-consuming burden on all the taxpayers who are going to have to make many additional calculations called for by this section.

For example, farmers, real estate investors, oil and gas investors are going to have to keep an entirely separate set of inventory and depreciation books, capitalizing or depreciating or treating the preferential items in question.

In the case of the oil and gas investor the cost depletion compution will be particularly burdensome since, as you know, to compute cost of depletion you have got to determine the amount of oil and gas reserves in place at the beginning of the year. This cannot be done without an up-to-date engineering report which is normally not available unless the taxpayer goes to the extra expense of having one made just for this purpose.

So to summarize, I think that section 302 will be a real administrative headache, add a great deal of complexity to the law and to the tax return forms at a time when the taxpayers themselves are instead clamoring for tax simplification, and when most of the rest of the tax bill the House has prepared does give them some measure of that tax simplification.

Thank you.

The Chairman. Thank you very much.

Any questions, gentlemen?

Thank you very much.

(David N. Mills' prepared statement follows:)

Statement of David N. Mills, Detroit, Mich.

SUMMARY

1. Since most of the "tax preference" items to which Section 302 would apply do not represent cash or property received by the taxpayer during the year, they cannot be regarded as the source from which any personal deductions could have been paid.

2. Personal deductions should not be disallowed except to the extent actually *attributable* to tax exempt income or preferences.

3. If the tax preferences in question should be eliminated or reduced, this

should be done by directly taxing the same rather than by using such preferences as the basis for disallowing wholly unrelated and legitimate deductions.

4. Section 302 discriminates between different classes of taxpayers (a) by applying to individuals but not to corporations with the same types of deductions, and (b) by applying unequally to taxpayers allowed the same aggregate amount of depreciation (or its equivalent) during the life of the same property.

5. Section 302 would have a serious adverse effect on charitable and educational institutions dependent primarily for their support on medium and large-sized gifts from individuals who measure their ability to give or the amount of their gifts by the "after-tax" cost of such giving.

6. The allocation of deductions called for by Section 302 would unnecessarily complicate the tax law and the tax return forms.

STATEMENT

INTRODUCTION

Section 302 of the Tax Reform Bill of 1969 (proposed Code Section 277) is designed to require pro-rata allocation of so-called "personal" deductions between taxable and exempt income and deny a deduction for the portion thereof allocated to exempt income and tax preferences. In spite of the far-reaching impact of this provision, it has received very little attention or publicity, probably because there is no single large business or other organized group which would be peculiarly or particularly adversely affected by this Section.

Section 302 was intended as a companion to Section 301, which establishes a 50% of income limit on certain exempt income and preferences. Section 302 relates to exempt income and tax preferences from the same sources as those described in Section 301 (plus certain others). However, while Section 301 would apply only to those exceedingly *rare* individuals over half of whose income is from such exempt or preferential sources, Section 302 on the other hand would apply to every taxpayer who in any year has more than $10,000 of income or deductions from the exempt or preferential sources in question. Thus nearly every individual real estate investor with substantial accelerated depreciation of one or more buildings or investor with substantial gross income from oil and gas or individual with a substantial total capital gain (or unrealized appreciation from a charitable donation in kind) for any given year would be subject to the adjustments of Section 302 regardless of the relative or absolute size of his total income on which he is paying taxes.

1. Since most of the "tax preference" items to which section 302 would apply do not represent cash or property received by the taxpayer during the year, they cannot be regarded as the source from which any personal deductions could have been paid.

The basic rationale of Section 302 is that non-business or personal deductions should be allocated pro-rata between exempt and taxable income and that those thus allocated to exempt income should be disallowed as deductions on account of representing payments arising out of the production of exempt income or *paid out of* the proceeds of exempt income.

The most fundamental defect in this approach is the fact that most of the classes of tax preferences covered by Section 302 do not constitute cash or property received at all and therefore personal deductions could never have been paid out of such tax preferences—for example, (a) farm losses to the extent attributable to failure to use the inventory method of accounting of failure to capitalize capital expenditures, (b) intangible drilling expenses and percentage depletion to the extent that they exceed what would have been allowed if a taxpayer had capitalized such expenses and recovered the same by cost depletion and depreciation, and (c) accelerated depreciation of buildings to the extent that it exceeds straight line depreciation. Depreciation, acquisition of farm inventory or capital assets, and intangible drilling expenses never represent dollars or income received (taxable or exempt) but rather represent money paid out or spent (though in the case of depreciation it may have been paid out in a prior year). One might well argue that such payments should be treated as capital expenses (to be deducted gradually over the years by way of depreciation or depletion rather than all at once when incurred) but to prevent part of them from ever being deducted at all at any time would be grossly unfair. In any event it is clear that to the extent that during the year a taxpayer spends money on intangible drilling costs of oil and gas wells (or buys a depreciable asset for his farm not required to be capitalized under his method of accounting) resulting in a deduction of such costs in full when spent, he receives no net cash realization from such expenditure such as might be regarded even in part as the source of any of his payments resulting in personal deductions.

2. Personal deductions should not be disallowed except to the extent actually *attributable* to tax exempt income or preferences.

Certainly nobody can fairly object to denying a personal deduction for any expenditure actually attributable to or incurred in the production of tax-exempt income or preferences. The existing law already recognizes this, however, and denies, for example, a deduction of interest paid on money borrowed to pay the premium on a single premium annuity or insurance policy (IRC Section 264), interest paid on any debt incurred or continued to acquire tax-exempt state or municipal bonds (IRC Section 265(2)), and expenses incurred in the production of tax-free income (IRC Section 265(1)), such as trustee's fees and other investment expenses attributable to tax-exempt state or municipal bonds. If there are other examples of personal deductions which may with any frequency be in fact attributable to the receipt of tax exempt income or tax preferences (though I believe there are none), then IRS Sections 264 and 265 should be expanded to deny such deductions. But where the payments giving rise to personal deductions are not in fact attributable to any item of exempt income or tax preference (as is, in the nature of things, never the case with respect, for example, to the payment of a medical or dental expense) there can be no reason at all for making an arbitrary assumption to the contrary, on a pro-rata basis or otherwise, by constructively attributing or ascribing a portion of *all* personal deductions to exempt income or tax preferences. After all, the inherent nature of personal deductions is such that in an economic sense they are almost never traceable or related in any way to exempt income or preferences. Thus they become "personal" deductions by virtue of *not* being business-related.

The proponents of Section 302 may reply that even if a personal deduction cannot be identified as being *attributable* to or incurred in connection with the production of exempt income, it may still in economic effect be deemed pro-rata to have been *paid out of* such exempt income. This "source-of-payment" argument and its arbitrary pro-rata approach is, I submit, wholly fallacious. Thus a change might logically be made in the law to provide that personal deductions are only to be allowed to the extent that they are paid out of *taxable* income, but Section 302 is not predicated on that rationale. Thus payments made out of *capital* or *principal* (as opposed to exempt income or tax preferences) would of course remain allowable as personal deductions notwithstanding Section 302.

For example, if in a given year a taxpayer has $50,000 of ordinary income and sells capital assets for $40,000 resulting in $25,000 of long term capital gain (since the property cost him only $15,000 many years earlier), I fail to see why he should have any more charitable contributions and other personal deductions disallowed than an identical taxpayer with the same $50,000 of ordinary income but whose sale of the same property for the same $40,000 resulted in no capital gain (since his original cost was $40,000 or more). It may be perfectly true that in both cases the proceeds of sale of a capital asset may be said at least theoretically to constitute the *source* or *subject matter* of a pro rata part of the payment of a charitable contribution or other personal deduction, but what possible reason can there be for making the availability and amount of the deduction depend on the matter of how much of such sale proceeds happen to constitute capital gain rather than a return of capital costs?

It may be further noted that since personal deductions (unlike net operating losses) cannot be carried forward or backward to a different year (with a minor exception as to charitable deductions), no tax benefit can ever be had from any personal deduction in excess of what otherwise would be the taxpayer's taxable income for the year. That is to say, even under the present law personal deductions are in effect not allowable unless they at least *could have been made* from taxable (as opposed to tax-exempt) income.

The theoretical pro-rata source of payment approach of Section 302 also ignores the situation often prevailing as to personal deductions that are specifically attributable to or paid out of identifiable items of *taxable* income; for example, interest on money borrowed for the specific purpose of investing in (taxable) interest or dividend producing assets, or property taxes or mortgage interest paid on rental property held as an investment. Such interest and taxes, though incurred in connection with the maintenance of property held for the production of income (and not constituting purely *personal* expenses) would of course be allowed to an individual only as personal deductions if not incurred in a "trade or business". But Section 302 makes no provision for excluding such identifiable personal deductions from the items subject to the artificial proration called for by that section.

3. If the tax preferences in question should be eliminated or reduced, this should be done by directly taxing the same rather than by using such preferences as the basis for disallowing wholly unrelated and legitimate deductions.

If a taxpayer who has tax-exempt income or preferences should as a policy matter be required to pay additional income taxes as a result of same, this should be provided for either by eliminating the tax exemption feature or preference or a portion thereof directly (such as the House Bill has already done by narrowing the definition of long term capital gains and removing the 25% tax ceiling on same) or by directly taxing otherwise exempt income at some lower rate—and not by the "back-door" method of penalizing the recipients of such income or preferences by disallowing perfectly legitimate deductions (for charitable contributions, interest and taxes paid, medical and dental expenses, etc.) which are allowed in full to other taxpayers who don't happen to also have that particular type of preferential income. Direct taxation of exempt income or direct disallowance of a deduction of tax preferences would also have the advantage of treating in identical fashion different taxpayers with the same amount of exempt income or tax preferences, whereas the Section 302 approach differentiates between them by making the amount of the (indirect) tax on such exempt income or preference depend instead on the amount of the taxpayer's personal deductions. I submit that if two taxpayers, one using the standard deduction and the other having substantial itemized personal deductions, have an identical amount of taxable income and also an identical amount of exempt income and tax preferences, there is no reason why one of them should pay no additional tax on such exempt income and preferences (because of using the standard deduction in lieu of itemizing his personal deductions) whereas the other one must pay a substantial tax penalty as a result of having such exempt income or tax preferences.

If only such a direct approach could be employed, I am confident that Congress would, for example, not even consider taxing interest received on state or municipal bonds heretofore issued and which were bought at a price and with an interest rate entirely predicated on the assumption of their being exempt. Many also question whether Congress could constitutionally do so. I submit that if it would be unfair to tax directly such state or municipal bond interest, it would be even more unfair to attempt to tax it through the indirect method prescribed by Section 302. Furthermore, the uncertain, unequal and unmeasureable effect of Section 302 on different taxpayers (or on the same taxpayer in different years, depending on the varying amount of his personal deductions) might seriously disrupt or disturb the municipal bond market and thus substantially increase the future cost of state and municipal borrowing.

4. Section 302 discriminates between different classes of taxpayers (A) by applying to individuals but not to corporations with the same types of deductions, and (B) by applying unequally to taxpayers allowed the same aggregate amount of depreciation during the life of the same property.

Section 302 is worded so as not to apply to corporations. Thus under the House Bill a corporation would continue to be entitled to deductions for all charitable *contributions* paid (subject only to the applicable percentage of income limitations), all *interest* paid, and all property, sales, gasoline, state and local income *taxes* paid—even though unrelated to its trade or business and therefore constituting items which an individual could only take as "personal" deductions. The fact that such corporation also has exempt income or tax preferences of the type to which Section 302 applies will not cause it to be deprived under Section 302 of any part of its deductions for charitable contributions, interest and taxes paid.

Other forms of discrimination as between otherwise identical taxpayers would also result from Section 302. For example, accelerated depreciation of buildings in excess of straight line depreciation in any year is treated as a tax preference requiring allocation of personal deductions under Section 302. However, accelerated depreciation in a given year can only mean that in certain subsequent years during the life of the depreciable asset in question the taxpayer's depreciation will be less than what would have been allowed if the asset had been depreciated on a straight line basis throughout its life. But Section 302 proposes no adjustment in any subsequent year to allow for such "reverse preference", even though it in effect constitutes in economic effect a partial *repayment* of a preceding year's tax preference. Thus two identically situated taxpayers, one using the sum-of-the digits method of depreciation and the other using the straight line method, will each have the same amount of aggregate depreciation deductions during the full life of a given asset. Yet the one using the sum-of-the digits method will be required to make a Section 302 adjustment on account of the same during certain years while the one using the straight line method will never be required to make any Section 302 allocation on account thereof. Similar examples of unequal treatment of identical taxpayers could be demonstrated for the Section 302 adjustments called for as a result of failure to capitalize intangible drilling costs and certain farm expenses.

5. Section 302 would have a serious adverse effect on charitable and educational institutions dependent primarily for their support on medium and large-sized gifts from individuals who measure their ability to give or the amount of their gifts by the "after-tax" cost of such giving.

While other types of personal deductions represent for the most part involuntary payments and the amount thereof should accordingly not be appreciably affected by the enactment into law of Section 302, charitable contributions on the other hand are in their very nature voluntary. An independent school which I represent advises me that well over 90% of the dollar value of all gifts to it consists of gifts of $100 or more each. The amount of charitable giving by most donors above approximately this $100 level depends in large part on the tax effect of such giving. Recognition of this fact and the impact of same on hospitals, private colleges, universities, etc. resulted in the House's narrowing the scope of Section 201 (c) and (d) of H.R. 13270 (taxing the unrealized gain from appreciated property given to charitable organizations) to the point where it will only apply to a very small percentage of such contributions. But the House then proceeded to do under Section 302 what it was unable or unwilling to accomplish under Section 201 (c) and (d), by partially disallowing the charitable deductions in question in *all* cases where such unrealized appreciation (plus other forms of exempt income and preferences described in Section 302) exceeds $10,000. Certainly one result that could be fairly anticipated from the enactment of Section 302 into law would be for the many individuals whose substantial charitable donations in the past have invariably taken the form of gifts in kind of appreciated property to simply stop making large charitable gifts. I believe a previous witness at these hearings has testified to the effect that 56% of the dollar value of all gifts to a group of Massachusetts colleges are so made in kind rather than in cash. Undoubtedly cash gifts by foundations and charitable trusts made from the proceeds of sale of gifts in kind made to them by their own donors comprise a very substantial portion of the other 44%.

As applied to charitable gifts of appreciated property Section 302 provides in effect for a double penalty. Thus not only is the unrealized appreciation itself treated as one of the tax preference items requiring Section 302 allocation; but in addition such appreciation also represents part of a charitable gift which constitutes one of the personal deduction items subject to such Section 302 allocation. I would assume that it is for the above reasons that the administration has recommended narrowing the scope of Section 302 by removing unrealized appreciation from charitable gifts in kind from the list of tax preferences subject thereto.

96. The allocation of deductions called for by section 302 would unnecessarily complicate the tax law and the tax return forms.

The adjustments called for by Section 302 would apply in every year to hundreds of thousands of taxpayers who would have to bear the time-consuming burden of making the many calculations called for by that Section, nearly all of which apart from Section 302 would never even have to be computed by the taxpayer (except as to some such items in the extremely rare instances covered by Section 301).

The necessary additional computations and record-keeping required under Section 302 with respect to intangible drilling expenses, straight line depreciation, cost depletion and the keeping of a separate set of farm books using the inventory method of accounting (including the taking of a beginning inventory each year) would be most complex. As an example, in order to calculate for a given year the amount of his accelerated depreciation in excess of straight line depreciation (or, in the case of oil and gas wells and farm losses, the amount of depreciation which would have been allowed if the taxpayer had capitalized intangible drilling expenses and certain farm expenses), the taxpayer will have to make a separate determination of the salvage value of each item (a determination which is not necessary under the 200% declining balance method of depreciation) and if there has at any time been a change in useful life, he will have to recalculate straight line depreciation on a year-by-year basis from the time of his original acquisition of the property in question. Similarly with respect to determining percentage depreciation in excess of cost depletion, he will have to make a determination, from information not generally available, of the amount (in barrels of oil and cubic feet of gas) of oil and gas extracted and sold during the year and also of his oil and gas reserves in place at the beginning of the tax year. In order to determine reserves in place for cost depletion purposes, he must obtain a reasonably up-to-date engineering report, which will not normally be available unless he goes to the expense of having one made for this specific purpose.

In short, then, Section 302 would be an administrative headache, require a number of exceedingly complex computations and tax return entries (never heretofore required) to be made by a large number of taxpayers, entail additional work by the IRS in auditing, checking and reviewing such additional computations and the evidence necessary to verify the figures used in such computations, and be a step in the opposite direction of the objective of tax and reporting *simplification* which so much of the rest of the House Bill (particularly its proposed increase in the standard deduction) was so wisely designed to accomplish and which the taxpayers themselves are so vociferously demanding.

The CHAIRMAN. The next witness will be Mr. Robert M. Johnson, partner, Dawson, Nagel, Sherman & Howard, Denver, on behalf of informal committee of Municipal Bond Council.

STATEMENT OF ROBERT M. JOHNSON, ON BEHALF OF INFORMAL COMMITTEE OF MUNICIPAL BOND COUNCIL

Mr. JOHNSON. Mr. Chairman, other members of the committee, I have other bond counsel associated with me from throughout the Nation. I have Mr. Harold Judell from New Orleans; Bryce Huguenin from Dallas; Ray Hutchison, from another bond firm in Dallas; and Gerard Giordano, from New York City.

We speak on behalf of a much wider number of bond counsel but, at least, we wanted to have some of them present to assist.

I am appearing before this committee in order to present the views of members of several law firms which are nationally recognized as municipal bond counsel with regard to the tax reform proposals presently before this committee as they relate to treatment of the interest on obligations of States and their political subdivision—herein "municipal bonds" and collectively "Local Governments," respectively.

My statement is directed primarily at setting forth our views on the constitutionality of any attempt to impose a Federal tax directly or indirectly on income on municipal bonds under the "Limit on Tax Preference" (LTP) provision in section 301 of the tax reform bill of 1969, that is, H.R. 13270—herein the "bill"—constituting a direct tax on such income, and the "allocation of deductions" provision in section 302 of the bill, constituting an indirect tax on such income. While others, including Mr. Surrey this morning, have expressed their opinion or I should say excluding Mr. Surrey this morning, have expressed their opinion, that any attempt to tax such interest would raise a serious constitutional question, this view has apparently not been accorded much weight by some Members of Congress.

Further, others like Mr. Surrey, I have heard another attorney from the Treasury, make the flat statement there is no constitutional question. We wish to dispel here any notion that passage of the proposed legislation would meet with no resistance by those who issue and those who invest in municipal bonds.

It is the view of our group of bond counsel that a very serious constitutional question is raised by the proposals, both with regard to the right to tax either directly or indirectly the interest on municipal bonds and with regard to the right of a political subdivision within any State to waive the constitutional tax immunity under the waiver and Federal subsidy provisions in sections 601 and 602 of the bill, in the absence of the State's authorization of action pertaining thereto by the political subdivision at least by State act or possibly by State constitutional amendment in some States where they may have an atypical constitutional provision.

Under the Federal Constitution neither the Federal Government nor the local governments can materially impair the other's power to raise money by borrowing—incidentally or by taxation, which is a point here irrelevant, in other words, they cannot materially impair the so-called sovereign power of the purse of the other governmental body.

We understand that Secretary Kennedy recently conceded that the LTP provisions in the bill posed a grave constitutional question, but that he indicated that the allocation of deductions provision did not pose such a question, even though it related in part to municipal bond interest, in view of *United States* v. *Atlas Life Insurance Co.*, 381 U.S. 233, 1965.

Atlas actually concerned the allocation of tax-exempt municipal bond income to the policyholders' reserve, which consisted of 85 percent of the company's income, and which was not taxable because of the peculiar business of an insurance company, and the necessity to protect the policyholders' reserve, and to the shareholders' portion of income the balance which consisted of 15 percent of such income and was subject to taxation.

This was under the Life Insurance Company Income Tax Act of 1959, and the allocation had to be made on the same prorated basis, in that instance 85 and 15 percent.

The company, if this were not the case, by investing in a small amount of municipal bonds, could completely avoid Federal income taxes in the absence of such an allocation. The company contended that the formula imposed a constitutionally impermissible tax on municipal bond interest since its tax bill was higher than if it was permitted to assign all of its tax-exempt income to the shareholders' portion of income.

The U.S. Supreme Court rejected the contention, and indicated that the formula was equitable and the classification was reasonable, and stated that "[a]s the taxpayer displaces taxable income with exempt income, the size of the tax base, and the tax, are reduced: and that "[t]he burden per taxable dollar of taxable gross income does not increase, but remains the same."

In the *Atlas* case, however, the Court referred to the *National Life Insurance Co.* v. *United States* case decided in 1928, the earlier case holding that one may not be subjected to greater burdens upon his taxable property solely because he owns some that is free.

Then, in the *Atlas* case, of course, the Court said this is not the case under the 1959 act.

While different in form, in substance, the company's contention was actually the same as condemned in *Denman* v. *Slayton* case decided in 1931 where the taxpayer attempted to deduct interest on a loan to him, and then he used the proceeds for investment in municipal bonds, and he attempted also to deduct the interest received by him on the bonds. The interest on the loan was not deductible.

But under the present bill there is no factor similar to that in Atlas justifying an allocation formula like that there upheld. There is just no reasonable relationship between the deductions in question and the income in question, that is, the interest on municipal bonds.

Section 302 is merely an attempt to subject certain taxpayers to greater burdens upon their taxable property solely because they own some tax-exempt municipal bond income, and I know of no decision that has cut back on the court's statement that that is improper.

Very frankly, I cannot understand Mr. Surrey's flat statement that it is constitutional and there is no doubt about it.

We are not here trying to determine what the results of the litigation would be, but there is a very serious question.

The LTP provision and the allocation of deductions collectively clearly impose a material impediment upon the borrowing power of the local governments, particularly in view of the recent deterioration of the municipal bond market resulting merely from the consideration by Congress of the bill.

Probably each provision alone would constitute such an impediment to borrowing by local governments if the bill is adopted.

Incidentally, in the *Atlas* case we are unaware of any attempt to prove that that act would materially affect interest rates and create an impediment upon the borrowing power by governments.

I was recently informed by an investment banker that at the height of life insurance companies buying they bought no more than one-tenth of municipal bonds. Of course, here we are talking about all municipal bonds sold. The effect of this act would affect the entire market. Certainly there is nothing in the Atlas decision to suggest that the Supreme Court felt there was any such impediment.

As I indicated, of course, there is a divergence of opinion about what the outcome of any litigation would be. My purpose is solely to point out to this committee that a reputable group of attorneys experienced in this field of law hold the view that the questions presented by the tax reform proposals are so serious as to present questions which will undoubtedly be the subject of long and protracted litigation.

As a result, the market for municipal bonds during this period of litigation will probably continue in a seriously disrupted condition which prevails at the present time.

The committee is no doubt aware of the view that the doubts raised by the tax reform proposals have been a major source of problems prevalent in the municipal bond market today. The continued existence of such doubts can only result in the continued disruption of this important market, thereby making it increasingly difficult or impossible for public projects to be financed.

From October 2, 1968 to a recent date, September 4, 1969, the Bond Buyer's Twenty Bonds Index rose to 2.01 percent, to an historic high of 6.37 percent, and it is now about the same, just slightly better.

During the 2-month period from July 10 to September 4, 1969, when the money market for corporate securities and U.S. governments was relatively stable, the same Twenty Bonds Index rose about three-quarters of 1 percent, actually, .72 percent. That was presumably attributable solely to the increasing congressional threat to tax exemption from a press release of the House Ways and Means Committee and the bill's introduction and passage by the House.

I know of no other factor that accounts for this rise in an otherwise stable market.

Predictions as to the length of time needed to settle the various legal questions that will be raised range from a minimum of 2 years' time in the most agreeable circumstances to as long as 10 years.

I believe the Atlas decision took over 5 years to decide, and the U.S. Supreme Court decision was about 6 years from the time the act was adopted.

As you can see, even a minimum period of time of 2 years during which the municipal bond market will be disrupted is just far too long.

As bond counsel, my colleagues and I are, of course, deeply interested in the proposals presently before this committee. We should like to make it clear, however, that regardless of the legislation finally adopted, local governments will continue to borrow money even though at a far greater expense than is necessary and we will, in any event, be called upon to render legal opinions approving such obligations.

We think we are relatively free of any adverse effect from the bill's adoption, and believe our analysis is objective and free from any possible compromise from self-interest.

We hope to impress upon this committee our strong view that the proposals do, in fact, raise serious constitutional questions which undoubtedly will be the subject of protracted litigation resulting in a serious disturbance in the conditions of the municipal bond market for a period of up to 10 years.

While there has been, perhaps, during the first half of this century a tendency to cut back on exemptions, I know of no decision that suggests that the doctrine of reciprocal tax immunity is dead or dying. The converse is the case in decision after decision.

Senator ANDERSON. That bell signals the end of your time.

Mr. JOHNSON. I would be glad to answer any questions you have, sir.

Senator McCARTHY. I have one question: If the support program on interest rates were in effect, what would happen to the way in which the bond market or the sales are now allocated? Don't you have specialists in municipal bonds as opposed to those who specialize in bonds that are not tax-exempt? What does your company deal in, for example?

Mr. JOHNSON. I am an attorney, understand, Senator, not an investment banker.

Senator McCARTHY. I see. Yes.

Mr. JOHNSON. Generally speaking, a municipal bond is not market-on a private market without an approving opinion of municipal bond counsel. I would assume that that situation would continue because of the strict doctrine of powers which is enforced in the field of local government and sometimes called Dillon's Rule, and that this factor is not materially affected by whether or not the interest on the bonds is exempt from Federal income taxation.

If there was a Federal guarantee, then that situation might be different and we may be getting into an allied field in our legal practice. But a mere subsidy, I do not see why that should be affected.

Senator MCCARTHY. You would still have the same allocation.

Mr. JOHNSON. Same function, as I see it; yes, sir.

The private investor wants an opinion—this has been the case since the turn of the century, and before that there were so many invalid municipal bond issues outstanding in the market that investors just demanded that specialists get into this field.

Senator MCCARTHY. Your position is that the allocation would be improper, unless there is a clear determination of the constitutionality in order to carry through.

Mr. JOHNSON. Yes, sir. We think the *Atlas* case is clearly distinguishable on the two points. There is no reasonable relationship between the deductions and the income as there clearly was in that case.

Second, here you clearly have a material impediment on borrowing power that arguably was absent there, at least there was no showing of that.

Now, insurance companies do not, as a practical matter, invest significantly in the municipal bond market any more, so with hindsight you can say that with a little tongue in cheek but, at that time, that was not shown.

Senator MCCARTHY. I have no more questions.

Mr. JOHNSON. We would like to reserve permission of the committee to file additional statements on this, particularly since Mr. Surrey made such a statement which is so contrary to our comment on it.

Senator MCCARTHY. You have to remember Mr. Surrey is just an expert, he is not a man with political power. [Laughter.] You do not have to answer—as though he were in the Treasury.

(Mr. Johnson's prepared statement follows:)

DAWSON, NAGEL, SHERMAN & HOWARD,
Denver, Colo., September 19, 1969.

Comments Upon Proposed Taxation of Interest on Municipal Bonds Under The Tax Reform Bill of 1969 (H.R. 13270)

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.

SUMMARY

Gentlemen: Serious questions exist as to the validity under the Federal Constitution of certain provisions of The Tax Reform Bill of 1969 (H.R. 13270), specifically:

(a) the "Limit on Tax Preference" (LTP) provisions in section 301 imposing a direct Federal income tax on municipal bond interest,

(b) the "allocation of deductions" provisions in section 302 imposing an indirect Federal income tax on such income by the reduction of other deductions merely because of the receipt of such income by a taxpayer, and

(c) the Federal subsidy and waiver of tax exemption provisions in sections 601 and 602 in their application to the political subdivisions of any state in the absence of its authorization of action pertaining thereto by its political subdivisions at least by state act or possibly by state constitutional amendment.

GENERAL COMMENT

I am appearing before this Committee in order to present the views of members of several law firms which are nationally recognized as municipal bond counsel with regard to the tax reform proposals presently before this Committee as they relate to treatment of the interest on obligations of states and their political subdivisions (herein "municipal bonds" and collectively "Local Governments," respectively). My statement is directed primarily at setting forth our views on the constitutionality of any attempt to impose a Federal tax directly or indirectly on income on municipal bonds under the "Limit on Tax Preference" (LTP) provision in section 301 of The Tax Reform Bill of 1969, i.e., H.R. 13270 (herein the "Bill"), constituting a direct tax on such income, and the "allocation of deductions" provisions in section 302 of the Bill, constituting an indirect tax on such income. While others have expressed their opinion that any attempt to tax such interest would raise a serious constitutional question, this view has apparently not been accorded much weight by some members of Congress. We wish to dispel here any notion that passage of the proposed legislation would meet with no resistance by those who issue and those who invest in municipal bonds. It is the view of our group of bond counsel that a very serious constitutional question is raised by the proposals, both with regard to the right to tax either directly or indirectly the interest on municipal bonds and with regard to the right of a political subdivision within any state to waive the constitutional tax immunity under the waiver and Federal subsidy provisions in sections 601 and 602 of the Bill, in the absence of the state's authorization of action pertaining thereto by the political subdivision at least by state act or possibly by state constitutional amendment.

Under the Federal Constitution neither the Federal Government nor the Local Governments can materially impair the other's power to raise money by borrowing (or by taxation, a point here irrelevant), i.e., materially impair the so-called "sovereign power of the purse."

We understand that Secretary Kennedy recently conceded that the LTP provisions in the Bill posed a grave constitutional question, but that he indicated that the allocation of deductions provision did not pose a question, even though it related in part to municipal bond interest, in view of *United States* v. *Atlas Life Insurance Company*, 381 U.S. 233 (1965). *Atlas* actually concerned the allocation of tax-exempt municipal bond income to the policy-holders' reserve (which consisted of 85% of the company's income, and which was not taxable) and to the shareholders' portion of income (which consisted of 15% of such income and subject to taxation), under the Life Insurance Company Income Tax Act of 1959, on the same prorated basis. The company, by investing in a relatively small portion of municipal bonds, could completely avoid Federal income taxes in the absence of such an allocation. The company contended that the formula imposed a constitutionally impermissible tax on municipal bond interest since its tax bill was higher than if it was permitted to assign all of its tax exempt income to the shareholders' portion of income. The U.S. Supreme Court rejected the contention and indicated that the formula was equitable and the classification was reasonable, and stated that "[a]s the taxpayer displaces taxable income with exempt income, the size of the tax base, and the tax, are reduced" and that "[t]he burden per taxable dollar of taxable gross income does not increase, but remains the same." (381 U.S., at 244.)

In *Atlas* the Court stated that in *National Life Insurance Co.* v. *United States*, 277 U.S. 508 (1928), the "Court ruled that '[o]ne may not be subjected to greater burdens upon his taxable property solely because he owns some that is free' " but "that this is not the case under the 1959 Act." (381 U.S., at 244.) While different in form, in substance the Company's contention was the same as that condemned in *Denman* v. *Slayton*, 282 U.S. 514 (1931), where the taxpayer attempted to deduct interest on a loan to him for investment in municipal bonds and also to deduct the interest received by him on the bonds.

Under the present Bill there is no factor similar to that in *Atlas* justifying an allocation formula like that there upheld. Rather section 302 is merely an attempt to subject certain taxpayers to greater burdens upon their taxable property solely because they own some tax exempt municipal bond income.

Further, the LTP provision and the allocation of deductions provision collectively impose a material impediment upon the borrowing power of Local Governments, particularly in view of the recent deterioration of the municipal bond market resulting merely from the consideration by Congress of the Bill. Probably each such provision alone will constitute such an impediment to borrowing by Local Governments, if the Bill is adopted. (We are unaware of any contention in *Atlas* that the 1959 Act imposed such an impediment and the decision does not indicate the Court felt that such was the case.)

There is a divergence of opinion on what the outcome of such litigation would be. I am not here today to predict the result of this litigation. My purpose is solely to point out to this Committee that a reputable group of attorneys experienced in this field of law hold the view that the questions presented by the tax reform proposals are so serious as to present questions which will undoubtedly be the subject of long and protracted litigation. As a result, the market for municipal bonds during this period of litigation will continue in the seriously disrupted condition prevailing at this time. This Committee is, no doubt, aware of the view that the doubts raised by the tax reform proposals have been a major source of the problems prevalent in the municipal bond market today. The continued existence of such doubts can only result in the continued disruption of this important market thereby making it increasingly difficult or impossible for necessary public projects to be financed.

From October 2, 1968, to a recent date (September 4, 1968), The Bond Buyer's 20 Bonds Index rose 2.01% to a historic high of 6.37%, and is about the same now. During the two-month period from July 10 to September 4, 1969, when the money market for corporate securities and U.S. Governments was relatively stable, the same 20 Bonds Index rose about ¾ of 1% (0.72%), presumably attributable solely to the increasing Congressional threat to tax exemption from a press release of the House Ways and Means Committee and the Bill's introduction and passage by the House.

Predictions as to the length of time needed to settle the various legal questions that will be raised range from a minimum of two years time in the most agreeable circumstances to as long as ten years. As you can see, even the minimum period of time during which the municipal bond market would be disrupted is far too long.

As bond counsel, my colleagues and I are, of course, deeply interested in the proposals presently before this Committee. However, I should like to make clear that regardless of the legislation finally adopted, Local Governments will continue to borrow money, even though at far greater expense than is necessary, and we will, in any event, be called upon to render legal opinions approving such obligations. We are relatively free of any adverse effect from the Bill's adoption and believe our analysis is objective and free from any possible compromise from self-interest. We hope to impress upon this Committee our strong view that the proposals do in fact raise serious constitutional questions, which undoubtedly will be the subject of protracted litigation resulting in a serious disturbance in the conditions of the municipal bond market for a period of up to ten years.

Thank you for your consideration of our views.

Yours truly,

ROBERT M. JOHNSON.

The CHAIRMAN. Next is Mr. Richard H. Wangerin, president, American Symphony Orchestra League.

STATEMENT OF RICHARD H. WANGERIN, PRESIDENT, AMERICAN SYMPHONY ORCHESTRA LEAGUE; ACCOMPANIED BY WENDELL J. ASHTON, PRESIDENT, UTAH SYMPHONY ORCHESTRA BOARD; AND KENNETH LILES, TAX ADVISER

Mr. WANGERIN. Thank you, Mr. Chairman.

Senator BENNETT. I wonder if the witness would introduce the other men at the table.

Mr. WANGERIN. On my left is the president of the Utah Symphony Orchestra Board, Mr. Wendell J. Ashton; and on his left, Mr. Kenneth Liles, the tax adviser for the American Symphony Orchestra League.

Senator BENNETT. Mr. Chairman, I did that on purpose because I am very happy to welcome my friend, Wendell Ashton, here today. He promised not to talk too long.

Mr. ASHTON. Thank you, Senator.

Mr. WANGERIN. We are grateful to have an opportunity to speak orally on behalf of the symphony orchestras of the United States.

Our written testimony indicated some of the statistics and the financial terms of the operation of symphony orchestra.

We had here earlier today, but regrettably he had to make an airplane schedule, the distinguished music director of the Washington National Symphony, Dr. Howard Mitchell, who will be writing you shortly.

We are asking him, however, in the light of his experience as conductor of many of the U.S. orchestras and as auditor to many others, and as conductor in Europe, behind the Iron Curtain, and in South America, to document the artistic level that has been achieved by symphony orchestras in the United States under the present private philantrophy system that has been in effect.

He was prepared to document, and will, as I say, in writing to you, that the level of artistic achievement of symphony orchestras of the United States has no peer abroad despite the fact that many of the orchestras abroad are supported by massive funds, governmental funds, from all levels, Federal, State, and municipal.

Incidentally, also there are virtually no individual gifts being given to the cultural performing arts organizations abroad, probably due to the fact that there is no tax incentive, no tax deductibility for such gifts.

Very quickly, we would like to support the position that a tax on foundations is really a tax on the beneficiaries of foundations' largesse, rather than on the foundation itself, and we favor instead a 2-percent filing fee to make sure that there are funds to assist in the policing of the foundation effort.

The Treasury Department reports that, taking all proposed tax changes into account, there will be a revenue increase to the Treasury in the charitable contribution area in the neighborhood of $100 million. But the Treasury does not indicate how charity can recoup that amount.

Now, since symphony orchestras traditionally get the last few pennies of the contributed dollar, a cut of $100 million in the charitable area that is not replaced could spell the end of the operation of many of the U.S. symphony orchestras. We cannot dare to follow Professor Surrey's suggestion that we try it out because there would not be any time left, in our opinion, to restore the patient if the experiment failed.

Also, as to the proposal to raise the standard deduction, we would hope that the committee could see fit to carve out the charitable gift for separate deduction in addition to the standard deduction. We feel that this would have a positive psychological effect, rather than necessarily a great tax loss to the Government, on both the solicitor and the donor, and would give the small donor, as well as the solicitor, the idea that the Government is hand in hand with him in his support of these semiprivate or semipublic, if you will, organizations.

You have heard a lot of theory already. So we thought maybe someone should testify who has actually labored in the vineyard, and doing a very good job, I might add, because the Utah symphony has a higher percentage of earned income, that is revenue from ticket sales, than is the national average. So we have asked Mr. Ashton, who is its president, to give you a firsthand account of the difficulties of raising money and financing a symphony orchestra.

Mr. Ashton.

Mr. ASHTON. Thank you very much.

Mr. Chairman, I asked Senator Bennett beforehand if he had any advice for me when I appeared here, since it was my maiden attempt. He gave me all of his advice in three words, "Keep it brief."

So, if I may, I will just read a short statement here that I think might reflect the picture across the country as it is protrayed in our Utah situation.

The ratio of operating costs for our Utah symphony which we must obtain from contributions is climbing steadily, even though the number of concerts and the total audience are gaining markedly.

Five years ago, for example, approximately 70 percent of our operating costs were met from earned income, by the sale of tickets primarily.

During our fiscal year which just ended, June 30 of this year, 61 percent of our operating costs came from earned income. As has been indicated, we do better than the national average. The national average for symphonies is that 48 percent of total operating costs come from earned income

Thus, our earnings-to-cost ratio has dropped 9 percent in 5 years. Our decrease came despite an increase of over 50 percent in total audiences this year compared with 5 years ago.

Our symphony, like others, cannot trim our major costs, which are for musicians' salaries, with technology. No one has yet figured out how to replace a violinist with a computer.

All of this means we are constantly pounding, and I do mean pounding, for more contributions—from both the wealthy and those of modest means.

Many people in Utah continue to be generous, but we are also hitting some stiffening resistance from givers. Despite the growing challenges of this job of raising more money for symphonies, many of us still believe the effort is worth it. If for no other reason than what our symphony is doing for youth, I sincerely believe the effort is worth it.

Yesterday, here in Washington, the National Commission on the Causes and Prevention of Violence, under the chairmanship of Dr. Milton S. Eisenhower, reported that our American youth is getting far too much violence in its entertainment. Symphony music gives a positive answer to this problem.

Our orchestra this season is giving 40 school concerts in 31 different school districts. We estimate that the orchestra's total concerts this season will be attended by some 350,000 people. That will be approximately 100,000 more spectators than attended the home football games of Utah's three major universities last year, that is, the University of Utah, Utah State University, and Brigham Young University with a spectator total of 266,000.

Senator ANDERSON. Of course, the new field house helped.

Mr. ASHTON. You said the new field house?

Senator ANDERSON. Helped it.

Mr. ASHTON. It will help basketball but not football, Senator.

Senator BENNETT. You are thinking of the Astrodome.

Mr. ASHTON. I think we will take care of New Mexico this year. (Laughter.)

Senator BENNETT. Is that on the record?

Mr. ASHTON. That is on the record.

Senator ANDERSON. I almost asked for that myself.

Senator BENNETT. You walked into that.

Mr. ASHTON. When school boys and girls attend a symphony concert, we find they comb their hair and strive to look their best. The orchestra's music seems to draw and motivate the loftier inner self.

This fact was underscored a year ago when we took our orchestra to the State Penitentiary. The orchestra did not on that occasion play rock and roll. The orchestra presented Bethoven, Bach, Brahms. There were seven standing ovations, and the warden said the concert was one of the best stabilizers that had come to the institution in months.

For these and other reasons, we believe the Government should not discourage, with tax revisions, volunteers giving to our symphonies.

If we cannot get our principal support from contributions, we must go to the Government as our prime source.

No thinking American, I believe, wants that. In the first place, we all know that too often dollars that go through the Federal Government laundromat have a way of shrinking before they reach the place of need.

Further, you will not attract to the symphony cause the numbers or the quality of dedicated volunteers you now have. Some of our leading Utah citizens now serve as volunteers in raising funds and selling season tickets for our orchestra, and they work hard.

Gentlemen, I appeal to you to use your best efforts to keep our symphonies American, supported principally by those who volunteer both their time and their means.

Thank you very much.

Mr. WANGERIN. Thank you, Mr. Ashton.

(Mr. Ashton's prepared statement follows:)

STATEMENT OF WENDELL J. ASHTON, PRESIDENT OF THE UTAH SYMPHONY ORCHESTRA BOARD, BEFORE THE FINANCE COMMITTEE OF THE UNITED STATES SENATE, SEPTEMBER 25, 1969

The ratio of operating costs for our Utah Symphony which we must obtain from contributions is climbing steadily, even though the number of concerts and the total audience are gaining markedly.

Five years ago, approximately 70 percent of our operating costs were met from earned income, principally ticket sales. During our fiscal year ending June 30, 1969, 61 percent of our operating costs came from earned income. This was despite an increase of over 50 percent in total audiences.

Our symphony, like others, cannot trim our major costs (for musicians' salaries) with technology. No one has yet figured out how to replace a violinist with a computer.

All of this means we are constantly pounding, and I mean pounding, for more contributions—from both the wealthy and those of modest means. Many people in Utah continue to be generous, but we a 'e also hitting some stiffening resistance of givers.

Despite the growing challenges of this job of raising more money for symphonies, many of us still believe the effort is worth it.

If for no other reason than what our symphony is doing for our youth, I sincerely believe the effort is worth it. Yeserday, here in Washington, D.C., the National Commission on the Causes and Prevention of Violence, under the chairmanship of Dr. Milton S. Eisenhower, reported that our American youth is getting far too much violence in their entertainment.

Symphony music gives a positive answer to this problem. Our orchestra this season is giving forty school concerts in 31 different school districts. We estimate that the orchestra's total concerts this season will be attended by some 350,000 persons. That will be approximately 100,000 more spectators than attended the home football games of Utah's three major universities last year (University of Utah, Utah State University, and Brigham Young University, with a spectator total of 266,000).

When school boys and girls attend a symphony concert, we find they comb their hair and strive to look their best. The orchestra's music seems to draw and motivate the loftier inner self.

This fact was underscored a year ago when we took our orchestra to our State penitentiary. The orchestra did not play rock and roll. The orchestra presented Beethoven, Bach and Brahms. There were seven standing ovations, and the warden said the concert was one of the best stabilizers that had come to the prison in months.

For these and other reasons, we believe the Government should not discourage, with tax revisions, volunteer giving to our symphonies.

If we cannot get our principal support from contributions, we must go to the Government as our prime source. No thinking American, I believe, wants that.

In the first place, dollars that go through the Federal Government laundromat have a way of shrinking before they reach the place of need. Further, you will not attract to the symphony cause the numbers or the quality of dedicated volunteers you now have. Some of our leading Utah citizens now serve as volunteers in raising funds and selling season tickets for our orchestra. And they work hard!

Gentlemen, I appeal to you to use your best efforts to keep our symphonies American, supported principally by those who volunteer both their time and their means.

All of us need to remember that the men who stood up and battled at Lexington and Concord were volunteers!

Mr. WANGERIN. Earlier this morning, there was a clergyman on a local radio station who had as his text—I happened to hear it—"Give. But, if you are going to give grudgingly to the church, don't give."

Well, we know the Lord loveth a cheerful giver, and certainly symphony orchestras do, too. All we can plead with you is that you do all you can to give us the ince'itives for the givers to remain cheerful in their support of symphony orchestras.

Thank you.

The CHAIRMAN. Thank you very much, gentlemen.

Any questions?

Senator MCCARTHY. The symphony would take gifts even from uncheerful givers? [Laughter.]

Mr. WANGERIN. Yes, sir; and we do.

Senator MCCARTHY. You do not want to push this cheerfulness too far. [Laughter.]

I do not mind so much with music. I have always questioned whether we ought to give a tax deduction to people who give to religion. It seemed to me it kind of discounts the faith a little bit.

Mr. ASHTON. Thank you.

Mr. LILES. We will take whatever we can get.

Senator MCCARTHY. Cheerful, tax deductible or undeductible or not.

Mr. LILES. Right.

Mr. WANGERIN. I think the symphony orchestra presidents try to have their hands in every pocket to underwrite the cause to which they are giving voluntarily of their time and effort.

Senator BENNETT. Mr. Chairman, I am glad to be here when my friend of long standing, Wendell Ashton, is here.

I appreciate the experience he and the Utah Symphony is going through. He did not tell you that in addition to the gifts that they have been receiving directly that they have been twisting out of citizens of the State of Utah, they are just now prepared to match a foundation gift of $1 million, or was it half a million?

Mr. ASHTON. No; is was $1 million.

Senator BENNETT. $1 million. So the citizens of Utah have raised $1 million for the symphony.

Mr. ASHTON. Not quite, Senator, but we are almost there. We are still accepting contributions. [Laughter.]

Senator BENNETT. So they would be damaged in two ways if the House text of this bill were to become law, and I am sure there are other symphonies which have the same experience.

Mr. WANGERIN. Yes, sir. About 20 cents on the dollar contributed annually to orchestras comes from foundations.

Senator BENNETT. When you are talking about the Washington radio and television programs and the Commission on Causes and Prevention of Violence, I thought you were going to say you wanted to substitute violins for violence. [Laughter.]

Senator MCCARTHY. I think you can get a good violin player if you have the money, but what do you do about French horn players?

Mr. ASHTON. It is a little harder.

Senator MCCARTHY. That is harder, is it not? These fellows are all right. They are pretty good witnesses.

Senator BENNETT. Thank you very much.

The CHAIRMAN. Any further questions, gentlemen?

If not, thank you very much.

(Mr. Wangerin's prepared statement and a resolution received by the committee relative to the two preceding statements follow:)

STATEMENT OF RICHARD H. WANGERIN, PRESIDENT, AMERICAN SYMPHONY ORCHESTRA LEAGUE, ON BEHALF OF THE SYMPHONY ORCHESTRAS OF THE UNITED STATES

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

My name is Richard H. Wangerin. I appear before this Committee on behalf of the nation's more than 1,400 symphony orchestras and in the capacity of President of the American Symphony Orchestra League.

The League, chartered by the Congress, serves as the nonprofit, tax-exempt educational, service and research membership organization of the nation's symphony orchestras, and derives its basic support from dues paid by those organizations. The League's voting membership consists of nearly every one of the nation's leading symphony orchestras and hundreds of the lesser known symphony orchestras established in the smaller cities.

The League maintains permanent national offices with professional staff in Fairfax County, Virginia.

In presenting the case of the nation's symphony orchestras we are, in effect, presenting also the case of other performing arts organizations—the ballet companies, the opera companies, the chamber music ensembles, the choral groups. The basic economics of all these groups are similar. They share common concern over the effects of certain provisions in the proposed legislation.

We know that the members of this Committee and of the Ways and Means Committee, members of our Congress and of the Executive and Administrative branches of Government have no intention of deliberately causing hardships for the nation's cultural organizations, of curtailing the arts, or of reducing their financial support.

But what apparently is little understood is that many of the provisions under consideration for improving certain aspects of our tax structure will have disastrous side effects for symphony orchestras and all other organizations that depend on charitable contributions for a large part of their support.

Cultural and arts organizations especially will be hard hit; they come at the tail end of philanthropic giving. People generally make contributions to symphony orchestras only *after* they have given to their churches, their colleges, their hospitals, their community chests. Since this is so, we feel certain that symphony orchestras and other arts groups will bear even more than their aliquot share of the reduced giving that inevitably will result from passage of H.R. 13270.

If the provisions of the House Bill that adversely affect charitable giving are adopted *in toto* and without substantial modification, we are convinced the ultimate result would be the demise of most of our symphony orchestras as we know them today. They inevitably would have to turn to government for direct subsidy. We have little hope that at this time government would give the massive support required to finance the orchestras and other arts groups in view of the already pressing and ever-growing demands upon government funds to meet basic human needs.

We believe that our symphony orchestras are a vital part of our national life, and we beseech you most earnestly to continue the Federal Government's present methods of stimulating private support of symphony orchestras and other cultural organizations through the incentives that the tax laws presently provide.

I. SYMPHONY ORCHESTRAS ARE VITAL TO THE TOTAL CULTURAL AND EDUCATIONAL LIFE OF THE AMERICAN PEOPLE AND THUS MERIT THE CONCERN OF THIS COMMITTEE

Symphony orchestras are part and parcel of our modern nation that operates on the philosophy that the total citizenry should have equal opportunity to partake of the nation's total cultural activity. Gone are the days when great music, great art, great beauty were reserved for the enjoyment of *only* the affluent.

Today, there are over 1,400 symphony orchestras in operation in the towns and cities of this nation; 382 of them exist in the home states of just the 17 members of this Committee.

The nation's orchestras exist in large and small cities. They present concerts in hundreds of other towns and cities many of which are too small to maintain their own orchestras.

Altogether, the nation's symphony orchestras play approximately 11,000 symphony concerts a year (an average of over 30 concerts a day) to an estimated gross audience of at least 20 million men, women and children, plus a radio and TV audience of uncounted millions. The orchestras play approximately 3,500 concerts for school children each year and hundreds of free concerts in the nation's parks and civic auditoriums.

Over a third of a million persons are directly involved in the work of these orchestras—including over 80,000 musicians who perform in them, and over 250,000 men and women who serve on the orchestras' volunteer governing boards and committees. Invariably, the top business, industrial, cultural, educational and religious leadership of each community is to be found on these boards and committees. Frequently, the top political, governmental and labor leadership also is represented.

The presence in a community of highly trained symphony musicians enables other sponsoring groups to organize local opera companies and chamber music groups. The presence of these musicians strengthens the teaching resources of the community and enriches the music of the churches.

The nation's 1,400 symphony orchestras provide the only significant employment for musicians in this country who study and train for a career in performance of so-called "serious" instrumental music. It is the orchestras that provide the motivation for millions of young people to engage in the study of music today.

Just as our libraries make available the world's literature to the total population, just as our museums make great art available to the people, the nation's symphony orchestras bring to life the world's great music for the enjoyment and cultural development of the citizens of their home cities.

This, then, is the role of the nation's symphony orchestras in the spiritual, cultural and educational lives of our people—a role that goes back 127 years to the founding of the nation's first symphony orchestra, now known as the New York Philharmonic.

Today, the citizens of every town and city of significant size undertake to establish and maintain their own symphony orchestra just as they support their own local libraries as part of the total cultural and educational facilities of their communities.

II. THE BASIC ECONOMIC STRUCTURE OF U.S. SYMPHONY ORCHESTRAS AND OTHER ARTS ORGANIZATIONS REQUIRES THE SUBSIDY OF CHARITABLE GIVING FOR THEIR VERY EXISTENCE

You well may ask why, if symphony orchestras are so treasured throughout the nation, if so many millions of people want to hear them play, if they serve educational needs of so many children—then why shoud their financial support have to be of such pressing concern to this Finance Committee?

The reason is very simple and is to be found in the basic economic structure of symphony orchestras. Such orchestras are comprised of large numbers of highly trained people—from 65 to over 100 musicians are required to play this music. This means that symphony orchestras are very expensive to operate—so expensive that even the box office revenus from capacity audiences meets less than half the costs. The remaining costs must be met through some form of subsidy.

When we appeared before Congressional committees in 1963 relative to tax proposals which at that time would affect symphony orchestras, we reported that the nation's orchestras were operating on a gross annual expenditure of $30 million, of which they could earn 55%, or $16 million, and that they were dependent on contributed income for the other 45%, or $14 million, of their annual operating costs.

In the intervening six years, population increases and greater demands for concerts for students have served to greatly expand the musical and educational public services required of orchestras. Musicians' salaries have spiralled upwards as have other basic operating costs.

Today, the United States symphony orchestras are operating on a gross annual expenditure of $85 million. They are earning approximately $41 million as compared to $16 million six years ago. Nevertheless, the current earnings represent only 48% of total costs as compared to an earning power of 55% of costs six years ago.

As a result of these changes, the nation's symphony orchestras must now develop $44 million a year in contributed income as compared to $14 million in 1963.

The worsening financial condition of the symphony orchestras is clearly indicated by these figures. The future looks even more bleak.

To understand the basic economics of the performing arts, it must be remembered that:

1. Performances can be produced only through what might be termed "handwork" of each performer.

2. Each concert of a symphony orchestra, each performance of a ballet or opera company is an "original".

It still requires the same number of musicians to play the Beethoven Symphony No. 8 as it did when Beethoven wrote it in 1812. It still requires the same length of time for the 80 to 100 musicians to learn, rehearse and perform that Beethoven Symphony.

There is no way in which orchestras can take advantage of mass production techniques and technological developments that have aided business in meeting rising operating costs through savings in net unit production costs.

In other words, orchestras face the same spiralling costs faced by all other enterprises, but orchestras cannot offset these costs through modern production methods. Due to continued inflation the need for subsidy with which to close this gap between earned income and total costs increases each year. So far, the private sector, encouraged by the Federal Government's tax incentives for giving, has barely been able to keep up with symphony orchestras' needs for increased subsidy—thus, any lessening of these incentives would be disastrous.

In this country, financial subsidies for orchestras have come traditionally from voluntary contributions. In other countries, the subsidy comes directly to the orchestras from their governments.

Under a Ford Foundation grant, our organization has just completed a study of finances and operations of a number of orchestras abroad. The study was made by Howard Taubman, the distinguished critic and writer of the *New York Times*. The following is indicative of his findings:

(*a*) The Berlin Philharmonic, operating on an annual budget of $2 million, receives $1.5 million from its federal and city governments.

(*b*) The Amsterdam Concertgebouw, operating on $1.3 million annually, receives $900,000 from its governments.

(*c*) The Vienna Philharmonic, which serves also as the orchestra for the Vienna State Opera, receives all of its support from its government—an amount totalling $6 million annually for both the opera and the orchestra.

Mr. Taubman goes on to report that "there is little or no private support of orchestras abroad, by individuals or foundations or corporations. It may well be that major reason is that there are no provisions for tax deductions for contributors in most countries."

We want to point out that, today, it generally is conceded that the world's leading symphony orchestras are no longer to be found in Europe in spite of the extensive subsidy given by their governments. Today, the world's leading symphony orchestras are to be found in the United States.

The excellence of several of our American symphony orchestras is unsurpassed by those of any other nation, and there is no counterpart in any part of the world for the many competent symphony orchestras found in literally scores of America's lesser known cities.

The results of our Government's traditional policy of tax incentives for charitable giving speak for themselves and commend not only the generosity of our people but the generosity of our Government.

Should this private support be reduced, the orchestras would have no choice but to seek aid directly from government sources, or to abandon their operations—and their music.

III. WHY ARE WE CONCERNED OVER H.R. 13270?

We are by no means opposed to this proposed legislation in its totality. As citizens, as representatives of responsible and distinguished civic organizations, we applaud the work of our elected representatives in trying to achieve equity and simplification of our tax laws, in trying to clarify provisions that lead to tax abuses, in strengthening certain filing requirements for private foundations and tax-exempt organizations so as to protect those that are conscientiously trying to do what is right and root out those that deliberately are trying to take advantage of enlightened legislation.

But—

The Treasury Department reports that "taking all of the proposed tax changes into account we estimate that there will be a revenue increase to the Treasury in the charitable contribution area in the neighborhood of $100 million".

That is one reason we are concerned.

If this $100 million is channeled into tax revenues instead of to philanthropic causes, then obviously something constructive must be done to offset this financial loss to philanthropic endeavors in this country.

We already have shown why it is necessary for symphony orchestras to depend on some sort of subsidy for half or more of their total financial support. The provisions of H.R. 13270 cut into the ability of every form of voluntary giving to continue to provide financial support of orchestras even at current levels.

A. Take the matter of contributions from individuals

Currently, symphony orchestras are receiving over half of their subsidy from contributions made by individuals.

Among the 382 orchestras operating at a total annual expenditure of $17 million in the home states of the members of the Committee, this form of support totals $4.5 million annually.

The proposals of H.R. 13270 would reduce affluent donors' financial ability to give away money as a result of repeal of the unlimited deduction, changed tax treatment of gifts of appreciated property, and gifts of use of property, and proposed changes in many aspects of the more sophisticated types of giving.

Under the Bill, gifts of appreciated property would be discriminated against in several important respects. The tax preference items included in the so-called "Limit on Tax Preferences" (LTP) and "Allocation of Deductions" (AOD) provisions include the appreciation in value of property contributed to charity. Inevitably, this would substantially decrease important "leadership gifts" which are usually in the form of appreciated securities or real estate. For this reason, we heartily support the Administration's recommendation to delete the appreciation element of charitable gifts from those provisions.

However, this still would leave charitable contributions as an item of deduction subject to allocation under the allocation of deductions provision. This would have the effect, we fear, of postponing many substantial gifts until the end of a year when the effects of the complex allocation provision could be finally determined, with the unfortunate result that many such gifts simply would not be made.

Moreover, gifts of appreciated property to public charities would remain subject to the present 30% limitation rather than counting toward the extra 20% to be allowed under the Bill for gifts of cash to "publicly supported" organizations. We see no reason for such discrimination against gifts of appreciated property.

Furthermore, gifts of appreciated tangible personal property and future interest gifts would be further discriminated against in that the donor would have to limit his deductions to his cost basis or include the appreciation element in his income.

This change may or may not be justified if the property is normally held by the donor for sale to his customers in the ordinary course of his trade or business and thus would produce ordinary income when sold.

However, it certainly is not justified with respect to capital items which, if sold, would produce capital gains. To treat a gift of such items as a constructive sale overlooks the fact that the donor is not confined to a choice of selling or giving away the property but can hold on to it until his death and pass it on to his heirs without income tax consequences. It is obvious that the proposed treatment would discourage future gifts of such property to charity.

In the past for instance, symphony orchestras have been recipients of gifts of rare musical instruments such as a gift of a Stradivarius violin for use by the concertmaster. There is no reason to discriminate against such gifts *vis-a-vis* gifts of appreciated securities or real estate.

For these reasons we approve Treasury's position that gifts of tangible personal property should continue to be allowed the same preferential treatment as gifts of securities and real property would be afforded under the Bill.

Similar treatment should be extended to gifts of future interest.

B. Take the matter of the increased standard deductions

There is no question that the process of itemizing contributions on individual tax returns and claiming deductions from personal income tax for those contributions provides a tax incentive for giving.

Eighty-eight per cent of the total number of gifts made to symphony orchestras' annual maintenance funds are in amounts of less than $100, averaging $37. These small gifts account for approximately 40% of the total annual contributed dollars received by symphony orchestras.

These percentages apply to symphony orchestras of all sizes—from the New York Philharmonic, Boston Symphony, and the Philadelphia Orchestra on down to obscure symphony orchestras in small towns.

Now comes the proposal to raise the standard deduction. The Ways and Means Committee report estimates that 34 million more taxpayers will use the standard deduction if these changes are enacted. Treasury estimates that at least 8 million more tax payers would use the standard deduction if their version of the proposed change were adopted.

Be it 8 million or 34 million or someplace in between, the statistics include many modest contributors to symphony orchestras and millions of what we hope are prospective contributors.

Under the increased standard deduction the taxpayer, in effect, will receive deduction for charitable contributions whether or not actually made. So, the orchestras face further shrinkage of contributed support as a result of *this* provision. Again, no spokesman for Government has offered any suggestion whatsoever as to how these losses to philanthropic causes would be offset.

We strongly urge that charitable deductions be isolated from other personal deductions for separate treatment, and that they be subject to continued itemization with deduction permitted even though the proposed increased standard deduction is used, thereby preserving this crucial incentive for continued support of philanthropic endeavors. If this plan were adopted we would support adoption of a requirement that receipts or cancelled checks be attached to the tax returns to support claims for all contributions over a stated minimal amount.

We are not against the worthy aim of simplifying tax returns through increased use of the standard deduction, but simplification should not be achieved at the price of reducing support of charitable activities.

C. Take foundation aid to orchestras

Orchestras are receiving approximately 20% of their contributed support from foundations. Again, we cite the circumstances of the 382 orchestras operating in the home states of the members of this Committee. Foundation aid to these orchestras totalled $1.6 million last year, representing over 18% of their total contributed support.

H.R. 13270 proposes to tax the foundations' investment income by 7½%, and impose various other changes that would serve to reduce future support of existing foundations and deter establishment of new foundations.

If the legislation were enacted, we can only conclude that the amount of money foundations currently are giving to symphony orchestras would be reduced immediately by a factor of 7½% and possibly by a great deal more as the full effects of proposed changes are felt. In other words, it would be the recipients of foundation gifts that would bear the burden of the proposed tax.

We are strenuously opposed to the philosophy of taxing foundation funds for the purpose of adding to the Government's tax revenue, but we endorse Treasury's proposal to substitute for the proposed 7½% tax, a 2% filing fee and use the income from that fee to pay for increased policing of private foundations by the Internal Revenue Service. We are heartily in favor of such a program so financed.

Treasury's viewpoint of the total effects of H.R. 13270 provisions concerning foundations does not agree with past experience of recipients of foundation aid.

Mr. Edwin Cohen, Assistant Secretary of Treasury, has this to say about the ultimate effect of those proposals of the Bill designed to require current annual distribution of foundation funds for charitable purposes:

"We estimate that because of adoption of a rule we recommended to require private foundations to distribute to public charity not less than five percent per annum of the value of their assets, there will be an increase in funds flowing out of private foundations into public charitable and educational organizations on the order of $200 million"[1] . . .

Mr. Cohen cites the proposed forced distribution of foundations' funds as the offsetting factor for anticipated losses of $100 million to charitable organizations that would result from proposed changes in tax treatment of charitable contributions.

This statement seems to be based on the assumption that the current charitable contribution dollar will be exchanged for two foundation dollars on a *quid pro quo* basis as far as the support of charitable organizations is concerned. Such will not be the case.

Gentlemen, let us explain a little about operations of foundations from the point of view of the recipient organizations.

Foundations are vital to our work. But it must be remembered that foundations become donors. As donors they have the right to choose to whom and for what purposes their money shall be given—within the framework of the law.

[1] Remarks delivered before the American Bar Association, Section on Taxation, Aug. 9, 1969.

As you are so well aware, there are large foundations and small foundations. It is the small local foundations that customarily contribute to annual operating funds of symphony orchestras and other tax-exempt organizations.

The large foundations seldom contribute to these on-going operating expenses of organizations. Instead, their gifts usually enable an organization to experiment with a challenging new idea, engage in much-needed research, undertake some project with foundation funds during the period that more permanent, on-going support is gradually developed for the future financing of that activity.

Indeed, the charters and/or trustee resolutions of many foundations expressly forbid granting of funds to organizations for the purpose of meeting annual operating deficits because this is a never-ending need. Foundation funds very quickly could become tied up entirely in commitments for organizations' annual operating funds thereby leaving almost no resources with which to aid in experimental work and expansion of programs and services.

Let me give you a few examples of how this distribution of foundation funds customarily works in the orchestra field.

Take the American Symphony Orchestra League itself:

In addition to dues paid by our members, we must obtain about $40,000 annually in contributions to finance our on-going services to the orchestras. Last year, foundation gifts accounted for approximately 25% of our annual maintenance fund.

However, it has been through substantial gifts from the Rockefeller Foundation and other Rockefeller philanthropic interests that the League has been enabled to:

Initiate and maintain a comprehensive training program for young conductors, composers, and orchestra musicians for the last 13 years.

Initiate and maintain the first formal, in-service training projects for orchestra managers.

Make the first comprehensive study of the arts council movement.

Undertake the first comprehensive research on basic legal documents of symphony orchestras, and publish the only manual in this basic aspect of their work.

To experiment in psychological testing of orchestra managers.

To make career grants to a few outstanding young American conductors some of whom now are emerging as leading young conductors of our country.

Under a current Ford Foundation grant, we undertook the first comprehensive study of operations of European orchestras that I referred to earlier, and now are engaged in a complete analysis of the bookkeeping and auditing practices of symphony orchestras so that truly comparable statistics can be made available when the U. S. Department of Labor, the U. S. Department of Commerce, the State Department and Treasury call for such material—as they frequently have done in the past.

The League could not have done any of these important things from its regular income. Neither would we have been granted these funds by the large foundations for the purpose of financing our basic, on-going, day-to-day work. We have made such requests and have been turned down.

The Ford Foundation's recent massive grants to 61 symphony orchestras are another good example of foundation policies in selecting projects they wish to support. These grants, totalling $80 million, were given for the express purpose of aiding orchestras in establishing permanent endowments. The orchestras are required to match the foundation funds on a 1-to-1, 2-to-1, or 3-to-1 basis depending on the circumstances of each orchestra.

Another requirement for eligibility for these grants is that the orchestras must maintain their local annual contributed support at least at former levels. In other words, the endowment grant program added a challenging new dimension to symphony orchestra finance and operations, but it was not a substitute for continued local contributions toward the day-to-day work of the orchestras. Annual gifts from individual contributors continue to be absolutely vital to the existence of the orchestras—even those that received the endowment fund grants.

These examples are typical of the manner in which foundation funds flow into symphony orchestras—funds from local foundations to help meet annual expenses—larger grants from the large foundations for expansion of program, research and experimentation.

It is completely unrealistic to assume, therefore, that plans to force distribution of foundation assets will result in replacement of losses suffered by tax-exempt organizations as a result of changes in tax treatment of individual charitable contributions.

Yet, unrealistic as it is, this is the only official release of the Government having come to our attention that offers *any* statement of what might be put in place of the $100 million now going to charitable organizations but slated to go to the U. S. Treasury under H. R. 13270.

Furthermore, even if the initial effect of forced distribution would be to add to the amount of cash made available to charitable organizations, the long range effect would be the shrinkage of capital funds for future support of charitable organizations. Of course, we are not opposed to distribution of private foundations' annual income, but we are opposed to forced distribution of their capital. In this proposal, we can see only the ultimate liquidation of foundations.

In connection with the Bill's provisions on foundations, we want to commend the House on its final action to make it possible for foundations to continue to make grants to individual musicians, conductors, composers, etc. under IRS-approved plans.

D. Total effect of the losses from reduced ax incentives for giving:

When we total the dollar losses in contributed income that would result from these many reduced tax incentives for charitable giving as proposed in H. R. 13270, they spell life or death for symphony orchestras. But the dollar gains the Government would realize from these tax changes would become only a statistic in the financial reports of the United States Treasury—a statistic that will not produce music, a statistic that will not add one iota to the nation's cultural development of the future, a statistic that never can produce America's Beethoven, another Isaac Stern, a statistic that never can be transformed into America's next George Gershwin or next Leonard Bernstein.

If our Congress goes ahead with these proposed changes that will result in withdrawing at least $100 million annually from support of tax-exempt organizations—if this be the plan then, in all seriousness, perhaps we should propose the following:

That there be included in the tax legislation a provision whereby a stated percentage of the nation's Federal tax revenue be set aside for direct payment for support of philanthropic organizations.

We realize it is not within the province of this Committee to initiate appropriations. We are told over and over that the demands upon our Government for financial solution of the problems of the cities, of the Vietnam war, of the space program, of health and welfare needs, of public education, of the care of the aged—that these demands would preclude serious consideration of such a proposal at this time.

If that be the case, we most earnestly beseech you to protect what we already have in the way of support by continuing the tax incentives that encourage our people to give voluntarily on behalf of the public good.

Without this continuing support through federal tax policies, the symphony orchestras of this nation eventually will have only two alternatives:

1. To come to Congress year after year seeking direct subsidy in ever-increasing amounts of money;
2. To disband.

In addition to our concern over these overwhelming financial problems the proposed legislation poses for us, we are concerned also with some technical problems raised by the Bill.

E. Take the matter of the proposed new definition of "private" foundations:

First, we are concerned that the proposed definition of "private foundations" for purposes of the new tax provisions may inadvertently cover many organizations that should not be treated as "private foundations."

Many deserving organizations may fail to meet the second exception provided for determining what organizations are not "private foundations," because of unwarranted restrictions: (1) that gifts from "substantial" contributors (i.e., those who contribute more than $5,000 in any one year) cannot count toward the required ⅓ public support test; (2) that related income receipts from any "person" in excess of 1% of total support likewise do not count towards ⅓ "public support"; and (3) that ⅓ of total support cannot come from gross investment income.

We point out that under the 1% rule, it is only the amount *in excess* of 1% that is excluded from qualifying as "public support," whereas the entire amount of the over-$5,000 gift is excluded. We feel that at least the first $5,000 of a large gift should count as a part of an organization's public support.

Secondly, the phrase "any person" is too broad in that it would subject to the 1% rule payments made by government units and public charities. It is ridiculous to exclude any part of support from public funds from "public support".

The third test should be dropped. Since investment income already is included in total support and more than ⅓ of total support must be derived from gifts, contributions, membership fees, admissions or other related income in order to qualify the organization as "publicly" supported, there is no reason for having a separate limitation as to the amount of investment income. It serves only to penalize those organizations which have received substantial contributions from generous donors in the past to build up endowment funds.

Moreover, the third exception has a number of technical defects:

(1) It certainly could not have been intended to penalize a trust which now must be operated entirely for charitable purposes simply because, as originally constituted, part of the income was required to be distributed to private annuitants for a term of years or for their lives.

(2) It also should be made clear that organizations with defective charters may amend them to satisfy the "organized" test.

(3) There is no reason why a separate organization which is operated "in connection with" two or more qualified institutions rather than one such institution should not be protected under the third exception to the definition of a "private" foundation.

Unless substantially modified, these provisions relating to determination of what organizations are not "private" foundations are going to result in unending work for the IRS and will place an especially unwarranted burden upon predominately volunteer, small budget charitable organizations that cannot afford to employ professional staff and legal counsel.

Just within the symphony orchestra world alone, the Service will be besieged with inquiries, requests for explanations, and 30% classification applications from literally hundreds of small budget orchestras and modestly financed women's auxiliaries of symphony orchestras.

F. Take the Matter of the New Requirements on Disclosure of Information

We strongly support the provision requiring all tax-exempt organizations to file an annual return.

However, we challenge the proposed additional requirement that all 501(c)(3) organizations be required to file listings of major contributors and amounts given, and names and salaries of highly compensated employees.

In many cases, contributors make their gifts upon the contingency that the gifts be accorded complete anonymity. Donors should have this right. And what useful purpose possibly can be served by the United States government having a list of salaries and fees paid to symphony orchestra conductors, concertmasters and first oboists?

These requirements are an improper invasion into the affairs of nongovernment organizations, and the provisions are not germaine to the enforcement of the internal revenue laws. We urge that they be removed at least from the filing requirements of "publicly supported" tax-exempt organizations.

IV. IN CONCLUSION

It must be remembered that voluntary giving is a fragile thing. It has to be encouraged, nurtured, protected.

Voluntary gifts cannot be legislated into being; they cannot be produced on demand. There is a limit to the giver's willingness to give.

Government officials had much to say last spring about an impending taxpayer's revolt. In the nonprofit world, we hear warnings of a giver's revolt, and rumblings of the exhaustion of the volunteer civic leadership required to keep these contribution campaigns going year after year.

As operating costs spiral and force charitable and educational organizations each year to seek more and larger contributions than the year before, we fear the day will come when the givers will lapse into a state of utter frustration and hopelessness over their ability to meet the challenges of private philanthropy.

We may be close enough to this point that enactment of these complicated strictures on tax treatment of contributions coupled with actual cancellation of long established tax incentives for giving would prove to be the final push toward a disastrous breakdown in the willingness of voluntary givers even to attempt to continue to shoulder these charitable burdens.

America's record in private philanthropy is one of the things that sets it apart among all nations. That record is due to courageous and enlightened tax policies of our Government throughout its 193-year history.

We plead with our Government to continue searching for a solution that will correct tax abuses but that will not induce paralysis of this nation's private philanthropy.

RESOLUTION ADOPTED BY THE BOARD OF DIRECTORS OF THE OREGON SYMPHONY SOCIETY AT ITS MEETING ON MARCH 11, 1969

Resolved, That the Oregon Symphony Society is strongly opposed to any change in the Internal Revene Code adversely affecting the deduction of contributions as suggested in the Tax Reform Studies and Proposals of the U.S. Treasury Department.

The Oregon Symphony has for decades brought fine music, cultural improvement and musical training to the State of Oregon. This has only been accomplished through the generous contribution of monies by public-minded citizens and a vast amount of volunteer effort by thousands of individuals. The contributions received enable these many volunteers to provide the cultural enrichment to the area at a far lower cost than if operated as a government function.

Our experience in fund raising has indicated that the income tax deduction is a substantial factor in successfully raising the necesary funding of the orchestra. Much of the money that is raised is in small to medium sized contributions. We are fearful that the suggested change would reduce the amount of contributions, thereby threatening the continued existence of the orchestra.

The Oregon Symphony Society urges our Representatives in Congress to recognize that volunteer cultural, civic, educational and religious programs contribute greatly to American life and at a cost substantially lower than comparable government projects and that any change in the tax laws discouraging contributions will adversely affect our communities.

The CHAIRMAN. Our next witness is Mr. Osmon Springsted, president, Springsted, Inc.

STATEMENT OF OSMON R. SPRINGSTED, PRESIDENT, SPRINGSTED, INC.

Mr. SPRINGSTED. Mr. Chairman and members of the committee, with me is Mr. Michael Doherty, a member of our firm.

We are municipal bond consultants serving currently approximately 118 governmental units in the five States of Iowa, Minnesota, North Dakota, South Dakota, and Wisconsin.

During the count of this year these clients will issue approximately $90 million of bonds.

In August of this year there were 367 bond offerings in this five-State area, totaling in excess of $452 million. These bond issues produced the funds by which local communities were able to build schools, streets, sewers, parks, and all of the other people needs of local government.

Assuming that these communities which issues this $452 million of bonds had done so at an average rate of 6 percent, with an average maturity of only 15 years, and assuming that the 6-percent rate is 60 percent of what a taxable rate would be, these communities in this five-State area were able to undertake this financing at a saving of over $270 million to the taxpayers of these local communities.

They saved their taxpayers this sum by being able to avail themselves of one of the oldest, if not the oldest, Federal subsidy programs that there is, the tax exemption of municipal bonds.

We submit to you that it is a unique program. It starts and ends entirely with the beneficiary.

There are no administrative costs. The recipients get 100 percent on the dollar. There are no protests that the local economy is being infringed upon and, of course, there are no letters to the Senators or the Congressmen.

In our opinion, it is one of the most efficient self-help programs that there is today. It is the program by which a preponderant part of the local municipal capital improvements of our country have been and are continuing to be built.

In our area without the benefit of tax exemption, it is our opinion many communities simply would not be able to undertake their own financing. If they had to resort to a taxable bond, it is our opinion that many of them that now are paying 7 would have to pay at least 14 percent, if they could sell the bonds at all.

Obviously, even a 40-percent subsidy means that instead of borrowing money at the present 7, they are going to pay over or almost 8½ percent, because we must bear in mind that all communities are not of the same credit standing, and we have many in our area that are not AA or AAA rated, and they are going to have to compete for the investor's dollar with the corporate bond that is going to have a better security behind it.

Now, of course, the municipality can continue, if it wishes to, to issue tax-exempt bonds. But we submit to you that if this happens it is going to mean that only the poor communities will be left in the municipal sector of the money market because with a 40-percent subsidy, the better credits, perhaps, can come out as well, and perhaps even better by issuing a taxable bond. But the poor ones cannot, and so this is going to contract the municipal bond market, is going to contract the number of dealers that are left in it, and as such we are going to have a smaller base for the offering of the bonds of local communities and this, of course, is going to have an adverse effect upon the rate which they receive. We feel that really municipal bonds ought to be called people bonds because it is by these means or by the use of municipal bonds of local communities that they are able to take care of the needs of their people.

Now, we are unwilling to concede that there is ever a time to tamper with the tax exemption of municipal bonds, but certainly now is not the time.

Our communities are already suffering with the rest of the economy from the high cost of money, and then they are going to be further inopportuned by even the higher costs imposed by the threat of the present proposed legislation. Many communities, as you know, as has been testified to previously here, have not been able to sell their bonds on the present market. This means that they are going to have to further delay urgently needed capital improvements, and they are going to have to postpone the satisfaction of the needs of their people.

As a very practical matter, many communities if they cannot within the statutory limits that they now have issue taxable bonds until the legislatures meet to remove the present statutory restrictions as far as interest rates are concerned, this is going to cause a hiatus in the building programs throughout the Nation.

Now, some may argue that there is some benefit from this. But it totally ignores the fact, of course, that the kids are waiting to enter schools today even before the footings are poured and, of course, the ooze of polluted rivers knows no moratorium.

We recognize that the proponents of the legislation make every positive statements that there will be little or no administration connected with the proposed subsidy program.

Well, this is a refreshing thought, but it certainly would be a most unusual Federal program if this is the case. It is to us very doubtful that the village clerk of Evening Shade would sit down and drop a handwritten note on a piece of tablet paper to the Secretary of the Treasury, which would inform him that Evening Shade has just sold a bond issue and they have an interest payment due next week, and will the Secretary please send a check by return mail.

It seems reasonably certain that this is a condition to which the reflexes of Government lawyers just would never adjust, and it is most difficult to accept the assertion that there will not be a great deal of administration connected with such a program.

Local governments have little prospect of gain in these proposals. but they certainly have assurances of losing. At best, they can only hope to borrow the money at about the same rate they are now, and it is far more probable that they are going to pay more.

The local community is left solely, or almost solely, to the property tax to support itself.

The growth factors of our economy, income principally, are resorted to by the Federal and State Governments, and so if the local community in the financing of its needs for its people is going to have to pay even more to satisfy those needs, the burden is going to fall entirely upon the property tax.

We concede that the provisions of the bill which relate to the taxation of income of municipal bonds directly or indirectly of themselves, perhaps, do not perceive all the dangers that we foresee, but there are certainly warnings to the municipal investor. The investor who buys a bond due in 30 years from the school district of Burnsville, Minn., has made a commitment by which he must live. He cannot come back to the school district in future years and say that inflation has set in and he should have a higher rate of interest, and please could they pay his bonds sooner than its 30-year maturity.

He has to live by his contract. He invested in the people of that school district, and by reason of his investment they were able to give their schoolchildren a little better education.

We think that he is entitled to have his rights protected as well.

This is a day, actually, when the people who are willing to invest in local communities should be encouraged to do so and not discouraged, because unless they continue to make possible local communities being able to finance their own needs, there is no other answer but for the local communities to have to come to the Federal Government to help them, because these are needs that must be satisfied.

We wish to thank you for this opportunity, Mr. Chairman, of being able to appear before this committee. If there are any questions we would be glad to answer them.

The CHAIRMAN. Thank you very much.

Any questions?

The CHAIRMAN. Thank you very much, Mr. Springsted.

Mr. SPRINGSTED. Thank you.

(Mr. Springsted's prepared statement follows:)

TESTIMONY OF OSMON R. SPRINGSTED WITH REFERENCE TO THE PROVISIONS OF H.R. 13270, TAX REFORM ACT OF 1969, RELATING TO THE IMMUNITY OF THE YIELD OF MUNICIPAL BONDS FROM FEDERAL TAXATION

Springsted Incorporated is a municipal consulting firm engaged principally with municipal financing. As such, it is currently serving 118 units of government in the five-State area of Iowa, Minnesota, North Dakota, South Dakota and Wisconsin. The firm will assist its clients with approximately 90 million dollars of bonding this year. It does not buy or sell bonds. Its only concern is to assist the municipalities it serves to accomplish the issuance of their bonds as economically and expeditiously as possible.

Through August of this year there were at least 367 bond offerings totalling in excess of $452,000,000 by the local governments of this five-State area. The average size of the offerings was $1,234,092 but they ranged in size from $14,000 to multi-million dollar sales.

The proceeds of these bond issues were used to build schools, streets, sewers, parks and all of the other facilities required to meet the people needs of local government.

Assuming an average rate of 6%, on average maturity of only 15 years and that a tax-exempt rate of 6% is as much as 60% of a taxable rate, these communities were able to give their people a better drink of water, a better school at a cost of $271,000,000 less than if they had not been able to issue tax exempt bonds.

They saved their taxpayers this sum by being able to avail themselves of one of the oldest, if not the oldest, Federal subsidy programs of our Country—the tax exemption of municipal bonds. It is a unique program. It starts and ends entirely with the beneficiary. There are no administrative costs. The recipient gets 100 cents for each of its dollars. There are no regulations. There are not protests of forfeiture of local autonomy. There are no legions of administrative staffs. There are no letters to Senators or Congressmen. It's difficult to think of any self-help program that has worked much better. It is the program by which the preponderant part of our local municipal capital improvements have been, and are being, built at the current rate of about $15 billion dollars a year.

Perhaps the program is ahead of its time. Some of our Federal Agencies today are just realizing the benefits of encouraging the local unit to undertake all of the financing of a Federal-sharing program. Then the agency subsidizes the interest difference. So instead of its borrowing its full share at 8% to lend back to the local unit at 3%, the agency borrows only a fraction of the amount to subsidize only the rate difference.

Without tax-exemption many of the communities of our area, in our opinion, could not provide for their own needs. Remove the tax exempt status from the offering of a "Ba" rated community with a per capita debt of $1,100 for local indebtedness and place it in direct competition for the investment dollar with an offering of General Motor's bonds and the ratio of a tax exempt rate to a taxable one will realistically be at least 1 to 2. In other words, if such a community must now pay 7% for tax exempt money, it can expect to pay 14% for taxable bonds. Thus, the maximum 40% subsidy of H.R. 13270 will leave it paying a net rate of 8.40% or 1.40% more than it now is. And, of course, if the subsidy is ultimately lowered to 25%, as it may be, the Community is then left in the position of paying 10.5%. This assumes that it can find a buyer!

The municipality may still, under the provisions of the proposed legislation, elect to continue to sell tax-exempt bonds. But it will be in a contracted market if this legislation is enacted. For the good municipal credits it may be to their advantage to elect to issue taxables. This will then leave the municipal market only to the poor. Like any other business, there has to be merchandise for the underwriters of municipals. Reduce the supply and the quality and a natural concomitant must be a withering distribution organization. In our opinion the underwriters of this Country have done an outstanding task of merchandising the bonds of our local governments. They can not be expected to continue their high performance if they are left only the drippings.

Really municipal bonds should be called "People Bonds" because the things they make possible are evidenced from the time each of us turns on a faucet in the morning until we fall asleep to the klaxon of a fire truck. The battle cry of those who would impair these People Bonds is that the person who has invested in people in preference to some purely profit-orientated venture has committed a venomous crime upon society because he pays no income tax. But he has. If he purchased a State of Massachusetts bond in 1960, with a coupon of 3.10%, not only did he accept a lower rate of interest than if he had purchased a taxable bond, but he forfeited any growth benefits. In fact, he has experienced the opposite result. He is still getting only 3.10% when the rate now quoted for the bond is 7.00%, and his bond is worth less than 71 cents on the dollar. He doesn't need much encouragement to become discouraged with municipal bonds.

While we are unwilling to concede that there is ever a time to tamper with the exemption of municipal bonds, certainly now is not it. Already suffering with the rest of the economy from the high costs of money, our local governments are further inopportuned by the even higher costs imposed by this threat to their major means of meeting their capital needs. Many have not been able to sell their bonds within statutory rate limits. This has meant further delay and cost in the efforts of these local governments to attempt to satisfy the needs of their people. And, probably has served to intensify the already clarion calls for help to the Federal government.

As a very practical point, until State legislatures could meet to remove existing rate limits, few municipalities could issue taxable bonds today. If then the effect upon the municipal market is what we think it will be if the tax exempt status of municipals is in any way impaired, we foresee a hiatus in municipal building programs throughout the Nation. Perhaps there is some economic merit in this, but it totally ignores the fact that the kids are waiting to enter the school even before the footings are begun, the ooze of the polluted river knows no moratorium.

We recognize that assurances are being made that there will be little or no administrative overlay for those bond issues which would be subsidized if an issuer elects to float taxable bonds. Refreshing as it may be to believe this might be the case—it will assuredly be different from any other Federal program. At the moment a Wisconsin client has been waiting 60 days, and is now advised it may be another 60 days, for the preparation of the regulations which will permit it to issue Federally subsidized bonds. In the meantime, both interest rates and construction costs have risen and the much-needed program delayed. It is to us, frankly, doubtful that all that the Village Clerk of Evening Shade will need to do is to drop a handwritten note on a sheet of tablet paper to the Secretary of the Treasury advising him that Evening Shade a few months ago issued some taxable bonds and seeing as how there is an interest payment due next week will the Secretary please send a check for the Federal Government's share. It seems reasonably certain this is a condition to which the reflexes of Government lawyers could never adjust.

Local governments have little prospect of gain in these proposals but almost certain assurances of losing. At best, they can only hope to borrow their money at about the same rate they now are. It is far more probable they will pay more. Already in the position of having the Federal and State governments having taken the Big Boy's share of the real growth factor in our economy—income—this means they must again add yet another layer upon the only major tax left them—the property tax which comes from a source far less responsive to growth than income. Less related to ability to pay, too, we might add.

We do concede that the provisions of H.R. 13270 which relate to the taxation of income of municipal bonds directly, or indirectly, of themselves should not conceive all of the dangers we foresee. But they are truly warnings to the municipal investor. If now the historic inviolability of the income of municipal bonds from Federal taxation is in any manner impaired the investor must be most apprehensive of what may follow, especially when it was announced by a spokesman for the House Ways and Means Committee when the bill was introduced in the House that it was the avowed purpose of the committee to eliminate the tax exempt status of municipal obligations. The buyer of a bond of the Burnsville, Minnesota School District maturing in 1990 must live by his contract. He can not come back for an upward adjustment of the rate or demand prepayment no matter how equitable his request may be. He invested in the people of that School District accepting his contract and believing his rights would be protected.

We urgently request that the proposals of H.R. 13270 which will infringe in any manner upon the exemption of municipal bonds from Federal taxation be conclusively rejected. To do otherwise, in our opinion, will be to add even further costs to already tax bent local communities, will impose even greater burdens upon local boards and administrations in their never ending search for revenues and will further delay any hope of meetng the local needs of the people of this country.

We've got a pretty good system, let's not mess it up!

The CHAIRMAN. Dr. Edgar F. Shannon, Jr., president of the University of Virginia, is the next witness.

Senator BYRD. Mr. Chairman, may I say that we in Virginia are very proud of Edgar Shannon, and the outstanding job that he is doing as president of the University of Virginia. I am glad that he is here today so that my colleagues can come to know him.

STATEMENT OF EDGAR F. SHANNON, JR., PRESIDENT, UNIVERSITY OF VIRGINIA; ACCOMPANIED BY WALLER H. HORSLEY; AND LEIGH B. MIDDLEDITCH, LEGAL ADVISER, UNIVERSITY OF VIRGINIA

Dr. SHANNON. Mr. Chairman and members of the committee—thank you, Senator Byrd.

I would like to say that I have with me on my left Mr. Waller Horsley of the firm of Hunton, Williams, Gay, Powell, & Gibson of Richmond; and Mr. Leigh Middleditch is the legal adviser to the university.

I would like to express my great appreciation for the opportunity to appear before you to discuss this matter that is of vital concern, I think, to education in the United States, but especially to the University of Virginia in this context, and I do point out that I have filed a formal statement which appears on page 141 of the committee print for today, and I would just try to briefly cover orally some high spots and summarize the matter as it affects us.

In the very briefest form, the purpose of my testimony is to urge the committee to amend or to delete the language proposed in section 601(b) of H.R. 13270 to make clear that the definition of "arbitrage bonds" will not apply to the university's bonds secured by mortgages for faculty housing.

So our concern is with assistance in faculty housing at the university, and I ask the committee to accept two basic premises.

First, the privilege of issuing evidences of indebtedness carrying tax-exempt interest now accorded to State-supported colleges and universities extends to indebtedness incurred for faculty housing, and in our view at the university, a faculty home loan program is essential to the recruiting, the development of a high quality faculty at a college or university.

The second point is that even though generality and simplicity are certainly desirable attributes of a tax statute, the tax law adopted should not create uncertainties and confusion when exposed to the light of real situations.

Now, the concrete example of the trouble that 601 of the House bill brings to us is this: for many years, the University of Virginia, as a part of our overall program to provide housing for faculty and students, has offered to its faculty assistance in obtaining mortgage loans for their homes, both on and off the grounds of the university, and we normally have done this by providing 20- to 25-year home loans at 1 percentage point below the prevailing local mortgage rate.

The practicalities of such a program require the university to have interim funds for each mortgage application. These loans are normally made in the $20,000, $25,000, and $30,000 category. It is not practical, obviously, for the university to issue its notes as each faculty mortgage loan application is processed, and for this reason interim funds have been obtained from the university's endowment funds.

The university at the present time holds some $8 million in mortgage loans on faculty homes. This spring it contemplated issuing bonds, as authorized by the General Assembly of Virginia, to raise funds to reimburse the endowment funds for these interim loans to the extent that the tax-exempt bond market would allow.

The bonds issued by the university would be secured by and payable solely out of the faculty mortgage loan portfolio.

Now, we were advised by underwriters bond counsel that the pending arbitrage bound proposal included in the House version of the tax reform bill of 1969 could be construed to deny the tax-exempt interest privileges for the university's faculty housing bond issue even though from the university's standpoint the proceeds of the issue were to be applied to only the faculty housing program, and even though the current average interest rate in our faculty mortgage loan portfolio is 5.8 percent, considerably lower than the anticipated coupon rate of the university's bonds under present market conditions and, therefore, resulting if at all in a negative arbitrage factor.

There was also concern that a superficial view of the endowment fund's involvement through its interim loans, coupled with a strict administrative construction of new arbitrage bond limitations, would result in a classification of such bonds as within the generic group of arbitrage bonds. An unfortunate and unwarranted application of the so-called step transaction doctrine, which is familiar to tax practitioners, could result then in the view that the university is issuing its bonds for the sole benefit of its endowment funds, which then would be entitled to invest the proceeds in taxable obligations in the traditional arbitrage context.

But this view completely disregards the true purpose of the university's bonds issue, which is strictly to fund the faculty home loan program, and the impracticality of issuing bonds to cover each individual $20,000, $25,000, and $30,000 home mortgage as it arises.

Senator ANDERSON. Will you explain what arbitrage bonds are and how they compare with other bonds?

Dr. SHANNON. Excuse me?

Senator ANDERSON. You referred to arbitrage bonds.

Dr. SHANNON. Yes.

Senator ANDERSON. What variety is that?

Dr. SHANNON. Well, this is the issuing of a bond essentially to make money. In other words, you are able to issue a bond at a lower cost to you and proceed then to buy other bonds that will give you a higher return basically, and one of the problems is that we do not have a precise definition in the bill as to what is meant by an arbitrage bond, but basically, as I will point out here, the university is not in any way involved in the idea of trying to get in and out quickly by gaining money that it can then invest to its advantage.

Senator ANDERSON. Does it seek to make a profit?

Dr. SHANNON. No. This is not the purpose and, as we say, in the market today or any time in the foreseeable future, we would not make a profit, and this is not, I say is not, the purpose of the operation. We are only trying to carry out the faculty home loan program.

This was the point, as I mentioned, that these mortgages have been refinanced, and have been held in our endowment fund for an average of several years. So, as I say, it is not a matter of short-term investment to raise money.

Senator ANDERSON. What is it on, is it a mortgage on a house?

Dr. SHANNON. Yes.

Senator ANDERSON. What is involved there?

Dr. SHANNON. We are providing the money for the mortgages to the faculty members and securing these with our endowment.

We were now proposing to sell bonds to support these mortgages that would then be underwritten by the mortgages, and it appears—it is not certain but it appears—that the arbitrage provision of this tax bill in its present form might prevent us from doing this, and thus interfere with a sound proposal we feel for, a sound program we feel for, assisting our faculty with their housing.

Senator ANDERSON. Have you placed a mortgage on each individual dwelling?

Dr. SHANNON. Excuse me?

Senator ANDERSON. Have you placed a mortgage on each individual dwelling?

Dr. SHANNON. Do we place—yes.

The CHAIRMAN. Proceed.

Dr. SHANNON. Perhaps I can, if I go on with this, I may make it a little clearer, and I will try to come back if I have not answered your questions.

Senator ANDERSON. I only had one arbitrage experience. I bought a railroad bond once, and what happened was after I made a few thousand dollars I got hooked for many thousands of dollars. I wondered if you would have the same problem. [Laughter.]

Dr. SHANNON. Well, as I say, this, as we stand now, there is uncertainty, and it looks as though we could well be prevented from this, and it seems ironical that the university would be prevented by present legislation or really caused to curtail the faculty home loan program at a time when other legislation in this field, both laws passed last year and now pending, have made special exemptions to protect and promote residential housing programs.

The other note that I have alluded to already, and the final note that I would make concerning the realities in the tax-exempt bond market is, as you are aware, the market has been in a highly volatile state for several months now, and uncertainty that would lead us to rely on administrative rulings concerning the status of a proposed tax-exempt bond, as to whether or not it falls under the arbitrage provision of a proposed issue, which certainly takes several weeks, sometimes months, to be clear, and no group of underwriters today would accept such uncertainty, and the net effect is that having to request administrative clearance, even if such clearance is obtainable, would substantially limit the use of this badly needed source of funds for our faculty housing program.

So, gentlemen, I feel that we must have certainty in the statute. We cannot leave the matter to tax administrators and the issues clouded by vague purpose tests, and we ask that the definition must be written into the act itself, must be written into the legislation, to establish clear and precise standards or, of course, a simple solution would be to strike section 601(b) entirely. But either way, we certainly are asking that the provisions in the bill will make it possible so that we can support a program for faculty housing, very vital to the University of Virginia and to other educational institutions.

Senator Williams. Was not one of the factors they were trying to reach, was to stop a tax-exempt organization from floating a bond issue which would be tax exempt, and then reinvest that in taxable bonds with taxable interest, and use that as the spread for profit? That is what they were trying to prevent, I think. Maybe they overdid it.

Dr. Shannon. Well, that is what we feel, yes, sir. We understand that and hope that we can make provision here so that this won't inadvertently destroy what we feel is a very important program.

The Chairman. Dr. Shannon, you are well represented on this committee, and I do not think you need worry about what you hear. I think that the Senator from Virginia will see to it that nothing of that sort happens when the bill emerges from this committee. You might have to worry about the House, but I would not worry about the Senate. I think you will be all right on that side.

Dr. Shannon. Well, that is very encouraging.

Senator Byrd. It seems to me he has a very fair proposal. I do not fully understand Arbitrage bonds, I must admit, but I think your proposal sounds to me to be a reasonable and fair one.

Dr. Shannon. Thank you very much. I should say that I have learned a lot about Arbitrage bonds in the last few weeks.

Senator Byrd. Mr. Chairman, could I ask Dr. Shannon a question?

The Chairman. Yes.

Senator Byrd. A faculty member who has a mortgage on his home and desires to sell his home: can he sell it at a standing favorable rate?

Dr. Shannon. No, but——

Mr. Middleditch. Perhaps I can answer that, Senator Byrd.

We have a provision in our mortgage whereby the loan is callable by the university if the faculty member leaves the employment of the university, such that there is an assurance that the pool of mortgage money remains available only for the faculty members, such that if he leaves to go, as an example, to another institution, he sells his home on the open market, and if it is purchased by a nonfaculty member it would have to be purchased free and clear of the mortgage. The nonfaculty purchaser would have to get his own financing.

Senator BYRD. Thank you.

The CHAIRMAN. Thank you very much, sir.

(Mr. Shannon's prepared statement follows:)

FORMAL STATEMENT OF THE HONORABLE EDGAR F. SHANNON, JR. PRESIDENT, UNIVERSITY OF VIRGINIA

SUMMARY

The University of Virginia desires to issue bonds secured by and payable out of mortgages taken as security for loans made by the University for faculty housing.

In the opinion of bond counsel, the interest on these bonds would be exempt from Federal taxation under present laws. The arbitrage bond provisions of the Tax Reform Act, as reported by the House Ways and Means Committee and as passed by the House, appear to prevent these bonds from being issued by the University as tax exempt bonds.

The University urges the Senate Finance Committee to amend the language of proposed Section 601 of H.R. 13270 to make clear that the definition of arbitrage bonds will not apply to the University's bonds secured by mortgages on faculty housing.

STATEMENT

The University of Virginia proposes to issue bonds pursuant to Virginia Code Section 23–30.01 passed by the General Assembly of Virginia. That section authorizes any State educational institution, with the approval of the Governor, to issue bonds secured by and payable out of securities held by its endowment fund where the securities are secured by a lien upon real estate or personal property.

The University now holds in its endowments approximately $8,000,000 in notes and mortgages received as security for loans on faculty housing. These mortgage loans all derive from the University's overall plan to assist faculty and student housing, and have been made to faculty members to aid in the financing of their homes at a rate of interest approximately one percentage point less than the available market for mortgage loans.

Of necessity, the University cannot issue its bonds every time it proposes to make an individual mortgage loan. It must rely on its endowment funds to make the necessary advances, accumulate the mortgages, and then fund the obligations by issuing its bonds when sufficient mortgages have been accumulated.

It is the opinion of bond counsel that, under the present tax law, interest on the bonds to be issued as discussed about would be construed by a court to be exempt from Federal income taxes as interest on bonds issued by or on behalf of an instrumentality of the State of Virginia.

THE HOUSE PROPOSAL

H.R. 13270, the Tax Reform Act, as passed by the House of Representatives contains a provision on "arbitrage bonds" which, if adopted, would in all probability prohibit the University of Virginia from issuing tax exempt bonds secured by mortgages held in its endowment funds, as permitted by Section 23–30.01 of the Virginia Code. Section 601 of the Tax Reform Bill contains the following ambendment to Section 103 of the Internal Revenue Code (Section 103 grants the exemption for interest on bonds of states and political subdivisions):

"(b) Arbitrage Obligations—Section 103 is amended by inserting after Subsection (c) the following new subsection:

"'(d) Arbitrage Obligations—Under regulations prescribed by the Secretary or his delegate, any arbitrage obligation shall be treated as an obligation not described in Subsection (a) (1)'".

In the Act the effective date of this amendment is July 11, 1969.

The report which accompanied the bill makes the following explanation of the proposed amendment:

"Some state and local governments have misused their tax exemption privilege by engaging in arbitrage transactions in which the funds from tax exempt issues are employed to purchase higher yielding Federal obligations whose interest is not taxed in their hands. The tax exempt issue in these cases generally specifies that the interest on the Federal bonds will be used to service the state and local securities. An individual who purchases a state or local security under such an arbitrage arrangement has the advantage of a tax exempt security with the safety of a Federal security. The Federal government then finds itself in the position of becoming an unintended source of revenue for state and local governments while losing the opportunity to tax the interest income from its own taxable bond issues. The Internal Revenue Service has announced that it will not rule on the question whether such arbitrage obligations are entitled to tax exemption under existing law." H. Rep. 91-413, part 1, page 173.

The Committee report correctly states the Treasury Department's current problem, but the broad sweep of the language in the Act goes much further. The Treasury Department has been concerned about the issuance of tax exempt securities the proceeds of which are reinvested in Federal securities required to be held as security for the tax exempt security so that the holder has, in effect, a tax exempt Federal security.

The language in the Act as passed by the House of Representatives would permit the Internal Revenue Service to forbid the University from issuing its bonds and reinvesting in new securities (e.g., United States or corporate bonds, preferred stocks or equity stocks), whether or not these new securities were pledged as security for the bonds. It also appears that the Act could be extended to prohibit the use of securities already held in the University's endowment funds (e.g., existing mortgages) as security for the University's bond issue.

RELIANCE UPON ADMINISTRATIVE REGULATIONS

The administrative interpretation of proposed Section 601 would undoubtedly extend its scope beyond the Treasury's problem in the use of tax exempt securities to finance reinvestment in Federal securities. When applied to the University's use of bond proceeds to fund mortgages held in its endowment funds, technically, the mortgages held as security for the payment of the bonds constitute securities the interest on which is taxable, while the interest on the bonds is tax exempt.

Such an interpretation of the present House provision would ignore the fact that, under current market conditions (and for the foreseeable future), the coupon rate of the University's bonds would be *higher* than the current 5.08% average interest rate in the faculty loan portfolio. Thus, the amount of bonds which the University could issue (perhaps $7,000,000) would be sufficiently less than the amount which it has already invested in the faculty mortgages (i.e., $8,000,000). This difference, represented by a discount from the principal balance of the mortgage collateral (i.e., money already advanced from the endowment funds), would continue as a subsidy by the University for its faculty housing and represent no benefit to the State from the tax exempt financing. The University does not engage in the buying and selling of mortgages at a discount but invest in each faculty loan the full principal amount of the mortgage. Therefore, such investment, rather than any hypothetical market value for the mortgage, is the proper measure of the University's needs and the proper standard for judging whether the University's bonds actually operate as an arbitrage.

It might also be argued, by one who overlooks the entire purpose of the transaction, that in view of the fact that the bond issue will free an equivalent amount of endowment funds for investment in other securities, whether bonds, preferred stocks, or equity stocks, the University's bonds would be issued for the benefit of its endowment funds, and the endowment funds will be entitled to invest the proceeds in taxable obligations even in the traditional arbitrage context. Such a view, however, totally disregards the true purpose of the University's bond issue (namely to fund the faculty home loan program) and the impracticability of issuing bonds to cover each individual $20,000, $25,000 and $30,000 faculty home mortgage.

Further, the present language of Section 601 of H.R. 13270 grants such broad latitude to the Secretary of the Treasury that he could deny the tax exemption for interest on any bonds issued by the University, regardless of the security, so long as the University owns securities the interest on which is taxable. For instance, the Secretary could argue that the University should sell its endowment securities to build dormitories, rather than issuing tax exempt bonds to finance their construction. He has made a similar argument against individuals and corporations who hold tax exempt securities when they borrow money for purposes unrelated to their holding of the tax exempt securities. See, e.g., *Wisconsin Cheeseman, Inc.* v. *United States*, 388 F. 2d 420 (7th Cir. 1968).

Assistant Secretary Edwin Cohen, in his statement to the Senate Finance Committee on September 4, recognized that the language in the Act on arbitrage bonds as passed by the House was too broad. He stated:

"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." (Senate Finance Committee, Committee Print, p. 85).

As of Saturday, September 20, 1969, the Secretary has made no specific proposal, and we understand that emphasis will be placed again on an administrative interpretation. Cf T.I.R. 840 (August 11, 1966), attached as Exhibit A hereto. We strongly recommend, however, that the language as passed by the House be amended *in the Act* to permit the University to issue tax exempt bonds to aid in the financing of its faculty housing needs.

We cannot afford to leave such exemption to administrative regulation for several reasons:

1. The present volatile state of the tax-exempt bond market is known to all of you. Underwriters cannot maintain any kind of orderly market and wait the weeks and sometimes months necessary to obtain a ruling from the Internal Revenue Service.

2. This delay factor is especially evident now when the regulations for the entire new bill are yet to be written. Any interim administrative regulations would not permit bond counsel to avoid requests for ruling. Actually, such requests would become a necessity.

3. Any temporary administrative regulation keyed to a use of proceeds to reinvest in taxable securities (as opposed to taxable Federal securities) to be held as security for the tax exempt bonds would be unworkable because, technically, faculty mortgages are securities the interest of which is taxable. The use of the old rules (i.e., T.I.R. 840) would not ease the situation because the entire context of interpretation would have changed; that is, T.I.R. 840 would now be viewed as an expansion of specific legislation limiting arbitrage situations, whereas under former law arbitrage bonds were permissible under the statute as an additional indirect subsidy to State and local governments.[1]

4. If the funding of the mortgages is indeed an arbitrage under the statute, the Treasury would not have the authority to issue regulations which would exempt a specific program such as aid to faculty housing.

[1] In truth, what is so wrong with arbitrage bonds issued by instrumentalities of State and local governments? If the Commonwealth of Virginia issues $36 million of its 6 percent tax exempt bonds and uses the proceeds to purchase at the current market discount $40 million in 6 percent taxable Federal bonds, using the $4 million arbitrage spread for the construction of hospitals, housing or other publicly supported capital needs, why is this so sinful? As pointed out below, the Federal Government actually encourages this with respect to local housing authority bonds.

CONGRESSIONAL SUPPORT OF HOUSING AID

There is ample precedent in current Congressional policy for a statutory exemption to permit the University to aid the furnishing of its housing needs in this way. First, the Federal government guarantees payment of bonds on all local housing authorities in the country. In effect, therefore, it gives to the bondholders, when housing is involved, a tax exempt Federal security. Second, the Congress last year, when adopting restrictions on tax exempt industrial development bonds, provided an exemption for bonds to finance "residential real property for family units." Third, in the Act as passed by the House the recommended changes in the deduction for depreciation do not apply to new "residential rental housing." (Section 521 of H.R. 13270).

The needs of a university in the housing area are as important as the policies underlying the need for these statutory exemptions. At the Univesity of Virginia alone, the endowment funds already hold almost $8,000,000 in mortgages on faculty homes. It is projected that by 1975–1980 there will be a need for $7,000,000 more, or a total of $15,000,000.

. Last year legislation was introduced in the Senate and agreed to by the Treasury Department which would have addressed itself specifically to the Treasury's problem with arbitrage bonds. S. 2636, introduced by Senator Ribicoff, defined "arbitrage bonds" in the bill and denied tax exemption for interest on such bonds. The language of S. 2636, to a great degree, incorporated the Internal Revenue Service's prior announcement in T.I.R. 840. The Treasury Department supported S. 2636 at that time. (Hearings before Senate Finance Committee on Tax Adjustment Act of 1968, page 90).

A statutory definition of "arbitrage bonds" such as presented in S. 2636 might not apply to the University of Virginia bonds. In any case, an amendment, which would be only a clarifying amendment, could be added to the other exceptions to the definition of "arbitrage bonds" in that bill to make clear the definition did not apply to faculty housing bonds. This would be only one available alternative.

CONCLUSION

We, therfore, strongly urge the Senate Finance Committee to define arbitrage bonds with some particularity and with a definition or an exception *in the Act* which would permit the University to issue its bonds to aid in the financing of its faculty housing programs. We base this request on two basic premises:

1. The privilege now accorded to State supported universities to issue evidences of indebtedness carrying tax exempt interest extends to indebtedness incurred for faculty housing.

2. Even though generality and simplicity are desirable attributes of a tax statute, the tax law adopted should not create uncertainties and confusion when exposed in the light of real situations.

If this Committee accepts these premises, it should accept our request.

EDGAR F. SHANNON, Jr.,
President, University of Virginia.

[EXHIBIT A]

T.I.R. 840

TECHNICAL INFORMATION RELEASE OF THE U.S. TREASURY DEPARTMENT, INTERNAL REVENUE SERVICE, PUBLIC INFORMATION DIVISION, AUGUST 11, 1966

The U.S. Internal Revenue Service today announced details of its policy of *declining* to issue rulings that the interest on certain obligations is exempt from Federal income taxation under Section 103 of the Internal Revenue Code of 1954.

The policy will continue in effect, pending the conclusion of a study to determine whether such obligations should be considered obligations of States, Territories, possessions, their political subdivisions or the District of Columbia. The study will be directed at obligations issued by these governmental units where a principal purpose is to invest the proceeds of the tax-exempt obligations in taxable obligations, generally United States Government securities, bearing a higher interest yield. The profit received by the governmental units on the difference between the interest paid on the exempt obligations and the interest earned on the taxable obligations is in the nature of arbitrage. The study will not affect obligations issued prior to the date of this release.

More specifically, this ruling policy will apply to obligations falling within either of the following two categories:

1. Where all or a substantial part of the proceeds of the issue (other than normal contingency reserves such as debt service reserves) are only to be invested in taxable obligations which are, in turn, to be held as security for the retirement of the obligations of the governmental unit.

2. Where the proceeds of the issue are to be used to refund outstanding obligations which are first callable more than five years in the future, and in the interim, are to be invested in taxable obligations held as security for the satisfaction of either the current issue or the issue to be refunded.

The following are *examples* of transactions with respect to which no ruling will be issued:

First, a State may issue obligations and invest the entire proceeds in United States bonds with similar maturities bearing a higher interest yield. The United States bonds are then placed in escrow to secure payments of interest and principal on the States obligations. The profit on the interest spread accrues to the State over the period of time that these obligations are outstanding.

Second, a municipality may immediately realize the present value of the arbitrage profits to be derived over the future by casting the transaction in the following form: It may issue obligations in the amount of $100 million, use $20 million to build schools or for some other governmental purpose, and invest the balance, $80 million, in United States bonds which bear a higher interest yield. The United States bonds are escrowed to secure payment of interest and principal on the municipal obligations. The interest differential is sufficiently large so that the interest and principal received from the United States bonds are sufficient to pay the interest on the municipal obligations as well as to retire them at maturity.

Third, a municipality may issue obligations for the stated purpose of refunding outstanding obligations first callable more than five years in the future. During the interim before the outstanding obligations are redeemed the proceeds of the advance refunding issue are invested in United States bonds bearing a higher interest yield, and such bonds are escrowed as security for the payment of either of the issues of municipal obligations. During that interim period, arbitrage profits based on the interest spread inure to the municipality.

The Service made clear that this announcement covers only obligations falling within the two categories described above. Thus, for example it does not cover an issue of obligations where the proceeds are intended to be used to construct a facility even though the proceeds are initially placed in a trust for the security of the bond holders, and invested in taxable obligations, pending their use to meet the construction costs as they occur. Nor does it cover an issue of obligations merely because a portion of the proceeds is invested in taxable obligations and held solely to meet interest payments on the obligations pending the availability of other revenues.

The CHAIRMAN. The next witness will be J. Donald Reilly, executive vice president, Management Services, Airport Operators Council International, Inc.

STATEMENT OF J. DONALD REILLY, EXECUTIVE VICE PRESIDENT, AIRPORT OPERATORS COUNCIL INTERNATIONAL, INC.; ACCOMPANIED BY WARREN HAWES, VICE PRESIDENT FOR ECONOMIC AFFAIRS

Mr. REILLY. Mr. Chairman and members of the committee, I am J. Donald Reilly, executive vice president of the Airport Operators Council International. Accompanying me is Mr. Warren Hawes, AOCI vice president for economic affairs.

I would like to submit our entire statement for the record and merely highlight the principal portions, if I may, sir.

AOCI is the nonprofit trade association of the governmental bodies which own or operate the principal airports in the 50 States, Puerto

Rico, and the Virgin Islands. In 1968, U.S. member airports enplaned about 90 percent of the domestic and virtually all of the U.S. international scheduled airline passenger and cargo traffic.

We are grateful for this opportunity to express the views of our membership in opposition to those provisions of H.R. 13270 which, if enacted, would:

1. Destroy the primary source of capital funds for airport development—the tax-exempt market—and

2. Have a demonstrably adverse effect on the development of our national airports system and, worse, our Federal system of Government.

The local governmental body is the foundation of today's system of airports in the United States.

I am sure you are acutely aware as we are of the problems presently facing the local governmental bodies which operate these airports. Air transportation in the United States in recent years has grown at such an accelerated pace that airport operators have for clearly identified reasons been unable to provide increases in capacity as fast as required in the public interest. Within the next 10 years, airline passenger totals will triple over today's level with a million people a day clogging airport access roads and arriving at terminal buildings which may not be physically able to handle them.

This airport capacity problem is basically one of financing—$13 billion in new capital requirements are projected for public airports served by the scheduled air carriers through 1979. Most of the money to support this development will have to be provided from local sources with financing arranged through the tax-exempt market.

However, existing sources and levels of funds cannot finance all this development, even with the planned increases in local airport fees and charges which have been reported to us.

Any congressional action which further impedes the ability of local governments to obtain airport capital funds, such as that proposed in H.R. 13270, will only compound these existing problems.

Previous witnesses have discussed in detail the reasons for local government's objections to inclusion of bond interest in the limit on tax preferences (LTP) and allocation of deductions rule (ADR) and the interest subsidy plan as passed the House in early August. We shall not repeat these technical arguments here. Suffice it to mention that public airport operators fully share these concerns.

Each of these objections to LTP, ADR and the "voluntary" interest subsidy plan has already had a decided and costly effect on the bond market—well in advance of final congressional action. Interest costs are up, with airport bond issues being withdrawn or withheld because of these increased costs. Existing statuatory interest limits on general obligation bonds in many cases cannot meet today's market requirements.

Increased interest costs on $8 to $10 billion of new airport issues to be floated in the next decade would likely be astronomical over the life of the bonds. We estimate that a 1-precent interest increase on this amount of bonds over a 20-year amortization period could more than equal the total costs of construction of two new major jetports. Whether these funds are to be utilized for construction costs or financing charges will largely be determined by this committee.

We mentioned earlier that, apart from the tax-exemption issue, new sources of capital funds will be required if airport sponsors are to be able to "get the job done" in a timely manner over the next decade. This additional requirement has been recognized by the administration in its proposal now pending before the Commerce Committees for new Federal programs for airport development.

Under the administration's recommendations, new resources for airports and airways modernization would come from increased Federal taxes on the users of the aviation system and primarily from the commercial airline passenger. Approximately a 2-percent increase in the existing Federal tax rate on passenger fares would be dedicated to airport development purposes under the administration's proposal, or about $200 million annually averaged over the next 5-year period. The tax provisions of this legislation also are pending before this committee.

We fear that affirmative action by this committee on both the tax-exemption provisions of H.R. 13270 and the new user taxes for airport development as proposed by the administration would result in the right hand of Congress taking away the same amount of funds which the left hand is making available, as the yields in question are about the same. They clearly would not fulfill the intentions of the Congress as regards either piece of legislation and would stifle the orderly growth of aviation system capacity.

In conclusion, Mr. Chairman, the Nation's airport operators seek congressional recognition that continuation of the tax-exempt status of municipal airport bonds is justified and necessary if the National Airport System is to be ready to handle the traffic of the 1970's.

Thank you very much.

The CHAIRMAN. Thank you, sir.

Senator WILLIAMS. No questions.

STATEMENT OF THE AIRPORT OPERATORS COUNCIL INTERNATIONAL ON TAX TREATMENT OF STATE AND MUNICIPAL BONDS

SUMMARY

I. The Airport Operations Council International (AOCI), representing the governmental bodies which own or operate the principal public airports in the United States, opposes those provisions of H.R. 13270 which would adversely affect the tax-exempt status of interest on bonds issued by local governments for airport development purposes.

II. Airport development capital requirements for public airports served by the scheduled air carriers are projected at $13 billion through 1979. Approximately $8 to $10 billion of this total will be financed through the municipal bond market—the primary source of airport financing capital—and supported by revenues generated locally. New sources of funds must be found to supplement local sources.

III. Congressional action adversely affecting the municipal bond market will intensify the capital financing problems facing local governments. Such provisions as were included in the House-passed version of H.R. 13270 relating to Limit on Tax Preferences (LTP), Allocation of Deductions Rule (ADR) and the interest subsidy plan are opposed by airport operators for numerous reasons:

A. Increased interest costs on airport bonds;

B. Chaos in the bond markets;

C. Federal intervention into local government revenue allocations.

IV. Concurrent Congressional action affecting municipal airport bonds and approving new Federal user taxes for airport development would leave public airport sponsors without additional resources for meeting system needs in the 1970's, and would not fulfill the intent of the Congress on either issue.

STATEMENT

Mr. Chairman and Members of the Committee, I am J. Donald Reilly, Executive Vice President of the Airport Operators Council International (AOCI). Accompanying me is Mr. Warren Hawes, AOCI Vice President—Economic Affairs.

AOCI is the non-profit trade association of the governmental bodies which own or operate the principal airports in the fifty states, Puerto Rico and the Virgin Islands. In 1968, U.S. Member airports enplaned about 90 percent of the domestic and virtually all of the U.S. international scheduled airline passenger and cargo traffic. In addition, our Members operate many reliever and other general aviation airports which supplement the larger airports in their communities and regions.

We are grateful for this opportunity to express the views of our membership in opposition to those provisions of H.R. 13270 which, if enacted, would:

(1) destroy the primary source of capital funds for airport development—the tax-exempt market—and

(2) would have a demonstrably adverse effect on the development of our National Airports System and, worse, our federal system of government.

The local governmental body is the foundation of today's system of airports in the United States. Of our approximately 10,000 civil and joint-use airports, about 3,600 are owned and operated by local governments of all kinds—municipalities, counties, towns, special airport authorities, or a combination of these. This public ownership and public use is particularly applicable to the 525 U.S. communties which receive service from the scheduled airlines and which form the nucleus of the National Airport System.

I am sure you are as acutely aware as we are of the problems presently facing the local governmental bodies which operate these airports. The "Airport Crisis" is a crisis caused by success. Air transportation in the United States in recent years has grown at such an accelerated pace that airport operators have for clearly identified reasons been unable to provide increases in capacity as fast as required in the public interest. Within the next ten years, airline passenger totals will triple over today's level with a million people a day clogging airport access roads and arriving at terminal buildings which may not be physically able to handle them.

This airport capacity problem is basically one of financing. $13 billion in new capital requirements are projected for public airports served by the scheduled air carriers through 1979. Most of the money to support this development will have to be provided from local sources with financing arranged through the tax-exempt market. However, existing sources and levels of funds can not finance all this development, even with the planned increases in local airport fees and charges which have been reported to us.

Any Congressional action which further impedes the ability of local governments to obtain airport capital funds, such as that proposed in H.R. 13270, will only compound these existing problems.

Previous witnesses have discussed in detail the reasons for local government's objections to inclusion of bond interest in the Limit on Tax Preferences (LTP) and Allocation of Deductions Rule (ADR) and the interest subsidy plan as passed the House in early August. We shall not repeat these technical arguments here. Suffice it to mention that public airport operators fully share these concerns:

Increased interest costs on airport bonds.—Less development and higher financing charges would result. Needed projects would be delayed or cancelled.

Chaos in the bond markets.—Not only individuals but institutional investors would be discouraged from the purchase of local obligations because of fear of additional Federal action against these airport bonds. Litigation which would follow upon enactment of the House's provisions would leave the status of tax exemption in doubt for years.

Federal intervention into local government resource allocations.—Our federal system of government is premised on separate levels of government with each responsible for the allocation of its own resources. Under the pending legislation, the fiscal independence of public airport sponsors and other local public agencies would be impinged upon by a greater Federal Government involvement in strictly local matters of debt management.

Each of these objections to LTP, ADR and the "voluntary" interest subsidy plan has already had a decided and costly effect on the bond market—well in advance of final Congressional action. Interest costs are up, with airport bond issues being withdrawn or withheld because of these increased costs. Existing statutory interest limits on general obligation bonds in many cases can not meet today's market requirements.

Increased interest costs on $8–10 billion dollars of new airport issues to be floated in the next decade would likely be astronomical over the life of the bonds. We estimate that a 1% interest increase on this amount of bonds over a 20-year amortization period could more than equal the total costs of construction of two new major jetports, so badly needed at many locations to handle the traffic of the 1970's. Whether these funds are to be utilized for construction costs or financing charges will largely be determined by this Committee.

We mentioned earlier that, apart from the tax-exemption issue, new sources of capital funds will be required if airport sponsors are to be able to "get the job done" in a timely manner over the next decade. This additional requirement has been recognized by the Administration in its proposal now pending before the Commerce Committees for new Federal programs for airport development. Under the Administration's recommendations, new resources for airports and airways modernization would come from increased Federal taxes on the users of the aviation system and primarily from the commercial airline passenger. Approximately a 2% increase in the existing Federal tax rate on passenger fares would be dedicated to airport development purposes under the Administration's proposal, or about $200 million annually averaged over the next five-year period. The tax provisions of this legislation also are pending before this Committee.

We fear that affirmative action by this Committee on both the tax-exemption provisions of H.R. 13270 and the new user taxes for airport development as proposed by the Administration would result in the right hand of Congress taking away the same amount of funds which the left hand is making available, as the yields in question are about the same. This clearly would not fulfill the intentions of the Congress as regards either piece of legislation and would stifle the orderly growth of aviation system capacity.

In conclusion, Mr. Chairman, the Nation's airport operators seek Congressional recognition that continuation of the tax-exempt status of municipal airport bonds is justified and necessary if the National Airport System is to be ready to handle the traffic of the 1970's. The tax-exempt municipal bond is the only proven method of financing local public projects yet devised. For these reasons we respectfully urge this Committee to delete the provisions of the House-passed bill which would include bond interest in the Limit on Tax Preferences and the Allocation of Deductions rule, and which propose a "voluntary" interest subsidy plan.

The CHAIRMAN. The next witness is the Honorable Paul J. Manafort, Mayor of New Britain and President of the Connecticut Conference of Mayors.

STATEMENT OF HON. PAUL J. MANAFORT, MAYOR OF NEW BRITAIN, CONN.; ACCOMPANIED BY GERALD J. McCANN, DIRECTOR OF FINANCE, NEW BRITAIN, CONN.

Mayor MANAFORT. Mr. Chairman and members of the committee, I have accompanying me Gerald J. McCann, director of finance of the city of New Britain.

I am also chairman of the Connecticut Conference of Mayors, representing the conference of mayors as well as my own town in Connecticut.

I wish to go by my prepared statement. I know there have been many of them here today, and I will try not to be repetitious, and try just to pick out some of the highlights.

First of all, I would like to announce that our conference, the Connecticut Conference of Mayors, was unanimous in endorsing the resolution that accompanies my statement here today.

To give you a few highlights of what this taxing of the municipal bonds would do, in my community alone we have sold bonds approximately 2 years ago for 3.85 percent. We have $7 million worth of bonds to go out on the market, and our bonding experts and our financial director feel the best estimate they could get would be 6½ percent because of the fear that has been put in the bond market because of the possible passage of the proposals now before you.

We in New Britain, as well as the $7 million bonds that go out for bid, we have before us a $30 million school building program, and if these bond interest rates should go anywhere near the areas that have been suggested, which could be anywhere from 6½ to 8½ percent, I know our community just could not afford this any more.

They seem to be debating what the cost of this would be at the income tax level, but as mayor of a community I am deeply concerned that the property owner, the man who owns the one- and two-family house, has reached a saturation point, and this is the only place of revenue that a community has in which to take care of many programs that we face in the cities, and the cities where the problems are the greatest. We seem to be suffering the most.

Another point has come up about what might happen. I would like to call to your attention, and this is not what might happen but what has already happened. In recent weeks there have been communities that have put out some bonds for bids. For example, there were no bidders, no bidders on these bonds whatsoever.

Hawaii was trying to put out $30 million in bonds, and there were no takers; Jacksonville Electric Authority, Fla., $22 million; Omaha, Nebr., $9.5 million, and many others such as this, and there were just no bidders there.

What happens if there are no bidders and we cannot sell our bonds? What do we do? Do we stop building? We stop building schools, sewers, many streets.

I say to you gentlemen that we on the city level in the towns, because these problems will be reaching the suburbs, if they have not reached them already, I can tell you as one who comes from an urban center, that property owners have reached the saturation point. We have applied to the State and to the Federal Government for additional help.

If this is passed, instead of getting additional help we will be penalized.

The Mayors' Conference was very successful in trying to reverse in our local general assembly the disruption to construction bonds, from the State, as far as our school construction was concerned, and we thought we had made inroads, but that was a drop in the bucket, and if this thing passes, this issue now before you, I can assure you that will wipe out everything we have gained, and then some.

The CHAIRMAN. Mr. Mayor, were you in the committee room this morning when Mr. Surrey testified?

Mayor MANAFORT. Yes, sir.

The CHAIRMAN. You heard him explain that he did not think the mayors and local officials understood what the scheme was at all, and that when you fully understood what his subsidy plan was that he felt that either your people would not be opposed to this House proposal or else that you would be in favor of it.

Do you think you understand what the subsidy scheme is now?

Mayor MANAFORT. Well, Mr. Chairman, it was not just the elected officials. Our finance people, town managers, all collectively say that this is going to hurt the community. I do not think the subsidy will take care of it.

In my estimation of what my finance people have tried to break down—they claim that by making these bonds taxable there could be approximately $80 million coming in in income tax level. Now, assuming that $15 billion worth of bonds are sold next year, a 1-percent increase is going to be an increase of $150 million. So it is costing the communities $150 million where the Federal Government will be making $80 million, and this is only talking 1 percent. This is talking now—this will go on and on and on, and it gets cumulative as it goes along.

I think it is a false economy.

I think it is something that not only the local taxpayer, property owner is going to be hurt by this, I honestly do not see even under the subsidy program—many times I think the speaker this morning stated that it looked like we would be able to break even at the 40-percent subsidy. Well, I am sure that you gentlemen are plenty busy down here not to look for projects that will have a break-even point, plus he did take into consideration there was a 40 percent, assuming that they decide it is only going to be a 25-percent subsidy, now who picks up the difference?

The CHAIRMAN. Well, frankly, Mr. Mayor, I am not afraid of a new idea. In fact, sometimes I have initiated what I thought were some new ideas, threw them out just to see what might happen to them.

When Mr. Surrey testified this morning that he felt that if the mayors and the local elected officials, including the Governors, had heard his side of the argument that they would feel entirely different about the overall proposal, and I could not help but think that in my own part of it—I heard Mr. Surrey's proposal before I heard from the Governors and it sounded extremely interesting to me when I first heard that proposition, it sounded very appealing.

After I heard the other side of the argument, that is the side against Mr. Surrey's side of the argument, I was then convinced that his is a very poor argument. But on first hearing his, it sounded very good to me until I heard the other side of the argument, and it would seem to me that there may be quite a few of you among the mayors and among the Governors and the State finance directors or those who represent the people of the city and State level, who may very well understand Mr. Surrey's side of the argument and just not agree with it at all.

Mr. MCCANN. I would like to field that one, Mr. Chairman, if I may.

First of all, I heard Mr. Surrey also this morning. There were two things he mentioned. He did mention that he had spoken to some Massachusetts fiscal people and has expounded as to what the bill contained and, as a result of that, they were much enlightened.

He did not go one step further, however, and say that they agreed with what he was proposing. He said they were just more enlightened as to what he was proposing. There is a vast difference in the two areas here.

I think if he had been a member of the fiscal family in Massachusetts and had heard his own presentation he would probably not have been taken up too much himself by it, you see.

The idea that the subsidy is there—in fact, correspondence from my office sometime back to the House at the time the House was considering this same bill indicated that the proverbial carrot naturally is always hung there, otherwise it would have no appeal whatsoever. If you remove the subsidy from this bill you really have nothing at all.

So let us start there, and there is no guarantee it will ever remain. It means it is there now, it does not mean it is going to stay there.

Second, it is subject to adjustment. There is, furthermore, if you get into the techniques and technicalities of the bill, you have a $10,000 exemption now which may be dropped for a $5,000 exemption later on, you do not know. This is something that would affect the State and municipal level also. There are a number of areas, I mean, that you could punch holes in Mr. Surrey's thinking along this line.

I am not talking about his comments on the bill in general. He indicated there were special interest groups here of varying types. I cannot get involved with those because naturally we are dealing with one field, our field only. But we do sell bond anticipation notes.

For example, we anticipate we are going to sell these bonds sometime in the future, and we proceed with the project we are constructing. If we get on the open market and we have to compete with corporate bonds, and we cannot, let us face it, what is the only attractive feature that a municipal bond has on the market today?

There is only one answer, tax exemption. This is the only source, and the only reason why municipalities can project their own programs right now.

The capital improvements programs, we have on paper for 5 years in advance right now, is based on the sale of tax-exempt bonds in the future through 1974, and we are not the only community doing this. In fact, we are one of the latest communities doing it. So there are many instances here that I felt, that as well as he presented the case, there was no question that even if he did present it in its entirety to all the people that he projected that he would propose this to, I do not believe he would be convincing in his argument because, in the final analysis, this is going to be a boomerang type of operation, and the amount of money that is going to be realized—I am talking about Federal money that is going to be realized—will nowhere offset the amount of additional tax burden which will be faced by the people back on the local level, and that is going to be reflected on the local level from the standpoint of mayors and, of course, governors, and right down the line, and that is why you have had all these people here, I am sure.

The CHAIRMAN. Well, the subsidy scheme just had a lot of defects to it that the sponsors of the plan do not like to admit.

I can recall when I was in high school we were debating a subject, "Federal Aid to Education," and I think those of us who debated the affirmative side of the argument had the burden to prove that this Federal aid would not be accompanied by Federal strings.

I came to Washington prepared to advocate Federal aid without Federal control. Well, we have got the aid to education. Do you see the strings on it? They are all over it. You do not get any of that money unless you pursue certain important Federal policies or certain policies that the Federal Government thinks are important. Maybe you agree with those strings, but the point is that they are there, and the whole burden of the argument 30 years before that became part of the program was that this could be done without attaching Federal strings to it, and there it is.

The Federal strings are all over it. So anyone who has devoted enough to any program he has in mind, to say that the cities or the States ought to do certain things, cannot resist the temptation to offer his amendment and try to make them do it his way, so you get into that.

Then you get into this question that the Federal Government is going to subsidize it, and it raises a question whether the Federal Government should subsidize some of these bonds, whether the community is, in fact, making a wise investment anyway, or whether the community can, in fact, afford it as, Senator Williams indicated, whether it is a sound investment, so then you have to get into that part of it.

Mr. McCANN. That is right.

The CHAIRMAN. So the Federal Government then has to pass judgment on whether the investment is a sound investment.

Then you have the third problem that comes into it, can the Federal Government afford the subsidy.

Over a period of time you find out the Government has a big deficit, and then someone offers one of these Williams amendments there to say let us just cut everything by 10 percent, and try to make the cloth fit the pattern, so the amendment carries, and everything is cut by 10 percent, and there goes 10 percent of the subsidy, let us say.

Or someone makes an even more fervent argument than that for economy and says, Who should we, being more in debt than all of the local governments put together, proceed to subsidize their interest rate when we cannot afford to pay our own?

Once having established the right to tax the cities, then you set the stage for someone to say, Wait a minute, this is a big subsidy where those people are in better position to pay than we are. Do you think they are in debt? Look how deeply we are in debt, so why should we subsidize their bonds against ours.

So someone then, the liberal of tomorrow, let us say, makes the argument that there is no reason why the cities and the communities, States and others should not carry their own part of it.

So it would seem to me if you are going to try Mr. Surrey's proposal there is only one suggestion I have heard here that makes good sense, and that is, perhaps, it might be worth saying that with regard to retirement funds held by State and local governments for the retirement of their own employees, it might be worth saying that if those funds wanted to buy some of their own State or municipal bonds or the bonds of another State or municipality, it might be worth making up the difference to them so they could afford to buy those types of securities in their retirement funds.

Mr. Surrey's argument, as I heard it here today, would be that insofar as they did that that would make a taxable bond available for somebody else to buy rather than a tax-exempt bond available for someone else to buy. That part of it, if you wanted to try it, would not seem to me to work any particular mischief.

Would you see anything wrong with that part of it?

Mr. McCANN. The only fault I see with that is the aspect of trying it and, perhaps, what happens if it does not work type of answer. Our problems are still going to be there. In fact, they are going to be compounded. We will no longer have the possibility of self-determination as to what we are selling our bonds for.

The CHAIRMAN. My only thought about it was if they wanted to have a try at subsidizing them, to say, you are subsidizing them so that a tax-exempt fund can buy some of these bonds which otherwise would not be an attractive investment for tax-exempt funds, if they wanted to do that, I really do not see that there would be any harm in it, but I would not want to vote to tax these bonds because I think that you have already hurt them badly enough as to what has been done, and I think we ought to undo that mischief as soon as we can.

What would your thought be if we simply said in connection with this legislation, if the funds for retirement of school teachers and retirement of State and city employees, things of that sort, could be invested in State and municipal bonds, and if they were that the Federal Government would make up the difference between what you could buy a Federal bond for and what it would cost you to buy a State or local bond; what would your reaction to that be?

Mr. McCANN. You are still talking about the subsidy aspect of the bill?

The CHAIRMAN. Yes, just the subsidy aspect.

Mr. McCANN. The subsidy aspect of the bill, so far as I am concerned, does not seem to have any value unless you are talking about the removal of the tax exemption provisions. It is not really the subsidy that is the problem here. It is the removal of the tax exemption problem.

The CHAIRMAN. You are not here opposing the subsidy. What you are here opposing is the taxation of these bonds.

Mr. McCANN. They are interrelated. You cannot separate them.

Senator WILLIAMS. But there is a catch in the proposal to let these pension funds, tax-exempt pension funds, and so forth, buy a State municipal bond, and the Federal Government subdizes them for the difference, which would be the equivalent of the tax which they would have paid if they bought industrial bonds. It seems to me it would not be the answer because at the very next Congress this Williams or Long could offer an amendment and say, why should we pay taxes to a tax-exempt organization, pay the taxes they would have paid if they were taxable. I mean, it is a round robin, and sooner or later that would be stopped, and I am just not too sure it would be practical.

Speaking of Mr. Surrey's ability to persuade his audience, I am not sure he has persuaded himself because it has been interesting to me that during the 7 or 8 years that he was serving in the Treasury Department he testified before this committee against practically everything that he recommended this morning, and he never got religion until after he got out of office. I wondered if getting him out of office did him good or bad, because, now he is on record as stating that practically everything that he has recommended since, in this bill, as not being workable and not being practical.

So I am just at a loss. I am waiting to see what he says tomorrow.

The CHAIRMAN. Any further questions?

Senator MILLER. Thank you.

I would just like to ask this question: as I see it, there are four points in this House-passed bill which impinge on the municipal bond. No. 1, this taxation subsidy approach. If it is any consolation to you, I have been opposed to this publicly ever since I first heard about it, and Senator Long's Governor gave a very eloquent statement against it the other day when the Governors appeared before us, and articulated the reasons better than I have.

No. 2, taxation of the banks on their sale of these bonds so that instead of getting capital gains they get ordinary income. The banks are the largest purchasers of these bonds, so that impinges upon the market.

No. 3, the allocation of deductions matter, and as you probably know, the Treasury representatives recommended this, that tax-exempt municipal bonds be included in the list of items for purposes of allocation of deductions.

The fourth is the limit on tax preferences approach to include tax-exempt municipal bonds in the list of limited tax preferences.

Now, I do not know, but it seems to me that the bank taxation could run up in the neighborhood of $200 or $300 million, that is a very substantial impingement on the bonds.

The Treasury testified that they estimated that the allocation of deductions item would bring about $45 million of revenue——

Mr. MCCANN. That is right.

Senator MILLER (continuing). From individuals. That is out of a $2 billion annual payout to individuals.

The limit on tax preferences they estimated will bring in $35 million out of $2 billion of payout. I have some reservations about the allocation of deductions item if for no other reason than the fact that is $45 million as against $35 million.

Another reason here why I have a reservation on the allocation of deductions item is because it does not get at the problem of some people being able to have a large amount of income and not pay 1 red cent of Federal taxation. But the limit on tax preferences is the only way I know of in which we can say to the American people there is not going to be anybody who gets a good chunk of income who does not pay so‍ ‍ tax.

What I find out from the Treasury is that they tell me that use of the limit on tax preferences means about $35 million of revenue out of $2 billion of annual interest outgo to individuals, and I find it hard to believe that if that is the only item we are talking about that this is going to have any particular impact on the bond market, because it seems to me that it is such a small amount, out of $2 billion, that it just would not have any impact.

The others could, allocation of deductions more, banks still more, and God help us if we get into the taxation subsidy approach.

What is the answer to this problem I have of seeing this impact, if this is the only item on the bond market?

Mr. MCCANN. Well, I am not a bond expert, but I do know from the local level what I feel the answer would be. I feel that any infringement of any type under any circumstances on the removal of the tax exemption provision on a municipal bond is going to have an adverse effect on the market. There is no question about it. I think, as——

Senator MILLER. I have a question about it, and that is why I am raising the question.

Mr. MCCANN. I say I do not think there is any question.

Senator MILLER. And if somebody came along and said, now the limit on tax preferences approach will bring in $35 million of revenue—I am not trying to put you in a corner, you can understand—but $35 million of taxation on $2 billion of payout seems to me to be almost de minimis.

Senator WILLIAMS. Would the Senator yield for a moment?

Senator MILLER. Yes, indeed.

Senator WILLIAMS. I think is not the problem this: it is not the $5 million or the $35 million tax that is being levied on this $2 billion of interest, but if everybody knew for a certainty that is all that would ever be done I do not think it would have much of an effect. But it is the uncertainty that will prevail in the minds of the investors in the months and the years ahead as to what this Congress or some future Congress may do later, once we have taken the initial step forward and adopted the premise. I think that is the problem. It is the discounting of the unknown which is bothering the people.

Mr. MCCANN. I also think, Senator, we are confusing two areas here, and I would like to straighten that out very, very carefully.

We are talking about $35 and $45 million of income. You are talking about Federal income from the taxation of these particular securities.

The loss on the local level would far exceed that amount, so that I cannot relate these two figures together.

Plus the fact, as you have just brought out, the fact that this could be a changeable point first of all, and it is a historic first at this point, to remove the tax exemption.

Senator WILLIAMS. That is the point, but the loss on the local level to a large extent would be the reflection of this uncertainty in the municipal bond market.

Mr. MCCANN. No question about it.

Senator WILLIAMS. As to what some Congress may do later, not what we do today.

Mr. MCCANN. That is right. The people paying $35 million or $45 million or $80 million in taxes may in no way at all be related to the people who would have to foot the bill to make up the difference in the interest rate on the local level, and, subsidy or not, let us put it that way.

Senator WILLIAMS. Yes.

Senator MILLER. Well, of course, I think everybody is guessing on this. Nobody knows what the psychology is going to be. If the American people were told, if all of the cities and towns around the country were told, "Well, now, look, this is a form of indirect taxation," most people who hold tax-exempt municipal bonds are not going to pay any tax on it anyhow, because they do not even get into the area of the limit on tax-preference maximum, a great majority of them would not, but those who get over the 50 percent will have to pay some tax, but the total tax take is $35 million on a $2 billion payout, and the only reason this is being done is to satisfy the American people that there are not going to be any citizens of this country with large amounts of income who do not pay some tax.

I do not know how uncertain the bond market would get over that because somebody might say, "Well, now, they have done this, and they are going to do this," and I do not think it necessarily follows, because I, for one, would be very much opposed to this tax and subsidy thing that just because I might incline toward this limit on tax preferences, that does not force me to go any further at all, because I do feel that there is a principle involved here that has caused concern to every Member of Congress, and that is the number of our constituents who are concerned when they read articles that there are some people with high incomes who pay no tax, and that is not good from the standpoint of a general taxpayer.

We already have the reaction in the form of testimony by George Meany, president of the AFL-CIO, whose members receive wages taxable as ordinary income, and they are, some of them apparently are, so unhappy about that that now the AFL-CIO comes in here and tells Congress they think they ought to do away with capital gains.

So my point is that the reaction from reading these articles and from realizing that there are some people with large incomes who do not pay any tax is something to be considered.

But to measure the fact that $35 million of taxation on $2 billion of bonds is going to have a highly disturbing effect on the market, I must tell you, although I am no psychologist, taxes my credulity.

Mr. McCANN. Let me answer that in a little different manner, Senator. The report out of the House Ways and Means Committee by no means indicated a finality in this act, and that had a significant effect on the market, so it is more than just a psychology.

Senator MILLER. Wouldn't that have an effect on the market with all of these things in it?

Mr. McCANN. Of course.

Senator MILLER. Suppose the House Ways and Means Committee report had come out with only the limit on tax preferences, nothing else.

Mr. McCANN. I feel very strongly that if the limited tax preference had been incorporated as the only provision coming out of the House, and there was any attempt made for an inroad onto the municipal market itself that the effect probably would have been exactly the same.

Senator MILLER. Well, of course, we have got a lot of conjecture. I cannot agree with you that the effect would have been at all the same.

I can understand how there might have been a little effect because of the uncertainty, that maybe because the House had done this the Senate Finance Committee might start horsing around with taxation and subsidies and all that. But if that was all that was in it, I do not think you would have had nearly the impact on it. Of course, there is another thing that a lot of people are concerned about, and I share their concern, and I do not know anybody on this committee that does not share this concern, and that is another thing that has not been particularly talked about, but I think that some economists will tell you this has had even more impact on the bond market than some ideas advanced in the form of a piece of paper known as a tax bill from the House Ways and Means Committee in the House, and that is the inflationary situation.

It has been driving down the value of bonds and really doing a job on their salability in the market. So I do not think that this is all attributable to the House Ways and Means bill.

Mr. McCANN. That may be true, Senator.

However, I think that evidence has indicated as late as this afternoon that other market areas, being relatively stable, there was that impact in that very, very short period of time and this, of course, is a clear indication as the market goes as to what is taking place, and you can examine it rather closely at that point to decide what has triggered that change.

Under these circumstances, and the people in the field more versed in it than I am—I am only on the receiving end of the thing, but I am concerned about it, don't get me wrong by any means—the people versed in this field clearly indicate this was the underlying cause.

Senator MILLER. You are not going to tell us that before the House acted on this bill over there that the municipal bond market was not in deep trouble, are you?

Mr. McCANN. Oh, no, I do not mean to indicate it was not in deep trouble. Let us put it this way, it was not quite as deep.

Senator MILLER. I'll agree with you, and what the House bill did was to add insult to injury.

Mr. McCANN. That is correct, no question about it.

Senator MILLER. I think we can agree on that.

I only point out, my only point is, that I feel rather strongly about the reaction of the general taxpayer. I do not want to see that reaction go to such an extent as to do away with capital gains, which some of them want to do. I do not want to see it go to such an extent that they are going to have a tax on municipal bonds, as some of my colleagues, especially over in the House on the Joint Economic Committee, have advocated for some years, always over my vigorous protests, but you have got a number of people thinking that way, and some of them even talking about a subsidy, and I do not want to go to the extent of a taxation subsidy approach because of the potential, as the Governors pointed out.

But I do not know how we are going to handle this problem. If you have any suggestions on how to avoid taxpayers picking up the papers and reading where some people have got large incomes without paying any tax on it, I would sure welcome it because that is the question posed here. It may be that the collective judgment of the Congress may be that we will let them continue to pick up newspapers on that.

Mr. McCANN. One answer I can give you, Senator, I can give you the question, of the several individuals that you have mentioned who have been able to avoid taxation, and as to what is the exact breakdown, and I am talking from the municipal end of it, or to what extent do they have municipal holdings.

They may be insignificant, nonexistent for that matter, and yet it is the idea of throwing out the baby with the dirty water, I'm afraid.

Senator MILLER. I think Senator Baker made a good point on this the other day, you might have heard him. He indicated that he was questioning the hardness of the evidence of the Treasury backing up its figure of $35 million. I do not know where they got it, and the suggestion has already been advanced that we might include a box on the tax return form where you have to show the amount of your municipal bonds to permit the Treasury to get the hard evidence. So there is merit to that.

I appreciate your responses very much.

Thank you very much.

The CHAIRMAN. Thank you, gentlemen.

(Hon. Paul J. Manafort's prepared statement follows:)

PREPARED STATEMENT OF MAYOR PAUL J. MANAFORT

The Connecticut Conference of Mayors strongly opposes Federal taxation of interest on municipal bonds. This exemption is essential, if municipalities are to provide badly needed public facilities and to prevent further deterioration of their serious financial condition.

Municipalities in Connecticut, as in other States, are trying hard to meet the pressing needs for schools, streets, sewers, and other public facilities. These needs are greatest in the older cities, which are attempting to catch up with years of neglect, and in the suburbs which must adjust to new growth.

The interest on bonds for such facilities is one of the largest items of local government expense. Interest on each million dollars of bonding costs us about $500,000 over the life of our 20-year bonds. Every rise in the interest rate adds to our local tax burdens, and impairs our ability to provide essential public facilities and services.

Connecticut's cities and towns face mounting costs daily. Debt service costs for urgently needed public facilities are already staggeringly high.

In Connecticut, for example, municipalities completed $60 million in school construction projects last year—projects taking care of some 35,000 additional children. The interest on these schools alone will be roughly $15 million to the cities and $15 million to the State. Add to that the libraries, roads, police stations, and other facilities we have built and need to build, and the cost is immense.

These costs are difficult enough for cities to meet. Taxation of municipal bonds will result in higher interest rates. Wall Street municipal bond experts advise us that communities now paying from 5 to 6½% will have to pay 8 to 8½% interest to compete with corporate bonds. Communities with weaker financial structures—including some of those with the most difficult problems—may have to pay as much as 10 or 11%. Municipal bond experts advise us that fear of the legislation before your committee has already caused a 1% increase in the rate at which municipal bonds are now selling.

Higher interest rates will mean higher local taxes, bearing most heavily on those who can afford it the least.

The situation is particularly difficult in Connecticut. Our municipalities are straining to find adequate sources of revenue. Yet our cities must rely exclusively on the overburdened property tax. The State of Connecticut pays a smaller proportion of our local costs than in 45 other states. The property tax bears the rest.

The Federal and State governments should be helping cities solve urban problems, not adding to our burdens. It is unfair to single out municipal bonds for "reform" while other tax loopholes continue to exist. We should be getting more financial assistance, instead of being penalized.

We therefore strongly urge you not to include taxation of municipal bonds in the bill your Honorable Committee will report.

A copy of the resolution passed unanimously by the members of the Connecticut Conference of Mayors is attached.

RESOLUTION

Whereas, local property taxes are much too high, and as a result, municipalities are unable to provide all the needed services, and

Whereas, increasing the cost of financing schools, sewers, streets, and other very badly needed public facilities, through taxation of municipal bonds, would aggravate the problem by leading to high property taxes and diminished municipal services, and

Whereas, the Connecticut Confe‹ence of Mayors believes that every American should pay his fair share of taxes, but

Whereas, taxation of muncipal bonds will add further to the financial burden of all municipalities, and

Whereas, it is completely unreasonable to single out municipal bonds for "reform" while many other exemptions, favorable tax treatments, and loopholes will continue to exist, *now therefore*

Be it resolved that the Connecticut Conference of Mayors vigorously opposes Federal taxation of interest on municipal bonds.

The CHAIRMAN. The next witness is Mr. Irwin Karp, counsel, the Authors League of America.

STATEMENT OF IRWIN KARP, COUNSEL, THE AUTHORS LEAGUE OF AMERICA, INC.

Mr. KARP. Mr. Chairman and members of the committee, I have submitted a statement for the record, and I will try not to repeat too much in my presentation.

I appreciate very much this opportunity to appear before the committee, and I would like to discuss two aspects of the bill which are of great concern to authors, composers, artists, and other self-employed creative individuals.

The first is section 802, which would impose a 50-percent maximum tax rate, and the second is section 301 dealing with the averaging provisions of the Internal Revenue Code.

As to section 802, the authors league supports the section and believes it should be adopted, with one very strong reservation; namely, that as the section is now written it does not apply to authors, composers, artists and other individual taxpayers.

In my prepared statement, I have pointed out that this is probably mere inadvertence. I think that we are simply the victims of semantics. The purpose of section 802, as the chairman pointed out earlier in discussing this with Mr. Surrey, was to apply the limit only to earned income and not to income produced by capital.

However, in drawing the distinction between these two categories of income, the draftsmen of the bill borrowed a definition of "earned income" from section 911 of the Code.

Section 911 deals with an entirely different problem, the taxation of nonresident citizens. There "earned income" was very narrowly defined to include only income from personal services, because in giving an exemption to nonresident citizens in section 911, the Congress only wanted to extend the exemption to those people who actually had to go abroad to earn a living, who rendered services abroad.

Actually, personal service income is not the only type of earned income. People earn their income by various means. Authors and composers, for example, when they are self-employed, do not in the Treasury's eyes receive personal service income but the Treasury recognizes that their income is earned.

Consequently, if section 802 contains only the present definition, and does not include an additional definition, authors and these other people would be excluded from its benefits.

This problem has been before the committee once before in connection with the provisions of the Keogh Pension Act, now section 401 of the Code. There the right to participate was based on "earned income," and the definition was originally borrowed from section 911.

As this committee pointed out, it was not its intention to exclude authors and others who earn their income, and it added a further definition to section 401. We respectfully urge the committee to adopt that definition and add it to section 802.

I would like to say a word, if I may, as to why I think the 50 percent limit is important and should be added to the Code. First of all, as the House committee report points out, and as former Secretary of the Treasury, Mr. Barr, pointed out, present rates are extremely high. Mr. Barr terms them "confiscatory." Speaking for authors, I take my reference from a literary magazine, the Saturday Review of March 22, 1969, where at page 25, Secretary Barr said:

> Quite possibly the 50-percent maximum rate proposal would be the most significant aspect of tax reform. Ultimately, if the top rates could be reduced to 40 percent or 45 percent, with compensatory plugging of loopholes, then I think there would be a good chance to meet Secretary Kennedy's goal—

And he quotes—

> All Americans in similar circumstances paying approximately the same amount of tax.

I think that the provisions of 802 are a great step forward in that direction. As the chairman pointed out, because they are limited to earned income, they do not benefit those taxpayers who have a large amount of unearned income, and who are right now, according to the Treasury's tables, paying much less than 50 percent in tax on that income. They would benefit the comparatively few taxpayers who are in the $100,000 and above bracket who actually pay tax at the effective 50- to 70-percent rate.

Authors are usually in that group because they are particularly exposed to high bracket taxation in those few years when they are fortunate enough to make a considerable amount of money. Because they are self-employed, they cannot avail themselves of the tax shelters and deferment plans, that people who own businesses or who are highly paid executives of corporations can take advantage of.

I also think that the application of the 50 percent maximum rate, would remove a considerable obstacle to independent creativity. Actually, the high rates today serve to drive many creative people out of doing independent work and into working as employees—doing the same kind of work but subject to the control of an employer because it is much easier, safer, and more lucrative to work for somebody else, with the rates being what they are today.

The second provision of the act which is of concern to us is section 311 which would modify section 1301 of the Code.

When this committee approved section 1301 in 1964, its report pointed out that the purpose of the section was to permit taxpayers with fluctuating income to pay tax at a rate equivalent to that paid by other taxpayers earning the same amount of income but receiving it proportionately over a long period of time pay. Because authors, athletes, actors, and other people whose income fluctuates widely happen to have their income concentrated in a few years, it is taxed at a much higher rate, and more of it is actually paid in taxes.

In 1964, the Code was amended to permit the averaging of this excess income—to permit a taxpayer whose income in a given year exceeded by a third his average of the preceding 4 years, to pay a tax on that excess income, according to a formula which, in effect, taxed it as if it had been received proportionately over 5 years—the 4 years of the base period and the current year.

This has helped a lot but it has not met the problem of the individual (such as the author) who labors for many years, 6, 7, 8, or 9 years, and produces a work which in 1 or 2 years earns a great deal of money; nor the individual—the author or the athlete or the actor—who spends many years at his profession or at his art, is not successful financially, but suddenly has a period of 2 or 3 years where he earns a lot of money.

In the first instance the 4-year base period just does not spread the income over the same period of time that in actuality he spent producing it. We have proposed in our statement to the committee the possibility of adding two alternative base periods so that such a taxpayer could elect a longer period. We propose there be periods of 3, 4, and 6 years, but we are not wedded to any particular number of years.

A taxpayer could elect the longer period if his income in the current year exceeded the base period by a great amount. In other words, the more that income in a current year exceeds the average income of a longer base period, the more likely it is that it is the product of a longer period of work.

Under our proposal, the taxpayer whose income in the current year is at least 20 percent of the prior 3 years could average over those years. The House committee proposed 20 percent for a 4-year base period; we suggested 33⅓ percent.

At the other end of the scale, if his income in the current year were, say, 40 percent—a considerably higher amount—above the average of the preceding 6 years, he could average over the 6-year period.

We think this approach would more closely approximate the purpose of averaging which is to have a tax rate on this kind of income reach some equivalence with the income tax paid by individuals who earn the same amount over the same period of time but receives it gradually.

Those are the two proposals we submit for your consideration.

The CHAIRMAN. Well, let me see, how many years do you want to average across now? Right now you can average over 5 years, as I understand it?

Mr. KARP. Over 5 years.

The CHAIRMAN. You take this year and average it with the four previous ones; right?

Mr. KARP. That is right, Mr. Chairman.

The CHAIRMAN. How many do you want to put into that?

Mr. KARP. We propose 6 years plus the current year, which would make a total of 7 years as the maximum period. But with a much higher requirement to elect that longer period. The excess income in the current year must be higher than the 20 percent—for the 5-year period. It would have to be 40 percent.

The CHAIRMAN. Right.

Now, give me your example, if you would, please, of the kind of case that you think would require 7 years.

Mr. KARP. I can think, without actually knowing the gentleman's personal financial problems, of an author like William Shirer, who spent almost that much time writing the "Rise and Fall of the Third

Reich," and who has now spent as much time writing a history of the French Third Republic. Since the "Rise and Fall of the Third Reich," which was almost 6 years ago, he has thus been at work on one book, which will be published, I think, this year. If it succeeds he will have in 1 or 2 years the fruit of approximately 6 years of labor.

The CHAIRMAN. Well, you could say, I guess, the same thing about someone who is an inventor who works over a period of many years, perhaps even longer than 7 years. Let us assume for the sake of argument some fellow—and usually this is done in a big research organization—but if some individual person who was working on an invention, suppose something, for example, he is trying to find a cure for cancer, and he worked on it over a period of 15 years, and eventually he did come up with it, it would stand to reason that he should not be taxed all of that in 1 or 2 years, but that he should have it spread over a longer period of time.

Inventors, I guess, would be an example, too; wouldn't they?

Mr. KARP. Yes; inventors would be covered by this, as they are now; lawyers, doctors, any self-employed person or any person who is an employee for that matter, who had this concentrated income. That is how the law works today.

We are just suggesting a change to add two additional base periods. It is not confined to authors or inventors.

The CHAIRMAN. Well, I was trying to recall—I believe when I was on the Interior Committee—a lawyer pleading one of these Indian claims cases, was told if a lawyer is going to take one of these old Indian claims cases he ought to be a young lawyer, otherwise he would not live long enough to see it to a conclusion.

So that that type of thing justifies an even broader averaging than just the 5 years.

Mr. KARP. Yes, sir.

The CHAIRMAN. All right.

Thank you.

Senator Miller.

I am going to leave this with Senator Miller.

Senator MILLER. I have no further questions.

The CHAIRMAN. Senator Miller usually has a depth of intellectual curiosity that makes him want to delve into some of these things more deeply, so I thought he might have been intrigued by your testimony here today.

Senator MILLER. Mr. Chairman, I was impressed by the testimony, and I think that this is the kind of testimony that we like to get where not only do we receive some criticism of a bill but we receive some suggestions, and not just one but we are given some options.

I was only going to make this point, and that is that it seems to me that the longer we go back beyond the years the more difficulty we have from an administration standpoint. The average taxpayer does pretty well to save his tax records back 3 years, and he does wonderfully well to save them for 5 years, but if we keep pushing it back we won't have the kind of information we need to have to substantiate tax returns, and my instinctive reaction, looking at the administrative side of it, would be to go with the 3-year approach to it.

Mr. KARP. I think that could be possible, although, with an incentive, I think many people would save their tax returns a little longer.

Senator MILLER. Especially authors.

Mr. KARP. Especially authors.

Senator MILLER. Yes.

We appreciated your testimony very much. Thank you.

(Mr. Karp's prepared statement follows:)

STATEMENT OF IRWIN KARP, COUNSEL, THE AUTHORS LEAGUE OF AMERICA

SUMMARY

Sec. 802—The 50% tax limit

1. The 50% tax limit would not apply to authors, dramatists and composers under the present definition of "earned income", which is restrcited to income from "personal service".

2. The 50% limit was incended to apply to income *carned* by a taxpayer's personal efforts—as distinguished from income produced by the use of capital. An author's income is "earned income".

3. "Earned income" should be defined to include income derived by an author from the disposition of rights to use his works [as in Sec. 401(c) (2) (C) (IRC)].

4. The 50% limit would provide a more equitable tax rate and would eliminate a formidable deterrent to independent creative work.

Sec. 311—Income averaging

1. Sec. 1301 (IRC) does not provide equitable taxation of an author when his income from one or two works, resulting from the creative effort of several years, is concentrated in the upper brackets of one or two tax years.

2. Section 1301 should be revised to permit the use of 3 alternative base periods for "income averaging"; the extent to which current income must exceed the average of a given period to increase in relation to the length of the period.

My name is Irwin Karp. I am counsel of The Authors League of America, a national society of professional writers and dramatists and submit this statement on its behalf.

The Authors League urges the Committee to extend the protection of the proposed 50% tax limit to authors, composers and dramatists. It also requests the Committee to consider revisions in the "tax-averaging" provisions which are described below.

Sec. 802—The 50% limit

Section 802 would limit the maximum tax rate on earned income to 50%. The Authors League believes that this maximum rate should be adopted. However, the proposed new section od the Code (Sec. 1438, IRC) would not—as written—apply the 50% limit to writers, dramatists, poets, composers, artists and persons in other creative occupations. They would continue to pay taxes ranging up to 70%, if their earnings were substantial. These individuals should not be taxed at higher rates than corporate executives and employees, lawyers and doctors, actors or professional athletes. Yet that would be the result, unless 802 is amended to include a more reasonable definition of "earned income".

We believe that the exclusion of authors from the 50% limit was inadvertent. The limit was intended to apply to income *carned* by a taxpayer's personal efforts—and not to income produced by the use of capital. However, to draw the line, a definition of "earned income" was incorporated from Sec. 911(b) of the Code. But that definition was formulated to serve the particular purposes of Sec. 911 which exempts income earned by certain non-resident citizens from tax. The Sec. 911 definition consequently limited "earned income" to salaries and other income from "personal services"—to confine the exemption to those citizens who are required tolive abroad, i.e., those who earn their living by rendering services in other countries.

The Sec. 911 definition does not include other forms of income earned by a taxpayer's work and personal efforts, such as income earned by writing, composing and other creative occupatons. Thus, while the Internal Revenue Service (and the Code) recognize that a self-employed author *earns* income by creating a book or play, it contends that this does not constitute income from "personal services" as that term is used in Sec. 911. Consequently, if Sec. 802 only applies to income falling with the Sec. 911 defintion, authors will not be protected by the 50% limit.

Congress resolved the same dilemma in 1966 when it amended Sec. 401 (IRC) which permits self-employed taxpayers to make deductible contributions to retirement plans based on their "earned income". That section originally defined "earned income" by incorporating the definition of Sec. 911(b). As this Committee noted, IRS took the position that a free-lance author's income was not compensation for personal services and therefore not "earned income". (Sen. Rep. No. 1707, 89th Cong. 2nd Sess.) The Committee said:

". . . The intent of the Congress in adopting the 'earned income' concept was to limit the applicability of these provisions to the portion of a self-employed person's income which was a result of his individual efforts as distinguished from a return on capital. Your committee does not believe that for this purpose the classification of income from an author's writing (or an inventor's invention), which is so clearly a result of his individual efforts, as 'earned' or 'not earned' should depend upon the terms of the contract under which the author (or inventor) is to be compensated."

Similarly, self-employed authors' income should be recognized as "earned income" under Sec. 802. It as as much *earned* by his work and personal efforts as are the fees paid to a lawyer or doctor, or the salary paid to a corporate executive, or the writer who works as an employee. The only difference is that the free-lance author translates his creative work into earnings by licensing or selling rights in his book or play, rather than by doing the work under a professional retainer, or an employment relationship.

The Internal Revenue Code classifies an author's earnings as income produced by his personal efforts; not as income derived from the use of capital. Sec. 1221 prohibits an author from treating his book or play as a capital asset; and denies him the right to claim a capital gain on any disposition of his work. Congress enacted this provision in 1950 on ground that an author's income was the result of his personal efforts and should therefore be taxed as ordinary income. (House Report No. 2319, 81st Cong. 2nd Sess.)

We respectfully urge that Sec. 802 be amended to apply the 50% limit to income earned by self-employed authors (and by composers, artists and other creative persons)—i.e., the income they derive by licensing, selling or otherwise disposing of the works they create. This could be accomplished by inserting in Section 802 the additional definition of "earned income" contained in Section 401:

"(C)—Income from disposition of Certain Property.—For purposes of this section, the term 'earned income' includes gains (other than any gain which is treated under any provision of this chapter as gain from the sale or exchange of a capital asset) and net earnings derived from the sale or other disposition of, the transfer of any interest in, or the licensing of the use of property (other than good will) by an individual whose personal efforts created such property."

The Authors League believes that the 50% limit should be adopted. The present upper-bracket rates are "extremely high" and "unrealistic" (H. Rep. 91–413, page 208); and patently unfair to the individual who earns his income rather than derives it from "capital gains" investments. The rates impose a particularly heavy penalty on individuals such as authors and artists whose few years of high income are the result of many years of poorly compensated work. The tax averaging provisions of the Code, even improved as the Reform Act proposes (or as we suggest) cannot, in many instances, mitigate the confiscatory effect of these rates.

Furthermore, the present rates deter authors from independent creative work. Writing a book or play requires the self-employed author to expend a great deal of time (months or years) and money, to support himself and his family. If the work fails he loses everything; he has no loss deduction. The odds against success are high; free-lance writing is a high-risk occupation. Add to this the fact that if the book succeeds, as much as 70% of its earnings will go to the federal government in taxes (plus an additional slice for state tax), and it is understandable that some very talented writers frequently decide not to enter the contest.

It is much safer for an author to hire out to a motion picture company, magazine or other employer. He cannot write the book or play he would have created as a free-lance. But his writing is guaranteed to produce salaried income, whether the work succeeds or fails. And the money he would have used to finance a free-lance work can be invested in securities. Even in today's market, the risk is less; and any gain would cost him 25% (plus surtax) rather than 70%. What we lose is the book or play he might have created had the tax rates not made risk of independent work so exorbitant, a book or play that might have enriched our culture.

The Authors League believes that the 50% maximum tax rate would remove this formidable obstacle to independent writing and provide a more equitable tax system.

Sec. 311—Income averaging

Section 1301 of the Code was designed to eliminate unfair taxation of individuals whose compensation for several years of work is concentrated in one or two comparatively high income years. For example, the author who spends years, with little return, writing a book which produces substantial income in the year it is published. Or, the dramatist who creates several plays over a period of years, sees some score artistic success, but only has one that produces substantial income for a year or two. When the return for several years of work is concentrated in one or two years, it becomes high-backet income, taxed much more heavily than if it had been received gradually over the period of work.

Section 311 of the Bill would liberalize Sec. 1301 by permitting current income to be "averaged" when it was 20% (rather than 33⅓%) greater than average income in the prior 4 years. However, this improvement would not reach two areas of difficulty under the present section. The averaging formula imposes a tax on an individual's "concentrated income" which approximates the tax he would have paid had it been received ratably during the previous four years and the current year. But for some taxpayers, including many authors, the concentrated income represents the result of a much longer period of work. Limiting "averaging" to a five year period still produces harsh results: it does not leave such an individual with a fair share of "after-tax" income to compensate him for his years of work. Had the income been spread over the period of work, it would have been taxed at lower rates (often much lower than the 50% maximum of Sec. 802).

On the other hand an author may over a period of many years have only two successful works; but be unfortunate enough to have the second success occur within four years of the first. The income from the first work raises his four-year average to the point where he cannot apply Section 1301 to the windfall income of the second work and he is taxed at the high-bracket rates of the year in which the income was received.

To meet both problems, we respectfully suggest that Sec. 1301 be revised to allow an individual to elect one of three alternative "base periods":

(i) if his current year's income exceeds his average annual income for the three (3) previous years by at least 20%, he may compute the tax on the excess as if it had been received ratably during the prior 3 years and the current year;

(ii) if his current year's income exceeds his average annual income for the preceding four (4) years by at least 33⅓%, he may compute the tax on the excess as if it had been received ratably during the prior 4 years and the current year; and

(iii) if his current year's income exceeds his average annual income for the preceding six (6) years by at least 40%, he may compute the tax on the excess as if it had been received ratably during the prior 6 years and the current year.

The length of the base period would depend on the extent to which current income exceeded the average for prior years. Since a greater increase is more likely to be the result of a longer period of work, this formula would produce a closer approximation of the tax that would have been paid had the income been received ratably during that period. In each case, the method of computation provided in Sec. 1301 would apply, adjusted for the number of years in the applicable base period.

Other sections of the Internal Revenue Code allow a taxpayer to choose between alternative methods of "receiving" income, and taking deductions, amortization and depreciation—thus affecting the amount of tax to be paid. For Example: under Section 167 a corporate or individual taxpayer may select various methods of depreciation; under Section 451, they may report income on a completed contract or percentage of completion method: under Section 453, they may report income in the year a sale is made or over a period of years, on an installment basis.

We believe this change would provide more equitable taxation of self-employed authors, composers and artists, athletes, actors, musicians and others engaged in occupations where income fluctuates widely over a period of years.

Sec. 331—Minimum tax on deferred compensation

Sec. 331 of the Bill would place a minimum tax on deferred compensation for personal services. By its terms, the Section does not apply to periodic payments to authors under the "spread forward" provisions of publishing contracts; nor does the tax formula appear to have been drawn with any intention that it apply to such payments. However, if any changes are to be made in the Section which would effect payments under these contracts, we respectfully request the opportunity to submit a statement. The circumstances involved in such contracts are quite different from those involved in provisions for deferred compensation of employees; and imposition of the minimum tax on payments under these contracts would produce substantial inequities.

(The following communications were received by the committee expressing an interest in the subject of income averaging:)

THE AUTHORS LEAGUE OF AMERICA, INC.,
New York, N.Y., July 31, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate,
Washington, D.C.

DEAR CHAIRMAN LONG: The Authors League of America respectfully submits the following suggestion for revision of the "averaging provisions" of the Internal Revenue Code (Sec. 1301). We understand that changes in the Section are being considered by the House Ways and Means Committee.

Section 1301 was designed to eliminate unfair taxation of individuals whose compensation for several years of work is concentrated in one or two comparatively high income years. For example, the author who spends years, with little return, writing a book which produces substantial income the year it is published. Or, the dramatist who creates several plays over a period of years, sees some score artistic success, but only has one that produces substantial income for a year or two. When the return for several years of work is concentrated in one or two years, it becomes high-bracket income, taxed much more heavily than if it had been received gradually over the period of work.

While Section 1301 has reduced this inequity, it has not produced fair tax results in many instances. The House Ways and Means Committee, recognizing this, is considering various revisions to make the Section more equitable. We understand that one contemplated change would permit an individual to compute his tax under the "averaging" formula when his current income is at least 25% above his averaging income for the four preceding years. At present, "averaging" is only allowed if current income is at least 33⅓% higher than the average of the prior four years.

While this is an improvement, it would not eliminate inequities in two areas. The averaging formula of Sec. 1301 is designed to impose a tax on an individual's "concentrated income" (the amount exceeding 133⅓% of his four year average) which approximates the taxes he would have paid had it been received ratably during the previous four years and the current year. But for some taxpayers, including many authors, the concentrated income truly represents the result of a much longer period of work. Limiting "averaging" to a five year period still produces harsh results; it does not leave such an individual with a fair share of "after-tax" income to compensate him for his years of work.

On the other hand an author may over a period of many years have only two successful works; but be unfortunate enough to have the second success occur within four years of the first. The income from the first work raises his four-year average to the point where he cannot apply Section 1301 to the windfall income of the second work and he is taxed at the high-bracket rates of the year in which the income was received.

To meet both problems, we respectfully suggest that Sec. 1301 be revised to allow an individual to elect one of three alternative "base periods":

(i) if his current year's income exceeds his average annual income for the three (3) years by at least 25%, he may compute the tax on the excess as if it had been received ratably during the prior 3 years and the current year.

(ii) if his current year's income exceeds his average annual income for the preceding four (4) years by at least 33⅓%, he may compute the tax on the excess as if it had been received ratably during the prior 4 years and the current year.

(iii) if his current year's income exceeds his average annual income for the preceding six (6) years by at least 40%, he may compute the tax on the excess as if it had been received ratably during the prior 6 years and the current year.

A taxpayer would be entitled to elect any one of the three alternatives, provided he met the requirements. In each case, the method of computation provided in Sec. 1301 would apply, adjusted for the number of years in the applicable base period.

As you know several other sections of the Internal Revenue Code allow a taxpayer to choose between alternative methods of "receiving" income, and taking deductions, amortization and depreciation—thus affecting the amount of tax to be paid. For example: under Section 167 a corporate or individual taxpayer may select various methods of depreciation; under Section 451, they may report income on a completed contract or percentage of completion method; under Section 453, they may report income in the year a sale is made or over a period of years, on an installment basis.

We believe this change would produce more equitable taxation of free-lance authors, composers and artists, of athletes, actors and musicians and of other self-employed individuals. It would not give them an advantage over other taxpayers. As self-employed persons, in high risk vocations, they are now paying more taxes on their total income than do employees of corporations and other businesses (often with much higher incomes) who have the advantage of constant salary income, bonuses, stock options and deferred compensation—remuneration which is spread over a far longer period of time.

We respectfully urge your favorable consideration of this suggested amendment.

Respectfully yours,

JEROME WEIDMAN, *President.*

ARTHUR ANDERSEN & Co.,
Chicago, Ill., September 18, 1969.

Re Statement Regarding H.R. 13270 Tax Reform Act of 1969.

COMMITTEE ON FINANCE,
New Senate Office Building,
Washington, D.C.

DEAR SIRS: The primary reasons given for revision of the income averaging provisions are simplification and equity, yet, the effective date for the new provisions is for taxable years beginning after December 31, 1969. Apart from any effect on revenue, there appears to be no justification for prolonging the complications and inequities of the income averaging computation. We suggest that the proposed income averaging provisions be effective for the calendar year 1969 as well.

This statement is submitted as part of a series of letters, each dealing with a particular area or the proposed legislation. It is intended that the comments and recommendations contained herein be made part of the record of testimony relative to the legislative changes contemplated for income averaging. We shall be pleased to discuss these matters further with you or the Committee, either in person or by telephone. Please call us collect at 312-346-6262 if necessary.

Very truly yours,

JOHN MENDENHALL, *Director of Taxes.*

The CHAIRMAN. The committee will be in recess; we will adjourn until tomorrow morning at 9:30.

(Whereupon, at 4:35 p.m., the committee adjourned, to reconvene at 9:30 a.m., Friday, September 26, 1969.)

APPENDIX A

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECT OF FARM LOSSES

Written Testimony Received by the Committee Expressing an Interest in the Subject of Farm Losses

UPHAM, MEEKER & WEITHORN,
New York, N.Y., August 25, 1969.

Re: Comments and Suggestions *re Tax Reform Act of 1969.*

COMMITTEE ON FINANCE,
U.S. Senate,
New Senate Office Building,
Washington, D.C.

GENTLEMEN: This letter comments upon several aspects of H.R. 13270 (as passed by the House on August 7, 1969) 91st Cong., 1st Sess., i.e., Sections 211 (gains from dispositions of farm property), 213 (hobby losses), 221 (limitations on deduction of interest), and 302 (allocation of deductions) All of the comments concern the fact that the provisions in question are, to some extent, inconsistent with the stated purposes thereof.

SECTION 211

The ordinary income treatment provided for by new Section 1251 extends to situations beyond those apparently intended to be covered in accordance with the stated purpose of the Section. Therefore, it is respectfully suggested that Section 1251 be revised to limit its operation in conformity with such purpose, as described below.

It is stated, at pages 62–66 of the Report of the House Committee on Ways and Means (Part 1) ("House Report") that the abuse against which Section 1251 is directed is the conversion, under present law, of ordinary income into capital gain. Such abuse is effected by the deduction of farm losses under circumstances where ordinary nonfarm income is offset. Since the farm expenditures so deducted do not enter into the tax computation of the tax basis of the farm asset to which they relate, the net effect is to increase the capital gain realized on the eventual sale of such asset. Because the reduction of ordinary income results in a greater tax saving than the larger tax incurred due to the increased capital gain, there is a substantial net tax benefit to the taxpayer. (House Report, at p. 63.) Section 1251 would diminish, or eliminate, such tax benefit by providing ordinary income treatment upon the disposition of certain farm properties, which disposition otherwise would result in capital gains, to the extent of the taxpayer's "excess deductions account".

The tax abuse against which Section 1251 is directed, i.e , the conversion of ordinary income into capital gains, does not occur where the farm loss is, in fact, deducted against nonfarm long-term capital gains. However, while the determination of the amount of the "excess deductions account" under Section 1251(b)(3)(A) does require a reduction of such account "for deductions which did not result in a reduction of the taxpayer's tax . . . for the taxable year or any preceding year . . .", no similar adjustment is required for deductions which were applied against long-term capital gains.

Where farm losses have been deducted against nonfarm capital gains, Section 1251, in its present form, goes beyond its stated purpose to prevent the conversion of ordinary income into capital gain. It converts what otherwise would be capital gain into ordinary income, even though the taxpayer has not enjoyed the advantage against which the provision is aimed. Thus, in the name of preventing taxpayer abuse, an apparently unintended inequity has been created.

It is, therefore, respectfully suggested that Section 1251(d)(3)(A) be revised, in order to eliminate the above described inequity, to read as follows—

"(A) an amount equal to the farm net income for such year, plus the amounts (determined as provided in regulations prescribed by the Secretary or his delegate) necessary to adjust the account for deductions which (*i*) did not result in a reduction of the taxpayer's tax under this subtitle for the taxable year or any preceding taxable year (including such amounts which did not result in a reduction of tax because of the application of section 84 (relating to limit on tax preferences)), or (*ii*) *were applied in the reduction of long-term capital gains*, and"

SECTION 213

The House Report states (at p. 71) that the new hobby loss provision, Section 270, as amended, reflects existing case law. As such, it is said to be preferable to the tests of existing Section 270. If it is correct that the new statutory provision is based on existing case law, it is not explained why a new statutory provision is necessary. However, there is a fundamental difference between existing case law, under which the allowance of deductions is dependent upon the taxpayer's intention to earn a profit, and the rule of new Section 270, which depends on the reasonablenes of the taxpayer's expectation of profit. Section 270, as amended, appears onerous and raises many difficult technical questions. It is respectfully suggested that Section 270 be revised to correspond more closely with present case law, or that the handling of the hobby loss problem be left to the courts, which appear to have dealt adequately with it in the past.

The overwhelming majority of the courts have held that the taxpayer's intention or motive to earn a profit from an activity determines the allowability of deductions connected therewith. See *McGowan* v. *Commissioner*, 347 F. 2d 728 (7th Cir. 1965) ; *Lamont* v. *Commissioner*, 339 F. 2d 377 (2d Cir. 1965) ; *Howell* v. *Commissioner*, 332 F. 2d 428 (3d Cir. 1964) ; *Hirsch* v. *Commissioner*, 315 F. 2d 731 (9th Cir. 1963) ; *Broderick* v. *Derby*, 236 F. 2d 35 (10th Cir. 1956) ; *White* v. *Commissioner*, 227 F. 2d 779 (6th Cir. 1955) ; *Coffcy* v. *Commissioner*, 141 F. 2d 204 (5th Cir. 1944). While the reasonableness of a taxpayer's expectation of profit may, in fact, be evidence of his motive, we have found no case in which such *expectation* was held to be the ultimate test. On the contrary, the Courts of Appeals for the Second and Fourth circuits, and the Tax Court, have expressly rejected the reasonable expectation test. See the *Lamont* and *Hirsch* cases, cited above, and *Valentine Howell*, 41 T.C. 13 (1963), aff'd. per curiam, 332 F. 2d 428 (3d Cir. 1964).

The reasonable expectation test should not be used, primarily because it penalizes honest business mistakes, as well as for the other reasons discussed below. Many new businesses entered into solely for profit, as well as with high expectations prove, on hindsight, to have been ill conceived. It is often difficult to show, in retrospect, that the prospects for success of a business with a continuing loss history initially were, in fact, reasonable. Yet, if an entrepreneur were ill advised, his deductions would be denied under Section 270, as amended, irrespective of his motives. We submit that such a result is fundamentally unfair.

The ultimate test of deductibility should be, as it is under present law (apart from Section 270, I.R.C.), the taxpayer's intent to make a profit. It may be contended that such test is difficult to administer, resting as it does on subjective intent, and that a more objective criterion would limit tax avoidance in this area. It is doubtful that this is correct. The correlation between the existence of a profit motive and a reasonable expectation of profit will vary greatly from case to case. Moreover, even the House Report does not state that the application of the intent test by the Courts has allowed substantial tax avoidance.

Indeed, it appars that the intent test has been applied very effectively, and without undue leniency, by the courts. This is indicated to some extent by the fact that all of the cases cited above, except the *Derby* case, resulted in the disallowance of loss deductions, including those cases in which the reasonable expectation of profit test was expressly rejected. (The above cases were selected on the basis of the fact that they appear to represent recent expressions of the Courts of Appeals in question. There are dozens of cases in this area other than those cited which also hold for the Government.) There is substantial reason to doubt that the proposed statutory provision would more effectively prevent avoidance than does present law, and the net result probably would be to disallow losses resulting from profit-seeking ventures which went awry.

Moreover, the proposed form of new Section 270 seems inadequate and would raise difficult interpretative questions (for example, whether "profits" corresponds to taxable income or some other concept). To illustrate, suppose a business is begun with assets having a high tax basis, in excess of value. Although the enterprise is operated on a sound economic basis, tax losses may be expected to result because of high depreciation deductions. Or, suppose the fairly common situation of an operating business which has become unprofitable after years of success, and, although there is no substantial prospect of current profits the business is continued in the hope of a future turn, which hope eventually proves to have been unreasonable. Or, further, suppose an unprofitable business is continued for a period of time, without any expectation of profits, so as to permit an orderly liquidation of assets which might minimize or prevent additional losses. It appears that all of the above described situations, as well as other similar situations, could or would undeservedly be adversely affected by the proposed section.

The people of this Nation rightly take pride in their spirit of enterpirse, and most of our presently large and successful business organizations started small and with dubious prospects. Many new businesses, with good prospects, do fail, for a variety of reasons. To subject any substantial number of those entrepreneurs whose businesses have failed to the burden of a hindsight examination of the reasonableness of their profit prospects seems disproportionate to the problem, and would, in some measure, discourage new enterprise.

It seems preferable, in view of the above described potential for inequity, to leave matters in their present state. If, as seems to be suggested by the House Report, the continued existence of present Section 270 in the Code will cause too much administrative reliance on its provisions, and insufficient use of the profit motive test, then Section 270 should be repealed.

SECTION 221

There is a possible construction of the term "investment interest", as defined in Section 163(d)(3)(D), as amended, which would disallow, as a deduction against rents from real property, the interest on a debt incurred to purchase such real property. According to the House Report, such a construction appears not to have been intended. But, in the interest of certainty and clarity, Section 163(d) should be revised to more clearly effectuate such intent.

Section 163(d)(1) disallows "investment interest" (with exceptions not here relevant) in excess of "net investment income." The latter term does not include rents derived from a business. See Section 163(d)(1) (A) and (C), as amended. But, under the possible interpretation here discussed, "investment interest" could arise from property used in a business.[1]

The combined application of these rules would result in interest being disallowed as a deduction against income from the very same property as gave rise (via a debt incurred to purchase the property) to such interest.

Section 163(d)(3)(A), as amended, defines "investment income" to include rents, etc., and gains from the disposition of "property held for investment." Income or gains "derived from the conduct of a trade or business" are expressly excluded from "investment income." As an original proposition, it might have been concluded that the term "property held for investment," without more, does not include property used in a business. But, the use of an express exclusion in Section 163(d) (3) (A) results in a strong contrary implication.

Section 163(d)(3)(D) defines "investment interest" as interest on debts incurred to purchase or carry "property held for investment." Therefore, under the above described implication regarding the meaning of "property held for investment" derived from Section 163(d) (3) (A), above, "investment interest" may include interest on debts incurred to purchase or carry property used in a business. The interpretation of investment interest as including interest incurred in a business is further strengthened by new Section 277(c)(1)(B) (relating to "Allocation of Deductions"). That Section refers to "interest . . . incurred in the conduct of a . . . business (other than for investment interest, as defined in Section 163(d)(3)(D) . . .)." Here, the express exception of investment interest from interest incurred in a business implies that it is possible for investment interest to be incurred in the conduct of a business.

Despite the above described support for this interpretation, the Committee Report clearly indicates that such a result was not intended. The Report states (at p. 73), in explanation of the section, ". . . interest on funds borrowed in connection with a trade or business would not be affected by the limitation." If the above described interpretation of "investment interest" were to prevail, otherwise valid interest deductions incurred in a business would be disallowed without any reason.

[1] It is clear that real estate held for the production of rental income, and which may therefore be viewed as held for investment, may also be treated as property used in business. See e.g., *Gilford* v. *Commissioner*, 201 F. 2d 735 (2d Cir. 1953); *Fackler* v. *Commissioner*, 133 F. 2d 509 (6th Cir. 1943), and Regs., Section 1.355–1(d), example 4.

Therefore, it is respectfully suggested that Section 163(d) (3) (D) be amended to read as follows:

"(D) INVESTMENT INTEREST—The term "investment interest" means interest paid or accrued on indebtedness incurred or continued to purchase or carry property held for investment, *but only such property as is not used in the conduct of a trade or business.*"

SECTION 302

The possible interpretation of the term "investment interest", discussed above, also affects the operation of new Section 277 of the Code. Such interpretation would result in treament inconsistent with the stated purpose of Section 277. Therefore, Section 277 should be revised in conformity with that purpose.

Under the possible interpretation of "investment interest," discussed above, Section 277 would require the allocation of interest incurred in carrying on a business. See Section 277(c) (1) (A) (i) and 277(c) (1) (B). That such an interpretation of "investment interest" was not intended is indicated in the above discussion of Section 221.

Moreover, allocation of interest incurred in a business would be inconsistent with the avowed purpose of Section 277. It is stated (at p. 82 of the Report) that allocation of a deduction is required only where it is reasonable to assume that a portion of the pertinent expense is met out of nontaxable income. Such an assumption is not reasonable in the case of any business expense, including interest incurred in a business. Section 277 does not include business expenses among the "allocable expenses" set forth in Section 277(C) (1) (A), and Section 277(c) (1) (B) expressly excludes from the operation of the Section all taxes and interest incurred in a business, subject to the above discussed possible exception with respect to "investment interest." No reason is stated, nor does any exist, why interest expense incurred in business should be treated differently from any other business expense.

It is therefore respectfully suggested that Section 277(c) (1) (B) be revised to read as follows:

"(B) EXCEPTION—Subparagraph (A) shall not apply to interest and taxes paid or incurred in the conduct of a trade or business."

Very truly yours,

RAYMOND RUBIN.
STANLEY S. WEITHORN.

NATIONAL WOOL GROWERS ASSOCIATION,
Salt Lake City, Utah, September 15, 1969.

Honorable RUSSELL B. LONG,
U.S. Senate, Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: The National Wool Growers Association is joining with the National Livestock Tax Committee in opposing the following provisions of the House-passed tax bill because of their potential for large-scale damage to the livestock industry:

1. Excess Deduction Account (EDA)—EDA will tend to eliminate the use of the cash basis of accounting utilized by ranchers and farmers throughout the country. EDA could require sheepmen and cattlemen to switch to the impossibly complex and virtually unenforceable strict accrual accounting system.

Also, under EDA, capital gains on the sale of ranch land would be abolished to the extent of soil, water, and land clearing expenses claimed in the five years prior to the sale.

2. Operating ranch without profit motive—This dangerous provision of the Tax Reform Act would make the presumption that if a ranch showed losses of $25,000 or more in three out of five consecutive years, then even a bona fide sheepman or cattleman who has been in business all his life would legally need to prove he was in business to make a profit, and therefore could lose all farm loss deductions unless he made such showing.

3. Limit on Tax Preferences (LTP)—LTP is an attempt to limit the amount of certain "tax preferences" a rancher could claim in one year; such "tax preferences" could include the amount by which farm losses calculated on the cash basis, exlusive of capital gains and losses on farm assets, exceed the farm losses calculated under the strict accrual method. In other words, the rancher would need to keep two sets of books—one on the cash basis, and the other on the strict accrual basis.

4. Allocation of Deductions—In addition to the provision on LTP, the Act would also limit certain personal deductions by non-corporate taxpayers which are fully allowable under present tax rules, based on the amount of "tax preferences" which would include certain farm losses.

In lieu of these provisions, we strongly support the positive approach taken bythe National Livestock Tax Committee which will be presented before the Senate Finance Committee on September 22nd. The proposals of the National Livestock Tax Committee would eliminate tax profiteering by a few iwthout inflicting substantial damage to the livestock industry.

We would greatly appreciate your support of the Tax Committee proposals.

Sincerely,

EDWIN E. MARSH,
Executive Secretary.

SHEEP AND GOAT RAISERS ASSOCIATION,
San Angelo, Tex., September 3, 1969.

Honorable RALPH YARBOROUGH,
U.S. Senate,
Senate Office Building,
Washington, D.C.

DEAR SENATOR YARBOROUGH: The actual physical structure of the livestock industry may be partially at stake because of some of the proposed tax reforms. There are two particular reforms which we feel would be extremely detrimental to the livestock industry. These are the abolishment of the cash basis of accounting, and the portion known as the Excess Dedutcion Account, which would under certain conditions reduce or eliminate capital gains on livestock used for breeding purposes.

As you are well aware, the livestock industry has long been on the cash basis and has become accustomed to this type of accounting system. Under some of the proposals, deductions could not be made for production and other costs until the livestock is sold. Also, land clearing and soil and water conservation expenses could not be deducted, rather they would be capitalized.

Senator Yarborough, we feel that all of this is totally unneeded, and we would urge that you oppose this legislation. Further, we urge that you contact members of the Senate Finance Committee and express the dissatisfaction of the Senate Finance Committee and express the dissatisfaction of our industry toward these proposals.

Sincerely,

JOE YORK, Jr., *President.*

TEXAS AND SOUTHWESTERN CATTLE RAISERS ASSOCIATION,
Amarillo, Tex., September 29, 1969.

The Honorable RALPH W. YARBOROUGH,
U.S. Senate, Old Senate Office Building,
Washington, D.C.

DEAR SENATOR YARBOROUGH: Recently the Texas and Southwestern Cattle Raisers Association presented statements regarding agricultural policies at the "Listening Conference" held at Texas A&M University by Secretary of Agriculture Clifford M. Hardin and his staff. I am enclosing copies of my statement and the statement given by Mr. Ben H. Carpenter, the immediate past president of this Association.

Senator, I wish to call to your attention that there are certain provisions in the Tax Reform Act of 1969, already passed by the House as H.R. 13270, which would have disastrous effects on the cattle industry should they be enacted, and we of the Texas and Southwestern Cattle Raisers Association are quite concerned over this possibility. These proposals are now under review by the Senate Finance Committee and we urge your immediate attention to this matter which is so important to the thousands of people engaged in livestock production in Texas.

In effect these provisions would segregate livestock producers into a special class of taxpayers upon whom discriminatory and punitive restrictions would be imposed which are not imposed upon any other taxpayers. It is obvious that the authors of these particular provisions have no knowledge of the commercial livestock industry. In the past you have supported the livestock industry of

Texas and we respectfully and urgently request your active leadership in preventing these disastrous provisions from being enacted into law by the Senate.

We recognize that there have been a few wealthy individuals in the country who have made investments in farm and ranch operations on a short term basis for "tax profit" purposes. However, the solutions to this problem contained in the Tax Reform Act of 1969 go beyond the correction of this situation to the extreme detriment of the legitimate livestock producers of the country. The livestock industry acting through the National Livestock Tax Committee, has accepted a certain provision in the bill as appropriate and adequate to remedy the abuses by the wealthy tax profiteers. However, an additional four provisions, while they do not contribute significantly to additional deterrent to abuses by these individuals, do constitute an outrageous mistreatment of the legitimate livestock producers of the country, both large and small. Whereas, in Texas we do have some of the largest ranches in the country, our industry is still made up of many small and medium size producers. The great majority of the ten thousand members of the Texas and Southwestern Cattle Raisers Association fall into this classification. These additional provisions of the Tax Reform Act of 1969 would result in disastrous effects upon the livestock industry of Texas. I urge you to examine carefully the enclosed statement on the subject by the Association's immediate past president, Mr. Ben H. Carpenter.

Texas is the largest livestock producing state in the country by a wide margin. You are the Senior Senator from this important state and your consideration of this industry and any assistance that you may be able to provide will be appreciated.

Respectfully yours,

T. L. Roach, Jr., *President.*

Statement Presented by T. L. Roach, Jr., President, Texas and Southwestern Cattle Raisers Association, Amarillo, Tex.

At the Hearing on Agriculture and the Rural Economy, College Station, Tex., September 18, 1969

Mr. Secretary, I am T. L. Roach, Jr., a rancher and President of the Texas and Southwestern Cattle Raisers Association which has represented the cattle producer in this area for more than 93 years.

Texas is the largest single beef cattle state in the nation with some 11 million cattle of which some 5 million are cows. In addition, Texas is the fastest growing feeding state. It is readily apparent the importance of cattle to Texas.

The cattle industry is dedicated to and capable of providing the nation an abundant supply of beef. Its record of success is obvious in the growth in the per capita consumption of our product, now in excess of 109 pounds. This production of beef has been accomplished primarily through the initiative of thousands of individual ranchers willing to risk their capital and labor in beef production. This tremendous production of beef has come about without any of the government supports or controls that have been the case in certain other commodities.

The cattle industry has been willing to increase its annual output without the public burden of controls and supports. In fact given a reasonable price has tended to overproduce to the benefit of the consumer. Those of us in the cattle industry firmly believe that our interest and the interest of the consumer can best be served under the system of private initiative and enterprise.

We are not anxious to have our industry burden other commodities of agriculture. Equally, we strongly oppose efforts to solve other commodity problems at the expense of livestock industry.

It has been the policy of the Texas and Southwestern Cattle Raisers Association to take a position only on those agricultural policies directly affecting the cattle business. There have been comments and suggestions that a massive land retirement program be put in effect and a large part of these retired crop acres be turned to livestock production on what would amount to a government subsidized basis.

Land retirement might be beneficial for other commodities and we take no position on that question. We most emphatically oppose the proposal to allow grazing on retired crop acres or easements where production of beef would be allowed on a subsidized basis. These proposals are unacceptable to the cattle industry and the short and long term effects will be contrary to the public interest.

It would inevitably bring sharply higher meat prices on short term and chaos to the industry on long term.

The result of government planning has brought other commodities to this crisis and we submit there is no justification in bringing the cattle business under the same government planned scarcities and surpluses that have been disastrous to the other commodities which is apparent in these proposals to use the beef industry in an attempt to ease the burdensome surpluses in other commodities.

If land retirement must be a part of our nation's agricultural policy, it should be handled in such a way that the land taken out of production of one surplus commodity does not wind up producing another surplus of even greater magnitude.

The cattle industry and the consumers, in summary, can best be served under the atmosphere of open competition where the right to make a profit is associated with the risk of going broke and certainly not where either result is brought about by the effects of arbitrary rules or programs.

We feel that the USDA should carefully measure any changes in national agricultural policy. We realize the delicate balance of responsibility that is yours, Mr. Secretary. The Texas and Southwestern Cattle Raisers is willing at any time to consult with you and your staff concerning areas of mutual interest. Thank you for the opportunity this forum at College Station has provided us . . . and you.

Statement Presented by Ben H. Carpenter, Immediate Past President, Texas and Southwestern Cattle Raisers Association, Dallas, Tex.

AT THE HEARING ON AGRICULTURE AND THE RURAL ECONOMY COLLEGE STATION, TEX., SEPTEMBER 18, 1969

My name is Ben H. Carpenter. I reside in Dallas, Texas, and operate ranches in East Central Texas. My family has been in the business of raising cattle in Texas since 1877.

My appearance at this conference is in my capacity as the immediate past president of the Texas and Southwestern Cattle Raisers Association and as current regional vice president for the southwest of the American National Cattlemen's Association.

Mr. Secretary, during the political campaigns last year, I served as chairman of the statewide Texans for Nixon Committee. In that capacity on several occasions, I shared the platform with President Nixon in his campaign appearances in Texas. On those occasions in regard to agriculture and livestock matters, he repeatedly made one statement which was made in other parts of the country as well.

That statement was to the effect that it was his intention that this administration would have a Secretary of Agriculture who would sound off and speak up in behalf of the livestock and agricultural industry to the administration and to the other agencies of the federal government rather than merely serving as a mouthpiece for the national administration to those who are engaged in the livestock and agricultural business. This conference is evidence of your desire to hear from representatives of agriculture as you develop the policies of your department during the coming months and years, and I wish to express our appreciation for your making this time available to us. I fully endorse the comments presented to you by the current president of the Texas and Southwestern Cattle Raisers Association, Mr. T. L. Roach, Jr., with regard to future agricultural policies.

However, Mr. Secretary, I wish to call to your attention a more urgent matter regarding the well being and fair treatment of the livestock industry upon which thus far there has been only silence from this administration and your department. I refer to the highly discriminatory penalties that would be imposed upon those persons engaged in the business of raising livestock by the 1969 Tax Reform Bill, already passed by the House and currently under study by the Senate. Tragic consequences will result for the livestock industry if these discriminatory and damaging provisions are enacted into law, and it will be an even sadder situation if this is done while the Secretary of Agriculture remains silent and does not speak out to the Treasury Department and to the Congress in defense of the livestock industry of this country.

There are nine provisions in the 1969 Tax Reform Bill which specifically and directly affect those persons engaged in the business of raising livestock. The legitimate livestock producers of the country recognize that there have been abuses of the tax laws by wealthy tax profiteers who have invested in various relatively short-term cattle ventures, and the industry through the National Livestock Tax Committee has accepted and approves five of these nine proposals as being appropriate and adequate to prevent these abuses. These five acceptable provisions are:

1. Increasing the holding period to two years to obtain capital gains on breeding animals.
2. Preventing tax free exchange of male and female calves.
3. Permitting the recapture of ordinary income of excessive depreciation on breeding animals.
4. Providing for recapture as ordinary income land improvement expenses for land held for a short period of time.
5. Requiring proof that animals are actually held for breeding purposes.

However, Mr. Secretary, there are four other provisions in the House passed Tax Reform Bill which constitute an outrageous segregation of the livestocck producers of this country into an isolated category of taxpayers, upon whom discriminatory restrictions and penalties are imposed which are not placed upon any other group of taxpayers in the country. When the full effects of these discriminatory restrictions are understood and realized, the ultimate damaging repercussions upon livestock producers and land values throughout the country could become very significant and large.

I call upon you, Mr. Secretary, in your capacity as watchdog and spokesman for the livestock industry, as President Nixon indicated you would be, to become familiar with these four damaging provisions which discriminate against the livestock industry of this country and I call upon you to urge the Treasury Department and the Senate Finance Committee to remove these provisions from the Tax Reform Bill.

Among other things, Mr. Secretary, these four provisions in effect say this: "If you are engaged in the business of raising livestock, you cannot engage in or invest in other activities for supplemental income except with certain penalties and restrictions. On the other hand, if you are the butcher, the baker, the candlestick maker, the lawyer, the merchant, the restaurant operator, or are engaged in any other business endeavor *except agriculture*, you are free to supplement your income by other investments without these restrictions and penalties." The farmer and rancher are singled out as what might be described as "second-class taxpayers" with special penalties imposed upon them alone and tax benefits available to all other taxpayers removed from their use and reach. At a time when the country is striving to eliminate "second-class citizenship" in all forms, it would be ironic for the Congress to segregate the farmers and ranchers into such a classification without any voice of protest in their defense by the Department of Agriculture.

It is obvious that those persons who authored these four punitive tax reform provisions have no realistic knowledge of the range livestock industry. For example, one provision is that if a farm or ranch operates at a loss of $25,000 or more for more than two consecutive years or any three years out of five consecutive years, it is automatically presumed to be a hobby and special penalties are imposed and the rancher is denied the right to the deduction of his losses. In the southwestern states, we are all familiar with the fact that droughts sometimes last for a period longer than two years, and in some cases, ranchers must reduce and remove their breeding herds from their rangelands for extended periods of time. Yet, under the House approved proposal, a rancher, while operating under the severest of conditions, would automatically be declared to be operating a hobby by act of Congress and would be stripped of the normal tax procedures with regard to the handling of expenses.

Mr. Secretary, if this ridiculous provision had been in effect over the last forty years, I would dare say that there would not be a single significant range cattle operation in the southwestern United States that at one time or other during that period would not have been automatically, but erroneously, declared to be a hobby.

The provision requiring all farmers and ranchers not on a strict accrual method of accounting to establish an Excess Deduction Account is an outright punitive requirement that would result in the denial to farmers and ranchers of normal tax procedures available to other taxpayers. EDA would unduly penalize the large number of farmers and ranchers who owe several thousand dollars on their property, since interest and taxes, which are quite high, would increase the size of losses. This would make it virtually impossible for persons to acquire a farm or ranch and pay for it, and would, in effect, also deny the traditional deduction in full of taxes and interest which is available to other taxpayers.

In addition to the proposed new definition of hobby losses and related penalties and the EDA and its unfair pressure on small farmers and ranchers to switch from a cash basis of accounting to the more complex system of accrual accounting, the other provisions which result in discriminatory treatment of farmers and ranchers are those which by the manner of application of the limitation on tax preferences and the allocation of deductions single out farm and ranch losses as tax preferences in spite of the nature of farm losses and their relation to uncontrollable weather conditions and the high risk of agricultural economic factors.

The livestock business receives no subsidy. In spite of the fact that they receive one of the lowest yields of all businesses, livestock producers do not want any subsidy from the government. However, they do expect and deserve fair treatment from the government instead of the punitive and discriminatory treatment singled out for the industry in the proposed Tax Reform Bill.

Mr. Secretary, I urge you to speak up and sound off to the Congress and to the Treasury Department and demand fair treatment for the range livestock producers of this country. We look to you not only to prevent the tax mistreatment of the ranchers and livestock farmers of the country, but also to prevent the resulting damaging impact upon the economic stability of the industry in subsequent years. Mr. Secretary, there is an old saying that "an ounce of prevention is worth a pound of cure." In this instance, the time for preventive action is NOW!

FLAT TOP RANCH,
Walnut Springs, Tex., September 30, 1969.

Hon. RALPH W. YARBOROUGH,
Senate Office Building,
Washington, D.C.

DEAR SENATOR YARBOROUGH: I certainly appreciated your seeing L. E. (Sonny) Nance, Jim White, Bryant Harris and me Tuesday morning, September 23. We appreciated your consideration of our position on the provisions of H.R. 13270 that affect Farming and Ranching.

We believe that serious damage would be done to the livestock producers of Texas by not taking the following provisions out of H.R. 13270:

1. Excess Deductions Account
2. $25,000.00—hobby loss
3. Limitation on Tax Preference
4. Allocation of Deductions

These provisions will adversely affect the small as well as the large producers. Also this will affect the many small towns that depend on livestock for income.

Very sincerely,

CHAS. CLINTON BOOTH.

SAN FRANCISCO RANCH,
Marathon, Tex., September 29, 1969.

Senator RALPH YARBOROUGH,
Senate Office Building,
Washington, D.C.

DEAR SENATOR: We wish to express to you our extreme opposition to the proposed legislation that would so adversely affect the oil and livestock industries. We are sure you are doing all you can to have these proposals eliminated from the final bill that will be passed.

If only your fellow legislators could be made to understand that such severe curbs to the oil and livestock industries will not only severely affect large operators but will be against the interests of all the consumers of petroleum products, all the holders of small amounts of oil company stocks and in the case of small livestock producers may be disastrous. The tax setup on top of the normal difficulties of a small ranch or farm in this day of high labor costs will remove the incentive and put many small operators out of business.

The purpose of this letter is simply to assure you of our support in your efforts to serve the interests of Texas which in this case would seem to be also the interests of all the Nation.

Yours truly,

MORGAN R. CHANEY.
FRANCES H. CHANEY.

DAVIS TRUCK & TRACTOR, INC.,
Sweetwater, Tex., September 15, 1969.

Hon. RALPH YARBOROUGH,
U.S. Senate,
Washington, D.C.

DEAR SIR: I would like to ask you to support the National Livestock Tax Committee and the American National Cattlemen's Association proposals.

These proposals would correct most of the tax abuses that Congress is trying to correct, so far as farmers and ranchers are concerned. On the other hand, if a plan is passed requiring the ranchers to go on an accrual basis, or to establish an "EDA" account, you are going to break a lot of small ranchers who are having trouble keeping their heads above water now.

I have worked for thirty five years trying to pay for a ranch big enough to make a living on and retire to. I still do not have it paid for and if these damaging measures are passed, I doubt if I can ever pay for it.

Surely you don't have to pass legislation which would damage thousands and thousands of people, just to stop a few offenders.

There must be a better way!

Respectfully yours,

W. W. DAVIS.

BROWN, BEASLEY & ASSOCIATES, INC.,
San Antonio, Tex., September 11, 1969.

Sen. RALPH YARBOROUGH,
Old Senate Office Building,
Washington, D.C.

DEAR SENATOR YARBOROUGH: I represent companies that have many millions of dollars invested in mortgage loans on farm and ranches throughout Texas as well as in other states.

We find that the farmer and the rancher is being squeezed unduly from every angle and that it is becoming more and more difficult for him to realize enough return from his land to service the debt requirements. In many parts of our state the state, county and school taxes themselves are now to a point where they are equal or nearly so to the amount that a grazing lease will return.

Now, the farmer and rancher is faced with a new bill that if passed will be very detrimental to everyone in that field. The "excessive deductions account" is grossly unfair and singles out only the livestock breeder for this type treatment. The "hobby loss" provision in a way seems fair BUT WHERE ELSE IS OUR GREATEST NATURAL RESOURCE going to get the funds necessary for its preservation and improvement. The money going into this regardless of the source is worth every penny of the tax revenue that is lost and is probably much cheaper to our government than direct subsidies paid in other programs.

Please do not forsake the agricultural people by allowing new tax bill and/or to Metcalf bill to be passed.

Very truly yours,

BROWN, BEASLEY & ASSOCIATES, INC.,
EDWIN S. BROWN, *President.*

STATEMENT OF KENNETH M. PLAISTED GENERAL COUNSEL, NATIONAL BOARD OF FUR FARM ORGANIZATIONS, INC.

Mr. Chairman, Members of the Committee:

My name is Kenneth M. Plaisted. I am the General Counsel for the National Board of Fur Farm Organizations, Inc., a Minnesota Co-operative, with offices located at 152 West Wisconsin Avenue, Milwaukee, Wisconsin. Our association is comprised of the 52 state, regional and marketing organizations the approximate 3,500 members of which are farmers engaged in the raising of domestic mink.

Our purpose in presenting this statement is to urge this Committee to review in depth the provisions of the Tax Reform Act of 1969 that affect (1) the holding period for livestock for capital gain tax purposes, (2) the treatment of the gain from the disposition of property used in farming, and (3) the proposed recapture of depreciation of purchased livestock. Thesc are all areas of the Act which, if adopted, will result in placing new and unfair additional tax burdens on the nation's mink farmers who are already confronted with increased production costs and, as the members of this Committee are well aware, Mr. Chairman, with the problem of competing with heavy import competition and without the benefit of any regulation of mink imports in any form whatsoever.

The Change in the Required Holding Period for Livestock to Qualify for Capital Gain tax treatment would result in Gross Inequities When Applied to Mink Farmers

Under present law the gain from the sale of breeder mink, or the pelts taken from breeder mink, qualifies for capital gain treatment if the animal has been held by the farmer for 1 year or more. The proposed bill now before your Committee would increase the holding period to the extent that the animal must be held for at least 1 year after the animal would have first been used for breeding purposes. In practice, when applied to breeder mink, this would actually increase the holding period for an additional 12 months.

The mink animal is born in May, used as a breeder (male and female) the following March and, if the animal is to be culled from the breeder herd, is then pelted in late November of the same year when the pelt is in its prime condition and when the mink would be approximately 17 months old. Present law permits the capital gain tax treatment of the proceeds of the pelts taken from the breeder animal when the mink has been held by the farmer for more than 1 year. The proposed bill would deny the farmer capital gain treatment on those animals culled from his breeder herd after only 1 year's use for the reason that from the time the animal was first used as a breeder (in March) to the time the animal was pelted (in November) would cover a period of only approximately 8 months. Therefore, if the mink farmer wanted to be in a position to treat the proceeds from the sale of his pelts from his first year breeders as capital gain, he would be required to carry these mink breeder animals over to the next pelting season (November) which would be another 12 months. This, of course, would not be economically feasible due to the high cost of feeding and caring for the animal during this additional one-year period and at the end of which period there would have been no increase in the value of the pelt to be taken from the breeder mink.

Not all breeder mink are culled from the herd after one season's use as a breeder. Some of the animals are used for 2 or 3 years for such purposes. In many mink herds, however, depending upon the type of mink raised by the farmer, a substantial number of the mink in the breeder herd are pelted after only 1 breeding season. This is true particularly in herds comprised of the so-called light color types. In fact, if the mink farmer has a progressive breeding improvement program, the quality of the fur of the young mink should equal or excel that of its parents and the farmers would then retain the kit (young mink) for use as a breeder the following year and pelt the adult animal.

The enactment of Section 212(b) of the bill in its present form as applied to breeder mink would defeat the legislative purpose of the Congress in its adoption of the present wording of Section 1231(b) of the Code. A review of the reports of the legislative committees[1] which accompanied the enactment of Section 117(j) (now Section 1231(b)) clearly indicates that the adoption of Section 117(j) was intended to provide tax relief and thus be an incentive to farmers to turn over their breeder herds for improvement purposes and that the improvement in breeder herds should result in subsequent higher farm profits and, therefore, a more desirable economic condition within the farm economy.

As was stated previously, this Committee is well aware of the competition our mem.ers are confronted with as a result of the large quantities of mink pelts being improted into the United States. One reason that our domestic mink farmers have been able to stay in business at all is due to their constant herd improvement programs which result in higher quality fur pelts. For the reasons we discussed earlier, an effective herd improvement program requires a relatively high turnover of the breeder herd after the first breeding year, in particular with the lighter color types of mink. In the past our members have not been penalized, tax-wise, for these programs to improve their herds. The enactment of Section 212(b) of the bill as presently worded would remove any tax incentive for herd improvement and penalize the progressive mink farmer

[1] H. Rep. No. 586, 82d Cong., 1st Sess., p. 32; S. Rep. No. 781, 82d Cong., 1st Sess., pp. 41-42.

who was striving to upgrade his herd and keep ahead of the quality of the foreign imports which, in the last analysis, is his only hope of survival.

The reasons for the proposed extension of the holding period for livestock as set forth in the House Report[2] on this bill are not persuasive and have no application whatsoever to the operation of a mink farm. The intended change is apparently designed to correct a few isolated instances where wealthy non-farm taxpayers have invested heavily in certain types of livestock for tax-motivated investment purposes only. This specific proposed change, we respectfully submit, is an overkill and can only result in economic hardship to the farmer and defeat the basic intent of the Congress when it originally enacted Section 117(j) in 1951.

We believe that the present wording of Section 1231(b) of the Code should remain the law on the subject of the holding period for breeder livestock. In the event, however, that Congress decides to amend the section as proposed in Section 212(b) of the bill in order to correct what it may consider to be certain abuses involving other types of livestock, a further provision should be included in such amendment so that livestock used as breeders on mink farms would qualify for capital gains tax treatment if the animal had been held by the taxpayer for 1 year or more which is the present law.

[2] H. Rep. No. 91-413, 91st Cong., 1st Sess. (Part 1), p. 70.

Proposed Changes Relating to Recapture of Depreciation on Purchased Livestock and the Disposition on the Sale of Property Used in Farming will add to the Tax Burdens of the Farmer

The bill before your Committee also proposes to change the existing tax law affecting the recapture depreciation on purchased livestock and the treatment of the gain from the disposition of property used in farming.

The House Report on the bill states that the present depreciation recapture rules as applied to most properties are not applicable to farm livestock and that the House Committee could see no reason why livestock should be treated any differently than other types of properties used in a trade or business.[3] The Report further states the reasons the bill provides for a change in the treatment of the gain on the disposition of farm property is that the farm accounting rules now applicable to farmers have allowed certain "high-income taxpayers" who farm as a sideline to obtain tax losses to offset their other business income.[4]

The reason why many of the provisions of the tax law relating to farming, and particularly livestock, are different from those related to other trades or businesses, we believe, is relatively simple. Congress has always recognized that in the raising of any type of livestock there are certain

[3] H. Rep. No. 91-413, 91st Cong., 1st Sess. (Part 1), p. 68.

[4] *Ibid.*, pp. 62-63.

inherent risks which are not present in the carrying on of other businesses. The farmer is at the mercy of all of the elements of nature in the course of raising his livestock whatever the type of livestock may be. Because of these risks taken by the farmer, he has been afforded tax allowances with regard to depreciation and certain costs of raising his animals in the reporting of his income from the sale of livestock. These risks which we have mentioned are still present in every field of agriculture. The elements of nature still affect the breeding habits of all farm livestock, including mink. Any defect in a breeder animal is not discerned until after it has been used as a breeder and the female has produced its young. The farmer may, therefore, have a substantial investment in a breeder animal who will turn out to be completely unproductive. This is hardly the case when a piece of machinery breaks down in a factory and where the defect can be immediately discovered and corrected.

For these and other reasons, we believe there are sound justifiable reasons for affording the farmer certain tax treatment on the sale of his breeder livestock and the options of using certain accounting methods that are not necessarily afforded other businesses.

Conclusion

The changes in those areas of the tax law which are the subject of this statement, as proposed in the bill (H.R. 13270), are apparently designed to correct certain abuses by taxpayers in the high income brackets who carry on limited farming activities. In practice, however, as is often the case with tax "reform" legislation, it will be the small and medium sized farmers who will bear the burden of additional taxes, if this legislation is adopted in its present form. We earnestly urge this Committee, Mr. Chairman, to explore other ways to correct the alleged farm tax abuses referred to in the Report of the House.

The domestic mink industry in the United States is fighting for its very survival at this moment under a government policy that is apparently committed to free trade. During the past 2-year period, one-half of our members have been forced out of business. During this same period our domestic production has declined from 6-1/2 million pelts to 5 million pelts. The market today is at the lowest point in the history of the mink farming business. Tax reform may well be needed in many areas, but we plead with this Committee to thoroughly review the proposed reforms and to take action by eliminating those "reforms" in the bill that will increase the tax burden of the domestic mink farmer.

Statement of Herrick K. Lidstone, New York, N.Y.

I am Herrick K. Lidstone, 280 Park Avenue, New York, New York, and I am a member of the law firm of Battle, Fowler, Stokes & Kheel.

I am appearing before you on behalf of Spencer & Spencer, Tacna, Arizona, of which W. E. (Sam) Spencer and C. V. Spencer are members, DVR Corporation, Main Street Plant, Yuma, Arizona, and Sierra-Pacific Distributors, Inc., Nogales, Arizona. I am also appearing before you in my individual capacity.

Spencer & Spencer are specialists in the care and management of citrus groves and, through Mr. W. E. (Sam) Spencer, have been engaged in citrus operations in Southern California and Arizona for more than 60 years. They are responsible for the management and cultural care activities of more than 7,000 acres of citrus groves, primarily on the Wellton and Yuma Mesas in Southwestern Arizona.

DVR Corporation owns and operates a citrus fruit packing house in Yuma, Arizona and supplies citrus fruit picking, hauling, storage, packing and marketing services primarily to the groves managed by Spencer & Spencer.

Sierra-Pacific Distributors, Inc are constructing a warehouse and fresh fruit and vegetable packing and shipping facilities in Nogales, Arizona.

In both my prepared statement for, and my oral testimony on March 10, 1969 before, the Committee on Ways and Means of the House of Representatives on the farm loss problem, I agreed with the conclusion of the February, 1969 study of the Treasury Department of President Johnson's administration that there were abuses in the use of farm loss deductions by the so called "investor-farmer", but I pointed out that the relatively narrow area of abuse and the small amount of revenue loss did not justify the shotgun approach proposed in the Treasury's February, 1969 Report. I emphasized that, contrary to the Treasury's arguments, the reports and studies conducted by the Committee on Agriculture of the Section of Taxation of the American Bar Association led me and other persons who have had broad experience in advising farmers and "investor-farmers" that the proposals of the Treasury Department of President Johnson's administration would create serious advantages in favor of the wealthy farmer-investor as opposed to both the ordinary farmer and the less wealthy farmer-investor. Specifically, wealthy farmer-investors can always buy the farm income to offset excess farm losses as they have done in the past to eliminate the consequences of present section 270 which requires recomputation of loss deductions if losses from any business exceed $50,000 per year for five consecutive years.

Rather than repeat in any further detail the substance of my testimony before the Committee on Ways and Means, I am annexing to this Report a copy of my prepared statement to the Committee on Ways and Means.[1]

Analysis of Farm Loss Proposals of H.R. 13270

The proposals to limit farm loss deductions now contained in sections 211, 212, and 213 of H.R. 13270 represent an interesting but complex solution to a problem which is really not of sufficient importance to the tax revenues to justify the complexities of the solution. The question, therefore, is whether the complexities of the solution and the added bookkeeping burden which are placed on America's already overburdened taxpayers can be justified on the grounds of equity.

Let me answer the question by stating, as I stated to the Committee on Ways and Means, that, if the Congress desires to eliminate or to reduce equitably all tax advantages obtained by all groups of taxpayers, no one can properly object to any approach that would apply across the board to all forms of investor-participants in business. In other words, if the so called passive investor in real estate, in oil and gas, in the theater and in the other forms of American business were subjected to the same type of limitation on deductions and required to maintain the same type of bookkeeping as that proposed by section 211 of H.R. 13270, no objection would be proper. But, even though H.R. 13270 proposes certain limitations which would affect passive investors in the petroleum and real estate industries, none goes so far in the attack on deductions as the excess deduction allowance (EDA) proposal goes in the case of farm loss deductions. In the legitimate theater industry, for example, the accounting treatment of applying first income against the costs of the production has not been affected. The differ-

[1] This statement is made a part of the official files of the committee.

ence in structure and scope between the passive investor in the theater and the investor-farmer is comparable, because, in both instances, development costs are, in effect, deducted currently.

If, in spite of the lack of equity inherent in the desire to limit farm loss deductions, it is the sense of Congress that the investor-farmer is utilizing the cash basis to create future capital gains out of current operating loss deductions, the EDA approach of section 211 of H.R. 13270 is perhaps the most equitable way to attack the problem and clearly represents a method and a technique which cannot be properly objected to by either the opponents or proponents of legislation to limit farm loss deductions.[1]

The requirement that the EDA be recaptured out of first income is appropriate because it clearly meets the stated objective to prohibit (or at least to reduce) the opportunities for wealthy investor-farmers to convert current deductions into capital gains. In my opinion, based on personal surveys of lawyers and accountants who represent numerous full time and investor-farmers and also based on my own experience with crop farming in Kansas, commercial cattle operations in Colorado and Wyoming, citrus operations in Arizona and row crop and orchard operations in Mexico, the EDA approach is fair and should not trouble anyone who is engaged legitimately in farming. Furthermore, neither I nor my clients can see any legitimate grounds for objecting to the proposal of Hon. Edward S. Cohen, Assistant Treasury Secretary for Tax Policy, in his statement to the Senate Finance Committee on September 4, 1969, to apply the EDA rules "to any taxpayer with non-farm adjusted gross income in excess of $25,000 whose farm losses exceed $15,000."

Subject to congressional awareness of the imposition of inequities of reporting parties and tax treatment on the so called investor-farmer as opposed to the more liberal rules applied to other forms of business enterprise, I heartily endorse the novel and imaginative, albeit complex, approach to the farm loss problem embodied in section 211 of H.R. 13270.

Section 212 of H.R. 13270 adds an unnecessary complicated rule to the Internal Revenue Code in connection with the determination of livestock used in trade or business. Before commenting on this problem, let me express my general agreement with the concept of depreciation recapture in the case of livestock, except that, in order to eliminate a very heavy administrative burden both on the Internal Revenue Service and on the owners of livestock, I recommend that the depreciation recapture provision with respect of livestock apply to livestock acquired after December 31, 1969 and not to depreciation taken after December 31, 1969 on livestock which might have been acquired before January 1, 1970. The revenue loss of such a modification would be very small while the administrative convenience of such a change to the Internal Revenue Service and the country's farmers would far outweigh the disadvantage of any revenue loss.

With respect to subsection (b) of section 212 of H.R. 13270, relating to property used in trade or business, the concept of extending the required holding period for 365 days after the animal "normally would have first been used for any of such purposes" does not take into account the differences in the optimum breeding periods of various animals. For example, in the case of hogs, it is quite clear that the optimum breeding period commences when a sow is considerably less than a year and that after one or two litters, good commercial hog operators dispose of the sow in order to reduce feeding costs. Sows of an older age have a tendency to consume excess food and thereby reduce the profitability of hog operations. A somewhat similar but less rigid practice is in effect in the case of sheep, where, except in the case of the better ewes most ewes are disposed of well before a year after the first normal breeding.

While the purpose of section 212(b) of H.R. 13270 is commendable and should be supported by most commercial livestock breeders, (just as it will be objected to by most breeders and associations of breeders of prize livestock), it is suggested that the proposed changes included in section 212(b) will result in very considerable administrative complexities. Therefore, unless the Congress desires to add to the burden of both the Internal Revenue Service and the farmer tax-

[1] Since as to farm land there is only a five-year recapture rule (proposed new Section 1251(e)(5), a limit should be considered for the recapture period for other farm property. The primary purpose of such a limitation is to reduce the burden on the taxpayer to keep records for all of his life or face the possibility that all of his gain on a sale of all or a part of his farm property will be taxed as ordinary income. A ten-year potential recapture period would seem to be more than adequate.

payer, it is suggested that the complicated rule contained in section 212(b) be abandoned and that the current rule be continued. In the alternative, it is suggested that separate rules be stated for different types of animals, for example, a 365 day holding period in the case of hogs and sheep, 18 months to 2 years in the case of cattle; 2 years to 3 years in the case of horses, etc.

As a lawyer I welcome the provisions of section 213 of H.R. 13270 which amend the hobby loss rules from the present provisions of section 270 (5 consecutive years of losses exceeding $50,000 per year) to a presumption of hobby activities if the loss exceeds $25,000 in any 3 of 5 consecutive years. As a lawyer I can visualize participating as an attorney in an increasing number of interesting cases such as the professional football case, *J. M. Collis*, 34 T.C. 592 (1960), and the farming case of *Arthur Vining Davis*, 29 T.C. 878 (1958). However, I am troubled, and I suggest that the Committee on Finance should be troubled, by the drastic change which has failed to take into account the inflationary trends in this country since the enactment in 1943 of the predecessor of present section 270. If a $50,000 limitation was appropriate in 1943 in determining what constituted a hobby loss, it is difficult to justify in 1969 the reduction of the limitation to $25,000.

Since the provisions of section 213 of H.R. 13270 relating to hobby losses, extend far beyond the farm loss deduction problem, I recommend that the Congress, and particularly the Senate Finance Committee, consider raising the rebuttable presumption limit of $25,000 contained in subsection (b) of the proposed new section 270 to $50,000; otherwise, there will be an unnecessary deluge of cases to be decided by the Tax Court and the various District Courts. Indeed, because of the nature of the problem, the present inequities of approach in the judicial administration of the tax law in many District Courts will be accentuated because taxpayers residing in Federal District Court areas outside of metropolitan communities have historically been treated in one way, while those who reside in eastern metropolitan communities have been treated in another way.

CONCLUSION

As is increasingly apparent, the margin of profit in farm operations is at best small. To increase the administrative costs of farmers, whether they are full-time farmers or investor-farmers, will result in a great disservice not only to the farming community, but to the great consumer community in which we all must live. The particular burden of the administrative complexities imposed by the farm loss provisions of H.R. 13270 will fall on the people who do not deserve it—the operators of profitable farms in the rural communities of the United States. Nevertheless, if the requirements of tax reform are deemed to be sufficient to justify the imposition of additional administrative and bookkeeping burdens and expenses on the farming community, the EDA approach adopted by the House of Representatives in H.R. 13270 should be enacted into law.

STATEMENT OF KENNETH M. PLAISTED, GENERAL COUNSEL, NATIONAL BOARD OF FUR FARM ORGANIZATIONS, INC., MILWAUKEE, WIS.

Mr. Chairman, Members of the Committee: My name is Kenneth M. Plaisted. I am the General Counsel for the National Board of Fur Farm Organizations, Inc., a Minnesota Co-operative, with offices located at 152 West Wisconsin Avenue, Milwaukee, Wisconsin. Our association is comprised of the 52 state, regional and marketing organizations the approximate 3,500 members of which are farmers engaged in the raising of domestic mink.

Our purpose in presenting this statement is to urge this Committee to review in depth the provisions of the Tax Reform Act of 1969 that affect (1) the holding period for livestock for capital gain tax purposes, (2) the treatment of the gain from the disposition of property used in farming, and (3) the proposed recapture of depreciation of purchased livestock. These are all areas of the Act which, if adopted, will result in placing new and unfair additional tax burdens on the nation's mink farmers who are already confronted with increased production costs and, as the members of this Committee are well aware, Mr. Chairman, with the problem of competing with heavy import competition and without the benefit of any regulation of mink imports in any form whatsoever.

The Change in the Required Holding Period for Livestock to Qualify for Capital Gain tax treatment would result in Gross Inequities When Applied to Mink Farmers

Under present law the gain from the sale of breeder mink, or the pelts taken from breeder mink, qualifies for capital gain treatment if the animal has been held by the farmer for 1 year or more. The proposed bill now before your Committee would increase the holding period to the extent that the animal must be held for at least 1 year *after* the animal would have first been used for breeding purposes. In practice, when applied to breeder mink, this would actually increase the holding period for an additional 12 months.

The mink animal is born in May, used as a breeder (male and female) the following March and, if the animal is to be culled from the breeder herd, is then pelted in late November of the same year when the pelt is in its prime condition and when the mink would be approximately 17 months old. Present law permits the capital gain tax treatment of the proceeds of the pelts taken from the breeder animal when the mink has been held by the farmer for more than 1 year. The proposed bill would deny the farmer capital gain treatment on those animals culled from his breeder herd after only 1 year's use for the reason that from the time the animal was first used as a breeder (in March) to the time the animal was pelted (in November) would cover a period of only approximately 8 months. Therefore, if the mink farmer wanted to be in a position to treat the proceeds from the sale of his pelts from his first year breeders as capital gain, he would be required to carry these mink breeder animals over to the next pelting season (November) which would be another 12 months. This, of course, would not be economically feasible due to the high cost of feeding and caring for the animal during this additional one-year period and at the end of which period would have been no increase in the value of the pelt to be taken from the breeder mink.

Not all breeder mink are culled from the herd after one season's use as a breeder. Some of the animals are used for 2 or 3 years for such purposes. In many mink herds, however, depending upon the type of mink raised by the farmer, a substantial number of the mink in the breeder herd are pelted after only 1 breeding season. This is true particularly in herds comprised of the so-called light color types. In fact, if the mink farmer has a progressive breeding improvement program, the quality of the fur of the young mink should equal or excel that of its parents and the farmers would then retain the kit (young mink) for use as a breeder the following year and pelt the adult animal.

The enactment of Section 212(b) of the bill in its present form as applied to breeder mink would defeat the legislative purpose of the Congress in its adoption of the present wording of Section 1231(b) of the Code. A review of the reports of the legislative committees[1] which accompanied the enactment of section 117(j) (now Section 1231(b)) clearly indicates that the adoption of Section 117(j) was intended to provide tax relief and thus be an incentive to farmers to turn over their breeder herds for improvement purposes and that the improvement in breeder herds should result in subsequent higher farm profits and, therefore, a more desirable economic condition within the farm economy.

As was stated previously, this Committee is well aware of the competition our members are confronted with as a result of the large quantities of mink pelts being imported into the United States. One reason that our domestic mink farmers have been able to stay in business at all is due to their constant herd improvement programs which result in higher quality fur pelts. For the reasons we discussed earlier, an effective herd improvement program requires a relatively high turnover of the breeder herd after the first breeding year, in particular with the lighter color types of mink. In the past our members have not been penalized tax-wise, for these programs to improve their herds. The enactment of Section 212(b) of the bill as presently worded would remove any tax incentive for herd improvement and penalize the progressive mink farmer who was striving to upgrade his herd and keep ahead of the quality of the foreign imports which, in the last analysis, is his only hope of survival.

The reasons for the proposed extension of the holding period for livestock as set forth in the House Report[2] on this bill are not persuasive and have no application whatsoever to the operation of a mink farm. The intended change is

[1] H. Rep. No. 586, 82d Cong., 1st Sess., p. 32; S. Rep. No. 781, 82d Cong., 1st Sess., pp. 41–42.

[2] H. Rep. No. 91–413, 91st Cong., 1st Sess. (Part 1), p. 70.

apparently designed to correct a few isolated instances where wealthy non-farm taxpayers have invested heavily in certain types of livestock for tax-motivated investment purposes only. This specific proposed change, we respectfully submit, is an overkill and can only result in economic hardship to the farmer and defeat the basic intent of the Congress when it originally enacted Section 117(j) in 1951.

We believe that the present wording of Section 1231(b) of the Code should remain the law on the subject of the holding period for breeder livestock. In certain abuses involving other types of livestock, a further provision should be the event, however, that Congress decides to amend the section as proposed in Section 212(b) of the bill in order to correct what it may consider to be included in such amendment so that livestock used as breders on mink farms would qualify for capital gains tax treatment if the animal had been held by the taxpayer for 1 year or more which is the present law.

Proposed Changes Relating to Recapture of Depreciation on Purchased Livestock and the Disposition on the Sale of Property Used in Farming will add to the Tax Burdens of the Farmer.

The bill before your Committee also proposes to change the existing tax law affecting the recapture depreciation on purchased livestock and the treatment of the gain from the disposition of property used in farming.

The House Report on the bill states that the present depreciation recapture rules as applied to most properties are not applicable to farm livestock and that the House Committee could see no reason why livestock should be treated any differently than other types of properties used in a trade or business.[3] The Report further states the reasons the bill provides for a change in the treatment of the gain on the disposition of farm property is that the farm accounting rules now applicable to farmers have allowed certain "high-income taxpayers" who farm as a sideline to obtain tax losses to off-set their other business income.[4]

The reason why many of the provisions of the tax law relating to farming, and particularly livestock, are different from those related to other trades or businesses, we believe, is relatively simple. Congress has always recognized that in the raising of any type of livestock there are certain inherent risks which are not present in the carrying on of other businesses. The farmer is at the mercy of all of the elements of nature in the course of raising his livestock, whatever the type of livestock may be. Because of these risks taken by the farmer, he has been afforded tax allowances with regard to depreciation and certain costs of raising his animals in the reporting of his income from the sale of livestock. The risks which we have mentioned are still present in every field of agriculture. The elements of nature still affect the breeding habits of all farm livestock, including mink. Any defect in a breeder animal is not discerned until after it has been used as a breeder and the female has produced its young. The farmer may, therefore, have a substantial investment in a breeder animal who will turn out to be completely unproductive. This is hardly the case when a piece of machinery breaks down in a factory and where the defect can be immediately discovered and corrected.

For these and other reasons, we believe there are sound justifiable reasons for affording the farmer certain tax treatment on the sale of his breeder livestock and the options of using certain accounting methods that are not necessarily afforded other businesses.

CONCLUSION

The changes in those areas of the tax law which are the subject of this statement, as proposed in the bill (H.R. 13270), are apparently designed to correct certain abuses by taxpayers in the high income brackets who carry on limited farming activities. In practice, however, as is often the case with tax "reform" legislation, it will be the small and medium sized farmers who will bear the burden of additional taxes, if this legislation is adopted in its present form. We earnestly urge this Committee, Mr. Chairman, to explore other ways to correct the alleged farm tax abuses referred to in the Report of the House.

The domestic mink industry in the United States is fighting for its very survival at this moment under a government policy that is apparently committed to free trade. During the past 2-year period, one-half of our members have been forced out of business. During this same period our domestic pro-

[3] H. Rep. No. 91–413, 91st Cong., 1st Sess. (Part 1), p. 68.
[4] *Ibid.*, pp. 62–63.

duction has declined from 6½ million pelts to 5 million pelts. The market today is at the lowest point in the history of the mink farming business. Tax reform may well be needed in many areas, but we plead with this Committee to thoroughly review the proposed reforms and to take action by eliminating those "reforms" in the bill that will increase the tax burden of the domestic mink farmer.

STATEMENT OF J. HENRY SEARS, CHAIRMAN, AGRICULTURE AND RANCHING COMMITTEE, WEST TEXAS CHAMBER OF COMMERCE, TO SECRETARY OF AGRICULTURE CLIFFORD M. HARDIN AT TEXAS A. & M. UNIVERSITY

Background: During the final months of the previous administration, a detailed tax reform program, prepared by the Treasury, was presented to the President. Mr. Johnson, however, declined to make specific recommendations as desired by the Treasury. Instead, the Administration left office in January with the proposal, made up primarily by Mr. Stanley Surrey, unacted upon. Two of the principal recommendations in this reform tax package dealt with lowering percentage depletion on oil and gas and a drastic revision of the statutes having to do with agricultural taxation. This memorandum will deal with the agricultural taxation matter. In rather brief form we will try to set out the following:

A. What agriculture and the livestock sector mean to our economy;

B. The principal area of change being discussed by both the Treasury and the principal tax writing committee of the House, Ways and Means; and

C. What the forementioned changes might mean to the industry and the nation as a whole.

I. WHAT AGRICULTURE AND THE RELATED LIVESTOCK INDUSTRY MEAN TO THE NATION

If we can visualize agriculture as a giant wheel touching every American daily, either in his eating, buying, or selling habits, then looking closer we find at the hub of this giant industry the livestock sector, a mental picture of American agriculture emerges.

Agriculture, then, as a whole, and the livestock industry in particular, are a finely tuned part of this well balanced wheel. Each American farmer and rancher is presently feeding twenty of his fellow citizens on a high protein diet of 109 lbs. of red meat per capita that is the envy of the world. At the same time, enough grain is being produced to not only convert a vast amount of lean beef to fine steaks, but on top of this, a grain surplus is available as one of this country's most valuable foreign exchange earners. On this point it is vital to remember that were it not for overseas agricultural sales, this country would be in even more serious trouble than it is, in its balance of payments. Many times when we consider agriculture, it is assumed we are speaking about an isolated sector of the economy; this is far from the truth. Agriculture is one of the best customers of the energy, machinery, and chemical industries. Modern day agriculture also utilizes vast amounts of short and long term credit from the nation's banks and insurance agencies. In brief, then, what some might picture as a shrinking industry, is far from it, yet its own efficiency of production and lessening use of labor, make it unobtrusive.

II. THE PRINCIPAL CHANGES IN THE TAXATION OF AGRICULTURE BEING CONSIDERED

As of this date the House Ways & Means Committee has held lengthy hearings on contemplated changes in agricultural taxation, and the Administration has also presented its views along with its other recommendations for tax reform. It is important to realize the context in which the recommendations have been made. It has been widely stated in the Press and by certain members of Congress that there has been considerable abuse of some agricultural tax features. These so-called "tax loss farmers" have used certain features of the Code to shelter other outside income. The fact of the matter is that there probably have been some abuses, but when taken in the context of the industry as a whole, they are miniscule.

What changes then have been recommended to correct these so-called abuses? The principal changes would literally force agriculture to utilize the accrual basis of accounting instead of the traditional cash basis, or face the consequence of having a ceiling placed on agricultural losses that could be deducted. The second major change would deal with the capital gains treatment accorded to breeding livestock. It has been recommended that the holding period would either be lengthened, or in some cases capital gains would be disallowed. Lastly, certain types of land improvement that have been traditionally expensed, would have to be capitalized instead of being expensed in the year incurred.

The cash basis of accounting and the capital gains treatment of breeding stock, it should be pointed out, are not tax gimmicks. They are essential tools to the farmer and rancher who, in many cases, does not have adequate accounting help to keep books on the accrual basis. Secondly, the capital gains treatment for breeding stock is the way the rancher replaces his "machine tool"; or, in other words, his production unit must be replaced when it reaches a certain age, and this tax treatment enables him to do so, much like any other manufacturer.

III. WHAT WILL THESE CHANGES MEAN TO THE INDUSTRY AND THE NATION AS A WHOLE?

There are several important consequences that could result, 1) There could be a curtailment of new funds coming into the industry, at a time when they are needed most. 2) We could well see a depression of farm land prices that could effect the entire economy, especially in the rural areas. 3) Agriculture has not been an industry characterized by a high rate of return, and these tax changes could well force a great number of small and medium-sized operators out of existence. 4) Lastly, we might well see higher prices for basic agricultural commodities to the American housewife, with a good chance of less available production for export.

Certain questions, then, should be asked—why is Agriculture being singled out for this harsh tax treatment that is not being applied to any other industry? What other industry is not allowed to charge off its developmental expenses, or must have a limit set on losses? Are these contemplated changes in the best interest of the American farmer, the housewife, and our nation's economy? Is this new Administration ready to recommend tax changes before its own Department of Agriculture has settled on a Farm Program?

In conclusion, to draw a parallel, there is considerable debate going on in the country and in Congress concerning the so-called ABM missile system and its supposed superiority to the Russian delivery system. In this context, there is *no* question about America's food industry—it has been delivering on time for generations, and is the envy of the world. The question really is, then, is the Congress prepared to make drastic changes in the tax structure that regulates the nation's most important delivery system—food!

STATEMENT SUBMITTED BY ROBERT C. GUENZEL, ON BEHALF OF THE NEBRASKA COOPERATIVE COUNCIL, LINCOLN; GOTHENBURG COOPERATIVE OIL CO., GOTHENBURG; FIRTH COOPERATIVE COMPANY, FIRTH; FRENCHMAN VALLEY FARMERS COOPERATIVE, INC., IMPERIAL; AND COOPERATIVE GRAIN AND SUPPLY CO., ROSELAND; ALL IN NEBRASKA

This statement is in opposition to the proposed amendment of the Internal Revenue Code concerning itself with the procedures for the taxation of Farmer Cooperatives.

FARMERS ARE NOT CAPTIVE CUSTOMERS OF COOPERATIVES

Since no public hearing was held upon this proposal by the House of Representatives Committee on Ways and Means the arguments in favor of this legislation are difficult to anticipate unless we can be guided by the Summary prepared by the Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance published August 18, 1969. In reading the arguments advanced therein in favor of such legislation it would appear that at least some of the proponents are under the misapprehension that a cooperative serving farmers operates in some unique territory with captive customers and no competition. In fact, even though in Nebraska such cooperatives operate almost entirely in rural areas in very small towns competition from non-cooperative businesses does exist. A survey was conducted by the Nebraska Council of Farmers Cooperatives through a questionnaire sent to a state-wide sampling of its members. Attached hereto as Exhibit A is a map showing the location of the towns from which replies were received. Of 135 replies 70% of these cooperative businesses had a non-cooperative competitor within a distance of 1,000 feet and the greatest distance to a competitor was 12 miles. In a state of the character of Nebraska even a distance of 12 miles is no barrier to competition. (Exhibit B, attached hereto, is a tabulation of the replies, and the distances involved.) The originals of these questionnaires have been deposited in the office of the Senator from Nebraska who is a member of this Committee.

FARMERS CONTROL PATRONAGE REFUNDS

In listing the arguments in favor of such legislation your Staff indicates that farmers "have little dominion over the treatment of patronage dividends" and yet the foregoing figures show that the farmers have no need whatsoever to become involved in a situation returning to them a patronage refund unless they choose to do business with the cooperative. Regardless of any other factor of control the farmer can vote against the retention of partonage refunds, if he disapproves of such retention, by simply doing business with a competitor of the cooperative. If the farmer does not, in fact, vote in such a fashion and chooses, instead, to do business with the cooperative he certainly cannot be considered to have "little dominion" over his own financial affairs as he makes such free choice with full knowledge of the policies of his cooperative.

Regardless of their ability to "vote with dollars" by doing business with a competitor such patrons have absolute voting control over the policies of the cooperative and the retention of patronage refunds. The author of this statement has personally represented in excess of 150 farmer cooperatives in the middle west and states, without qualification, that in each instance such cooperative was, in fact, controlled by those members who patronized or intended to patronize the cooperative. Such control, in each instance, under local law could be exercised, without notice, at any annual meeting where such members desired to change the policies of the cooperative. After attendance at literally hundreds of annual meetings over the last 20 yeass the undersigned can state that he has never seen a meeting at which the farmer-members were prevented by any technical means or legal rules from a free exercise of their collective will in the matter of patronage refunds.

THIS AMENDMENT IS NOT "TAX REFORM"

That such amendment as herein proposed would have an adverse effect upon the financial structure of cooperatives and that this was, in fact, its intention is patent. Not one dollar of revenue will be produced for the Treasury of the United States by this "reform". The financial consequences to cooperatives will lie in two areas. First, there will be the effect upon existing contracts relating to loans and existing policies relating to redemption of members equities. All present loans to cooperatives have been made upon the basis of repayment projections premised upon current cash flow potentials. This change in tax policy will have a detrimental effect upon the cash flow position of the cooperatives by diverting unanticiptaed amounts of cash to equity redemption and will thus effect the ability of the cooperatives to repay existing loans. In the area of existing policies relating to redemption of patrons equities most cooperatives have programs to redeem, in total, the equities of patrons upon retirement or upon the patron terminating his farming activities in the community and moving elsewhere. Such policies have the effect of insuring that the investment in the facilities of the cooperative are in the hands of its current patrons. If cash must be used to repay the current patrons such cash can, of course, not be available to repay the equities of retiring patrons whose total investment should be redeemed as they are no longer utilizing the cooperatives facilities. Surely such a program of total repayment of the investment of retiring members is preferable to increasing the cash return to current patrons.

The second area in which this amendment will have an adverse effect upon the financial structure of cooperatives is in the reduction of the equity interest in cooperatives. In order to obtain a broad picture of the effect of the amendment we have caused a survey to be made of the accounting records of 32 of 35 cooperatives in the counties of Lancaster, Hamilton, Dodge and Seward in Nebraska and such balance sheets have been totaled and averaged and projected from the year 1968 to the year 1984 based upon such amendment being in effect. The average balance sheet appears attached hereto as Exhibit C. The equity section of the balance sheet has been reduced from $395,000 to $129,000 as a result of the payout requirements. The difference has been transferred to the liabilities section and the effect upon the ability of the cooperative to do business is immediately apparent.

COOPERATIVES ARE NEEDED TODAY

Substantially all of the members of this Committee are from states with sufficient rural areas to be aware of the problems of farmers and of the need of such farmers for all of the economic help that we can be made available to them but two examples, dealing with actual cost figures, might demonstrate the need to maintain strong cooperatives to contribute to such economic help. In 1954 in Gothenburg, Nebraska, there were several non-cooperative dealers in anhydrous ammonia, selling the same to the farmers in that area for fertilizer at a cost of $229.60 per ton. The cost to such dealers of anhydrous ammonia delivered to Gothenburg was $102.50 per ton. The gross margin, therefore, on such sales was $127.10 per ton sold. In that year the local cooperative installed facilities for the handling of anhydrous ammonia, and the price to the farmer began to drop rapidly. (Of course, as such usage has increased, the cost of anhydrous ammonia to the supplier has also gone down.) In this year the cost has decreased to $41.00 per ton, delivered into Gothenburg, but the price to the farmer decreased to $58.00 per ton, giving a gross margin of $17.00 as opposed to the gross margin of $127.10 per ton which existed prior to the entry of the cooperative into this field. There has been no change in the competitive situation in the town except the addition of this cooperative fertilizer supplier. Nor has a similar decrease in price occurred in areas where no cooperative supplier exists. In many parts of Nebraska which lack a cooperative competitor such fertilizer is still selling for $190.00 to $200.00 per ton.

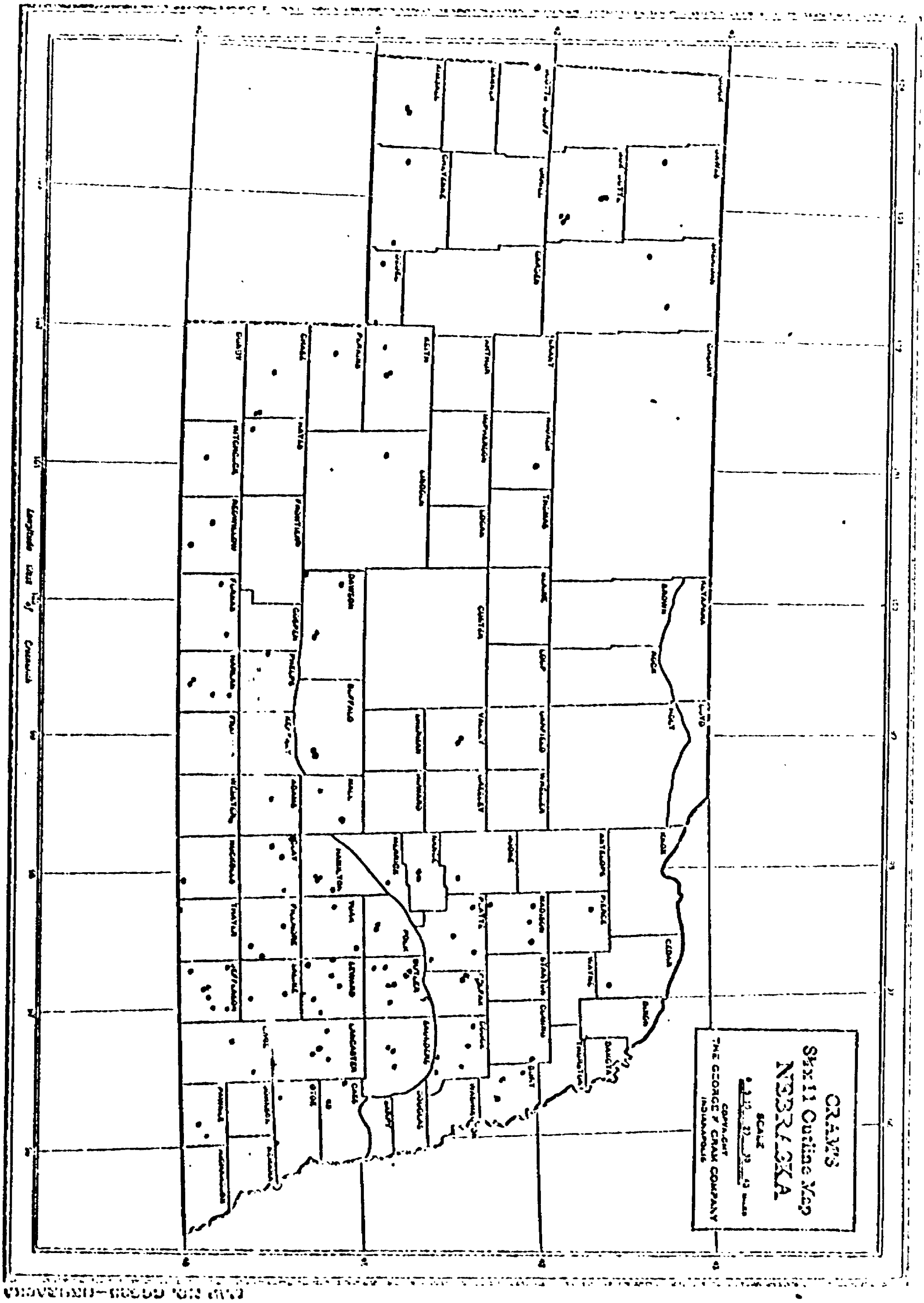
The same situation can be found in an examination of the cost of liquefied petroleum gas for the operation of farm equipment. In this same town of Gothenburg, the cooperative went into the LP gas business in 1963 and found that it was making a gross margin of 55 percent while selling its gas at the same price as the competitors in the area. In the intervening years the gross margin has declined to 35 percent. In view of the experience of this farmer-owned enterprise, it is interesting to speculate as to whether these price decreases would have occurred without the existence of its activities. The evidence from other areas indicates a negative answer. The increased cost of doing business that must result without such reductions in gross margins of farm suppliers must necessarily be reflected in either higher food costs to the consumer or increased bankruptcies of farmers engaged in such production. If the objective of Congress is to increase the cost of food to our people or to bankrupt farmers without any increase in tax revenues then this is desirable legislation.

COOPERATIVES DO NOT NOW HAVE A "TAX ADVANTAGE" AS AGAINST COMPETITORS

A further argument in favor of this legislation, according to the Staff Report, appears to be that cooperatives enjoy an unfair tax advantage as against their competitors. The Staff Report refers to a reduction in "the amounts they can retain tax-free for expansion of facilities in competition with fully tax-paying businesses . . ." This argument may sound valid when the examples are held before this Committee of a few large regional cooperatives that exist in the United States. However, such arugment has no validity as regards the hundreds of farmer cooperatives in the State of Nebraska, or the thousands of such cooperatives that exist for the service of farmers throughout the United States. The competitors of these cooperatives are not businesses that stand at any tax disadvantage to the cooperatives. Such businesses are sole proprietorships or partnerships or small corporations with the Subchapter S Option, all of which pay a single tax, annually, upon their net income whether the same is used to expand the business or whether it is distributed to the owner. Returning to the town of Gothenburg, Nebraska, noted *supra*, the Gothenburg Cooperative Oil Co. appears to have 17 competitors divided among the products it handles of petroleum, liquefied petroleum, and anhydrous ammonia fertilizer. Of these 17, only a single one is not clearly a sole proprietorship, a partnership, or a small corporation qualifed to elect under Subchapter 8. (As to that single competitor information is unavailable, publicly, to make a determination.) It is simply a misrepresentation in by far the vast majority of the competitive situations to state that a cooperative holds a tax advantage over its competitor. It is simply a misrepresentation of facts to state that cooperatives can "retain (amounts) tax free for expansion of facilities" that its competitors cannot retain. In the area where farm cooperatives operate, for all practical purposes, all of the businesses are on an equal footing of paying a single tax upon their net income whether the same is distributed or retained for expansion of the business.

Respectfully submitted,

ROBERT C. GUENZEL.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KEYA PAHA
DEUEL
GARDEN
CHEYENNE
KIMBALL
BANNER
MORRILL
SCOTTS BLUFF
SIOUX
BOX BUTTE
DAWES
SHERIDAN

CAP NO. 60000—NEBRASKA

EXHIBIT A

Exhibit B

Distance to competitor

1,000 feet or less	96
1 mile	3
2 miles	1
3 miles	0
4 miles	3
5 miles	5
6 miles	9
7 miles	9
8 miles	4
9 miles	3
10 miles	1
12 miles	1
Over 12 miles	0

EXHIBIT C.—COMPARATIVE BALANCE SHEET, 1968 AND 1985

	1968	1985
ASSETS		
Current assets	$284,986.20	$284,986.20
Investments	105,054.12	105,054.12
Fixed assets	233,506.28	233,506.28
Other assets	1,260.98	1,260.98
Total assets	624,807.58	624,807.58
LIABILITIES AND EQUITIES		
Current liabilities	164,137.79	164,137.79
Current patronage payable		42,002.88
Long term liabilities	64,363.85	64,363.85
Long term patronage payable		225,302.68
Deferred income	1,092.39	
EQUITY		
Common stock	155,709.21	38,925.00
Preferred stock	714.06	
Certificates of participation	12,546.82	
Certificates of interest	3,080.45	
Equity reserve	40,845.39	
Stock credits	19,205.18	
Revolving fund	38,848.82	
Deferred refunds	13,179.80	
Surplus	69,080.94	69,030.94
Savings	42,002.88	21,001.44
Total equity	395,213.55	129,007.38
Total liabilities and equity	624,807.58	624,807.58

Statement Submitted for the National Livestock Feeders Association by Don F. Magdanz, Exec. Secretary, Omaha, Nebraska

Mr. Chairman, and members of this distinguished Committee: The Tax Reform Act of 1969 now pending before the Senate of the United States is unquestionably a comprehensive piece of legislation. In general we can compliment its purposes and intentions which are to make certain revisions in the Internal Revenue Laws. Without question, some modifications are essential in order to close what have commonly been called tax "loopholes" whereby some taxpayers have discovered ways of taking unreasonable advantage of existing laws and thus reduce, or even eliminate, their tax liability even though they might have high annual net income.

We fully agree with the necessity of taking away these advantages which are absolutely unfair and unjust. No one with income in reasonable proportions or above, should be able to relieve himself of tax liability, nor to take advantage of tax procedures which have been accorded to other taxpayers because of the peculiar nature of their business.

We submit to the Committee that one of the real dangers when making necessary adjustments is that those persons who are not intended to be affected may be caught up in the corrective procedures aimed at taxpayers who are taking undue advantages. Some of the provisions of the bill before this Committee do just that.

ORGANIZATION OF THE NLFA

Though the members of the Committee are well acquainted with the National Livestock Feeders Association, please allow us to insert briefly for the record that ours is a trade organization of persons engaged in the business of feeding livestock . . . cattle, hogs, and lambs. Though our membership extends into many more states it is most prominent in the north-central and plains area of the country, a region that feeds about 65% of the cattle and raises about 75% of the hogs produced in the United States. It is also well known as an abundant farming and agricultural region contributing immeasurably to the plentiful food supply of this nation as well as parts of the world.

THE PROBLEM WITH FARM LOSSES

In our discussion we address ourselves primarily to the Farm Loss Sections of the Tax Reform Act of 1969, and related sections dealing with limits on tax preferences and allocation of deductions both of which materially affect the treatment of farm losses.

It is common knowledge that certain taxpayers with considerable non-agricultural income have been taking advantage of accounting procedures allowed for farmers and using these privileges for an eventual tax profit. Though there are variations, a customary procedure has been to deduct expenses of a capital improvement nature while building assets, and thereby reduce income taxes at regular rates on non-agricultural income over a period of years. At the conclusion of a given period, the grossly appreciated assets may be sold to recover the expenses deducted, and possibly additional revenue, and the tax on resulting income is computed at capital gains rate.

This procedure can result in considerable tax advantage particularly to persons whose non-agricultural income is sufficient to place them in a high tax bracket. Such an opportunity was not intended under existing laws and clearly should be modified to the extent possible.

However, it seems only logical to direct corrective procedures toward those persons who are taking such advantages of the tax laws. By the same token, it is illogical to involve many persons engaged in agriculture for intended profit and their livelihood in requirements and procedures aimed at correcting a problem currently involving a relatively small number of taxpayers.

DEPRECIATION RECAPTURE AND HOLDING PERIOD FOR LIVESTOCK

Certain provisions in the Farm Loss Section of the bill are such that the livestock and agricultural industry can survive them without unreasonable impact. Furthermore, they would take away some of the advantage currently enjoyed by persons with large non-agricultural income who are taking advantage of the cash method of accounting in their agricultural activity for obviously intended tax savings.

We refer particularly to those provisions which would eliminate the exemption for livestock from the depreciation recapture rules, and extend the required holding period for livestock before it could qualify for long-term capital gains treatment upon its sale. Persons primarily engaged in livestock and agricultural business endeavors would be somewhat affected by these provisions, but the degree is not considered to be serious.

On the other hand, they would tend to discourage persons not primarily engaged in agriculture from entering the livestock business for the intended purpose of offsetting high non-agricultural income at regular tax rates with capital expenses in the development of a breeding herd, for example, and eventually regaining these offsetting amounts on which they would pay only at capital gains rates. Beyond these two provisions, we point out the dangers and threats to genuine and bona fide agricultural operators which are contained in the other requirements ofthe Farm Loss Section, and the sections dealing with limitations on tax preferences and allocation of deductions.

AGRICULTURAL ACCOUNTING PROCEDURES

For many years those engaged in agriculture have been exempt from general rules pertaining to methods of accounting required of those taxpayers involved in the production or sale of merchandise. They have been permitted to use the cash accounting method and disregard inventories of crops, livestock, etc.

While it is a fact that this privilege serves to ease the bookkeeping responsibilities for farm taxpayers, many of whom do not have ready access to trained and experienced accountants, nevertheless the very nature of the agricultural business clearly justifies this privilege and it is of the utmost importance that it be continued.

Farmers and livestock operators are subjected to many business hazards which are peculiar to the industry. Just some of these include abnormal price fluctuations, drought, disease, hail and other weather factors. In addition there is the fact that agricultural production cannot be regulated or controlled once it is begun in a manner similar to manufacturing, processing, or merchandising of other commodities.

Agricultural production activities are entirely within the realm of growth which, once having been started, must reasonably be carried to completion. These and other factors make it extremely difficult to profitably operate agricultural industries should the accrual method of accounting be required.

Generally, we have not seen or heard statements to the effect that proponents of tax reform are intent upon eliminating the cash accounting procedure for agriculture and imposing the requirement that accrual methods be used by all farmers and livestock operators. Yet, certain provisions in the Tax Reform Act of 1969 appear to be clearly aimed at so doing, and open the door for such a requirement eventually if not now. Should it occur, and we submit it is entirely probable and likely, those persons who are feeding the nation, and often have low profit returns would enter a dark era indeed.

Lending merit in our suspicions are statements by officials in the Treasury Department containing reference to the cash meth·d of accounting as unrealistic, generous, inaccurate reflection of annual income, liberal deviations from good accounting practices, etc.

EXCESS DEDUCTION ACCOUNT

The Excess Deduction Account contained in the bill is an innovation at least as far as farm operations and farm losses are concerned. On the surface, and with the limitations included in the bill, it might appear to be relatively harmless to actual farmers. On the other hand, it does open the door for pushing farm operators toward the accrual method of accounting and thus can be a threat to genuine and bona fide farm operators.

Admittedly, very few primary farm operations would be affected by the terms contained in the bill; namely, farm losses in excess of $25,000 would need be entered in the EDA, but only if the taxpayer had non-agricultural income of $50,000 annually or more. Not very many, if any, farm operators would qualify for this requirement in the amounts so specified.

However, we point to the recommendations made by the Treasury Department in its Tax Reform Proposals dated April 22, when it was stated, "We recommend that a taxpayer with farm operations be required hereafter to keep an 'Excess Deduction Account' (EDA) in years in which his farm loss exceeds $5,000." There was no mention of any amount of non-agricultural income to qualify a taxpayer for this requirement.

Since the Tax Reform Act of 1969 has been passed by the House of Representatives, containing the figures of $25,000 in losses, and under conditions of $50,000 in non-agricultural incomes, the Treasury Department now makes another recommendation. It is stated, "We now recommend that the EDA rules apply to any taxpayer with non-farm adjusted gross income in excess of $25,000 whose farm losses exceed $15,000."

Of course, those farm operators who elected to use the .ccrual method of accounting would not be subject to the EDA rules. These attitudes and recommendations plus the descriptive terms used by the Treasury Department add authenticity, to our strong feeling that an effort is underway to withdraw from all agriculture the use of the cash accounting method.

Even though the final act should contain the figures of $25,000 in farm losses provided a taxpayer had non-agricultural income of $50,000 or more, it would be much easier to prevail for a change in the figures to lower amounts in both cases and thus eventually force agricultural operators to abandon the cash accounting procedure and move over to an accrual basis.

For these reasons we object to including provisions for an Excess Deduction Account in the Tax Reform Act of 1969 and strongly recommend its elimination. The handwriting, in our opinion, is on the wall and we hope this Committee and the United States Senate will concur.

HOBBY LOSSES

Section 213 of the bill would replace the so-called Hobby Loss Provision of the present law, known as Section 270. The new rule would disallow the deduction of losses from any activity carried on by a taxpayer, including farming and livestock feeding, where the activity is not carried on with reasonable expectation of profit.

However, the bill itself is not clear, nor are statements made by the Treasury Department. We presume the meaning to be, it would be deemed, unless shown to the contrary by the taxpayer, that a taxpayer was not operating an activity with a reasonable expectation of realizing a profit from that activity if he sustains a loss in excess of $25,000 in each of any three out of five years. Here again, if such is the case, very few primary and genuine farm operators would be affected.

However, the language in the bill reads, "$25,000 of loss or more from any three of five consecutive years ending with the taxable year." Thus, it can be interpreted to mean that a farm operator, for example, would be deemed to be a taxpayer not operating with a reasonable expectation of realizing a profit if his total losses in three of the past five years accumulated to $25,000 or more. This could envelop many farm taxpayers, whose farming activities are clearly for profit and livelihood. A farmer so involved would be denied the privilege of deducting the loss from any non-farm income he might have. This would be a most unrealistic and unfair treatment of the nation's food suppliers.

While it is unlikely that even livestock feeders, who are subject to rather serious price fluctuations at times, would sustain as much as a $25,000 loss in each of three of the past five years, it would be entirely possible for many of them to have losses in three of the past five years, which losses in the aggregate would amount to $25,000. If the privilege of using these losses is denied a genuine agricultural operator as a deduction against any non-agricultural income he may have, he would sustain a serious financial blow that could seriously affect his financial condition.

In this discussion we have not ignored the phrase ". . . unless the taxpayer establishes to the contrary" contained in lines two and three on Page 154 and under Section 213 of the bill. The rebuttable presumption, however, would place the burden of proof upon the taxpayer, and even though his historical activity clearly eliminated him from the Hobby Loss arena, he could be forced to prove his innocence in court thus sustaining not only gross inconvenience, but unnecessary and unreasonable expense. We submit it would be very unfortunate to subject genuine farm operators with such possibilities.

LIMITATION ON TAX PREFERENCES

The provisions of the section pertaining to a limit on tax preferences is most disturbing and undesirable for agricultural people. Not only would it seriously complicate an already complex tax law, but there is a strong suggestion of a trend toward taxing gross income rather than net income.

Beyond this, a taxpayer's net amount of farm loss for the year as determined under the EDA rules is considered to be a tax preference, but only to the extent it exceeds what would have been the taxpayer's farm loss for the year if he had used the accrual method of accounting and capitalized capital expenditures. Under these grossly involved provisions, we suggest that any genuine farm operator having non-agricultural income would find the need to employ the services of an expert accountant and tax adviser. Furthermore, any farm operator who might find himself caught in the web of this involvement, could face the necessity of maintaining an accrual system of accounting along with his regular set of records in order to determine what his tax preference actually may be.

Furthermore, under the LTP procedure, a regular and genuine farmer who had non-farm income would find it necessary to add part of his legitimate farm loss to his adjusted gross income in the same manner he would have to add income from tax-exempt interest or the excluded one-half of capital gains sales. While this may be a satisfactory device for catching so-called tax farmers, who with large non-agricultural income are taking advantage of farm accounting rules, it imposes an unfair and unrealistic burden on genuine farm taxpayers.

The bill does provide for a five-year carryover of disallowed preferences which carryover can be used in succeeding years at any time the tax preferences claimed fall below the 50% limit. However, for the actual farmer who may be involved, this amounts to pushing him toward the use of the accrual method of accounting and abandonment of the cash rules allowed for agriculture.

ALLOCATION OF DEDUCTIONS

The requirement that itemized personal deductions must be allocated between taxable income and tax preferences presents a difficult task as related to agriculture. Only the personal deductions which can be allocated to taxable income would be allowed, while those allocated to tax preferences would be disallowed as tax deductions.

It is argued that the provision for allocation of deductions is justified on the grounds that personal deductions are paid for by an individual's entire economic income and not just his taxable income. Therefore 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.

However, for a genuine farmer the tax preference item of a farm loss can in no way be considered as part of his economic income. Thus, the disallowance of part of his personal or itemized tax deductions clearly amount to unfair treatment of the actual farm taxpayer.

CONCLUSION

We believe the arguments set forth in this analysis of the Tax Reform Act of 1969 clearly establish the gross undesirability of certain provisions as they would apply to those farmers who are engaged in business for the purpose of profit and livelihood. Furthermore, we believe it would be fundamentally wrong to move toward withdrawing from agriculture the privilege of continuing the cash method of accounting.

Needless to say, perhaps the agricultural industry is complicated enough without subjecting it to such far-reaching ramifications as are contained in the sections of H.R. 13270 to which we have addressed ourselves. We trust the Committee can give favorable consideration to the views and recommendations we have made, and we express appreciation for the opportunity to present them.

ARTHUR ANDERSEN & CO.,
Chicago, Ill., September 18, 1969.

RE: Statement Regarding H.R. 13270 Tax Reform Act of 1969 Farm Losses
Committee on Finance,
New Senate Office Building,
Washington, D.C.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

DEAR SIRS: The relationship between present Section 270 and the proposed Section 270 should be clarified by means of transitional rules.

BASIS FOR COMMENTS

No reference is made to the interrelationship between the old and new Section 270 in the proposed law as presently drafted. For instance, in computing the $50,000 limitation for years ending through December 31, 1969, will the same rules apply in determining the $50,000 limit on years after December 31, 1969? Also, will the $25,000 loss measure in new Section 270(b) originate in years before 1970 for purposes of testing years beginning in 1970 through 1973? If the answer to these questions is affirmative, then the years 1970 through 1973 will necessarily be subject to two separate tests, one under the old law and one under the new law, to determine the disallowance for a particular year. None of this is clear in the present proposal.

In a separate statement regarding limits on tax preferences, we have pointed out that the combined effect of this Section and Section 301 will apply to working farmers, and have recommended that farm losses not be considered as "tax preference" items under Section 301.

SUMMARY

The foregoing comments are no intended to indicate approval or disapproval of the remaining portions of the Act; instead, they are only indications of technical areas or unintended effects upon unsuspecting taxpayers. This statement is submitted as part of a series of letters, each dealing with a particular area of the proposed legislation. It is intended that the comments and recommendations contained herein be made part of the record of testimony relative to the legislative changes contemplated for farm losses. We shall be pleased to discuss these matters further with you or the Committee, either in person or by telephone. Please call us collect at 312-346-6262 if necessary.

Very truly yours,

JOHN MENDENHALL,
Director of Texas.

DYKEMA, WHEAT, SPENCER, GOODNOW & TRIGG,
Detroit, Mich., September 22, 1969.

Re: Tax reform bill of 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: We would like to submit our comments regarding the provisions of the Tax Reform Bill of 1969 that affect farmers in general and the horses breeding industry in particular. We are submitting these comments at the request of a client who is the owner of an outstanding herd of quarter horses and who has devoted a substantial amount of his time, effort and money to the creation of this herd.

We acknowledge the proper concern of the Treasury Department and of Congress over the trend that has manifested itself in recent years for persons who have excess funds for investment to direct those funds into the so-called "tax sheltered investments," a term that has come to include investments in livestock and farms. We feel, however, that the provisions of the Tax Reform Bill that are aimed at removing the tax advantages from a passive investment in farms and livestock have gone beyond that legitimate goal and will serve to strike down and destroy the genuine operator who has made a substantial commitment of his own personal and financial resources to the active management of a farming or breeding operation.

We believe that the Reform Bill will discourage the serious investor from entering the industry; it will cause the industry to shrink; and it will drive the established farmers and breeders out of business. No segment of our dynamic society ever stands still—it either grows and prospers with its growth or it withers and dies. If the Reform Bill becomes law in its present form, livestock and farming will begin to die.

We believe our client is typical of the active entrepreneur who makes a permanent commitment and becomes a genuine and legitimate part of the breeding industry. He has made a substantial direct investment in land, buildings and other improvements and equipment used in connection with the land, and he has acquired a large herd of animals, which is one of the finest, if not the finest, quarter horse herds in the United States. He is simply not in the same class as, nor does he sell to, the person who buys a herd of cattle described in a prospectus registered with the Securities and Exchange Commission, who has nothing to do with their management and care, and who never even sees the animals he buys. The legitimate operator of a breeding herd is actively engaged in the day to day operations of the business. He has employees, to be sure, but he oversees the operation and is in active control of it.

The creation of a herd of animals such as the one we describe is not an easy task. Nor is it one that is immediately profitable. Indeed, the early years of building such a herd are inevitably years of financial losses. Eventually, however, the properly managed breeding operation becomes profitable; and as the gross receipts from the sale of animals, stud fees, and purses from racing operations increase, the taxable income of the operator increases, and the taxes he pays to the federal and local governments increase.

We believe that the provisions in the Tax Reform Bill that affect the breeding and farming industry are most unrealistic. The breeding industry in particular relies heavily upon the influx of new capital, and the persons who possess such capital must expect, as did our client, when they enter the field that there will be losses for a period of several years. It is the expectation that these lossess will later be recouped, so that a reasonable return may be achieved over the years, that makes such an investment economically feasible in the first place.

The provisions of the Reform Bill penalize the person who incurs such lossess, even though he may incur them in good faith and without tax avoidance motives. They remove provisions that Congress has previously determined to be necessary and desirable to encourage the growth of this industry—and they are removed *not* because the industry no longer needs such encouragement, but because of the abuses of a few greedy non-farmers.

The proposed changes will deter persons from entering the industry and will cause many persons who have made recent commitments to it to get out of the industry. This will cause a general downturn in the industry and begin a cycle that will feed upon itself. As new investors are kept from or driven out of the industry, the owners of established herds, such as our client, will experience a drop in revenues because the persons who would otherwise be paying them stud fees and buying animals from them will no longer be there. This will, in turn, convert the now financially successful operations into loss operations and wreak a financial disaster for the established, successful breeders. The lost income from the destroyed ventures will, in turn, result in lost tax revenues to the federal and local governments.

We submit that the proposed changes are akin to going after a fly with a sledgehammer. They would go far beyond the desired goal of getting rid of the pesky tax manipulator and would destroy the entire structure of a highly desirable industry.

We believe that the limited abuses that have arisen as a result of investments by persons who are not genuinely committed to farming or livestock, but who think their investments are enhanced in yield because of the tax laws, can best be dealt with administratively by the Internal Revenue Service. We believe the Service has all of the tools it needs for this purpose. We have observed how it has in recent years successfully attacked a number of investors who were not genuinely in the business of farming or livestock, and we are convinced that these successes alone have served to keep many would-be hobbyists off of the farm.

If legislation is *really* needed, it should be refined to a much greater extent so as to be aimed at the person who is abusing the present tax laws. The shotgun provisions of the Tax Reform Bill would indiscriminately injure farmers and breeders whom Congress has sought for many years to encourage, and would be a major step backwards for the farming community and for the country.

Very truly yours,

E. JAMES GAMBLE.

LANGROCK & SPERRY ATTORNEYS AT LAW,
Middlebury, Vt., September 10, 1969.

HON. GEORGE D. AIKEN,
U.S. Senate,
Washington, D.C.

DEAR SENATOR AIKEN: I have written you before in connection with the proposed tax bill pending before Congress. Personally, I am in agreement with the concept that many of the so-called "loop-holes" of the tax law should be closed. I am however afraid that some of the proposals passed by the House of Representatives create more problems than they solve.

My main objection deals with the so-called hobby losses where deductions are only allowed where such activity was carried on with a "reasonable expectation of realizing a profit." This provision is especially pertinent to farms and farm losses that are incurred in many years by Vermonters.

I personally am very much concerned with the potential effect this will have on the racing industry. There are three other provisions which also effect the racing industry principally involving the attempt to stop the conversion of ordinary income into capital gain through depreciation of livestock. While the latter provision will hurt farmers, objectively, it would appear to be much more reasonable and have much less disastrous effects than the changes involving the hobby losses.

The problem with applying an objective test which this new section attempts to do to a subjective area is that it fails to leave a potential taxpayer with any degree of certainty as to his potential tax liabilities. It in fact allows for an arbitrary determination by an internal revenue agent which at a very minimum can cost a taxpayer tremendous time and trouble and expense in litigating the point.

I am sincerely worried that this element of the lack of certainty more than the potential tax consequences of the other changes will drive people out of the horse raising and racing business. It would also appear to me that the States require the revenue raised from parimutual racing and that they will not tolerate the racing business to be shut down entirely. You would therefore have a transfer of ownership of horses from many small private and honest owners to organized groups determined to make a profit. In many instances this profit can only be realized by illegitimate uses of the parimutual windows themselves together with the other incidental activities concerning the horse races themselves. Basically if the small owner is forced out a void will be created and this void is ripe for the extension by organized crime into this field.

I do not ask for any special favors to horse men, but I believe a person should be allowed to enter this business venture under the same rules as if he were going into a manufacturing or some other business venture. I do not believe that it is to the benefit of the taxpayers throughout the U.S. to segregate out this type of business for special rules as compared to other businesses.

There well may be a few abuses within this industry but the proposed rules rather than stopping these abuses will tend to destroy the industry.

It may seem an overstatement to say that it will destroy the industry, but statistically the horse racing industry is based upon a large number of small owners and if they are faced with the uncertainty of an adverse determination by an internal revenue agent after the fact of their potential expectations of realizing a profit, then the great bulk of these will not be able to afford to take the chance and proceed. For most people in the business this is not their primary source of livelihood but a second or third business and thus it is easier for them to get out of the industry than it would be in most other cases.

It is hard to fully express my feelings in this matter without making this letter inordinately long. I do feel quite strongly about this matter and would be willing to come to Washington to appear before any committee which might be considering this matter and to talk realistically of what effects this has on the small horse breeder with a small racing stable.

Sincerely yours,

PETER F. LANGROCK.

STATEMENT OF CHARLES DAVENPORT

SUMMARY

I appear in my own capacity as a citizen interested in equitable tax laws and represent no other person in making this statement.

Farm tax losses raise a problem of tax equity and foster unfair competition for many of America's farm families which must rely on farm income for a living.

The farm tax loss problem arises from the combination of (1) a unique administrative dispensation permitting the reporting of farm income and expenses on a cash basis and (2) the conferring of capital gain treatment on some farm assets.

This benefit is available to a taxpayer who (1) has a "farm tax loss" which is not an economic loss and (2) substantial non-farm income against which to absorb the "farm tax loss." There is no benefit to one who has only the farm investment. Thus, high bracket non-farm taxpayers enjoy a competitive advantage over farmers.

There are three proposals to deal with this problem:

(1) The authority to use cash accounting and to deduct some expenses which are capital expenditures could be revoked. I would urge this solution.

(2) Section 211 of H.R. 13270 proposes an excess deductions account which would convert certain sales of farm assets from capital gain to ordinary income. This proposal does nothing to prevent the offsetting of artificial farm losses against other income. It thus permits a deferral of tax on current income and is a wholly ineffective means of dealing with the problem.

(3) If the solution set out in paragraph (1) above is not adopted, I urge adoption of S. 500, herein called the Metcalf Bill. It is structured to reach only artificial farm losses, and it denies current deduction of them.

The present scheme is highly inequitable since it permits many high bracket taxpayers to shield their ordinary income from tax. More importantly it subsidizes by reduction of taxes on other income the "tax farmer" and puts him at an unfair competitive advantage over the "legitimate" farmer.

The Metcalf Bill should be adopted by Congress to solve the "farm tax loss" problem.

GENERAL INTRODUCTION

This statement discusses several pending proposals for changes in the income tax treatment of income from certain farm investments. Before returning to the substance of this discussion, permit me to identify myself.

I teach Federal income tax law at the School of Law, University of California at Davis, California. I represent no client nor organization in writing this statement. I am writing it solely in my own capacity as a citizen with special knowledge of taxation and an interest in an equitable tax system. I have had what I think is unique experience working with the taxation of farm investments. From 1960 to 1967 I was in practice in San Francisco, California, with a firm that represented many farm investors and operators. During that time I was a member, Vice chairman, and Chairman of the Committee on Agriculture of the Tax Section of the American Bar Association. From May 1967 until August of 1969 I worked in the office of the Tax Legislative Counsel in the Treasury Department. During the time I was with the Treasury Department, I participated in the consideration of many and in the development of two proposals concerning the farm tax loss problem, including that contained in "Tax Reform Studies and Proposals," which was published by this Committee and the House Committee on Ways and Means, and including the proposal recommended by the Treasury when it appeared before the House Committee on Ways and Means in April of this year.

THE PROBLEM

There is a general consensus that there is a farm tax loss problem. The House Committee on Ways and Means devoted an entire day to the discussion of this subject. The hearing record runs 183 pages. The Committee heard presentations from at least 15 different groups and printed in the record innumerable letters and comments from persons who did not appear before the Committee. All of these persons agreed there was some difficulty in the farm tax area, but there were differing opinions as to the nature of that difficulty. The purpose of this statement and to discuss the various solutions now pending.

The farm loss problem arises from two different provisions of the Federal tax law. One of them is an administrative decision made as early as 1915 which provided that farmers could report their income on either the cash or the accrual method of accounting, whether or not such method accurately reflected income. It also permitted farmers to deduct their livestock raising costs even though these were capital expenditures. Subsequently, in regulations promulgated in 1919, the Treasury also authorized farmers to write-off capital expenditures incurred in the development of orchards and ranches. Thus, very early in the administration of our tax law, farmers were accorded liberalities not accorded to any other industry. They could use cash accounting and expense capital expenditures even though these dispensations violated proper accounting rules and distorted the reporting of income.

At the time that these rules were developed, they may have been defensive on the ground that the identification of specific costs attributable to particular products on hand at the end of the year would have been difficult. Furthermore, the accounting principles then available were unsophisticated and probably not prepared to deal with the problem of segregating and capitalizing costs associated with livestock and assets such as farms and orchards. In addition, there seems to have been some notion that the average farm did not represent the type of financial investment usually found in other business operations. Thus, farming was looked at as a way of life rather than as a business, and it seemed inappropriate to require the use of highly developed accounting techniques even if they had been available.

It is interesting to note that these rules developed before there was any concept of capital gain. They were also developed by an administrative agency which was charged with prescribing accounting rules which would properly reflect income. Expediency undoubtedly was their chief justification, and there seems to have been no consideration as to their impact on investment and farm assets. Indeed, such consideration would have been improper by an administrative agency charged with the collection of a tax on income. But even so, it is doubtful that they had any such impact at that time.

In 1942, Congress expanded the category of assets entitled to capital gain treatment to include property used in the trade or business where there was a net gain for the year on such assets. After some period of controversy, the law was clarified to make clear that livestock held for draft, breeding or dairy purposes for a period in excess of 12 months qualified under this provision. The controversy then moved to a determination of whether the particular animal had been held for one of these purposes The courts interpreted the section very favorably to taxpayers and conferred capital gain in a number of circumstances which may not have been within the intendment of the law. The result is that a substantial part of the farm profits realized in certain types of farming operations are now reported as capital gain while the cost of assets yielding that capital gain have been fully written off.

The consequences of this interaction of fully deductible capital loss and the reporting of proceeds as capital gain have been fully explored and cogently summarized by the National Livestock Tax Committee in a leter to Honorable Wilbur D. Mills, Chairman, House Committee on Ways and Means, dated March 28, 1969. (This letter appears in Tax Reform, 1969, Hearings Before the Committee on Ways and Means, House of Representatives, 91st Congress, 1st Session, at page 2056 and following). The illustration there assumes a "typical commercial cattle operation" which yields an economic profit of some $22,600 over a five-year period. However, after application of the present income tax laws which create "farm losses" which also taxing the sales proceeds at capital gain rates, there is a total net reduction of taxes on *other income* (derived by subtracting the net capital gain tax from the savings in tax resulting from the "farm tax loss") in the amount of $56,344. This is referred to as a "tax profit," i.e., a payment from the U.S. Treasury to the taxpayer through the tax system. Thus, ths taxpayer's overall gain is approximately $79,000.

There are two striking features about this overall gain. First the "tax loss" generated from the raising of the livestock is of no value to one who has no other income. If the taxpayer is engaged in no endeavor other than that of raising livestock, the "tax loss" is of no benefit. Thus, the "tax profit" is available only to those persons who have substantial other income. Secondly, although there has been a "tax loss" there also has been a true economic farm profit of nearly $23,000, and the taxpayer who has this outside source of income has paid no tax on that farm profit. Instead, this taxpayer has received additional payments in the form of reduced taxes on other income in the amount of nearly $57,000 from the Federal government. On the other hand, a taxpayer who had only the livestock income would have paid some taxes on the $23,000 farm profit earned over the five year period. The exact amount would depend upon the taxpayer's personal exemptions and itemized deductions. Thus, the taxpayer having non-farm income has a competitive advantage over the taxpayer who had only the farming interest. This advantage, arising solely by reason of the tax law, is $57,000 on an investment which yielded an economic profit of only $23,000.

Contrast this also to a taxpayer engaged in the grocery business. If he earned $23,000 over a five year period, he would also pay some tax. Thus, taxpayers having both (a) non-farm income and (b) certain kinds of farm investments which produce "farm tax losses", also have a substantial advantage over taxpayers engaged in other businesses.

Thus, the taxpayer who has the happy combination of large non-farm income and certain farm investments which produce "farm tax losses" is granted an inequitable advantage over (1) those farm taxpayers who have no other income and (2) those taxpayers who have only non-farm income. In the former case, this advantage is also an unfair competitive advantage which permits the "tax farmer" to obtain higher profits on lower prices. The "tax farmer" thus is in a position to drive the "legitimate" farmer out of business. Any change in the tax law, then, should have the purpose of removing the unfair competition between farming interests having outside income as compared to those farming interests which have no outside income. In addition, such change should remove the inequity between farmers and non-farmers.

POSSIBLE SOLUTIONS

From time to time there have been suggestions for changes which would accomplish the goals just described. Perhaps the simplest of these would be the outright revocation of authority for taxpayers having farm income to use the cash method of accounting where it does not accurately reflect income and also to deny to them the right to expense certain capital costs such as the cost of raising livestock or developing orchards, vineyards, and ranches. There are a number of practical problems in this approach, but none of them is insoluble. This approach has much to commend it and is theoretically the correct one. If this Committee should decide to move in that direction, it certainly would be taking a proper action which would be a substantial reform of the income tax law. It is the action I would recommend. If this Committee does not, however, desire to adopt such a sweeping reform, it undoubtedly will go to consider two other pending proposals. The first of these is embodied in section 211 of H.R. 13270. The Treasury Department has recently made recommendations to modify this provision. The other proposal is that contained in the bill introduced by Senator Metcalf on January 22 of this year, S. 500.

The solution adopted by the House is a four part solution. The first is to require that to the extent that the "farm tax loss" exceeds $25,000 it be entered into an excess deductions account if taxpayer's non-farm income for the year is in excess of $50,000. Second, the House voted to extend the holding period on livestock receiving capital gain to one year beyond the time from which such livestock is placed in service by the taxpayer. Third, the bill provides for a recapture of depreciation on livestock so as to place it on an equal footing with other personal property. The second and third actions are appropriate and should be taken regardless of any other provisions which this Committee may chose. They do not, however, solve the farm loss problem. Fourth, the House revised some of the so-called hobby loss rules. They apply to all businesses of any kind. Since their application is not limited to farming, there is no reason to discuss them in the context of the farm loss problem. It seems appropriate thus to exclude them from our present discussion. This leaves us with the excess deductions account, which certainly is the major plank in the farm loss program. We shall compare it to S. 500.

The excess deductions account (herein referred to as EDA) adopted by the House would appear to be a most ineffective tool because it fails to recognize that the major difficulty in the farm tax area is the ability to deduct currently, against non-farm income, expenses which are capital expenditures. By so doing, the "tax dodge farmer" continues to create artificial farm losses which reduce his taxes on current non-farm income. Now under EDA it is true that at some later date, he may be required to include in ordinary income the receipts from the sale of certain farm assets which, absent the EDA provision, he would return as capital gain. But the subsequent returning as ordinary income amounts deducted in prior years permits the taxpayer to defer taxes on current income earned from sources other than farming. The consequence of all this is that in an industry where profits are relatively low, and I understand that in livestock farming total economic profits are often claimed to be as low as 3%, the ability to defer taxes on the income earned in the other endeavors is an extremely valuable benefit. Indeed, the ability to defer taxes may be more valuable than a complete exemption from tax. A simple example will illustrate this.

For the purposes of this illustration, the income and loss limitations contained within the bill are ignored because they are given special consideration below. Thus, we can assume that in the first year the taxpayer incurs a $100 raising cost on a breeding animal which he will ultimately sell at capital gain rates. He incurs the same expense in the second year, and in the third year he sells the animal for $210. His economic profit thus is $10 (or 5%). If he had been required to capitalize the raising costs and to pay a capital gains tax on the profit element only, his tax would be but $2.50. Under present law and under EDA, however, the taxpayer may deduct the raising costs of $200. Assuming a 70% tax rate, in the first year he would reduce his taxes on other income in the amount of $70. The same would be true for the second year when he would reduce his taxes on other income in the amount of $70. These reductions in tax are in essence an interest free loan. Under EDA, the taxpayer would be required to repay the interest free loan upon sale of the animal in the third year when EDA would recapture the prior deducted expenses at a $140 tax cost, just equal to the total of the taxes on other income saved in the first two years. In addition, there would be a $2.50 capital gain tax on the profit. The net tax cost thus is the capital gains tax on the profit. But in addition, the taxpayer has had the benefit of an interest free loan from the government. The value of this loan, assuming an interest rate of 6%, ridiculously low at current borrowing rates, is $12.60. The net benefit is the value of this loan ($12.60) reduced by the capital gains tax ($2.50) or $10.10. This may be contrasted to $2.50 benefit which the taxpayer would have realized if he had capitalized his costs and not been required to pay a tax on the profit. Clearly, then the value of deferring taxes on income earned in other endeavors may exceed the value of entirely exempting farm profits from tax. Any EDA proposal, or any other proposal, which operates on the basis of permitting taxpayers to continue to defer current taxes by the deduction of capital costs is excessively generous and does not handle the farm tax loss problem. Finally, since the repayment of the interest free loan from the Government depends upon a sale by the taxpayer, he has within his own hands the ability to decide when the loan should be repaid, certainly a strange position for a debtor.

In addition, the bill as it came from the House, had two further difficulties. One of them seems to be irremediable. When farm assets are transferred in nontaxable transactions, there either must be a transfer of EDA to the transferee, or the transferee is in a position to sell the assets at capital gain rates while the transferor will have deducted the capital cost of the assets against ordinary income tax rates. Due to the myriad kinds of transactions, it is impossible to devise a single workable rule which will adequately prevent this kind of manipulation. Thus, the bill has a hodge-podge of rules which are neither national nor curative. They may, however, be the best that can be devised to deal with an insoluable problem. Secondly, the income and loss limits of the bill are such that it would operate on approximately 3,000 tax returns. As far as can be ascertained, this would be about .1% of one percent of all farm tax returns and less than one-half of one percent of farm tax returns showing a farm loss. The long run revenue estimate is something less than $20 million. The almost negligible effect of these estimates undoubtedly led the Treasury to recommend that the outside income limit on the bill be reduced to $25,000 and that the farm loss be reduced to $15,000. The Treasury estimated that as so modified, the bill would affect 9,300 taxpayers and in the long run raise $50 million of revenue.

In concluding the discussion of EDA, let me point out that however modified EDA will be ineffective. It is premised on the belief that the payment of taxes one, two, or ten years from today is the same as the payment of taxes today as the income is earned. We all know this is not so, and deferral of paying taxes is now the "name of the game" for many highly skilled tax practitioners. Even if every dollar of farm loss were entered into EDA by every farmer in America, the substantial period of deferral and the benefits to be derived therefrom would render EDA ineffective to solve the farm tax loss problem. Thus, even if modified as suggested by the Treasury EDA will remain an inappropriate tool to deal with this problem.

In contrast to this rather ineffective proposal, Senator Metcalf has introduced S. 500, which is now pending before this Committee, I believe, as Amendment No. 139 to H.R. 13270. That bill would achieve the objective of removing the tax subsidy from tax loss farming by limiting to $15,000 (or the amount of the "special deductions" mentioned in the bill, whichever is higher) the deduction for a farm loss which the taxpayer could use to offset non-farm income. Generally speaking, a farm loss would be the amount by which farm deductions exceeded farm income. For these purposes, the untaxed one-half of long term capital gains attributable to farm property would not be included in income. Farm deductions will include all deductions attributable to the farming business. If the taxpayer's non-farm adjusted gross income exceeded $15,000, the limit on his deductible loss would be reduced by $1 for each $1 of such excess. On the other hand, this limit would be raised to the amount of the taxpayer's "special deductions" if it were higher. The special deductions are (a) taxes, (b) interest, (c) abandonment, theft, fire, storm or casualty losses, (d) drought losses and expenses, and (e) losses on the disposition of assets to the extent they are attributable to farming. If the farm loss of any year is greater than the allowable amount, it would be reduced by the untaxed portion of farm capital gains in that year and then be available to be carried backward three years and forward five years to offset farm income in other years. Partners and shareholders in corporations electing to be taxed under sub-chapter S of the code would then be treated as engaged in the farming operation of the partnership or corporation. It also provides that if a taxpayer is engaged in farming and one or more businesses which are directly related to this farming and conducted on an integrated basis with his farming, the taxpayer could elect to treat all such businesses as a single business of farming.

Finally, a taxpayer who elected to report income using inventories where significant and to capitalize capital expenditures would not be subject to the foregoing rules limiting the amount of this farm loss but could deduct it in full if there were no other provisions of the law which would disallow the deductions. It does not require anyone to adopt accrual accounting. As is mentioned below only 15,000 (out of 3,000,000 farmers) taxpayers would be faced with the choice of non-deduction of the farm tax loss on the use accrual accounting. The purpose of the bill is to preserve cash accounting for those farmers who have not made excessive use of the liberal accounting rules.

This bill offers as good a solution as can be devised short of requiring that all farmers use accrual accounting and be denied the right to deduct capital expenditures. By exempting all losses of less than $15,000 from the operation of the bill, it assures that the small farmer who must supplement his income from other sources or take part time or seasonal employment will not be subject to its provisions. However, this $15,000 limitation is not a blank check to all taxpayers to make deductible investments of $15,000 per year. Instead, as the adjusted gross income exceeds $15,000, the amount of the allowable loss is reduced so that at $30,000 of non-farm adjusted gross income, no farm loss is allowable. This seems clearly appropriate and is a necessary tool to render the bill fully effective. Also, any so-called legitimate farmer who satisfies the reasons for the special accounting rules will not have as much as $15,000 to $30,000 of non-farm adjusted gross income. The bill thus is a cleverly devised bill for which Senator Metcalf is to be complimented. If this Committee is not prepared to require accrual accounting and full cost capitalization where necessary to reflect income properly, I cannot urge too strongly that this Committee adopt the Metcalf Bill as a reasonable solution to the farm loss problem. Let me add, however, that there are a few changes which you may want to consider. They are discussed in the Appendix. They merely improve what would be a good tool.

One might take a look at the bill's operation. It would probably affect about 15,000 taxpayers and would raise as much as $200 million in revenue. This is only about one-and-one half percent of the total returns showing farm losses, but this group obviously are the taxpayers who are taking excessive advantage of the present tax law. The deferral of taxes on current income would be denied to this group, but if they, or for that matter any other farmer, have any sort of catastrophic loss that could not be absorbed by curent farm income, it could be carried over and carried back against farm income of other years. Additionally, most deductions which produce true economic losses are special deductions which are allowed even if they exceed the $15,000 loss limitation. They are taxes, interest, abandonment, theft, fire, storm and casualty losses, and drought losses and expenses and losses on the sale of assets. Thus, the charge that this bill would operate in any arbitrary fashion so as to disallow economic losses cannot be established. Rather it operates only after allowance of the enumerated deductions. It attacks the farm loss problem directly, and it tends to disallow only those artificial losses which would arise from the deduction of capital expenditures that is now permitted under present law.

The amount of revenue raised and the number of taxpayers affected by these various bills are not, of course, the sole criteria by which to measure the effectiveness of provisions dealing with the farm loss problem, however. Obviously, they do, however, go to the question of whether the proposal reduces the Federal subsidy going to taxpayers who have the kind of farm investment which produces a "farm tax loss" which is not an economic loss while also having other sources of income. It must be remembered that this subsidy does not provide any benefits to those who have only the farm investment producing the "farm tax loss." Thus, the purpose of any proposal in this area would be to discourage some investment in farm assets by placing those taxpayers who have substantial outside income on the same ground as those who have only farm income. When measured by this criterion, there is no doubt but what the bill passed by the House even if amended as recommended by the Treasury would be wholly ineffective while the Metcalf Bill at least would have a substantial impact which would appear to be effective. On the other hand, EDA would continue to permit a substantial deferral of taxes on current income for a large number of taxpayers.

CONCLUSION

A number of arguments defending the present provisions of the tax law were raised in the hearings before the House Committee on Ways and Means. To a large extent these are economic questions which claim that the present system yields a large "incentive" to invest in farm assets. It is doubtful that this incentive is desirable in light of our other farm programs designed to assist those most harmed by the tax subsidy. In addition, the "incentive," or more properly the "subsidy," questions the integrity of the tax law and perverts our concept of tax equity. Reduced to its barest form, the argument for this tax incentive is that persons having substantial non-farm income should be induced to invest in certain farm assets and receive the Federal subsidy described above. They are thus accorded a substantial competitive advantage over persons who must rely on only farm income and who therefore do not receive the tax subsidy. To anyone seriously interested in the family farm and its economic well being, it seems clear that the tax law should be amended to reduce this unfair competition. One must, then, view these statements by the defenders of the present system with somewhat of a jaundiced eye. They can be made only to defend a system which is highly inequitable in its operation and which benefits only those who have very high taxable incomes.

The Metcalf Bill would reduce, if not eliminate, this unfair competition. The capital which remained in farming could compete on equal terms whether it is supplied by one having large non-farm income or is supplied by one who must rely on the farm for his sole livelihood. The overall result should be a healthy re-introduction of the unsubsidized free enterprise system in the farm area.

It seems to me that we would all applaud such action and that this Committee would receive the thanks and commendation of millions of farmers throughout the country who today are struggling against Federally tax subsidized competition by high income taxpayers who need not rely on the farm to produce a profit, but rather can look to the Federal Government to supply a profit on the farm investment through the reduction of taxes on other income. There is no justification for the present system, either in terms of equity in the tax system or providing incentive in terms of inducing or strengthening the family farm.

OPPENHEIMER INDUSTRIES, INC.,
Kansas City, Mo., September 29, 1966.

FINANCE COMMITTEE,
U.S. Senate,
Washington, D.C.

DEAR SENATORS: At the hearings last week, quotations from myself and my books seemed to form a major element of the testimony of Senator Metcalf and others opposed to the entrance of outside risk capital into the agricultural industry. While our group testified extensively before the House Ways and Means Committee on March 10, we felt that our position was adequately covered by the American National Cattlemen's Association and did not want to tie up the time of the Senate Committee by appearing separately. On the other hand, we had no idea that we were going to be singled out by Senator Metcalf for so many adverse comments with no chance for rebuttal.

It is my feeling that there was a conscious attempt to confuse the Senate Finance Committee by several of the witnesses and I hope that you have an opportunity to review the following enclosures:

1. My rebuttal to four specific errors in Senator Metcalf's testimony.
2. Copies of resolution from the Montana Stockgrowers Association and the New Mexico State Legislature. These were selected at random from many similar documents since they come from two states where the Senator claims to have the support of all of the agricultural organizations.
3. By separate mail I am sending you a reprint of our group's testimony in March stressing the serious consequences to the agricultural credit system, the under capitalized smaller rancher, and many marginal rural areas if outside risk capital from urban areas was suddenly cut off from the agricultural industry. This entire subject was carefully avoided by Senator Metcalf and his proponents.

Sincerely yours,

H. L. OPPENHEIMER.

Rebuttal to Senator Metcalf's Testimony Before Senate Finance Committee, September 22, 1969

This past Monday, September 22, 1969, hearings were held by the Senate Finance Committee on the 'farm losses" aspects of H.R. 13270. Although I attended those hearings as a spectator, neither I nor any of my direct associates in the livestock industry requested the opportunity to testify at that time. The reason for this was that we had given extensive testimony on March 10, 1969 at hearings of the House Ways and Means Committee when this bill was being developed, and since there has been no change in our position we did not want to take up the Senate Finance Committee's time with duplicative effort.

During the course of the testimony occasional reference was made to me and to my company, Oppenheimer Industries, Inc., and it is primarily for this reason that I am writing you on the matter.

To identify for you our Company and the nature of its business, we are the nation's largest ranch management and rural real estate brokerage concern, having been so involved for the last 17 years or so. Although our company last year managed feeder or breeding cattle herds aggregating well over 200,000 in number, our company has no corporate "position" in either livestock or ranch property. We act solely as management agents.

From the inception of our cattle management operations, our aim has been one of concentrating entirely on commercial (or grade) beef cattle, the type that is raised by the preponderant number of good professional ranchers in this country. Although we use registered bulls for herd improvement, we do not otherwise deal at all in such registered cattle, involving enormously inflated purchase prices, which you will find to be the case in some of the more widely advertised purebred cattle "gimmick" operations. We, incidentally, never advertise. Cattle used in our programs are sold to our clients by ranchers or other sources at a price based entirely on the current fair market values established by the regular livestock authorities. One of our good cows for instance, would be valued at probably $220 to $240, in contrast to a registered cow of not much better real worth which might be bought in a "gimmick" operation for as much as $5,000.

Generally, we do not run any ranches but seek out competent ranchers of proven experience to run our client cattle on a contract basis. They are level-headed native ranchers—"legitimate" farmers, to use the word bandied around at the recent hearing—who realize the benefits which accrue to them by maintaining cattle on contract as a supplement to running their own. This procedure frees their own capital for ranch improvement and expansion. Our Company can point with some pride to at least 5 distressed farm communities where we have entered the picture with our programs, to provide outside venture capital for the expansion of livestock operations, and where the results have been completely visible and noteworthy. The influx of those "high velocity" dollars from our clients into a needy farm community does much to rejuvenate it. We can provide specific examples of this.

In the course of our activities, we have voluntarily registered as dealer and as market agent with the Packers and Stockyards Administration of the USDA. Such action, done on a not required basis but a voluntary basis, reflects our willingness to be openly controlled by the regulations of that Agency. Furthermore, in fact, we have formally offered our services to assist that agency in the enforcement of its laws (at *no* cost) where they believe they are being violated by livestock operators of the "gimmick" type.

With that discussion of our Company's background, I would like to pursue a couple of specifics related to the testimony of Senator Metcalf last Monday.

Another Senator on the Committee posed this question to Senator Metcalf. "Would the elimination of the exemption for depreciation recapture, as proposed in the current House bill, stop the 'gimmick' operator?" I contend that Senator Metcalf then attempted to confuse and mislead the Committee with an obviously prepared lengthy quotation from my book Cowboy Economics, selected out of context. The quotation concerned the ordinary commercial breeding cow costing around $200 with a salvage value for slaughter purposes of around $90. Here depreciation comes to approximately $14 per head per year and is relatively insignificant whether recaptured or not.

On the other hand the questioning Senator was referring to the tax abuse group dealing in $3,000 to $5,000 cows (which incidentally still have the same $90 salvage value for meat) in which depreciation is highly significant and to which the imposition of depreciation recapture would be a most significant item. Obviously, with the study that Senator Metcalf and his staff have given to the subject, they were clearly aware of the difference and were also aware that the section of my book which they had ready to quote referred to the former situation and not to the latter.

At another point during Senator Metcalf's testimony he indicated that his amendment to this tax reform bill (S–500) enjoys the support of all the farm organizations in the country. That this was patently incorrect was seen from the negative reaction of the many actual cattle ranchers then in the audience, most all of whom belong to at least one farm organization or association. Additional evidence that this is not at all true can be seen from the enclosed communication from the Montana Stockgrowers Association (Senator Metcalf's own state) and the Joint Resolution of the New Mexico State Legislature in this regard.

At another point in Senator Metcalf's testimony he was asked a question by Senator Byrd concerning whether farm losses caused by a market decline would constitute an exempted loss under his bill. His affirmative answer, which could not be true, further served to mislead the committee.

Finally, during questioning by Senator Miller who asked the question as to whether a farmer with off-farm income of $25,000 could deduct the $15,000 loss limit provided for in his bill, Senator Metcalf—or his assistant—several times stated that this would be allowable. Finally the correct answer came out that only $5,000 loss would be so allowed, and *not* the $15,000.

These several discrepancies in the testimony of Senator Metcalf have alarmed me and many associates in the livestock industry, and have prompted my writing to you and the other members of the Committee. I hope that the full story on so-called farm tax loss will be made completely clear to you before you vote on any finally proposed bill.

Recognizing that we did not testify in front of your committee, I am taking the liberty of providing you a copy of the testimony which a cross-section of witnesses in the livestock business gave on this matter before the House Ways and Means Committee. I earnestly hope that you and/or your staff can find time to read it. Also, I am sending you under separate cover a copy of my book Cowboy Economics, from which book a part of Senator Metcalf's testimony was quoted. I believe that when you find time to pick it up and read it, you will find it very interesting and informative.

MONTANA STOCKGROWERS ASSOCIATION, INC.,
Helena, Mont., March 5, 1969.

Hon. WILBUR MILLS,
Chairman, House Ways and Means Committee,
Longworth House Office Building,
Washington, D.C.

CHAIRMAN MILLS: Your committee has H.R. 4257 under consideration which is intended to correct abuses of present tax laws permitting deductions for farm and ranch losses against ordinary income. On the surface this proposal purports to protect bonafide farmers and ranchers from competition from "tax dodge" operators and halt the much-publicized take over of agriculture by giant corporations. Obviously, many react favorably to what the bill is for.

On the other hand, this is a complex piece of legislation and tax experts knowledgeable in the livestock and ranching business can see serious implication for legitimate farmers and ranchers. They stand to lose time-honored tax rights. The results can work severe hardships on some of the most important segments of ranching and farming. The young man trying to get started will be handicapped in building and developing a new enterprise. The multi-generation ranching and farming families will be penalized for prudent diversified investments over the years and discouraged from enlarging or developing their present holdings.

As a matter of fact, all taxpayers engaged in the business of farming or ranching will be restricted in the amount of deductions attributable to their operations which can be claimed on their income tax returns. Even the costs of raising breeding animals and raising crops will have to be capitalized. This would prevent deducting these expenses in the year paid or incurred and virtually eliminate from the Internal Revenue Code, Section 175 (dealing with soil and water conservation expenditures), Section 180 (concerning fertilizer costs), and Section 182 (regarding land clearing expenses). It took years of work to get these provisions added to the Internal Revenue Code, and it seems unjust and unnecessary to deny them to legitimate farmers and ranchers to attempt to get at a few who abuse their rights.

It is acknowledged, of course, that there is concern about the adverse economic effects of "tax gimmick" operations have on the legitimate business, but also that promotion of such operations have attracted the criticism of the Treasury Department which in turn is jeopardizing the tax equities which have been gained for the legitimate livestock industry over the years. But in spite of this farmers and ranchers should not be singled out for discrimination, even if the purpose of the crackdown is to get the relatively few persons who are in the livestock business for "tax gimmick" purposes.

Furthermore, it appears that the Internal Revenue Service already has broad authority to deny the deduction of losses if a livestock or any other operation is not a trade or a business being conducted with the expectation of making a profit. Attempting an "easy" way to halt abuses can hardly be condoned if it is to work hardships on all others involved.

Under the circumstances, it will be sincerely appreciated if you will carefully examine all of the facts of this proposed legislation and act accordingly. If it is found that present laws adequately enforced cannot correct the problems now clearly apparent, then only legislation which can deal with the situation without penalizing an entire industry could be sought.

Thanks for your interest and consideration of these matters.

RALPH MIRACLE, *Secretary*.

APPENDIX

SUGGESTED IMPROVEMENTS IN THE METCALF BILL

The operation of the bill could be improved by the following changes:

(1) Losses on ordinary assets (as distinguished from section 1231 assets) might be included in the category of specially treated deductions. Such losses are true economic losses, and there is no reason to disallow them.. The failure to include them would appear to be mere inadvertence. Such losses probably would not occur in many cases, for most of the farm assets producing ordinary income either have no basis or are held in an inventory. In the former case, a loss could not be realized on the sale, and in the latter case the taxpayer probably would not be subject to the bill in any event because he would qualify under the provision excepting taxpayers using inventories and capitalizing capital expenditures.

(2) The provision permitting a taxpayer to treat a nonfarm business as a part of his farming operation if it is related to and on an integrated basis with the farm business raises a definitional problem in determining whether the two operations are related on an integrated basis.

This problem could be cured by providing that a business would not be considered as related and conducted on an integrated basis with the farming operation unless it consists of the processing of a product raised in the farming operation. Furthermore, the sale of such processed product should produce a substantial portion of the total receipts of the over-all operation. In addition, the provision should make clear that treating the two businesses as a farming operation would be for the purposes of this bill only, *i.e.*, measuring the size of the "farm loss" to ascertain whether certain deductions are allowable. The bill should clearly preclude the treating of the other business as a farm operation for the purpose of adopting accounting methods, the filing of estimated tax returns, the filing of final returns, and the like.

Even with this modification, however, the bill might fail to achieve its goal and would permit the offsetting of some "farm losses" arising from the farm tax accounting rules against income earned in other business. For example, a taxpayer might be engaged in processing frozen orange concentrate from an orange grove on which large expenditures and consequent "farm losses" were incurred because a part of the grove had not yet reached full production. The grove, as a whole, presumably would meet all the tests set out above. Thus, the special benefit of deducting "farm losses" against other income would be continued for those taxpayers who have the capital and resources which would permit them to operate in a business related and integrated with their farming operations. Thus, with respect to such taxpayers the bill would not accomplish its objectives even though they would not appear to be the type of taxpayer for whom the special accounting rules were devised.

Thus, even if modified as suggested, the bill might not accomplish its purpose. Yet, the treating of separate businesses as a single operation departs from the usual practice in administering the tax law and may raise problems neither foreseen nor forseeable at this time.

(3) A number of taxpayers may purchase breeding herds, depreciate them for a short period, sell the herd and realize substantial capital gains on the excessive depreciation. While this practice appears improper, there may be an enforcement problem arising from the inability of the Internal Revenue Service to audit all taxpayers. The enforcement problem could be solved automatically by including livestock in the recapture provisions under section 1245. Logically, there is no reason to exempt livestock, and it would prohibit finagling with depreciation even though the taxpayer elected accrual accounting in order to avoid application of the bill.

(4) Under the bill the farm loss would be permitted to offset other farm income, and it may also be carried over to other years. In neither case does farm income include the untaxed portion of capital gains. A loss of $50 may thus continue to offset $100 of capital gain income in either the year of loss or when used as a carryover. This difficulty could be removed by requiring the loss to first be applied against ordinary income, and any balance then applied against capital gain income before the section 1202 deduction or before application of the alternative capital gain rate. The same treatment would be prescribed for carryovers. Thus, in the case where the farm capital gains in the current year are $100 and the farm loss is $50, the capital gain would be reduced to $50 on which a tax would be paid. If there were also ordinary farm income of $20, the farm loss would be reduced to $30, and the farm capital gain would be $70. Exactly the same treatment would be accorded carryovers. For example, if the current loss is $50 with no capital gain until the following year when $100 of farm capital gains are realized, the $50 loss carryover would reduce the capital gain to $50 on which a tax would be paid.

An alternative to the suggested treatment would be to require that the farm loss be an adjustment to the basis of assets. This would necessitate deciding whether to adjust the basis of ordinary income or capital gain assets. It could also raise administrative problems if depreciable property were involved by presenting a new depreciation base each year. If, however, the alternative of a basis adjustment were chosen, presumably the adjustment would not be permitted to create losses but only to reduce gains to zero.

[Telegram]

NASHVILLE, TENN., *September 18, 1969.*

Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building,
Washington, D.C.

As Governor of Tennessee, I submit this statement to you in opposition to the farm tax law changes as proposed in H.R. 13270. If adopted, these restrictive measures will have a stifling effect on the livestock industry in my State and drastically discourage future growth in a segment of our agricultural economy that is having such a positive and greatly needed impact in rural areas.

As one who was farm born and farm-reared in the rural South, I feel I am qualified to give testimony on this matter. I know and appreciate the farmer's problems and the very real and serious threat created by the provisions of this bill which are so harmful to his interests.

The State of Tennessee has many beautiful mountain ranges, but it also has great farmland areas. These rural areas have historically been the home of men and women of independent spirit, who have made the soil the source of their livelihood. We all want to preserve the time honored and basic occupation of farming. We all know that the technology of this age, and the rapid changes in farm production have brought depression to many formerly thriving areas of croplands. It has forced many of our citizens from the land, to seek jobs elsewhere. In recent years, there has been a decided development in new uses of this cropland, through production of horses and cattle. Livestock raising has always been an important part of the Agricultural Economy of Tennessee, but it has expanded into even greater significance in recent years. Tennessee-raised cattle are known throughout this land, wherever quality cattle are produced. And the famed Tennessee walking horse has become nationally popular, while other horse breeders are finding Tennessee's attractions encouraging to horse farming. The livestock industry in Tennessee amounts to an annual sum in excess of $372 million. The future of cattle and horse raising is bright in my State, unless it is discouraged. Growth of livestock production has expanded the job opportunities in rural areas where jobs are most needed.

We all know the problems of the crowded cities, made worse by the flow of the rural unskilled to the urban areas. Certainly, we should not discourage enterprise that has a tendency to bring jobs and opportunities to those rural residents, in their own environment.

My region of the United States, the South and Mid-South, is undoubtedly more sensitive to the effects of laws which discourage rural development because they affect more of our area, more of our people, and more of our economy, we are necessarily becoming more mindful of preserving farm areas, not only for the sake of conservation but because of the urgency of the economic situation. We need these rural lands for watersheds, for recreation, for limiting pollution, and for our own future. We should not discourage in any way their development as cattle and horse farms, for this form of agricultural pursuit is most compatible with sound conservation. The changes in this tax bill affecting farm taxes will discourage that development more, I believe, than many realize.

My concern, as Governor, of Tennessee, is that the proposed farm tax changes will discourage capital investment so vital to the health and growth of the livestock industry in our State. I have personally seen what new interest and new capital invested in cattle and horse farms can do to revive declining agricultural economics. In particular, horse breeding, horse training, and horse shows have opened new areas and have injected fresh capital and a vital ingredient into our rural economy. We need this income for our farmers who need the jobs. We need the markets created for agricultural products.

I appeal to this committee, to the Congress, to consider carefully changes in tax laws that can have a profoundly detrimental effect on our agricultural industry. I, too, favor tax reform and believe abuses of the farm tax laws should be corrected.

But we cannot afford the price of threatening the economic health of an entire industry which contributes so much to our economy, and promises so much for the future. I urge you to abolish or amend the discriminatory farm tax proposals contained in H.R. 13270.

BUFORD ELLINGTON, *Governor.*

PETITION SUBMITTED BY HOLT S. MCKINNEY, GROVE OWNER, LADY LAKE, FLA.

This Petition pertains to the provisions of Section 213 of the "*Tax Reform Bill of 1969*" (H.R. 13270), as passed by the Ways and Means Committee of the House of Representatives,—which provides:

(See exhibits A and B attached.)

Purportedly, this section is intended to deal with so-called "Hobby Losses", and is so designated in the Bill. But by its terms it is made to apply to one of the basic industries of the Country, namely *farming;* and it includes within its scope industry and research of vital economic benefit to the whole Country and to various States and sections in particular.

Under Section 213 any "*activity*" that is carried on at a loss in excess of $25,000 in 3 out of 5 years, shall be "*deemed*" (unless shown to the contrary by the taxpayer) to be operating without "*reasonable expectation*" of profit. This Section invites unending litigation, and in every case (regardless of circumstances or conditions) places the burden on the taxpayer of *proving* beyond all, reasonable doubt that the "*activity*" was engaged in, not simply with the "hope and expectation" of profit, but what, according to some Revenue Agent's particular views, might be or might not be "*deemed*" a *reasonable* expectation of profit. Litigation is made almost mandatory; and the decision in any one case will not be controlling or authority in another case. What one Judge or one Court might hold in one case was a "*reasonable expectation*" of making a profit, might just as well be considered by another Judge in another case as being unreasonable. The administration of the tax law should not be left to such tenuous and uncertain administration; and the taxpayer should not be forced to contend with interminable and expensive and time consuming litigation. The proposed law is itself an open invitation to harassment and enforced litigation.

Former President Woodrow Wilson use to say: "There are two *basic requirements* in any tax law, namely:

1. Certainty of the *amount* of the tax due, *and*
2. Ready and easy determination of that amount.

Certainly the present provisions of Section 213 of the present House bill do not conform to these "*basic requirements*". Not only are they fundamentally unsound and unjust, but as Congressman Utt, a ranking member of the Ways and Means Committee itself, recently said regarding the whole bill, it is "*fiscally irresponsible*". Moreover, as Congressman Utt further pointed out:

"It is time for the Congress to realize that *true tax reform* can only be achieved through *simplification*.

* * * * * * *

"In addition to adopting the wrong approach to tax reform, the committee's bill fails to take sufficient account of the adverse impact that several of the proposed changes *will have on our social and economic structure*."

ECONOMIC EFFECT

Not only should the major goal in the tax field today be tax simplification,—not litigation, but the application of Section 213 in the House bill will, I submit, have far reaching effect on our *economic* structure. This is clearly evident from the Orange Grove industry, with which I am particularly familiar. In the development of an Orange Grove in Florida, it is an established fact that it will take at least 7 or 8 years from the time the grove is set out before it will begin to show a profit; and if you have a Hurricane or severe freeze (which are not uncommon in Florida) during that period, it will likely take longer than that. During the development stage of grove (7 or 8 years), it is not expected to make a profit; and if a person has a 250 or 275 acre young grove, he can very easily lose $25,000 a year for the first 6 or 7 years. Yet the *economic* effect of the growth and production of orange groves in Central Florida (which is its principal industry) is not only *vital* to the economy and well being of the State, but it is important to the diet and well being of the whole Country.

Over 90% of all the Orange Concentrate sold and consumed in the United States is produced in Central Florida. If the owner of a 250 acre Orange Grove in Central Florida could not deduct his losses (if they exceeded $25,000 annually) during the first 6 or 7 years of the groves development, he would have to quit business. This would not only effect the business itself, but it would seriously effect the local economy, because the grove employees and their families would most likely have to go on Public Welfare, as other industry in this section is very limited.

In this connection, it should be noted that the development of Citrus Concentrate, when it first started, was a source of heavy losses for many years, and it was only after steadfast research and development and the expenditure of large sums of money that it was finally brought to a profitable stage. Without Citrus Concentrate today the economy of Central Florida would be bankrupt. Yet in the early years of its existence its future looked very dubious and large sums of money were lost.

This is not uncommon in the development of new products or patents, and it is only by the steadfast determination of the inventor and often after the expenditure of large sums of money that the product or patent is perfected. In one instance that I know of involving the patent and perfection of the process for making gasoline by what is now known as the "*catalytic process*", the owners of the patent spent 10 years and over 10 Million Dollars in perfecting it. In each of those 10 years, losses were many times in excess of $25,000, and at times it looked *very doubtful* whether success could ever be achieved. But had this process for refining gasoline not been perfected (at great expense and time) the price of gasoline in the United States today would probably have been double what it is at present. *Don't ever permit the laws of this Country to discourage infant industry. The future of this Nation depends on it.*

LEGAL EFFECT

Not only is Section 213 of the House bill unjust and a serious economic danger (or as Congressman Utt says: "*fiscally irresponsible*"), but its legal status is, I respectfully submit, of doubtful validity, both as a matter of practical application and as a matter of Constitutionality.

1. *Practical application of section 213.*—As regards the *practical* application of Section 213, take, for example, the case of a man who may engage in drilling for oil. His activities are dominated by the "*hope and expectation*" of profit. But if for 3 years during a 5 year period, he has lost money on his "activity" in excess of $25,000 a year, he is "*deemed*" as a matter of law under Section 213, to have had no "*reasonable expectation*" of profit and his losses are disallowed completely, even though in the fifth year he hits a Million Dollar oil gusher.

In this connection, I have in mind a specific instance of a fellow who went down to Texas some years ago and started drilling for oil. After 4 or 5 years he went broke. But his creditor, who took over his bankrupt organization, decided as a *final effort*, to extend the drilling on one well which had already been started but not finished, and in doing so the creditor hit one of the largest oil fields ever discovered in the United States. Which one of these two men would you say was operating with a "*reasonable expectation*" of profit, the bankrupt driller or the creditor who took a long shot on a partially drilled well?

What is a "*reasonable* expectation" of profit, and what guide lines are to be applied in that determination? How many men 5 years ago would have thought there was a "*reasonable expectation*" of finding oil in the ice covered region of North Alaska?

In the grove business, a severe freeze or Hurricane (which are not uncommon in Florida) can destroy or severely damage an orange grove, so that its production or "*reasonable expectation*" of profit can be destroyed for several years. And during this period, its expenses of restoration and maintenance are materially increased and prolonged. Section 213, however, takes no cognizance of this fact, and if during any 3 of the next 5 years after the freeze or Hurricane, the grove owner has annual losses and expenses in excess of $25,000, they are disallowed *in full* (not just the amount of the loss in *excess* of $25,000), even though the owner continues to carry on the business and undertakes to restore the grove at considerable expense (which in itself is clear evidence that certainly the owner "*expects and hopes*" to obtain an ultimate profit).

As a practical matter, business and industry (particularly infant industry) can not operate to its best advantage in such a restricted and litigious atmosphere. For many years, in its beginning, Television was a loosing industry, and at one time one of the largest companies in the industry was threatened with Bankruptcy. The Railroads of this Country lost money for many years (and some are still losing money), but it would be foolish to say these losses were mere "Hobby Losses" and not entitled to be deducted by the Railroad from its taxable income.

2. *Constitutionality of section 213.*—Section 213 raises a basic Constitutional question namely:

> Whether Congress can in a tax law *discriminate* against one group while permitting another group to carry on the *same kind* of activities with impunity and free from liability.

Certainly the rule of equality under the law would, it seems, make it difficult for Congress to tell one taxpayer he will not be entitled to the same benefits and privileges under the law as that granted to another taxpayer,—simply because, due to circumstances beyond his control (e.g., because of crop failures, hurricanes, floods, fires, etc.), he has had losses in his business for the past 3 years in excess of $25,000 a year.

Moreover, for Congress to enact tax laws granting to one taxpayer the *right to deduct in full* his losses of $25,000 a year, suffered in business during each of 3 years in a 5 year period,—and at the same time *deny* to another taxpayer, engaged in the *same kind* of business, *any part* of his losses amounting to $25,001 a year, during the exact same period, is, I submit, not only discriminatory but *confiscatory*. Yet that is exactly what Section 213 of the House bill provides for.

Section 213 of the House bill (H.R. 13270) undertakes to classify "*Hobby Losses*" not according to nature and type, but according to pure Dollar and cents gain or loss from operation. Such yard-stick can only lead to untold harassment and litigation for farmers and for infant industry in particular.

P.S.—In its Summary Report on the "Tax Reform Bill of 1969" (H.R. 13270), prepared by the Staffs of the Joint Committee on Internal Revenue Taxation and the Committee on Finance, some of the "*Arguments Against*" the proposed Section 213, as passed by the House, are concisely set forth as follows, namely:

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

EXHIBIT A

Sec. 213. Hobby losses.

(a) Section 270 (relating to limitation on deductions allowable to individuals in certain cases) is amended to read as follows:

"SEC. 270. LIMITATION ON DEDUCTIONS IN CERTAIN CASES

"(a) GENERAL RULE.—Items attributable to *an activity* shall be allowed only to the extent of the gross income from such activity *unless such activity is carried on with a reasonable expectation* of realizing a profit.

"(b) REBUTTABLE PRESUMPTION.—*If the deductions attributable to an activity exceed the gross income from such activity by $25000 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 out without a reasonable expectation of realizing a profit.*"

(b) (1) Section 6504 (relating to cross references with respect to limitations on assessment and collection) is amended by striking out paragraph (8).

(2) The table of sections for part IX of subchapter B of chapter 1 is amended by striking out—

"Sec. 270. Limitation on deductions allowable to individuals in certain cases." and inserting in lieu thereof the following:

"Sec. 270. Limitation on deductions in certain cases."

(c) The amendment made by this section shall apply to taxable years beginning after December 31, 1969.

EXHIBIT B

4. Hobby losses (section 213 of the bill and sec. 270 of the code)

Present law.—Present law contains a so-called "hobby loss" provision (section 270) which limits to $50,000 per year the amount of losses from a trade or business carried on by an individual, that can be used to offset other income. This limitation only applies, however, where the losses from the business exceed $50,000 per year for a period of at least 5 consecutive years. In computing the amount of a loss for purposes of this provision, certain specially treated deductions are disregarded. These deductions are taxes, interest, casualty, and abandonment losses connected with a trade or business, farm drought losses, net operating loss carryovers, and expenditures which may be capitalized or currently deducted.

General reasons for change.—The hobby loss provision generally has been of very limited application. It is often possible for a taxpayer to slightly rearrange his income and deductions so as to break the required string of 5 years. In addition, the exclusion of certain specially treated deductions from the loss computations means that a number of expenses are not considered to give rise to a loss even though they are in fact, deducted. Moreover, in the few cases in which the hobby loss provision has applied so as to disallow the deduction of the loss, the taxpayer has been faced in 1 year with a combined additional tax attributable to a 5-year period.

In addition to the hobby loss provision, some court cases have provided another basis on which the loss can be denied; namely that the activity carried on by the taxpayer from which the loss results is not a business but merely a hobby. Your committee believes that this basic principle provides a more effective and reasonable basis for distinguishing situations where taxpayers are not carrying on a business to realize a profit, but rather are merely attempting to utilize the losses from the operation to offset their other income.

Explanation of provision.—For the reasons discussed above, *your committee's bill would replace the so-called hobby loss provision of present law (section 270)* with the following rule. A taxpayer would not be allowed to deduct losses (to the extent attributable to business deductions) *arising from an acivity* carried on by him where the activity was not operated with a *reasonable expectation* of realizing a profit from it. The determination of whether an activity carried on by an individual was being operated with the expectation of realizing a profit would be made on the basis of all the facts and circumstances.

Where an activity has been *carried on by an individual at a loss* in excess of $25,000 in 3 out of 5 years, *it would be deemed*, unless shown to the contrary by the taxpayer, *that the taxpayer was not operating the activity with a reasonable expectation of realizing a profit from it.* In computing the amount of the loss arising from the activity for this purpose, all deductions attributable to the activity would be taken into account. As under present law, the loss would be determined separately with respect to each activity carried on by an individual.

Effective date.—This provision is to be effective with respect to taxable years beginning after December 31, 1969.

5. Revenue effect

The revenue increases under the farm loss provisions of the bill are estimated at $5 million in 1971 and $20 million in 1979.

ALFRED GWYNNE VANDERBILT,
New York, N.Y., October 3, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: It is my understanding that your Committee is now considering the so-called 1969 Tax Reform Act (HR 13270) which has been passed by the House. While I would be affected by various provisions of that Act, if finally enacted and signed by the President, I have some particular concern about proposed Sections 211, 212 and 213 which relate to farm losses, recapture of depreciation on live stock and hobby losses.

For many years I have been in the business of breeding and racing horses as an individual. My stable is known as "Sagamore Farm" and is situated in Glyndon, Maryland. My mother owned it before I did and in 1931 the Board of Tax Appeals in *Amory* v. *Commissioner* ruled that the operation of the stable was a business and not a hobby.

From the experience at "Sagamore Farm" over more than thirty-five years it seems apparent that in some years such an operation is at a profit and in some years it is at a loss. Such a net profit or loss has always been taken into account with my other income. It is my understanding that under the complicated provisions of the proposed new law this will not necessarily be possible in the future. It is my understanding also that on sales of horses the tax treatment would be different in the future than it has been in the past.

Many individuals are, like myself, in the operation of breeding, sale and racing of horses. I think it would cause overall economic harm to the country if the tax laws were changed so as to discourage this form of operation. We employ a substantial number of people. Last year my payroll alone was nearly $200,000. I take no salary. Moreover, the horse racing tracks at which the best of our horses are entered employ thousands of people and they produce very substantial revenues for the States through pari-mutuel taxes and for the localities through other forms of taxes. I do not think that individuals, like myself, can continue to operate in the future as we have done in the past, if the tax laws single out our form of business operation and treat it differently than other forms of business.

It may be suggested that the matter of breeding and racing of horses is a hobby. I think that this is not the case in the majority of situations, particularly with the larger stables like mine which employ so many people and have so many entries in horse races. We are in it as a business. It is a type of business that requires the investment of substantial sums of money and careful economic planning. We think it should be taxed as an ordinary business.

Very sincerely yours,

A. G. VANDERBILT.

MEMORANDUM SUBMITTED BY LYBRAND, ROSS BROS. & MONTGOMERY IN OPPOSITION TO PROPOSED LEGISLATION DEALING WITH FARM LOSSES

JULY 24, 1969.

The stated concern of the Treasury with respect to farming operation is that "excessive advantage" of farm accounting rules is being taken by wealthy individuals in high tax brackets, who deduct, as ordinary losses, large farm losses which, in actuality represent capital investments, and which losses are later recouped by sale of the investment at capital gain rates. (See official statement of Edwin S. Cohen.) However, the proposed legislation goes far beyond its objective of preventing such "excessive advantage."

The Treasury does not contest the fact that farm accounting rules have a legitimate purpose for their existence; farm accounting rules stem from the difficulties and impracticality of using traditional inventory accounting methods in connection with farming operations. Accordingly, the mere fact that a few wealthy individuals may be abusing farm accounting methods should not result in the imposition of the expense and complexity of the new EDA (Excess Deductions Account) upon all the rest of the legitimate farm operations. As presently proposed, EDA indiscriminately applies not only to the high-bracket "hobby" taxpayers to which it is actually directed, but also to small, low-bracket farmers, as well as all corporations. Clearly, the abuse sought to be eliminated has no application to corporations, since corporations do not fall into the category of high-bracket taxpayers. Similarly, the abuse sought to be eliminated has no application to low-bracket individual taxpayers.

Accordingly, it is submitted that the legislative approach of an EDA is both unnecessary and unwise, since it will impose substantial expense and inconvenience to the vast bulk of the farming taxpayers who are not guilty of the evil to which the legislation is being directed. Adequate protection against the evil involved can be achieved through the utilization of the "hobby" loss provision of the Code, Section 270, which is specifically designed to accomplish this task through provisions which are exclusively aimed at high-bracket individual taxpayers. Accordingly, if it is desired to use the concept of an EDA, it is suggested that the concept be part and parcel of Section 270 of the Code, since neither corporations nor low-bracket individual taxpayers would be affected.

As to corporations, it is believed that the proposed legislation is particularly inappropriate, since the corporate tax rates are not sufficient to provide an incentive for the abuses which are the subject of the legislation, and the corporate taxpayer is legitimately in the business of farming, and should not be penalized because of abuses by a limited number of wealthy individual taxpayers.

Assuming, however, that the proposed legislation were to be applied, as presently proposed, to corporations and low-bracket individual taxpayers, it is believed that the following aspects of the problem have not been considered in making the proposal:

(1) The only unusual aspects of farm accounting rules pertain to the right of the farmer to expense on a current basis the costs of capital items. However, the proposed concept of EDA is applicable to the entire excess of ordinary farm deductions over ordinary farm income. It is submitted that if the concept of EDA is to be created, it should extend only to a limited class of expenditures which represent capital costs which have been deducted on a current basis. By way of example, interest costs, taxes, and general overhead costs would be deductible by a normal manufacturing concern which conducted no farming operations, and certainly farmers should be no less entitled to a current deduction of these expenses. However, under the current proposal, such expenditures are deemed to be as tainted as any other types of expenditures.

(2) No thought has apparently been given as to the effect of several farming operations being conducted by the same taxpayer. In the case of an individual, he could be operating non-contiguous farms, or he could be operating contiguous farms in different types of farming operations. In the case of a corporation, it is likely that separate farming operations would be conducted either through separate divisions or through separate subsidiary corporations. No provision has been made in the proposed legislation to permit taxpayers, in computing their EDA, to offset the profits of one farming operation (including an operation conducted as a separate division or a separate corporation) against losses of another farming operation. Clearly, in the absence of such a provision, the provisions will discriminate against separate farming operations, as compared to farming operations which are accounted for as an integral operation.

(3) No indication has been given in conection with the proposed legislation as to how to allocate costs and expenses where a taxpayer conducts both farming and non-farming operations. Obviously, substantial difficulties will arise in attempting to allocate general expenses as between the two operations, and these difficulties reinforce the conclusion expressed above that (i) the proposed legislation should be confined to purely "hobby" loss situation, and should not be applied to the legitimate business operations of corporate taxpayers and low-bracket individual taxpayers, and (ii) in any event the proposed legislation should not apply to any expenditures other than a limited class of expenditures which fall into the category of capital costs which would not be currently deductible by other types of business enterprises.

Memorandum in Opposition to Proposed IRC Section 49(d), as Contained in Section 4 of H.R. 12290

July 24, 1969.

Proposed IRC Section 49(d), as contained in Section 4 of H.R. 12290, pertains to an adjustment of the investment credit where property which was acquired prior to April 18, 1969, is placed in service after December 31, 1970. The proposed section provides that in such event, the investment credit is reduced by $\frac{1}{10}$ of 1% for each month which elapses between November 30, 1970 and the date on which the property is placed in service (except that for property placed in service after December 31, 1974, the investment credit is eliminated).

This provision of H.R. 12290 differs from and is more restrictive than either (i) the Administration Draft Bill, which provides, in Section 4, for termination of the investment credit, but does not reduce the credit as to property acquired prior to the cut-off date, but placed in service thereafter, or (ii) the present Section 48(h) of the Code, dealing with suspension of investment credit as to property acquired on or after May 24, 1967, which contains no limits on investment credit based upon when the property is thereafter placed in service.

It is not understood why H.R. 12290 chooses to limit the investment credit based upon when the property is placed in service, instead of basing it, as was done in connection with the present Section 48(h) of the Code and the Administration Draft Bill, solely upon the date of acquisition of the property.

It is submitted that, if the property was acquired in reliance upon the existence of the investment credit, the investment credit should properly be allowable irrespective of when the property is actually placed into service. Moreover, even assuming there were merit in limiting or denying the investment credit to certain types of property placed into service after December 31, 1970, it is submitted that no merit exists in applying such a provision to farmers. In accordance with Rev. Rul. 65–104, 1965–1 C.B. 28, orchard trees qualify for the investment credit only at such time as they are commercially bearing, and trees which are too young to be commercially bearing at the time of acquisition qualify for the investment credit at such later time as they become commercially bearing. Of course, it may take a number of years before a tree becomes commercially bearing, and the effect of the proposed provision in H.R. 12290 is to limit or deny the investment credit as to trees which were acquired prior to the cut-off date, April 18, 1969, and as to which no further costs are being incurred, but nonetheless will not reach the stage of being commercially bearing until after December 31, 1970. As stated above, no reason exists for denying the full investment credit in such circumstances.

Statement on Tax Reform Act of 1969 as Passed by U.S. House of Representatives by Louisiana Cattlemen's Association

Mr. Chairman and Gentlemen of the Committee, we members of the Louisiana Cattlemen's Executive Committee do assure you of our full and complete support of the position being taken by the American National Cattlemen's Association on the Tax Reform Act of 1969 presently being considered by you.

We are concerned about many provisions of the House-passed bill but we will not go into detail as this will be more ably handled by representatives of the ANCA. We do feel that the application of the many damaging features of the measure would in due time force many dedicated and experienced cowmen out of business. The bill has been heralded as a most comprehensive tax reform effort but we see it as it applies to the cattle and livestock industry as a headache for the operator and a complexity in general. Cattlemen do not have the time or the accounting ability to properly inventory the cost and values going into the development of animals kept for breeding purposes. The present tax laws governing the livestock industry were designed to minimize the bookkeeping problems of cattlemen and other livestock producers by permitting them to keep their books on a "cash" basis. We think this is as it should be.

Great progress has been brought to all agriculture by people with outside nonfarm income enthusiastically engaging in the development of farms and ranches. These developments extend far beyond their tenure and they add value to their communities. We are informed by a representative of a Federal Land Bank that eighty seven (87) percent of their loans are made to people with nonfarm income. Forcing these many dedicated citizens out of agriculture will certainly adversely affect land values. Almost every rancher needs some outside income and he needs capital gains to generate capital. There is a definite shortage of needed capital in most livestock operations. Our costs have advanced out of proportion to our income.

The Excess Deductions Account as passed by the House of Representatives will be very difficult to maintain. Certainly beyond the ability and training of many operators.

STATE OF NEW YORK,
DEPARTMENT OF STATE,
DIVISION OF THE STATE RACING COMMISSION,
New York, N.Y., October 1, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: In our capacity as Commissioners of the New York State Racing Commission, the agency having responsibility for supervision of Thoroughbred racing in this State, we are impelled to communicate to you and to your honorable Committee our views concerning the effect upon the revenues of New York State from pari-mutuel taxes of H.R. 13270, the provisions of which are receiving the Committee's study.

The importance of the revenue from pari-mutuel wagering to the economy of New York State may be appreciated when it is realized that the pari-mutuel tax in 1968 amounted to $155,695,563—over $80,000,000 from Thoroughbred racing and close to $75,000,000 from Harness racing. This amount is almost $100,000,000 more than was received from this source by the next closest State. It represents over 30% of the pari-mutuel taxes received by all of the States receiving revenue from this source.

Any situation which would adversely affect this source of revenue is of vital concern to New York. If the provisions of H.R. 13270 which affect racing were calculated to increase the revenue accruing to New York State, they would be gratefully endorsed by a State which is terribly pressed to meet the demands our present-day problems impose.

But the fact is that H.R. 13270, in its present form, would seriously reduce the revenue New York receives from racing. It would impose upon an already hard-pressed citizenry the obligation of finding new sources of revenue to replace the loss, the full impact of which would be felt within the next few years.

New York has always been unique, as far as Thoroughbred racing is concerned. New Yorkers have been conditioned to expect the best to perform in New York—in racing and in all sports—and when the high standard to which they have been accustomed is lowered, or abandoned, public support falls off, sometimes to the point where the faltering organization has to quit altogether or move elsewhere. This has been the history of baseball, football, basketball and hockey teams in New York.

Racing in New York, on the other hand, has been consistently first class because the owners of the best horses in the land realize that triumphs in New York are necessary if their horses are to be recognized as champions. Such horses confirm breeding theories. Such horses make money for their owners and breeders. Such horses bring out the crowds, increase pari-mutuel wagering and increase the revenues of the State. In 1968, of the 42 leading horses in the seven recognized classes in Thoroughbred flat racing, 39 raced in New York and all of the seven national champions raced in New York. Should the production of such horses be threatened or their numbers curtailed, New York racegoers would lose interest and the economy of New York State would be seriously impaired. The stars get the publicity and bring out the crowds, whether it be racing, football or baseball.

H.R. 13270, as presently constituted, threatens the future of the outstanding horse. Such horses cost comparatively large sums of money whether they be purchased as individuals—privately or in the yearling market—or bred and raised by breeders who race their stock. The mares who produce such horses are expensive and the stud fees of the stallions to whom such mares are sent are high. The better stallions who sire such horses are very valuable animals.

In short, the men who produce and race the outstanding horses which bring out the crowds at Belmont and Aqueduct, and help to provide the pari-mutuel tax revenues so needed by New York State, are men who have invested large sums of money in those horses in the expectation that those horses will win more than they have cost. With these men the racing of horses is a business and the profits to be realized justify the huge capital investments made.

On the racetrack nine horses have made over a million dollars in the last twenty years and for the breeder of highclass Thoroughbreds there was the excellent prospect of making a profit on the sale of his yearlings. In 1968, at the best yearling marts—Keeneland and Saratoga—the averages for yearlings were $30,671 and $24,425 respectively.

For the most part, the people who make the huge investments in good horses derive income from other businesses as well. Diversification of business interests is a common practice for both individuals and corporations. As matters stand, money is to be made by those who risk capital in expensive horses even though there is—and has been—a good deal of discriminatory legislation on the books. For many it is a touch-and-go situation but the prospect of profit has kept them at it. And in keeping at it they have provided the stars of the horse world—the animals which have brought out the crowds and replenished the coffers of States scratching for revenue.

As matters stand now the losses permitted investors for a brief period of years are meager but they can be lived with. But consider the situation if the provisions were tightened, as is contemplated in those sections of H.R. 13270 having to do with horse ownership. Already the impact has been felt. The mere prospect that H.R. 13270 might be passed has reduced the average yearling price in 1969 at Keeneland by over 16% and at Saratoga by 25%—after ten years of steady growth.

Good horses—the stars who bring out the crowds—cannot be developed overnight. A man who decides to go into breeding good horses with the intention of racing them must gather a band of good mares. The following Spring he breeds the mares to first class stallions. The next year the foals arrive but they cannot be raced for two years—not until the youngsters are two-year-olds. But the early racing of horses is a dangerous procedure: the owner may wait until they are three-year-olds. Already six years have passed. But if the breeder is seeking to develop a stallion, or to confirm a breeding theory which could eventually be very successful, he must produce several crops—and nine years at least is required in the process.

Yet the expenses have been there since the beginning—the cost of maintenance of mares and foals, the stallion fees, and all the other expenses which must be borne if eventual success is to be attained. Success is attained, frequently, but the prospective investor—and even the one who has been in the business—is going to be very hesitant if there is no incentive for him to invest a significant amount of capital and to sustain losses until his product may be successfully marketed. In no other field of business, to our knowledge, are there comparable restrictions.

That the provisions having to do with horse ownership—in the proposed H.R. 13270—would seriously decimate the ranks of those who would otherwise enter the ranks of owners and breeders must be apparent. And not only will it affect the decisions of those who buy the best stock and provide the best horses—the effect will be felt all along the line.

New York's welfare—as far as the maintenance of its revenue from pari-mutuel taxes is concerned—depends on the steady flow of first class horses. With their number curtailed, interest in race-going in New York will be confined to what may be called the occasional player. No longer will New York racing attract those who honestly love and appreciate good horses. No longer will the great and tradtional names in racing make New York their headquarters, for the savor will have disappeared, to a great extent.

What will it mean to New York State in dollars and cents? Racing not particularly distinguished racing—is presented at quite a few tracks outside New York. It is that kind of racing which New York will have if its standards have to be lowered, as they undoubtedly will be if H.R. 13720 depletes the supply of investors in good stock and the supply of superior horses.

In 1968, the daily per capita bet at Belmont Park was $105.65. At Aqueduct it was $106.20. The average for the two tracks was slightly over $106. At tracks like Narragansett, Rockingham, Suffolk Downs, Churchill Downs and Detroit—whose standards of racing are comparable with what New York's racing would be under the proposed regulations, the average per capita bet is $86—19% less than in New York.

In 1968, Belmont and Aqueduct contributed to New York State $71,569,416 in pari-mutuel taxes and breakage. Should the new—and unhappy—situation develop, and New York's pari-mutuel play were reduced by 19%, the State would receive $57,971,226 in pari-mutuel taxes, a reduction of $13,598,190, assuming that attendance held up to the 1968 level.

In 1968, at Santa Anita and Hollywood on the west coast, tracks whose standard of racing is lower than New York's but higher than that of the five tracks mentioned above, the average daily per capita bet for the two tracks was $95.47—10% less than in New York. Should the fates be lenient and the pari-mutuel play in New York be reduced by only 10%, the State would receive $7,156,941 less than it received in 1968.

The loss of $13,000,000 in tax revenue—or even $7,000,000—would be catastrophic, as far as New York is concerned. What the federal government expects the farm tax provisions of H.R. 13270 to yield is not known. It has been estimated at $5,000,000 the first year but it would be tragic if the Federal yield was $5,000,000 and New York's loss were $7,000,000 to $13,000,000. Nor would the situation be confined to New York. If the investors in good bloodstock and the production of good horses were discouraged, the ramifications would extend to every corner of this country where the breeding and racing of horses is a business. The impact would be felt in other States which aspire to New York's standards—States which depend, to a lesser but significant extent, on the occasional appearance of first class horses. States like Florida, Maryland, New Jersey, Delaware and Illinois.

The racing and breeding industry is not an industry of a privileged few. Thoroughbred horses are bred in 49 of the 50 States, Alaska being the lone exception.

Race horses, as distinguished from other livestock, are the instruments which provide huge sums in taxes to more than half the States. It is in the public interest to preserve the revenues from racing: There is no comparable public interest in the case of other livestock.

Racing, and racing alone, should be identified as the provider of these crucially needed revenues. Breeding and racing are mutually inter-dependent.

If it is in accord with your procedures, the insertion of this communication in the record of the Committee's hearings on H.R. 13270 would be deeply appreciated.

Sincerely yours,

JOSEPH A. GIMMA, *Chairman*.
EDMOND M. HANRAHAN, *Commissioner*.
WILLIAM L. PFEIFFER, *Commissioner*.

THE NATIONAL BUFFALO ASSOCIATION,
August 27, 1969.

Hon. RUSSELL B. LONG,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: I am enclosing a copy of a Resolution adopted by the Directors of the National Buffalo Association at a meeting in Denver, Colorado on August 11, 1969 making a request that buffalo be excluded from any changes in our tax laws relative to livestock. I feel that the Resolution pretty well sets out the reasons for making this request.

I am also enclosing a copy of a story by Russell Kirk, which will further enlighten you as to the research work on the posibility of a break-through beneficial to humans in the control of cancer and other related diseases.

Any consideration you can give our Association pertaining to this request will be greatly appreciated.

Sincerely yours,

L. R. HOUCK, *President.*

RESOLUTION

Whereas the buffalo in the United States are very few in number, and

Whereas many individuals who are interested in preserving and propagating the buffalo in our country have associated themselves together and organized the National Buffalo Association for the purpose of preserving and promoting buffalo and buffalo products and through research try to find all avenues where buffalo can be of further value to mankind, and

Whereas this is done at considerable expense to the producers who are dealing with wild animals, making it very hazardous and necessitating the use of expensive equipment. He also must develop his own market for the buffalo and buffalo products, and

Whereas through the work being done by the Research Committee of the National Buffalo Association, it is felt that buffalo may contribute greatly to mankind through a serum that may be developed in the control and prevention of cancer. There is a possibility that through this research, control and elimination may be found for many diseases that plague mankind: Now, therefore, be it

Resolved, That the Directors of the National Buffalo Association at a meeting in Denver, Colorado called on August 11, 1969 respectfully request the Congress of the United States to exclude buffalo from any changes that may be enacted in our tax laws pertaining to livestock and because of the costly program the Asociation is embarking upon relative to research, that the owners of buffalo be granted a 25% depleted allowance.

[From the Pioneer, July 17, 1969]

TO THE POINT—WILL THE BISON BE A HEALER OF MAN

(By Russell Kirk)

Although man slaughtered almost to extinction the buffalo of the Great Plains, a time approaches when the American bison may turn his shaggy cheek and repay with kindness this cruelty of his ancient foe. For conceivably the bison may be used to produce "buffalo serum," an antitoxic agent for suppressing tissue-rejection in the transplanting of human organs.

Indeed, it may be possible to develop an anticancer vaccine from buffalo serum, to judge from what research has been undertaken. (Unlike domestic cattle, bison may be immune from cancer.)

Nowadays there exist some 20,000 buffalo scattered across this country, and soon about 5,000 will be slaughtered for meat annually. The hides, too, are valuable. But the benefit of medical agents derived from bison might be greater.

An able Michigan surgeon, Dr. Dwain Cummings, possesses a herd of some 40 bison and is the prime mover in this medical project. Also, he is a power in the National Buffalo Association (Box 995, Pierre, South Dakota).

Dr. Cummings believes that buffalo serum would be superior to horse serum—which already is used to produce antibodies that counter tissue-rejection in humans. For a decade, Dr. Cummings has studied bison, yak and musk-ox.

He has found that the buffalo manifest a high degree of resistance to disease, except for intestinal parasites. No cases have been found in which buffalo have succumbed to cancer. Several medical centers in the United States and Canada are interested in the Cummings project.

Ordinary cattle are susceptible to malignant lesions, or sores, of eye and flank. But though bison suffer the same afflications, those areas of tissue don't turn malignant in bison. Buffalo, Dr. Cummings finds, possess a very high gamma globulin level in their blood and apparently have a single blood type (as contrasted with some 50 different blood types among domestic cattle). Moreover, apparently human beings are not allergic to buffalo hair, flesh or blood; some allergists have prescribed buffalo meat for patients allergic to domestic beef.

In short, this interesting project is undertaken in the hope that the hardy and cancer-resistant bison might be superior to the horse and other animals as a source for vaccines applicable to human ailments. The bison's antibodies (blood substances that destroy or weaken malignant bacteria and toxins) might be employed in a serum to fight the viruses and white corpuscles hostile to transplanted human organs, or to contend against the mysterious malignancy called cancer.

Of all places, this research was commenced at little Mecosta Memorial Hospital, Stanwood, Michigan: a struggling rural hospital that at last is making headway against adversity. Dr. Cummings' buffalo ranch is next door to that hospital, and he operates there and at a Muskegon hospital.

"The Buffalo Doctor," as some of his patients call him, has borrowed $5,000 to carry on his research. He has his troubles: Sometimes people throw rocks at his bison or even shoot them with small-caliber rifles, and later the animals die of abscesses. Should a buffalo used to produce vaccine for organ transplant or for cancer-resistance be so destroyed, the harm to research would be incalculable.

The second weekend of this August, as every summer, Mecosta Memorial Hospital will hold a grand Buffalo Barbecue, a benefit for the institution; thousands of people turn out. The versatile and humorous Dr. Cummings—who was born on an Indian reservation in S. Dak.—will be on hand, as will his wife, Jean, who has written a book (soon to be published, I trust) about his research and his lively experiences as a rural surgeon and his adventures with buffalo.

Like other members of the National Buffalo Association, Dr. Cummings may slaughter animals from time to time, but he cherishes and honors the bison. The Buffalo Association is petitioning the federal Department of the Interior to restore the image of the buffalo to its official seal. Also, they're asking the Treasury Department to mint once more a buffalo nickel (with that Indian on the other side, I hope).

Members of the association think that the Department of Agriculture discriminates against bison by requiring that these creatures be tested and slaughtered for brucellosis, as are domestic cattle. Buffalo being wild animals, it is most difficult to corral and test them; many are hurt or killed in the process; and there is a calfhood vaccination process that apparently checks brucellosis in bison.

Anyway, if the buffalo has some potential talent for healing us humans, we had best be tender with him. The Plains Indians revered the bison even while they hunted him, and we devastators of this species owe the buffalo reparation. Nothing could be more fitting, if surprising, than the discovery of "buffalo serum," antibiotic and antitoxic, on a private buffalo range right beside a hardscrabble little country hospital.

CMR POLLED HEREFORDS,
Senatobia, Miss., September 3, 1969.

HON. JOHN C. STENNIS,
U.S. Senate,
Senate Office Building,
Washington, D.C.

DEAR SENATOR JOHN: Mine and Mississippi's greatest future in Agriculture and Livestock, is at stake in the new proposed tax bill.

To show you Mississippi's opportunities, I am enclosing some clippings, showing you where the beef-cattle herds are, and our idle acres, whose future is beef cattle, and the fact that I produce the top beef cattle in the world.

Then you will also find Bill Tarver's recommendations to me, and he has been my CPA for many years, and I doubt that there is a man in America that has the experience and knowledge of the cattle business as he does, because he has been my CPA, and Keady and Campbell my attorneys, in the two cases that I have had with the IRS in the Tax Court and in Federal Courts, both of which I won.

You see Mr. Tarver's recommendations and facts, and it simply means liquidation of my herd. I furnish seedstock to forty-three states and fourteen foreign countries, and there are many, many of the leading herds that depend on CMR as a source of seedstock for improvement.

I hope the whole Congress realizes that from the commercial industry up, is dependent on breeders who research and furnish improved seedstock today, as this is the only source available, and when you destroy the seedbeds, which the industry has improved as it has, and which millions of our beef cattle trace to, then it is a serious blow to our economy. And more particularly, when in 1967 we imported 1 billion 324 million pounds of beef into this country, about 1½ million pounds per day, and 555 million dollars for the year. Let me emphasize that this is most important, and definitely more important to Mississippi.

Then another point for serious consideration, is whether this bill will not loose more than it will gain. I personally think the bill, will lose more than it will gain.

I know you realize that Buck Newman has dispersed his herd, on August 29 and 30, and I understand that Colonel E. Brooke Lee is dispersing in November of this year, the Ken-Al Ranch herd. So it looks like, as it stands today, unless something is done, that three out of four of the better PH herds in Mississippi, are going to be liquidated.

Many more of these herds over the land are going to be dispersed like the herd of the Director of the American Polled Hereford Association, Frank Crosslin in Tennessee; and one of the real old foundation herds of Shiflet of Red Rock, Oklahoma, are both setup to be liquidated in October and November.

All indications at the present, looks like there will be a mass dispersing and liquidating, and the beef industry will sink in quality and volume.

Any consideration you can give this proposed tax bill to save the purebred industry, and particularly Mississippi's great opportunity in the future, as well as contribute to me, will be appreciated.

With best wishes, I am,

Yours very truly,

M. P. Moore.

Enclosures.

Tarver, Kirby, Bradley & Tarver,
Greenville, Miss., August 29, 1969.

Re Proposed Tax Bill.

Mr. M. P. Moore,
Senatobia, Miss.

Dear Mr. Moore: This has reference to the four items, or sections, which we discussed and which are identified for this purpose as follows:

1. Farm Losses
2. Depreciation Recapture
3. Holding Period for Livestock
4. Capital Gain and Losses

Item 1. Farm Losses. As I understand it, I do not consider this section inequitable nor do I believe it to be aimed at taxpayers like yourself whose principal efforts and investments are and have been dedicated to research in a continuing program of improving dairy and beef cattle. I believe this is aimed at those persons with very substantial non-farm income (and who may never have seen a live cow) who are using the present law as a tax scheme. The provisions of adjusted non-farm income in excess of fifty thousand dollars and of farm losses in excess of twenty-five thousand dollars appear to be an effort by the Committee to differentiate between bona fide farm oriented livestock breeding programs and non-farmers who are attempting to use the present tax law as a tax avoidance scheme. If my understanding of this section is correct, it is entirely reasonable.

Item 2. Depreciation Recapture. This section, also, appears to me to be entirely equitable.

Item 3. Holding Period for Livestock. It is this section which should give you the gravest concern for it is here that the proposed legislation almost completely rejects and repudiates the reasoning behind prior legislation. It is this section which, in my opinion, would be an economic disaster to you and to other persons who have long standing and major commitments to breeding research programs. Not only does this proposed section contemplate the denial of the tax incentive as to future operations but it occasions and immediate devaluation of your herd. This is for the simple reason that you have what is known as a "seed herd," that is you supply breeding animals to other breeders engaged in herd and breed improvement programs. The denial of the tax incentive, which provides a flow of funds necessary for such an operation, obviously makes their investment of funds in seed stock much less attractive and therefore substantially detracts from the value of the herd which you have already built up. This section strikes squarely at breeders like yourself who have relied primarily not on purchased animals but on a long range program of improved breeding stock animals developed *from the increase of your own herd.* I think that the intent of the present law is most clearly expressed in the phrase "regardless of age" and it is my opinion that the repudiation of the "regardless of age" provision will have disastrous effects on major livestock breeding and research programs. Also, I believe a secondary result will be the idling of thousands of acres of land presently devoted to livestock operations.

I believe that the Second Circuit Court of Appeals in McDonald vs. Commissioner, 214 F. 2d 341 analyzed correctly the true intent of existing legislation when the Court stated as follows:

"When Congress undertook to amend S. 117(j)(1), it was made fully cognizant of this situation by representatives of livestock and breeding associations. Hearings before Committee on Finance on H.R. 4473, Revenue Act of 1951, Part 3, pp. 1538, 1837, 2396; Sen. Rep. No. 781, 82d Cong., 1st Sess. 41–42. And it is manifest that the section was drafted with an eye to the breeders' complaints. Thus in defining property 'used' in the business the amendment speaks of livestock 'held' for an appropriate purpose, and adds the further proviso that it apply 'regardless of age.' The intent to repudiate the Commissioner's view is obvious, even without the specific statement in the Report of the Senate Committee on Finance, supra. And it is equally clear that the animal need not be mature and need not have been put to its intended use.

Hence we cannot accept the Tax Court's ruling that the animals must be 24 months old, the age at which they have presumptively had offspring. Equally we disapprove the view that an animal is held for breeding purposes only if there is an expectation and intention that it produce offspring. Life is replete with situations (advertising, war, reproduction) where many are employed in the hope that one will succeed. Yet the purpose subserved by the many is clear. This does not mean that every farmer can obtain the benefit of the capital gains provision for his entire calf crop merely by selecting one of the better looking animals every time he needs a replacement for his producing herd. This taxpayer, however, has made a thoroughly convincing record that his retention of calves was a necessary factor in building his champion herd. He is entitled to the benefit of I.R.C. Sec. 1:7(j)(1) in its new and revised form."

Section 4, Capital Gains and Losses. To a livestock breeder this section is significant only in that it is another blow to the capital gains incentive extended to those persons undertaking the hazards of research and exploration.

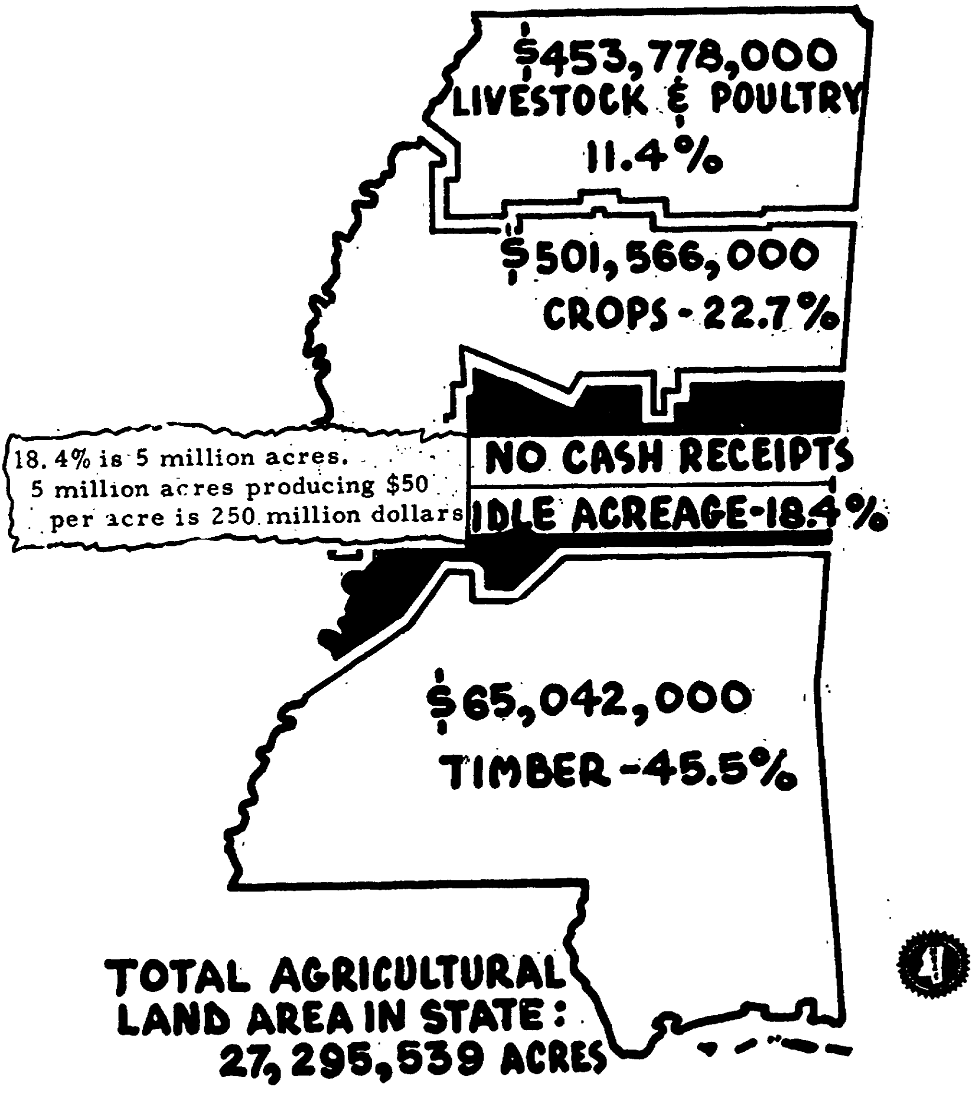
Summary. You have asked me for my opinion as to the effects of this proposed legislation upon your future program. If this legislation is enacted and I were in your position, I would salvage what I could from my investment by a complete dispersal. It would be helpful if you had a minimum of two years before the proposed provisions would become effective. Such a delay would afford some relief to those persons who like yourself have very substantial investments in large experimental and producing breeding herds.

I hope this is responsive to your inquiry.

Very truly yours,

J. W. TARVER.

1968 AGRICULTURAL CASH RECEIPTS


$453,778,000
LIVESTOCK & POULTRY
11.4%
$501,566,000
CROPS - 22.7%
NO CASH RECEIPTS
IDLE ACREAGE-18.4%
18.4% is 5 million acres.
5 million acres producing $50
per acre is 250 million dollars
$65,042,000
TIMBER -45.5%
TOTAL AGRICULTURAL LAND AREA IN STATE: 27,295,539 ACRES

CATTLE HERDS MOVING EAST

The cow-calf business, traditionally associated with the West of ranching fact and cowboy fiction, now seems to be moving Eastward, according to a provocative report from Merck & Co., Inc.

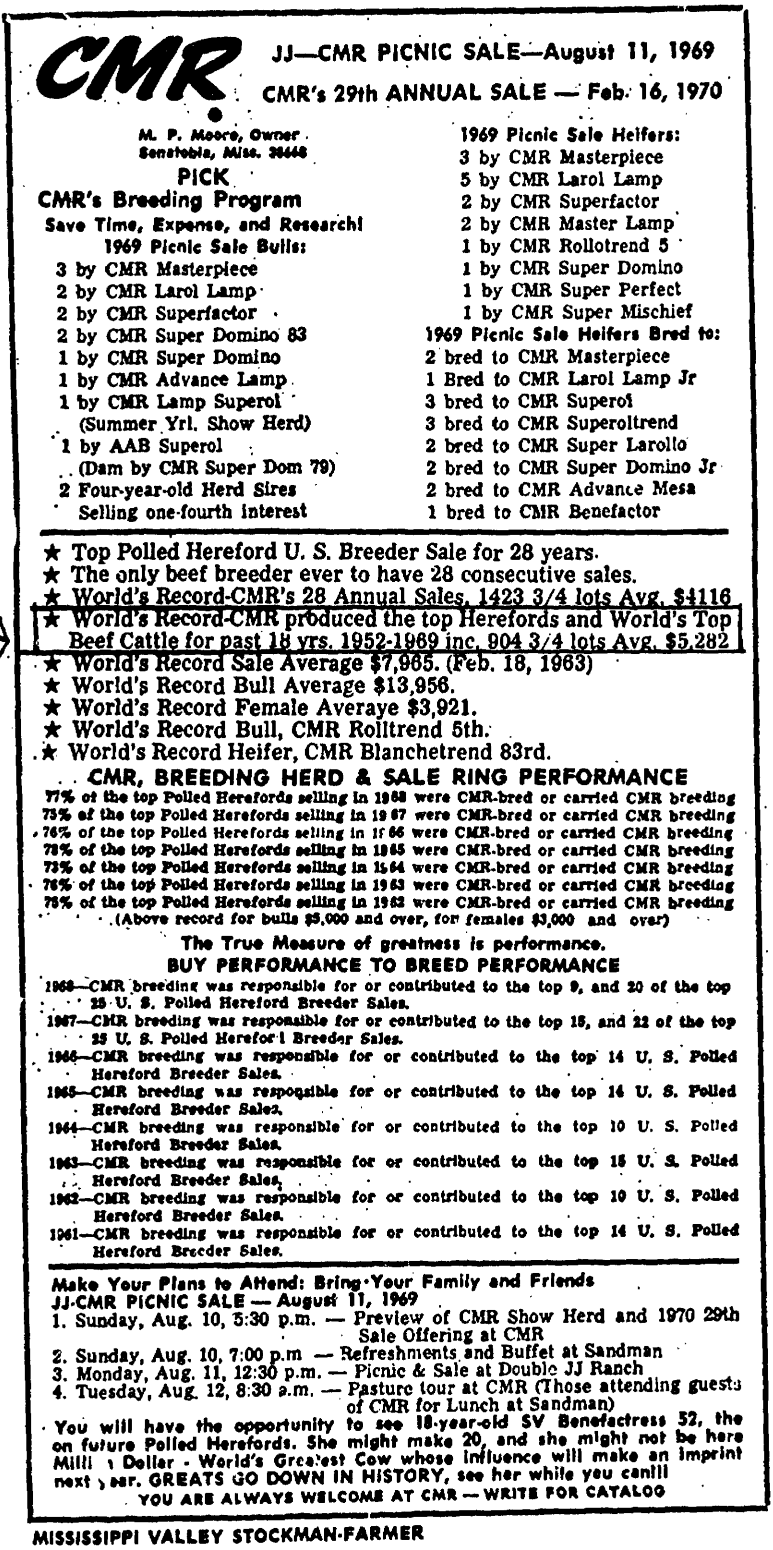
The migration was disclosed to feedlot operators. The report was based on interviews with dozens of animal scientists, agricultural economists and large-scale cattle operators.

Texas is still the dominant ranching state, with almost 5 million beef cows in 150,000 herds. But, according to a noted animal scientist quoted by Merck, "States like Kentucky, Tennessee, Mississippi, Florida, Alabama and Louisiana will move up fast as major producers of feeder calves."

Mississippi ranks 9th in Nation. 1st East of the Mississippi.

Whatever the reasons for the Eastward trend, it will have profound implications for the feedlot industry, which must depend on myraids of individual cow-calf men for the replacement animals it needs to feed a beef hungry nation. Americans now eat an average of 109 pounds of beef annually, compared with 90 pounds a decade ago, while the beefeating human population itself is rising. As a result, the feeder cattle population has been doubling every decade—from 3 million cattle on feed in 1949, to 6 million in 1959, to 12 million today.

Need approximately 7% increase per year thru 1975.



CMR JJ—CMR PICNIC SALE—August 11, 1969

CMR's 29th ANNUAL SALE — Feb. 16, 1970

M. P. Moore, Owner
Senatobia, Miss. 38668

PICK
CMR's Breeding Program
Save Time, Expense, and Research!

1969 Picnic Sale Bulls:
3 by CMR Masterpiece
2 by CMR Larol Lamp
2 by CMR Superfactor
2 by CMR Super Domino 83
1 by CMR Super Domino
1 by CMR Advance Lamp
1 by CMR Lamp Superol
(Summer Yrl. Show Herd)
1 by AAB Superol
(Dam by CMR Super Dom 79)
2 Four-year-old Herd Sires
Selling one-fourth interest

1969 Picnic Sale Heifers:
3 by CMR Masterpiece
5 by CMR Larol Lamp
2 by CMR Superfactor
2 by CMR Master Lamp
1 by CMR Rollotrend 5
1 by CMR Super Domino
1 by CMR Super Perfect
1 by CMR Super Mischief

1969 Picnic Sale Heifers Bred to:
2 bred to CMR Masterpiece
1 Bred to CMR Larol Lamp Jr
3 bred to CMR Superol
3 bred to CMR Superoltrend
2 bred to CMR Super Larollo
2 bred to CMR Super Domino Jr
2 bred to CMR Advance Mesa
1 bred to CMR Benefactor

★ Top Polled Hereford U. S. Breeder Sale for 28 years.
★ The only beef breeder ever to have 28 consecutive sales.
★ World's Record-CMR's 28 Annual Sales, 1423 3/4 lots Avg. $4116
★ World's Record-CMR produced the top Herefords and World's Top Beef Cattle for past 18 yrs. 1952-1969 inc. 904 3/4 lots Avg. $5,282
★ World's Record Sale Average $7,965. (Feb. 18, 1963)
★ World's Record Bull Average $13,956.
★ World's Record Female Averaye $3,921.
★ World's Record Bull, CMR Rolltrend 5th.
★ World's Record Heifer, CMR Blanchetrend 83rd.

CMR, BREEDING HERD & SALE RING PERFORMANCE

77% of the top Polled Herefords selling in 1968 were CMR-bred or carried CMR breeding
73% of the top Polled Herefords selling in 19 67 were CMR-bred or carried CMR breeding
76% of the top Polled Herefords selling in 1f 66 were CMR-bred or carried CMR breeding
78% of the top Polled Herefords selling in 1965 were CMR-bred or carried CMR breeding
73% of the top Polled Herefords selling in 1564 were CMR-bred or carried CMR breeding
76% of the top Polled Herefords selling in 19 63 were CMR-bred or carried CMR breeding
78% of the top Polled Herefords selling in 1962 were CMR-bred or carried CMR breeding
(Above record for bulls $5,000 and over, for females $3,000 and over)

The True Measure of greatness is performance.
BUY PERFORMANCE TO BREED PERFORMANCE

1968—CMR breeding was responsible for or contributed to the top 9, and 20 of the top 25 U. S. Polled Hereford Breeder Sales.

1967—CMR breeding was responsible for or contributed to the top 15, and 22 of the top 25 U. S. Polled Herefor l Breeder Sales.

1966—CMR breeding was responsible for or contributed to the top 14 U. S. Polled Hereford Breeder Sales.

1965—CMR breeding was responsible for or contributed to the top 14 U. S. Polled Hereford Breeder Sales.

1964—CMR breeding was responsible for or contributed to the top 10 U. S. Polled Hereford Breeder Sales.

1963—CMR breeding was responsible for or contributed to the top 15 U. S. Polled Hereford Breeder Sales.

1962—CMR breeding was responsible for or contributed to the top 10 U. S. Polled Hereford Breeder Sales.

1961—CMR breeding was responsible for or contributed to the top 14 U. S. Polled Hereford Breeder Sales.

Make Your Plans to Attend: Bring·Your Family and Friends
JJ-CMR PICNIC SALE — August 11, 1969

1. Sunday, Aug. 10, 5:30 p.m. — Preview of CMR Show Herd and 1970 29th Sale Offering at CMR
2. Sunday, Aug. 10, 7:00 p.m — Refreshments and Buffet at Sandman
3. Monday, Aug. 11, 12:30 p.m. — Picnic & Sale at Double JJ Ranch
4. Tuesday, Aug. 12, 8:30 a.m. — Pasture tour at CMR (Those attending guests of CMR for Lunch at Sandman)

You will have the opportunity to see 18-year-old SV Benefactress 52, the on future Polled Herefords. She might make 20, and she might not be here Milli 1 Dollar - World's Greatest Cow whose influence will make an imprint next year. GREATS GO DOWN IN HISTORY, see her while you canill

YOU ARE ALWAYS WELCOME AT CMR — WRITE FOR CATALOG

MISSISSIPPI VALLEY STOCKMAN-FARMER

APPENDIX B

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECT OF COOPERATIVES

Written testimony received by the committee expressing an interest in the subject of Cooperatives

STATEMENT OF HON. JOSEPH Y. RESNICK, FORMER REPRESENTATIVE FROM NEW YORK

SEPTEMBER 1969.

Mr. Chairman, and distinguished members of the Senate Finance Committee, in the early years of the 20th century, the United States Congress, conscious of the changing face of the American landscape and anxious to preserve something of the agrarian past, used the first income tax laws as a device to assist the American farmer. By exempting agricultural organizations and farmers' cooperatives from the tax bite, the Congress was announcing a wise legislative policy. The self-sufficient, humble yeoman who had made America great had fallen on hard times: he had contracted debts through deflation; he had trouble meeting the high cost of credit and insurance; and he was forced to pay discriminatory railroad rates and unreasonable elevator and storage charges. The only way to insure that in the future the farmer could compete on more even terms with the large corporation, the labor union and the political machine was by encouraging him to organize. Thus the tax breaks for farmers who banded together for their mutual advantage.

I have prepared my testimony today, to make it perfectly clear that these laws have not had the effect intended by the drafters. Rather than fostering organizations which would improve the bargaining position of the farmer and make life more pleasureable for him, the provisions of the Internal Revenue Code have been used by some so-called farm organizations to develop business complexes so diversified that they boggle the imagination—all at the expense of the American farmer, the American taxpayer, and our free competitive economy.

This accruing of vast profits unrelated, and even antagonistic to the needs of the farmer is most blatant in the case of the American Farm Bureau Federation, which boasts over 1.8 million "paid-up member families." For almost two years I have conducted an ad-hoc investigation of this rural colossus which, while claiming to speak for the American farmer, has managed to develop an empire of 92 interlocking insurance companies with over $1.2 billion in assets and over $6 billion of insurance in force, the profits of which are plowed into such farm-related businesses as shopping centers, hotels, a fleet of barges, rent-a-car, gasoline and tire companies.

The Farm Bureau has preserved its tax-exempt status by arguing that its insurance companies are independent of the farm organization and that its insurance companies pay taxes like all others. My investigation, however, proved this argument to be a fraud. The Farm Bureau and its insurance companies are separate entities in name only; they share the same offices, they use the same staffs and they have the same phone numbers. In some states, the salaries and expenses of the Bureau's board of directors are paid by the insurance companies. In others the insurance companies use the facilities and employees of the Farm Bureau to develop and lobby for insurance bills. In still others, state Farm Bureaus combine to form new Farm Bureau insurance companies (which now distribute roughly $3 million annually in tax-free dividends to the state Farm Bureaus).

The granting of membership in the Farm Bureau is simply a device to sell insurance; how else do we explain the fact that its members now include barbers, refrigerator salesmen, union leaders, ministers, townships, school districts, banks and bowling alleys, or that there are seven times as many Farm Bureau members in Cook County, Illinois as there are farms, or that Mr. Roger Fleming, secretary-treasurer of the Farm Bureau, told me that 25% of its members were not farmers—in spite of its sworn statement to the Internal Revenue Service that each of its members is "engaged in carrying on a farm or farms or has a major agricultural interest."

The Farm Bureau, in the bluntest of terms, is a tax-exempt insurance company, using its profits to fund its other business enterprises while it masquerades as a farm organization on Capitol Hill—all the time enjoying an unfair advantage over competitors who do not have the good name of the Farm Bureau as a spur to sales.

Shortly after launching my inquiry, I asked and the Internal Revenue Service agreed to investigate the tax-exempt status of the organization and its state affiliates. My argument for revocation of tax-exemption was simple. The interlocking relationship of the Farm Bureau and its insurance companies belied the claim of separateness. The two were participating in a joint venture in which membership dues were merely an insurance initiation fee and in which the dividends it received from its ownership of insurance company stock were not returns on investment, but earnings subject to the unrelated business income provisions of the Code. None of this income was being used for the tax-exempt purpose, since these dollars were being reinvested in the insurance companies or other businesses unrelated to farming. Under these circumstances, tax-exemption for these dollars seemed unjustified. As of this day, however, the Internal Revenue Service has not seen fit to act.

In the absence of regulatory action, I respectfully suggest that the Congress amend Section 501(c)(5) in such a way that organizations like the Farm Bureau be made to choose between continuing its profit-making ways—and pay the tax consequences—or becoming a farm organization pure and simple, and preserving its tax-exempt status.

This can be done in at least two ways. First, adopt language defining an agricultural organization in terms of the occupation of its membership; for example, it could exclude from membership those not engaged in farming. Second, adopt language limiting the business activities of the farm organization; for example, it could prohibit the farm organization from owning or operating in whole or in part, a business inconsistent with or irrelevant to the interest of the American farmer.

These changes would not, of course, prohibit farm organizations from providing needed services to its members. It would not prohibit farm organizations from offering low cost crop and hail insurance to its farmer members. Nor would it prohibit farm organizations from organizing feed and seed companies, for the benefit of its members.

What changes such as these are geared to do, in short, is to take the Farm Bureau out of the general insurance business: For many years, the insurance companies have been parlaying the name and the tax-exempt status of the parent organization into unfair competitive advantages over taxpaying insurance companies, the same time that they have been distorting the purposes of the farm organization exemption.

A past President of the state Farm Bureau once said that his organization could be a good farm organization or a good insurance company, but not both. The reforms I have suggested should help the Farm Bureau make its choice; if its insurance businesses win out then Congress will have closed the tax loophole and eliminated an unfair competitive advantage; if the Bureau chooses otherwise, it is the farmer who will profit.

Another area deserving of the Committee's attention is that of farmers' cooperatives. The co-op movement is over 100 years old in this country. Having grown up on a farm, I would be the last person to be blind to what it did for many of us. Born in response to the need of farmers to find an efficient method of marketing their crops and purchasing their supplies, coops have had remarkable success in improving the farmers' role in our economy. In 1921, in recognition of their contribution to the agricultural population and its non-profit nature, the co-ops were granted tax exemption by the Congress.

Since that time, co-ops have become big business in this country. There are now better than 5574 tax-exempt farm cooperatives with an annual volume of business of more than 9 billion dollars. In 1915, there were 650,000 members; today, there are over 7,000,000 members.

My investigation of the Farm Bureau and other cooperatives makes it perfectly clear that this transformation from a simple buying or marketing agent for a few farmers into a large organization making large profits like any other successful organization has not been without its unsatisfactory consequences—either for our competitive economy, or for the patron of the coop.

The Internal Revenue Code provisions have actually encouraged this rapid growth. The availability of large sums of untaxed income has had the effect of converting many cooperatives from local farm organizations into gigantic business monopolies which are swallowing up their members and competitors. Many Farm Bureau coops, for example, are using this vast source of tax-free capital to drive independent millers, supply houses, warehouses and grain elevators out of business. In one part of Ohio, I found the coops competing with (and, in fact, underselling) their own members. In other parts of the country, these cooperatives are expanding into contract farming—a system which destroys the farmer as an independent businessman and in effect makes him the captive employee of the contractor.

This fantastic growth would perhaps be justifiable if it were benefiting the hard-pressed farmer. But, too often, as the coop has swelled in size, the basic premises that distinguish it from any other corporation—one-man, one-vote and profit-sharing—have been subverted. The co-ops have too often become self-serving, management-dominated businesses offering none of the special advantages to its customer-members that originally justified a favored tax status.

In too many cases, the farmer-patron has lost all control. By issuing voting stock to a controlling organization, such as the Farm Bureau organization, and by obtaining farmers' proxies with very inadequate disclosure, the basic decision faced by any corporation—how much of the profits to plow back into the business and how much to distribute to shareholders or patrons—has fallen into the hands of corporate managers who are interested solely in the growth of the business entity. A very strange and tragic scene has developed. At the end of the year, some of the coops surplus is retained, the rest is distributed to patrons. Unlike a regular corporation, the coop can deduct from its income the entire distributed surplus. But it is presently only required to distribute 20% in cash. The other 80% of tax free income is plowed back into the coop.

Meanwhile, the farmer is required to pay taxes on *all* of the patronage refund he received—on the 80% stock certificates as well as the 20% cash. Until 1962, when Congress enacted the 20% cash requirement, the farmer had to dip into his other income to pay the tax.

The real shock to the farmer comes, however, when he tries to redeem these certificates. Over a period of years, many farmers have accumulated thousands of dollars of these stock certificates. In many cases they have no fixed maturity date and when the farmer has tried to redeem them, he has found them worthless. At least one court—in Ohio—has upheld that characterization. He cannot trade them at the marketplace, they cannot be given as collateral on loans, and they cannot even be used by farmers to pay their debts to the Farm Bureau coops that issued them. The farmer often does not come to this realization until a time of financial difficulty, when he especially needs the money, and resulting cases of hardship are not uncommon. In my investigation of the Farm Bureau, I found stock certificates issued more than thirty years ago that have not yet, nor can not be redeemed.

After many years of these abuses, the House of Representatives has addressed itself to their correction in HR 13270. Included in the House bill are two provisions which, although I do not believe they go far enough, at least begin to restore to the embattled farmer some of the investment he has made in his coops, some of his hard earned capital that has created the fantastic growth of the coops.

These two provisions are included in Section 531 of the House bill. They would:

1. Raise the required percentage of the annual patronage refund that the coop must return in cash from 20 to 50%.

2. Require that the patronage refunds issued by cooperatives in the form of stock certificates be revolved within 15 years of their issuance.

The first of these provisions would begin to restore a competitive balance between coops and their private competition. The 80% plow-back provision has converted my image of the coop from that of the grist mill at the fork of the creek to that of the modern corporation. The net profit of the coop is the same as the net profit of the corporation operating next door. Both are interested in profits and expansion. Both have an existence quite apart from those who make up the membership. But the coop has the considerable advantage of being able to shift the tax burden for its surplus to its patrons while not losing the use of this money for recapitalization. Requiring the coop to return 50% of its patronage refunds in cash will both restore a competitive equity with private business as well as place in the hands of the individual farmer enough money to pay his tax and still begin to realize some of the profits of his coop.

The other provision—to require a coop to revolve outstanding stock certificates within 15 years—would, at long last, put an end to the intolerable abuses I have described. Coops have a legitimate concern in retaining some reasonable reserve for the purchase and installation of machinery and equipment, or to redeem outstanding patronage dividends. But coops are now fluid enough so that this liberal 15 year requirement would not impose a harsh burden on them. Indeed, many diligently operated coops already revolve their certificates within 5 years, and I urge this Committee to consider an even more stringent requirement than the proposed 15 years.

Let me quickly add, that the abuses I have described are certainly not universial to cooperatives. They are, on the other hand, not isolated cases. They seem particularly endemic to Farm Bureau coops, especially the Mid-Western variety. But as long as these practices, until now sanctioned by our tax laws, continue, a shadow will be cast over all cooperatives, those greatly benefiting the farmer as well as those exploiting him.

My conclusion, in brief, is that by legislative and regulatory inertia, organizations created to protect the farmer and given favorable tax treatment to do so, have been allowed to use the Internal Revenue Code for purposes never conceived of by the draftsmen. I hope that this Committee will not overlook these farm organizations which literally have their cake and eat it too. The House version of the tax reform bill has made a start. I am hopeful that the Senate will endorse the effort to eliminate this double dealing.

MONTANA COUNCIL OF COOPERATIVES,
Helena, Mont., September 3, 1969.

Re section 531 (cooperatives), Tax Reform Act 1969.

Hon. MIKE MANSFIELD,
Senator from Montana,
Washington, D.C.

DEAR SENATOR MANSFIELD: I have received a copy of the statement prepared jointly by counsel for several cooperative groups including our own Farmers Union Grain Terminal Association and Farmers Union Central Exchange mailed to you August 28, 1969.

Since enactment of the 1962 amendments to the Internal Revenue Code, I have heard no accusation or allegation that cooperative patron-members or cooperative corporations are not paying full taxes on all patronage rebates. Section 531 would not change the rate or classification of property subject to tax; thus, although it is included in the tax reform bill, it is not actually a taxing measure and would produce no new tax revenue. It is primarily an effort to destroy farm marketing and supply cooperatives through restrictive and oppressive regulation.

Certainly there is a grave need for major tax revisions and our membership supports honest tax reform. However, insertion of non-revenue producing, discriminatory and crippling business regulations in the reform bill serves only to defeat the basic purpose of the broad reform act, and embroil it in irrelevant side issues.

Since Section 531 is not revenue producing and would further complicate Internal Revenue Service collection procedures, it would appear its' proponents are not people interested in basic tax reform or simplification of tax collection. Obviously the section was inserted in the bill as a decoy and an albatross merely to involve a great number of taxpayers in opposing at least one section (and hopefully the entire bill) of the much needed reform measure.

We sincerely hope you will be able to delete this punitive regulatory section from the Act without jeopardizing the Acts' many other fine qualities.

Very truly yours,

HUBERT J. MASSMAN,
Legal Counsel and Acting Executive Secretary.

STATEMENT OF GEORGE FOGEL, MANAGER, MACOUPIN SERVICE CO., CARLINVILLE, ILL.

I would like to register the following reasons for being in opposition to the Section of the Tax Reform Act of 1969 (H.R. 13270) as it pertains to Cooperatives.

A. The Macoupin Service Company is a locally owned and locally controlled Cooperative. The local membership yearly elects their Board of Directors. The stockholders, at their annual meeting have an opportunity to amend the Articles and By-Laws of the cooperative, if they so desire. If at any time, they wish to change the method of financing of this Cooperative, they may do so by amending the Articles and By-Laws. The law as sent from the House of Representatives denies the stockholders of the Cooperative the right to determine how their Cooperative will be financed.

B. The local Cooperative is a tool utilized by many of the farmers in Macoupin County. This is one method of self-help which has not solicited, nor does it desire any help from the Federal Government. The passing of the tax reform act would seriously weaken the financial strength of the Cooperative and jeopardize its ability to continue to serve this forming community.

C. To my knowledge, the Government does not set any limitations on the methods of payment of stock dividends by other corporations. I can see no legitimate reason for applying a different set of rules for cooperatives.

D. It is often erroneously assumed that Cooperatives do not pay income tax. The Macoupin Service Company last year paid approximately $40,000 stock dividends. It added approximately $50,000 to surplus and paid over $85,000 Federal Income taxes. We ask no special favor, however, we do not expect to be discriminated against.

E. In no way, I repeat, in no way will the tax legislation, as it presently stands, increase the amount of income tax we will pay to the Federal Government. In fact, I can see a possibility whereby the amount of money paid to the Federal Government will actually be less should we be required to rotate our patronage stock every fifteen (15) years.

I ask you to consider with an open mind the statement that I am submitting. I hope that after all of these facts have been considered the Senate Committee on Finance will delete from their tax reform legislation the portions dealing with mandatory revolving of patronage stock by Cooperatives as well as the section dealing with the cash versus non-cash portion of patronage refunds.

FORT ATKINSON, WIS.
September 18, 1969.

To Whom It May Concern:

In a time, such as the present, when businesses are growing through internal and external improvements and financing charges are increasing at a fantastic rate, it becomes particularly hard for smaller orgnizations to keep up. At this same time, larger corporations meet these growth costs by raising their prices and paying smaller dividends on the capital they are using from individual investors.

Cooperatives, run for and by farmers, are also financed by farmer through their limited capital investments. For this reason it is necessary for cooperatives to get the maximum use out of the capital they can use from retained patronage refunds. If the proposed legislation is passed into law, the ability of cooperatives to grow and adequately serve the needs of farmers will be severely limited. To my knowledge, no such provisions exist for noncooperative corporations and therefore is a discriminatory action directed toward further limiting the strength of farmers in favor of corporations.

I am strongly opposed to such dangerous and undemocratic legislation.

Sincerely,

CHARLES COOK.

BERKS-LEHIGH COOPERATIVE FRUIT GROWERS, INC.,
Fleetwood, Pa., September 16, 1969.

COMMITTEE ON FINANCE,
U.S. Senate,
Washington, D.C

GENTLEMEN: You have before you House Bill 13270 for your consideration and action. This small but growing Farmers Cooperative is certainly amazed that Section 531 of that Bill was allowed to pass almost without any appreciable amendments. This section strikes at the heart of small Farmer Cooperatives like Berks-Lehigh Cooperative Fruit Growers, Inc. Berks-Lehigh started in the early 1940's with a modest cash investment by its Charter Members of $5,000.00. From that point on with additional out of pocket investments and appreciable Patronage Capital our net assets as of the end of our last fiscal year were approximately $1,884,000.00. This growth certainly would not have been possible without the Patronage Capital used for the growth of this Cooperative. Our growers certainly have no opposition to this method of financing the activities of Berks-Lehigh. The Board of Directors of this Cooperative has constantly made efforts on a yearly basis to revolve outstanding patronage stock. As of this date we are in a position to recall most of the inactive out of pocket money invested in Berks-Lehigh.

However, it will be a few years until we are in a position to start revolving Patronage Stock. The value of this Stock on our books as of this time is in excess of $600,000.00. To put the tremendous burden of revolving this Stock in 15 years will certainly create tremendous hardships on us. It would hinder our continued growth as an outstanding small processing Cooperative, and also greatly impair our ability to borrow money from the Baltimore Bank for Cooperatives. I ask you as members of this committee to seriously consider Section 521 in its entirety. I rest assured that after careful consideration of this Section you will logically reach a decision that it has no place in the Tax Reform Bill before you.

Sincerely,

JOHN F. KLEIN,
Executive Vice President.

FELCO,
September 15, 1969.

Re section 531 (cooperatives, H.R. 13270).

HON. RUSSELL B. LONG,
Chairman, Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: I am writing in opposition to section 531 of HR 13270. We would like to encourage your efforts to eliminate this section referring to cooperative patronage refunds. The provisions of section 531 as adopted by the House do not affect the amount of revenue which the Government will receive on cooperative patronage. Since it is not a revenue producing section, its effect then is to control cooperative financing. We feel local cooperative members and boards of directors should continue to determine their method of financing. If the act is passed in its present form this means the Federal Government is making a basic financial decision for local cooperatives. We do not feel this is a good precedent to set for cooperatives or for any other type of business. Since cooperative members can control their organization through the adoption of policies or by changing their board of directors at their annual meeting, we see no reason why this provision should be enacted especially at this time when re-financing would be difficult.

It would be unfortunate if farmers would be required to change their financing now, with the current money shortage and high interest rates. Some of the newer and/or smaller cooperatives could be forced out of business, and their farmer/members would suffer as a result. Cooperatives have based their financing on the 1962 Revenue Act, and the 20% cash payment. Section 531 was inserted without an analysis of cooperative financing changes since 1962, and without any testimony to determine the effect of the new proposal.

Farmers own and control their cooperatives. Outside interests cannot gain control due to the requirements of Internal Revenue Service. Government funds are not a factor. Farmers have invested their own money and shouldn't they, through their democratic process of electing directors at annual meetings determine how to distribute their earnings and how to finance their own organization? These annual meetings 200 to 1,000 farmers gather together to hear the operating results for the past year and elect their neighbors to directorships. Cooperatives are, in essence, a self-help program, a method of supplying their production needs at cost and marketing their products. Isn't this what Congress and the people want—more self-help programs and less financial assistance for agriculture?

Section 531 would certainly work a hardship on farmer owned and controlled cooperatives if it is enacted. Since it is not a revenue producing section, we strongly urge that the entire section on cooperatives be deleted from the Tax Reform Act of 1969.

Very truly yours,

RALPH HOFSTAD.

STATEMENT OF THE SUN-MAID RAISIN GROWERS OF CALIFORNIA, KINGSBURG, CALIF., SUBMITTED BY ALLEN F. MATHER, PRESIDENT

Sun-Maid Raisin Growers of California is a farmers' marketing cooperative engaged in the processing and marketing of raisins for its 2,000 grower members in the San Joaquin Valley of California. It has operated as a cooperative since its formation in the early part of this century.

For almost two decades Sun-Maid, along with other cooperatives, has suffered through the various changes in tax laws affecting cooperatives and their members. The distinguished members of the Senate Finance Committee do not need to be reminded of the changes in position and inconsistencies that have occurred with respect to this matter over the recent past.

As a result of Congressional action in 1963, we felt that the issue of cooperative taxation had been settled. However, during an executive session of the House Ways and Means Committee, that body inserted Section 531 into the Tax Reform Act of 1969. This action was taken without any opportunity for testimony to be presented on either the revenue consequences (if any) or the impact upon cooperative operations.

The Senate Finance Committee now has the opportunity of removing Section 531 from the bill, and we would urge that this be done.

Our opposition to the provisions relating to taxation of cooperatives and their members is based on the uncertainty that this legislation will again create for cooperatives and their farmer members. This perhaps should not be a controlling factor if there were a significant tax revenue to be accomplished by the proposed changes. This, however, is not the case, and therefore it would seem that Section 531 would result simply in further harassment of cooperatives without any countervailing benefits.

Statement of the Indiana Farm Bureau Cooperative Association, Inc.

The Indiana Farm Bureau Cooperative Association, Inc., a federation of 85 local cooperatives serving approximately one hundred thousand Indiana farmers is strongly opposed to the cooperative section 531 of the House-passed Bill 13270, for the following justifiable reasons:

1. For many years, farmers have been trying to improve their economic position by using a self-help program, commonly known as a cooperative. Their efforts to sell farm products and buy supplies through their off-the-farm business have been encouraged by each administration, whether Democratic or Republican. In fact, President Nixon recently made the following statement in connection with Co-op Month—1969:

"Because I have seen the progress people have made by acting together, I have pledged assistance to cooperative programs for farm and rural people. I believe cooperative self-help effort is a vital element in improving the economic position of farm families and expanding opportunity throughout rural America."

Over the years, on the basis of this kind of encouragement, and the benefits, both direct and indirect, that are derived from their cooperatives, Indiana farmers have seen fit to invest more than eighty million dollars in their Indiana Farm Bureau Cooperative system. Most of these funds have come from patronage refunds which the farmers have chosen to leave in their businesses so that necessary goods and services could be provided by their cooperatives.

The proposed legislation would jeopardize the financial status of many local cooperatives, and could subseqently cause many Indiana farmers to lose much of the investment they have in their off-the-farm business, at a time when they are already under a severe cost-price squeeze. Furthermore, farmers would lose their instrumentality that provides price protection in the market place.

2. The proposed legislation would indicate that the farmer needs protection from financial decisions made by his cooperative. In actuality, the cooperative is controlled by a board of farmer-directors elected by their rural neighbors. During the ten-year period, 1959–1968, the board members of the Indiana Farm Bureau Cooperative system have deemed it advisable to return to the farmer-owners, $20,488,500 in cash patronage refunds, dividends and common stock redemptions.

Cooperative boards of directors are capable of deciding, and should continue to have the authority to decide when earnings should be used to modernize and expand facilities, and should not be restricted by law under what conditions they make such decisions.

3. The proposed legislation would seriously limit a cooperative's ability to borrow. Presently non-cash patronage refunds are considered as equity capital rather than long-term debt. Thus the proposed legislation would make it very difficult for the cooperative to borrow from banks, insurance companies and the Farm Credit System because it lacked necessary equity capital. Potential lenders would have little, if any, interest in making a loan to a cooperative under such conditions.

4. The proposed legislation is discriminatory. It is not tax reform, but a mandatory financial plan. Cooperatives would be forced to pay up to 50% of their

patronage dividends in cash whereas other corporations are not told when and in what form their dividends are to paid. They are free to pay them wholly or partly in stock if they so choose, or to pay no dividends at all.

Furthermore, under the provisions of the proposed legislation it would be mandatory that the non-cash portion of the patronage dividend be revolved in fifteen years or less. In effect, this would convert all non-cash patronage refunds to long-term debt and make it difficult if not impossible for cooperatives to expand or provide needed new facilities. Today the cooperative may select whether the non-cash refund will be capital stock or debt. Congress does not impose this restriction on other corporations.

5. Finally, the proposed legislation covering cooperatives is not true tax reform. It will not provide any more nor any less revenue to the Treasury. The cooperative would still be allowed a deduction for patronage refunds and the farmer would continue to pay tax on his patronage refund regardless of the per cent of cash either distributed or received and regardless of the mandatory revolving date.

It is for these reasons we believe that cooperative section 531 of H.R. 13270 should be eliminated from the Tax Reform Act of 1969.

Submitted by DeMain Warner, president, Indiana Farm Bureau Cooperative Association, Inc.

SWIG COTTON,
El Paso, Tex., September 16, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: Our association, representing more than 2,000 cotton growers in Arizona, New Mexico, and Texas, is opposed to Section 531 (cooperatives) of H.R. 13270, The Tax Reform Act of 1969.

This section on cooperatives does not produce any additional revenue, and could seriously reduce the ability of our association to increase its financial strength as needed to adequately serve our producer members in the difficult time ahead for these cotton producers.

Our Board of Directors, and members, feel that decisions on what percentage of dividends should be paid in cash, and when to to retire equities, should be made *by our members*, and not by some regulation sponsored by those who seek to destroy cooperatives.

Will you please include this letter in the printed record of the hearings on H.R. 13270 to be held by your committee on September 22, 1969.

Respectfully,

EDWARD BREIHAN,
Secretary.

STATEMENT OF THE IDAHO COOPERATIVE COUNCIL, BOISE, IDAHO

Farmer-owned cooperatives are an extension of the operation of farms. They are non-profit business arrangements by which groups of farmers collectively obtain supplies and services, and transport, grade, process and deliver their produce to market. As in other phases of farm operation certain amounts of capital are necessary to finance these functions, hence farmer-members of cooperatives authorize their cooperatives to deduct marketing fees or retain a portion of the proceeds from the sale of their produce to pay the cost of operating (including financing) the cooperative activity. Savings accruing to cooperative corporations after day-to-day operating costs are paid provide an important source of equity capital which is necessary to finance any business activity. Customarily ownership equities in the cooperatives are denominated by the issuance of certificates or letters of advice to farmer-members according to their respective shares of the services performed. Under existing revenue laws 20 pecent of such savings or margins are paid to members in cash annually, monies which obviously are available to the farmer to pay whatever income tax liability he incurs as operator of his business. It should be clearly understood that the farmer pays the tax on the gross amount (100 per cent) of the equities and that such gross amounts of farmer-owners' equities are evidenced to the Internal Revenue Service each fiscal year.

Subsequently it is customary to repay the farmer-member of the cooperative for the remaining 80 per cent of his equity-capital investment in the cooperative, thus revolving the ownership of the assets of the organization so that it is always held proportionately by active participants in the cooperative enterprise.

The proposed regulation of cooperative capital investment and repayment contained in the Tax Reform Act of 1969 clearly *will not increase the tax income of the federal government one iota.* On the other hand, the regulations, if enacted, will destroy an important method by which farmer-owners of cooperatives finance their own operations.

It has long been considered the policy of the federal government to recognize the merit and desirability of cooperative activity in Agriculture as a contribution to the efficiency and economy of American business. In fact, the adoption of cooperation has been one of the methods by which American farmers have been able to provide an abundant supply of food and fiber at relatively low cost to the ultimate consumers, a record that is probably unmatched in any other industry.

Much criticism has been leveled at Agricultural producers because they must depend on various federally-financed programs for their existence. Regardless of the merits of arguments about subsidies and other assistance provided by the government to farmers, and the effect on social and economic problems such payments made by the federal government have on Agriculture and consumers of agricultural products, we contend that the regulations proposed under the guise of tax reform in the act now before you are unworthy and pernicious because—

(1) They disturb a reasonable concept of taxation worked out in the past between legislators, treasury officials and farmed-owned cooperatives.

(2) No gain or loss of tax revenue to the government will result if the proposed regulations are adopted.

(3) The only foreseeable result of the regulations would be the destruction of the principle of self-help in an industry whose distress has long been a matter of paramount concern.

We strongly urge that your committee strike the provisions relating to cooperatives from the act as being extraneous, inappropriate and contrary to the national interest.

Very truly yours,

Idaho Cooperative Council,
Cecil L. Griggs, *Secretary.*

MFC Services (AAL),
Jackson, Miss., September 18, 1969.

Hon. Russell B. Long,
Chairman, Senate Finance Committee,
Senate Office Building,
Washington, D.C.

Dear Senator Long: I have attached a statement in opposition to the cooperative taxation amendment of the Tax Reform Bill of 1969, which I hope you will make a part of the record.

I am sure that you are aware of the damage the above named amendment would do to the free enterprise cooperatives, not only of Louisiana but of the entire nation. We know that cooperatives are a vital business tool for farmers and they should not suffer from punitive legislation now after many years of national support.

MFC Services, with its membership of 106 local farmer-owned cooperatives and some 70,000 farmers in Louisiana, Mississipp and Alabama, offers its entire support to you in any effort you can make to remove this cooperative-damaging amendment from the Tax Reform Bill of 1969.

Thank you for your continued efforts and consideration in behalf of farmer cooperatives and of agriculture.

Respectfully,

E. E. Beall,
General Manager.

Attachment.

Statement of MFC Services (AAL) in Opposition to the Cooperative Taxation Amendment to the Tax Reform Bill of 1969

The farmer leadership and management of MFC Services are strongly opposed to the cooperative taxation amendment of the Tax Reform Bill of 1969 because it is an improper invasion on the part of the federal government on the right of cooperative members to direct the affairs of their businesses. It is our belief that this section has been promoted by groups lobbying in opposition to farmer-owned free enterprise, who seek to destroy their ability to serve members and their ability to compete. The proposed restrictions are contrary to the long-standing policies of Presidents and Congress in regard to cooperatives, policies which have recognized them as an important contributor to a healthy, competitive, and free economy.

Many cooperatives would be destroyed by being forced into paying out 50% of their margins in cash, just as millions of proprietorships, partnerships and corporations who now pay no patronage refunds would be destroyed by such stringent requirements. No type of business can operate soundly without operating capital. No cooperative should be forced to pay out a large portion of its operating capital and jeopardize its very existence and the long-term welfare of its members, especially since funds would often have to be borrowed at high interest rate to replace those paid out.

The proposed cooperative restrictions would also severely hamper cooperatives' borrowing power and the terms by which money could be obtained.

To all of this can be added the fact that the amendment is not designed to add any new tax dollars to the treasury but appears, instead to be essentially punitive in nature. The principal group who would be punished are small farmers who work through cooperatives—voluntary farmer organizations—to effect savings in their farm programs. These farmers are already far below a parity income and are actually in need themselves of some *positive* legislation to help them survive while their costs are outpacing their net incomes. Every recognized farmer organization recognizes the grave threat of this cooperative taxation amendment and all are opposed to it.

MFC Service urges you and members of your Senate Finance Committee to carefully consider the consequences of this amendment and vote to strike it from this 1969 Tax Reform Bill.

STATEMENT OF OPPOSITION TO SECTION 531, H.R. 13270, SEPTEMBER 19, 1969

To: United States Senators serving on the Senate Finance Committee.
From: Gerald R. Pepper, Executive Director, Iowa Institute of Cooperation.
Subject: Opposition to Sec. 531, H.R. 13270.

ASSUMPTION

I assume the purpose of H.R. 13270 is to provide additional and more equitably derived income for carrying on the business of government. If this is correct, then Sec. 531 of this bill *should not* be included. The section is neither relevant nor pertinent to the purpose of the bill. Should the section be retained as part of this bill, it must be concluded that the intent of the Committee is to place so great a burden on self help cooperatives of all types that they will be forced out of business, for the only way additional revenue could be produced by this section would be to break cooperatives, allowing competitors a position of near monopoly and taxing higher unjustified profits.

CAPITAL

If cooperatives are good (Government has acknowledged they are; all of our Presidents have said so; most Governors and Senators have said so) it is inherent in their organization that they have some way to finance themselves. They have found the revolving fund method capable of providing member equity which can be provided no other way. Without this opportunity of flexibility in the revolving fund they cannot function. Section 531 would in effect *CHANGE THIS MEMBER EQUITY TO DEBT CAPITAL* by establishing a due date. It converts, in fact, an asset to a liability and no lending agency would seriously consider supporting a business entity to any degree on that basis.

PATRONAGE DIVIDENDS

Section 531 establishes the amount of patronage refund which must be paid in cash. Obviously, should a cooperative be forced by legislation to comply with such a requirement its hope of improving the members' situation over time is destroyed. Coupled with the due date section you would have, in fact, forced all cooperative business out of business over relatively few years.

DEMOCRATIC CONTROL

One of the principles of the cooperative businesses is democratic control by the members. The members *currently* have the right and responsibility to determine through representative government the disposition of patronage dividends and the form which they take.

Why should the United States Government, which usually encourages self help and Democratic principles, impose such damaging restrictions on a group of its citizens—particularly in a revenue bill—which obviously does not provide additional revenue—and is completely out of context with other sections of the bill?

It should be apparent to you that the section was included, not as a tax reform measure, but as something you must justify if you pass it. I cannot. But *it is not right* and *should not be included* in the bill!

Would you, the trustees of the greatest democracy of all, have such little faith in that system to dictate (that's another system) to the members of democratically controlled cooperatives the decisions they must make?

Should you not be the prime defenders of the representative government that is basic to a cooperative? Would you not leave the internal operation decisions to the members through their elected directors? I certainly hope so.

I strongly urge the deletion of Section 531 from this bill.

STATEMENT OF SUNKIST GROWERS, INC., LOS ANGELES, CALIF., SUBMITTED BY D. M. ANDERSON, GENERAL MANAGER

Pursuant to announcement of the Committee, this statement is submitted on behalf of Sunkist Growers, Inc., in lieu of personal appearance of D. M. Anderson, General Manager, in opposition to the retention of Section 531 as a part of the pending bill.

Sunkist Growers is an agricultural marketing cooperative organized under the Agricultural Code of the State of California and is engaged in the marketing of citrus fruits produced in California and Arizona and the processing and marketing of citrus products. Its members are growers and district or local cooperative associations of growers and in the aggregate Sunkist and its member organizations and growers market a substantial proportion of all citrus fruits produced in California and Arizona.

COOPERATIVE CAPITAL MUST BE OBTAINED FROM MEMBERS

In considering Section 531 of the pending bill, it is necessary to understand the conditions under which farmer cooperatives must obtain needed capital.

Farmer cooperatives are limited by most cooperative corporation laws and by federal and state tax legislation in what they may pay for use of capital. Usually they may pay no more than 8% (sometimes less) as dividends or interest on capital. And because earnings must be distributed to patrons on a patronage basis, there is no opportunity for increase in value of equity capital such as exists in the case of common stock of the usual business corporation.

So cooperatives do not have access to the investment market where most corporations obtain their equity capital. The cooperative must rely on its members to furnish the equity capital needed and it is the obligation of each member to furnish his proportionate share.

In obtaining such capital, the long-established practice has been to collect the capital contributions of each member through retaining portions of a patronage dividend or a part of the proceeds of marketing (per-unit retains) due to the member. This is the only practical way to collect capital contributions in the case of large memberships, sometimes numbering in the thousands. It is also the most economical form of operation in all cases.

The member is rewarded for his capital contribution—not by a return on the investment—but by an increased return from proceeds of marketing.

SECTION 531

Section 531 is drafted apparently on the theory that all cooperatives are financed by revolving funds. The provisions with respect to the proportion of patronage dividends that must be paid in cash to qualify a revolving fund retain and the requirement that capital contributions from retained proceeds must be repaid within 15 years are at least understnadable, although needlessly burdensome and unfair, in their application to revolving funds.

However, cooperatives are not financed solely by revolving fund methods of capitalization. Sunkist itself and some of its members have permanent capital in the form of non-revolving capital funds (without capital stock); some members use revolving fund methods; other members issue capital stock in various forms equivalent to the common stock of the ordinary business corporation. When the requirements of Section 531 are applied to permanent capital structures or to common stock financing, they become incomprehensible and incredibly discriminatory and prejudicial against cooperatives as compared with ordinary business corporations.

Section 531 of the pending bill would substantially and adversely affect the operation of Sunkist and its members, particularly in the important function of acquiring and maintaining the substantial amounts of capital required for their respective marketing and processing operations.

ADVERSE EFFECT ON SUNKIST PERMANENT CAPITAL

The balance sheet of Sunkist Growers, as of October 31, 1968, the end of the last completed fiscal year, shows "members' capital equity" of approximately $18,000,000. Some $15,000,000 of this amount represents capital fund credits held by members (or former members). These capital funds constitute a permanent investment in facilities, inventories and working capital, to maintain the processing and marketing operations of Sunkist. These capital funds are maintained by requiring each member to maintain his proportionate share of the capital fund requirements based on the volume marketed through Sunkist during the preceding six seasons. New members contribute capital in proportion to their respective marketings for the first six seasons. Old members who have retired or withdrawn receive refunds of their capital investments over a period of six years following termination of membership. Members who continue from year to year after the first six years need make no further capital contributions (except in the case of increased volume of such member) and therefore receive their share of marketing proceeds in full in cash. Sunkist thereby maintains its total capital fund credits at the required level.

Section 531 of the pending bill would require that the capital fund credits of a member, although intended as a permanent investment as long as the membership continues, must be refunded in full 15 years after investment. Thus, if a particular membership continued for 45 years, the "permanent investment" would have to be refunded three times and fully re-invested three times during the course of the membership. The objective of permanency of capital investment would thus be destroyed and the record keeping and accounting details would become needlessly complex, confusing, and expensive.

The modern cooperative needs permanent capital just as much as does the modern industrial or commercial corporation. To require a cooperative to repay in full its capital each 15 years after such capital is contributed, would be equivalent to requiring the United States Steel Corporation or Dupont to redeem each share of capital stock 15 years after its original issue.

In addition, to meet the requirements of Section 531, a cooperative endeavoring to maintain permanent capital investment, must label every dollar of such intended permanent investment as a debt maturing 15 years from date of issue. Could capital credits carrying such an obligation for repayment within 15 years be carried as "members' capital equity"? Or would it be necessary to describe them as notes payable or long term debt? Is it the intention of the Congress that cooperatives shall not be permitted to have permanent equity capital? Such is the result of Section 531 and such result is certainly most unjustly discriminatory and prejudicial against cooperatives as compared with ordinary business corporations.

ADVERSE EFFECT ON REVOLVING FUNDS

Some of the cooperative associations members of Sunkist continue to use revolving funds for financing their capital requirements. The period of revolution is usually from five to ten years.

In some cases the revolving funds are financed through redemptions of portions of patronage dividends; and others through per-unit retains.

To the extent that patronage dividends are issued in the form of revolving fund credits, the requirements of Section 531 regarding the proportion of the dividend payable in cash, varying from year to year, will cause execessive and burdensome record keeping, greatly and unnecessarily adding to operating expenses; and in some cases will disrupt financing plans and commitments

The further requirement of Section 531 that all such retains be redeemed or paid within 15 years also adds greatly to the expense of record keeping and accounting. More importantly, it converts what should be equity capital to indebtedness, with a definite maturity date. This will impair the ability of many cooperatives to obtain credit not only from banks but in trade channels as well.

To the extent that capital credits are issued as per-unit retain certificates, the objections of the preceding paragraph also apply.

ADVERSE EFFECT ON CAPITAL STOCK FINANCING

Some of the cooperative associations presently members of Sunkist are capital stock corporations. The California Agricultural Code permits cooperatives incorporated thereunder to issue capital stock of a character and in a manner similar to ordinary business corporations organized under the General Corporation laws. In such cooperatives, the capital stock issued performs the same function as common stock of the ordinary business corporation. It represents permanent capital investment and may also represent voting rights.

By all the rules of corporation law, common stock is equity capital redeemable only upon dissolution. But Section 531 of the pending bill apparently requires that capital stock issued as patronage dividends or in consideration of per-unit retains must be repaid within 15 years. Section 531(a) (amending Code Sec*t*ion 1388(c)(1)) requires that a qualified written notice of allocation be covered by a bylaw provision of the cooperative requiring that the amount represented by such notice of allocation be paid in money within 15 years after date of issue.

Elsewhere in Code Section 1388 a "written notice of allocation" is defined as meaning "any capital stock, * * *". (§ 1388(b)).

Common stock, having a due date of 15 years after issue, is certainly an anomaly in corporation law. Is it the Congressional intention by the enactment of this provision of Section 531 to prohibit the issuance of common stock by a cooperative corporation in consideration of patronage dividends or per-unit retains? Or is the Congressional intention that cooperative corporations should have a new kind of common stock which carries a mandatory redemption date of 15 years after issue? Would such redemption be free from the usual corporation law requirements relating to redemption of stock? These are some of the many questions that should be answered before a provision of this character is enacted as a part of the Internal Revenue Code.

SECTION 531 SHOULD BE REJECTED

The Section 531 amendments cannot possibly produce any additional tax revenue. The amount of capital contributions through patronage dividends or per-unit retains is taxed now to the member who receives a written notice of allocation—in whatever form it may be—whether a revolving fund certificate, a permanent capital fund credit, shares of capital st^ck, or any other form. This has been true ever since the 1962 Act with respect to patronage dividends and the 1966 Act with respect to per-unit retains. When such amounts are redeemed, they are capital transactions and do not constitute taxable income. If the member is not called upon to make a capital contribution in a given year because he has already fulfilled his capital obligation, he gets that much more in cash return of proceeds and his taxable income is the same as any other member having the same volume.

The enactment of this legislation will discourage the formation of new cooperatives and the expansion of existing cooperatives. This is doubtless a result highly desired and intended by those who initiated the present proposals. Such a result, however, is in direct conflict with long standing Congressional policy of encouraging farmers to organize cooperatives to increase their bargaining power in the market place and to improve their economic status.

In keeping with such long standing Congressional policy, Section 531 should be rejected and eliminated from the pending bill.

Respectfully submitted,

SUNKIST GROWERS, INC.,
D. H. ANDERSON, *General Manager.*

OHIO WOOL GROWERS COOPERATIVE ASSOCIATION,
Columbus, Ohio, September 18, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: The National Wool Marketing Corporation by board of director action at a regularly scheduled meeting Sept. 15, 1969 passed a resolution as follows:

"We support the National Council of Farmer Cooperatives in their stand in opposition to Section 531 (Cooperatives) H.R. 13270 in its present form."

The National Wool Marketing Corporation (a cooperative) is a marketing agency for the several local member associations assembling wool from the growers. We are operating in a business climate of declining sheep numbers, hence declining wool volume. It is our effort to get for the wool grower what we can for him for his wool. By so doing, it is our hope and objective to encourage the producer to reverse the trend and increase sheep numbers.

A farm cooperative is a democratic and a partnership method of self help. It is an effort on our part to solve our own market problems. We believe by removing the method of using our own organizational income for future financing it will severely hamper our growth and usefulness to help solve some of agricutures desparity of economic party.

I was authorized to forward this information to you by the National Wool Marketing Cooperative board of directors and trust that you will give it your fair consideration.

Very truly yours,

NATIONAL WOOL MARKETING CORP.,
ELWIN C. NEWCOMER, *V. Pres.*

RANCHERS COTTON OIL,
Fresno, Calif., September 18, 1969.

Re public hearings on section 531 (cooperatives), H.R. 13270—Monday, September 22, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SIR: At a meeting of our Board of Directors held Wednesday, September 17, 1969, they registered unanimous objection to the inclusion of Section 531 on cooperatives in H.R. 13270 as being restrictive and punitive.

Our method of capitalization is controlled entirely by our farmer board of directors. Any retain capital whether on a per unit base or a patronage base is considered constructive receipt and reinvestment. Therefore, these amounts are reported by our members currently as income to them. Although the length of time of repayment of this capital is far less than that suggested in Section 531, we feel that this suggested legislation become discriminatory because there is no law which requires corporations to pay out their equities at any time.

In regard of setting a percentage of pay-out in the current year, they feel that this becomes punitive and upsets our methods of not only capitalization but restricts our borrowing power. When and how much is paid out to our members is determined solely by our Board of Directors who are farmers and, therefore, it is not neecssary to have legislation to tell them when to pay money to themselves.

We strongly urge that this section be removed from H.R. 13270.

Very truly yours,

RANCHERS COTTON OIL,
C. R. RATHBONE, *General Manager.*

SCOTT COUNTY SERVICE CO.,
Winchester, Ill., September 19, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: I am writing in regard to tax reform bill H.R. 13270. I feel the passage of this bill would be a deterrent to cooperatives, and a bill that would provide no added revenue to the federal government.

As manager of a smaller local cooperative, this bill would hinder our financing program, and would take the financing of our company away from the users who hold equity capital, and the control and financing through debt capital.

I ask your support in discouraging the passage of tax reform bill H.R. 13270.

Please include the enclosed statement in the printed record of hearing on H.R. 13270.

Thank you for your support.

Sincerely yours,

SCOTT COUNTY SERVICE CO.,
JOSEPH BERNARDINI, *Manager.*

SUPPLEMENT TO SCOTT COUNTY SERVICE COMPANY LETTER OPPOSING H.R. 13270

1. The proposed tax reform bill H.R. 13270 would put no additional funds in the treasury as this would not change the basic tax structure for cooperatives.
2. This bill could possibly make it very hard for cooperatives to provide both the equity and debt capital to finance the growing farmer demand for facilities and services.
3. Since a majority of the conventional sources of acquiring capital that are available to competition of cooperatives, the cooperatives must look to its members and users for its financing. The passage of this bill would not allow this and could force many smaller cooperatives out of the picture or left to be taken over by a large conglomerate type corporation.
4. The proposed bill would not be in accordance with the national policy of supporting and promoting self-help programs to relieve local rural poverty.

SUNSWEET GROWERS INC.,
San Jose, Calif.

STATEMENT OF SUNSWEET GROWERS INC., SUBMITTED BY C. D. OWENS, EXECUTIVE VICE PRESIDENT

INTRODUCTION

1. Relevant information regarding Sunsweet Growers Inc.

Sunsweet Growers Inc. ("Sunsweet") is a non profit agricultural cooperative engaged in processing and marketing dried fruits produced by its 2400 Grower Members. Sunsweet markets approximately one-half of the prunes and other dried fruits produced in California. Most of the Grower Members of Sunsweet are also engaged in the production of agricultural commodities other than dried fruits and in many instances these other commodities are marketed through other agricultural cooperatives.

A substantial cash advance is made to Sunsweet members at the time of delivery of their product. Additional cash advances are made during the course of the fiscal year as permitted by the financial condition of the association. As soon as possible after the end of the fiscal year final payments in the nature of a patronage dividend are made to growers to account for the excess of net proceeds from marketing members' products (gross sales less expenses of processing and marketing) over advances previously paid to the Grower Members. A portion of the patronage dividend is retained to provide capital. Each Grower Member is notified of the amount of this retain by a qualified written notice of allocation, which the Grower Member has agreed to take into income at the face amount. This non-cash allocation is normally less than 50% of the amount of the patronage refund. Amounts retained in excess of the current capital needs of the association are used to repay the oldest credits. Sunsweet has an unblemished record of repayment of these credits within a period of less than ten years. In recent years the revolving fund cycle has been six years.

Sunsweet is in excellent financial condition and has a relatively stable membership.

2. Scope and purpose of statement.

The purpose of this statement is to indicate the immediate adverse effect of Section 531 of HR 13270 on the members of Sunsweet. To avoid redundancy with other statements which will be submitted, this statement will comment only on the specific adverse and unjustified effects on a mature, financially sound cooperative whose practices fully comply with the letter of the proposed legislation and which seemingly would be least affected by the proposal.

STATEMENT

At first blush, it would seem that the provisions of Section 531 of HR 13270 would have no effect on a cooperative such as Sunsweet. This is not correct.

1. The proposal would tend to delay rather than accelerate the flow of cash to the grower members of Sunsweet.

In almost every year at least 50% of the patronage dividend paid to Grower Members of Sunsweet after the end of the fiscal year has been in cash. However, if the non-cash portion of the patronage dividend (paid in the form of a qualified written notice of allocation) would be entirely non-deductible unless an equal or greater amount was paid in cash, the practical effect would be to require Sunsweet to reduce the amount of cash advances during the crop year in order to provide a greater reserve for cash payment after the end of the year. This would clearly be inconsistent with Sunsweet's policy of getting the cash to the growers as quickly as possible. It would also tend to place Sunsweet at a competitive disadvantage with respect to the independent handler who purchases dried fruit on a fixed price basis rather than a nonprofit cooperative basis.

2. The proposal would adversely affect Sunsweet's financial condition even though it normally repays non-cash allocations within six years.

The Grower Members of Sunsweet provide the necessary capital in proportion to their patronage as described above. The amounts retained to provide capital are taxable to the Grower Members in the same manner as if the amounts were paid out and reinvested in the capital of Sunsweet. Since the credits do not have a fixed maturity date and are subordinate to the claims of creditors generally, they are treated as member equity by financial institutions in establishing the highly favorable lines of credit available to Sunsweet. These lines of credit are essential to the financial well being of Sunsweet.

If the amounts retained to provide capital are required to have a fixed maturity date, as contemplated by the proposed legislation, this would effectively convert the retains from member equity to long-term indebtedness. This would unfairly impair the financial condition of Sunsweet by reducing its attractiveness as a credit risk to financial institutions.

3. The harmful effects on Sunsweet would be accomplished without increase in or acceleration of tax revenues.

Sunsweet is operated on a nonprofit basis to maximize the income of its Grower Members. All of the income from marketing members' fruit less expenses is taxed currently to the Grower Members. A portion of the amounts so taxed to the Grower Members are effectively reinvested in the association to provide necessary capital.

As indicated above, the proposed legislation would tend to delay the flow of cash to the Grower Members and would adversely affect the borrowing ability of the association, but the changes necessary to comply with the proposal would not result in one additional dollar of income being taxed at an earlier time than under the present legislation. Indeed, by requiring a greater proporiton of the total payments to Grower Members to be included in the final payment, the realization of income will in some instances be deferred to a later taxable year of the Grower Member than otherwise.

CONCLUSION

We respectfully submit that Section 531 in its entirety should be deleted from HR 13270. The proposal meddles with the basic policy of agricultural cooperatives and their relations to their Grower Members without any redeeming justification in terms of the tax revenue or tax fairness.

FULTON SERVICE CO.,
Lewistown, Ill., September 19, 1969.

HON. RUSSELL B. LONG,
Chairman, Committee on Finance,
2227 New Senate Office Building,
Washington, D.C.

DEAR SIR: Please find enclosed a statement expressing the feelings of the Board of Directors and Manager of a local farmer owned and controlled co-operative. The Board of Directors represent the stock holders who are also the patrons and owners of this co-operative.

We ask that this statement be included in the printed record of hearing on H.R. 13270.

Very truly yours,

GORDON DENISON, *Manager.*

Enclosure.

Subject: Statement of opposition to Section 531 of H.R. 13270.

As the Board of Directors and Manager of a farmer co-operative representing the interests of 1500 patrons and members, we wish to state our opposition to this bill that will have an adverse effect on co-operatives.

Our reasons are as follows:

1. Farmers need all the help they can get through their co-operatives to help them buy their supplies at lower prices and market their products for better prices. Both administrations have agreed to this. This bill if passed would stifle the growth of co-operatives.

2. Large corporations who are evidently pushing this legislation have the privilege of distributing their earnings in the same way if they so desired.

3. If this bill were passed it would gain little if any new revenue for our government. Farmer co-operatives would sell to their members at cost and ask them to finance their co-operatives by the purchase of stocks.

4. This legislation, i: enacted, would surely destroy some co-operatives who are small businesses and it would strengthen the large corporation or conglomerate. This is the food consuming public does not want.

FARMLAND INDUSTRIES, INC.,
Kansas City, Mo., September 19, 1969.

COMMITTEE ON FINANCE,
2227 New Senate Office Building,
Washington, D.C.

MEMBERS OF THE COMMITTEE: On behalf of the half-million Midwestern farmers and ranchers who are its owners and beneficiaries, Farmland Industries registers strong opposition to Section 531 (Cooperatives) of H.R. 13270.

Farmland Industries is a regional cooperative, headquartered in Kansas City, Missouri, and owned by some 2,000 local, farmer- and rancher-owned cooperatives in 15 Midwestern states. Farmland manufactures and distributes farm supplies through the local associations to about a half-million agricultural producers.

There are three broad reasons for opposition to Section 531. The proposal (1) produces no revenue, (2) imposes additional government regulations on business and (3) injures cooperatives and the farmers and ranchers who own them.

The primary purpose of Section 531 seems to be to limit the flexibility of cooperatives by imposing a rigid formula for their payment of patronage refunds. It presumes that Washington can run cooperatives better than the co-ops' owners. It reduces cooperative directors' ability to adapt financial policies to their associations' unique problems. No other form of business is forced to operate under such restrictions. Therein lies the proposal's wide-spread danger to business generally. If such restrictions can be enforced upon one type of business, they can, in the future, be applied to others.

Section 531 would hurt different cooperatives in differing ways and to differing degrees.

The proposed refund regulations would be especially damaging to new associations that are still deeply in debt or to cooperatives that have recently expanded, merged or had some other reason to borrow interest-heavy funds.

These regulations, and anything else that hurts cooperatives, also hurt the farmers and ranchers who own the cooperatives and depend on them to provide production supplies or to market farm products. Herein lies the subtle but particularly injurious feature of Section 531. The proposal implies that members must be protected or helped to benefit from their cooperatives. The simple truth is that cooperatives, as much as or more than any other type of widely-held business, are controlled by their owners.

Farmland Industries' structure and polices are good illustrations of the fact that cooperatives are controlled by and operated for the benefit of the farmers and ranchers who own them. Every one of the more than 2,000 local associations that make up Farmland's membership has one vote in the election of directors and the conduct of business. Farmland's 22-man board of directors includes 15 farmers and ranchers and 7 men who manage farmer-owned cooperatives.

A copy is enclosed of a letter signed by all the directors and already sent to Finance Committee members from states in which Farmland affiliates are located.

A proponent of Section 531 has attempted during testimony before the Committee to convey that too many cooperatives are becoming too large. He reported that five cooperatives, all farmer-owned and including Farmland Industries, are listed by Fortune Magazine among America's 500 largest industrial firms. In an era in which farmers and ranchers clearly need economic strength, it is perhaps one of their industry's major weaknesses that only five of their cooperatives qualify among the country's 500 biggest firms—and not one of the five is in the top 100.

Farmland Industries is one of the nation's largest cooperatives, it is one of the five on the Fortune list. However, its size is modest compared to the larger industrial firms in this nation. In fact, the annual sales of the largest firm in the United States exceeds the total volume of all farmer cooperatives combined. The implied danger of large cooperatives is a myth. Large cooperatives are needed to render effective service to farmers and ranchers.

Section 531 of H.R. 13270 is a direct attack on farmers and their cooperatives. We respectfully request that it be eliminated in its entirety.

Sincerely,

ERNEST T. LINDSEY, *President.*

Enclosure.

FARMLAND INDUSTRIES, INC.,
Kansas City, Mo., August 26, 1969.

Hon. CLINTON P. ANDERSON,
Hon. CARL T. CURTIS,
Hon. J. W. FULBRIGHT,
Hon. FRED R. HARRIS,
Hon. EUGENE J. MCCARTHY,
Hon. EVERETT MCKINLEY DIRKSEN,
Hon. JACK MILLER.

GENTLEMEN: This letter is sent to you as Senate Finance Committee members representing states in which there are farmer cooperatives affiliated with Farmland Industries.

Through Farmland Industries, these cooperatives, some 2,000 in number, manufacture for their farmer-members petroleum products, fertilizer, feed, steel buildings, batteries, paint and other farm supply lines.

Some of our members are mature and financially strong. Some are relatively new and heavily in debt. Some have been involved in recent expansions and mergers and have had to borrow large sums. They serve almost the complete range of producer interests. In countless rural communities the farmer cooperative is the center of economic strength.

As members of the board of directors of Farmland Industries, the signers of this letter are deeply concerned as to what would happen to many of our cooperatives if Congress should include in the pending tax reform bill those provisions relating to cooperatives that are now in the House version.

These provisions will not provide new funds for the federal treasury. They were conceived by interests whose primary aim is to find ways to cripple farmer cooperatives at a time when farmers and ranchers need these home-based services more than ever before. They would impose on all cooperatives a rigid formula for payment of refunds.

Such legislation is unrealistic. It disregards the individualistic nature of farmer cooperatives. It would make it difficult for many to meet their loan obligations. It would take away from boards or directors the right to develop financial policies tailored to the particular conditions of their respective cooperatives.

We know we speak for all of our member associations in urging you as members of the Senate Finance Committee, to take whatever steps are necessary to eliminate the anti-cooperative provisions from the tax reform bill.

Sincerely yours,

Ernest T. Lindsey, Liberty, Mo., President; John L. Schulte, Beloit, Kansas, Chairman of the Board; Roy Chelf, Scottsbluff, Nebraska; Roger Clark, Brady, Nebraska; J. B. Cooper, Jr., Roscoe, Texas; Troy Dillinger, Brewster, Kansas; J. M. Fuser, Jr., Afton, Oklahoma; Loren Garretson, Haxtun, Colorado; Maurice Happel, Palmyra, Missouri; Claus Kuehl, Selby, South Dakota; Les McGohan, Mt. Pleasant, Iowa; Edmund McGough, Ackley, Iowa; Oscar Miller, Carrollton, Mo.; Harold Ostermann, Ocheyedan, Iowa; N. B. Schmitz, Andale, Kansas; Albert Schramm, Winner, South Dakota; Vaughn Sinclair, St. James, Minn.; J. G. Stratton, Clinton, Oklahoma; Ted Sutter, Eaton, Colorado; Byron Torell, Gresham, Nebraska; Roland White, Aurora, Nebraska; Howard Young, Dodge City, Kansas.

Statement of Tri-Valley Growers, Submitted by Philip N. Mark, Vice President, Industry Relations

Tri-Valley Growers is a farmer owned cooperative with a membership of over 500 fruit and vegetable producers. It has been in existence since 1932. It markets, on a world-wide basis, products processed in canning plants located in Northern California.

Those portions of the subject bill if adopted by Congress would literally destroy conventional means of capitalization by cooperatives and would effectively thwart the farmer's desire and the cooperative's need for permanent capital investment.

We request the Senate Finance Committee to completely eliminate from the bill under consideration language involving cooperatives. Following are the more important reasons supporting our request.

First, we shall summarize in non-technical language the changes that the bill (Section 531) if finally enacted into law would make in the tax treatment of cooperatives.

(1) The present minimum 20 percent required to be paid in cash of patronage refunds by all cooperatives and non-patronage distributions by "exempt" cooperatives in order to qualify the total patronage refunds and non-patronage distributions for deduction by the cooperatives would for taxable years beginning in calendar 1970 and for ten years thereafter be increased 3 percent *annually*. Thus for taxable years beginning in 1979 and thereafter the required total cash payment would be 50 percent of the total patronage refunds of all cooperatives and non-patronage distributions for "exempt" cooperatives instead of the present 20 percent in order to qualify the total patronage refunds and such non-patronage distributions for deduction by the cooperatives.

(2) for taxable years beginning in calendar 1970 and thereafter, (a) that part of patronage refunds of all cooperatives and non-patronage distributions of "exempt" cooperatives not paid currently in cash and (b) per-unit retain allocations, in order to be qualified and thus deductible currently by the cooperative must be payable in money within a 15-year period beginning with the close of the taxable year. This requirement may be met by appropriate By-Laws provisions of the cooperative as described in the statute requiring such payment or by an unconditional written evidence of *indebtedness* issued for the remainder not paid in cash which matures within the 15-year period.

The requirement under (2) would change the very nature of a member's investment in his cooperative from equity to debt capital. This significant change could have serious effects upon the cooperative's ability to obtain adequate lines of credit from lending institutions to carry on its operations.

The proposal for cooperatives can neither be appropriately characterized as "reform" nor revenue producing. Its objective can only be looked upon by farmer cooperatives as punitive without availing any additional tax revenues to the United States. By thus singling out cooperatives in compelling retirement of equity capital by arbitrary federal edict, the proposed revisions would greatly restrict or cause abandonment of beneficial services historically provided by cooperatives to farmer patrons and the national economy. *This is in complete conflict with Federal policy (reflected in congressional enactments such as the Copper Volstead Act, Agricultural Marketing Act and Motor Carrier Act) of fostering farmer cooperatives and the supporting platform commitments by both National political parties.*

Traditionally, farmer cooperatives have generated needed capital from their own operations. Sale or issuance of securities to the investing public has not been feasible or practicable for cooperatives. Limited permissible return on securities and lack of opportunity to appeal to growth minded investors have resulted in farmer patrons', in effect reinvesting moneys otherwise payable to them from operations of cooperative corporations that require substantial amounts of capital for facilities, operations and as a basis for credit.

Under present law cooperatives are permitted to deduct from or exclude from gross income amounts retained for capital, if appropriately evidenced to their patrons. In addition, in the case of patronage dividends (related to earnings), twenty percent of the total patronage dividend must be paid in cash. With respect to so-called per unit retains (not related to earnings), there is no requirement of a current cash disbursement. *Under the assumed facts the patron is required currently to pay Federal Income tax on the stated dollar amount of the "appropriately evidenced" noncash distributions.*

It is obvious that the increase in the required cash disbursement would not produce any Federal revenue. A "qualified written notice of allocation" of a retained patronage dividend is no less taxable to the patron than the cash portion thereof whether the latter be twenty percent or fifty percent. As above indicated, the per unit retain evidenced by a "qualified per unit retain certificate" does not, because of its very nature, require any concurrent cash payment.

The second phase of the proposal would inflict upon cooperatives a requirement for compulsory redemption of equity capital which is not imposed on any other kind of American corporation. It would require that any capital represented by a "qualified written notice of allocation" or a "qualified per unit retain certificate" be redeemed within the fifteen-year period indicated. The redemption process would produce no Federal revenue because the tax on the retained amount has already been paid by the patron. Payment of the retained patronage dividends or per unit retains would only result in a nontaxable return of capital.

Why may not farmers and their cooperatives agree to needed investment by the farmers in their farmer owned and controlled organization? What policy is served by the compulsory redemption at a specified time?

The Revenue Act of 1962 in dealing with the taxation of cooperatives imposed for the first time the requirement that retained amounts would be currently taxable either to the patron (if evidenced by "qualified" paper), or to the cooperatives (if not so evidenced). Section 531 does not change the basic concept and tenet of the 1962 Act. It rather proposes to lay down two rules which cannot be described as other than penal and which bring no added revenue to the United States.

Contrary to the cooperatives' experience and that of others in presenting views to the Ways and Means Committee and Senate Finance Committee in respect to the Revenue Act of 1962, the decision of the Ways and Means Committee was reached in executive session without the subject of cooperative tax treatment ever having been referred to publicly by the Committee directly or indirectly.

The Banks for Cooperatives, a part of the Farm Credit System, would be adversely affected by both of the proposals described in this statement. The 13 banks obtain practically all of the funds loaned to farmer cooperatives from the sale of debentures to the investing public. Confidence in these debentures could be seriously impaired if the major portion of the present net worth of the banks had to be classified on their balance sheets as a liability rather than equity capital. This could result in a substantial reduction in the volume of money available to loan to cooperatives. Tri-Valley is a major borrower and stockholder of the Berkeley Bank for Cooperatives. It is dependent solely upon this bank for lines of credit to finance its operations, which this year aggregate approximately $70 million.

Statement of the Farm Credit Board of Columbia, Submitted by Edward L. Young, Chairman

The Farm Credit Broad of the Third Farm Credit District which is headquartered in Columbia, South Carolina, acts as the Board of Directors for the Federal Land Bank, the Bank for Cooperatives and the Federal Intermediate Credit Bank, all of Columbia. The Third Farm Credit District encompasses the states of North Carolina, South Carolina, Georgia, and Florida. It is on behalf of our Farm Credit Banks and affiliated Production Credit Associations that we wish to state our opposition to Section 531 of H.R. 13270 as approved by the House.

It appears to us that the intent of Section 531 is the reduction or elimination of competition from farmer-owned cooperatives by those businesses whose interests are furthered by farmers remaining economically weak. There will be no change in tax revenues generated by passage of Section 531, but the capital available to farmers for development of their marketing, purchasing and farm business service cooperatives will be seriously diminished.

For over a quarter of the century, the Columbia Bank for Cooperatives has provided the major source of credit for farmers' coopeatives in the Third Farm Credit District. During that time it has made over $1,574,000,000.00 in loans to legally qualified cooperatives.

With the retirement of all government capital in the Columbia Bank for Cooperatives on December 31, 1968, the Bank, being itself operated on cooperative principles, became subject to the same Federal Income Tax provisions as are applicable to its cooperative borrowers, that is, subchapter T of the Internal Revenue Code. Thus, the proposed Section 531 would be directly applicable to operations of the Columbia Bank for Cooperatives. In like manner. Production Credit Associations of the Third Farm Credit District, which provide short and intermediate-term credit to farmers, are operated on coopreative principles and would be directly affected by passage of Section 531 as they are also taxed under Subchapter T of the Internal Revenue Code.

The major source of loan funds for the Farm Credit Banks is from the investing public through purchase of consolidated debentures of the different banks. Additional capital is provided by members buying stock and by retention of a portion of earnings as equity capital. In the Banks for Cooperatives and Production Credit Associations earnings in excess of required loss reserves and operating expenses are returned to borrowing members in the form of patronage refunds. Generally, patronage refunds are distributed 20 pecent in cash with the remaining funds being retained on an allocated basis in proportion to the amount of the business done between the parties during the income period. Total patronage refunds including those not paid in cash are subject to normal income tax rates to the recipient. The funds thus retained constitute a second source of operating capital for the cooperatives.

With this background, we believe adoption of the proposed Section 531 would have very adverse effects upon operations of our Columbia Bank for Cooperatives and district Production Credit Associations. The section's payout requirement increasing the percentage of cash required to be paid out annually, in order to qualify patronage allocations for the income tax deduction by the cooperatives, would reduce the Bank for Cooperatives and PCAs available cash for working capital by the percentage of cash in excess of the current 20 percent required to be paid out in each successive year. The impact of such a provision upon the Bank for Cooperatives and PCA operations would be to force increasing reliance for its working capital upon funds borrowed or obtained by issue of consolidated debentures.

Now, the impact of the section's so-called 15-year payout requirement may well be to reduce acceptance by the investing public of these consolidated debentures. This is because the requirement will result in removing a substantial portion of a bank's capital from the equity section to the liability section of its balance sheet, thus impairing a bank's net worth. The weakened net worth position may well force Farm Credit Banks to pay more in the form of interest for loan funds. The burden of increased money costs would obviously be passed on in the form of higher interest rates to the borrowing members of a Bank for Cooperatives and PCAs.

As ever greater demands have been placed upon the nation's money markets, the natural forces of supply and demand have already forced the cost of money to unprecedented heights. To add the potentially crippling burden of Section 531 could significantly impair the ability of these farmer-owned Farm Credit organizations to continue effectively serving major segments of the nation's agricultural economy—namely, its farmers and its farmer-owned cooperatives.

It hardly need be pointed out that the weight of this Section 531 would fall heaviest upon small farmers and upon newly formed, small cooperatives who are in greatest need of funds.

We do not wish to dwell upon the contributions that cooperatives have made in the past to the improvement of the economic lot of American farmers, but allow us for a moment to defend the role of cooperatives in agriculture today and in the future.

Cooperatives are tools of the farmer devised to meet an economic situation peculiar to the farmer. The farmer sells his products in a producer or wholesale market and makes his purchases in a retail market. In an attempt to correct this condition, farmers created cooperative associations to market their products at a price nearer retail and to make their purchases at wholesale. The need for strong cooperatives has never been greater than it is today. The weak bargaining position of the individual farmer is accentuated in today's economy, characterized as it is by increasing concentrations of economic power. The bargaining position of the individual farmer becomes increasingly weakened as the marketing mechanisms for agricultural products fall into the hands of fewer and fewer buyers, processors and distributors, and as the cost and importance of agricultural inputs increase. Cooperative ownership by farmers of the businesses related to agriculture is the one way in which the economic imbalance in which the individual farmer finds himself can be corrected. Legislation, such as that now proposed, which impedes the development of strong agricultural cooperatives can only result in detriment to the farmer.

We hope your committee will eliminate Section 531 from the Tax Reform Bill of 1969.

STATEMENT OF MARVIN H. WALKER, EXECUTIVE VICE PRESIDENT, FLORIDA CITRUS CANNERS COOPERATIVE, LAKE WALES, FLA., IN OPPOSITION TO SECTION 531 OF H.R. 13270

My name is Marvin H. Walker and I am Executive Vice President of Florida Citrus Canners Cooperative, Lake Wales, Florida. We are a non-exempt federated farmers' cooperative, organized in 1934 to process and market oranges, grapefruit and tangeries produced by our 10 member associations, who serve approximately 1,000 growers.

At the time of our organization citrus fruits which could not be shipped fresh were worth nothing to growers. With the development of processing methods and better market practices citrus fruit for processing has become worth a great deal to them. In the 1968–69 season we processed 80 percent of our members' grapefruit, 73 percent of their oranges and 50 percent of their tangerines. We pack all major citrus products, and in the past fiscal year had sales of $42,000,000.00.

We oppose Section 531 of H.R. 13270 because it would force us to retire in a stated number of years the Revolving Fund Certificates we issue to members for the capital retains we collect on fruit handled for them. Our members hold about $8,000,000.00 of these Certificates, which, but for $130,000.00 in common stock, is the only capital we have. Each member pays our capital retains until it has $1.60 in Certificates for each box of fruit handled for it. If a member retires his Certificates are redeemed.

We expect to have a line of credit with the Columbia Bank for Cooperatives of $12,500,000.00 in 1969–70, for commodity and seasonal operating loans, payable within a year, to finance our operations. We also owe this bank about $2,500,000.00 for facility loans, payable over a period of years. With the increase in Florida citrus crops we are forced to expand our facilities almost every year, and we are spending approximately $1,600,000.00 for this purpose this summer.

All of our members have paid Federal income taxes on the Revolving Fund Certificates received from us in recent years, and many have paid such Federal taxes on all Certificates they hold. They are continuing to pay Federal income taxes on Certificates they receive from us each year. Legislation forcing us to redeem these Certificates in a specified number of years would not increase Federal income taxes, though it would hasten the payment of taxes on some Certificates issued prior to enactment of the Treasury Act of 1962, which would be comparatively small.

From our point of view, the most serious feature of Section 531 of H.R. 13270 is the proposed forced retirement of these Certificates. These Certificates are the basis of almost our entire capital structure. They are equivalent to stock in a corporation. We see no practical method of financing our operations if the Federal government tells us we must retire these Certificates. Since our members are paying Federal income taxes on these Certificates each year as they are issued, the government gains no tax revenue by forcing us to retire them.

It would be impossible, in my opinion, for us to borrow the large amount of money we need to finance our operations from the Columbia Bank for Cooperatives, or any financing institution, without the equity capital our members have in this business as represented by the Revolving Fund Certificates they hold.

We do not have patronage refunds, but most of our member associations do have patronage refunds on such things as fresh fruit packing and fruit production charges. The proposal that more than 20 percent of patronage refunds be paid in cash would most seriously affect their operations.

We are amazed that the House of Representatives passed Section 531 of H.R. 13270, without public hearings or any opportunity to express our views. Section 531 is purely punitive legislation, certainly not tax reform, and is designed to hurt farmer cooperatives. We hope the United States Senate will recognize the importance of farmer cooperatives to agriculture in this country and will strike Section 531 of the House bill in its entirety from any tax reform bill.

McDONOUGH F S, INC.,
Macomb, Ill., September 20, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: I am enclosing a statement for the consideration of your committee in their deliberations on Section 531 of the Tax Reform Bill of 1969. My statement is in opposition to the section as it deals with treatment of patronage refunds of cooperatives.

I have served in management positions with local cooperatives for over twenty years. My comments in the enclosed statement are based not only on my knowledge of the operation of local cooperatives but upon my convictions as a result of my study of the cooperative as a business form and its place in relation to agricultural policy and programs.

I have discussed this pending legislation with our Board of Directors which is made up of nine local farmers and with other local farm people and I believe that my statement correctly reflects their point of view as well as my own.

We respectfully solicit your support in opposing the provisions of the Tax Reform Bill that would place further restrictions on patronage refund payments by cooperatives.

Very truly yours,

HAROLD S. STIFFLER, *General Manager.*

SEPTEMBER 20, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
New Senate Office Building,
Washington, D.C.

STATEMENT IN OPPOSITION TO SECTION 531, H. R. 13270, AS IT AFFECTS TAX TREATMENT OF PATRONAGE REFUNDS OF COOPERATIVES.

1. Section 531 as now written will create serious survival problems for local farmer cooperatives. Investment capital is not readily available to farm cooperatives either from the farmer-users or from outside sources. Individual farmers face such large capital requirements for their own farming operations that they have readily agreed to accept portions of their patronage refunds from their cooperatives in stock or other investment certificates knowing that this creates capital funds for their cooperatives to use in providing essential farm services. Without the capital funds so provided, the corporate growth of farm cooperatives will be curtailed to the extent that many small cooperatives will not be able to compete with local branches of large, conglomerate organizations to whom unlimited capital funds are available.

2. Farmers individually and the agriculture industry in general are concerned about the economic problems that they must solve for survival. Vast government

programs have expended large amounts of money to alleviate rural poverty and to improve the lot of the farmer. Farmers, through cooperatives, have been able to work out the solutions to some of their problems dealing with the cost of production supplies and improved marketing of farm products. The significance of farmer cooperatives in these fields is large as far as farmers are concerned but rather insignificant as far as the total business community of the nation is concerned. It is indeed regrettable that the opponents of cooperatives have resolved to exploit their own personal interests and to fail to recognize the importance of cooperatives to the agricultural community.

3. It is possible that the anti-cooperative interests may be successful eventually in destroying the right of cooperatives to pay any form of patronage refunds to patrons. If this should occur, cooperatives will be forced to plan operations in such a manner as to virtually eliminate net margins. First, this would be a precarious type of operation for the cooperative and, secondly, the cooperative would be in the position of a price-cutter and, as such, would be a much more formidable foe for the non-cooperative business than is now the case. I believe that the opponents of cooperatives have failed to give proper consideration to the disorder that would result in the market place if cooperatives are forced to eliminate patronage refunds and to adjust their day to day operations so that net margins are reduced to a minimum. I understand that the act under consideration does not eliminate patronage refunds but it does place further restrictions on the patron-users' rights to adapt the patronage payment method to forms that generate capital for the cooperative. Furthermore, I believe that the advocates of such revisions as outlined in the bill are aiming not at tax reform but at the ultimate destruction of farmer cooperatives.

4. The proposed legislation would not result in additional tax revenue to the federal government. Such regulation, therefore, has no place in tax legislation. The purpose of such legislation is to regulate and to restrict a traditional form of doing business and it should be studied and considered in this light.

5. Farmer Cooperatives provide an orderly and legitimate vehicle for the improvement of the farm economy. They should be encouraged since they operate within the basic principles of the free enterprise system and they require no expenditure of public funds. They are not a threat to the economic well-being of the remainder of the business community but they do serve as a much needed check on the large conglomerate private corporations that are of sufficient size to exploit individual farmers who have no other means of countervailing power than their cooperatives.

6. Cooperatives are democratically organized and are controlled by the farmers who own and use them. Both local and regional cooperatives encourage and receive a high degree of participation in the corporate decision making process by the owner-users. Farmers participate in the affairs of their cooperatives to a much higher degree than do shareholders in most ordinary corporations. Of course, not all farmers agree with all corporate policies of their cooperatives. However, they live close to the management people and they engage actively in the election processes whereby directors are chosen. The bill under consideration will restrict the right of these individual farmers to decide basic issues which will seriously affect the future growth of their cooperatives. Such regulation by government is not desirable nor is it within the spirit of the free enterprise system which spawned the farmer cooperatives in the first place.

7. I respectfully urge that your committee oppose any further restriction on the right of cooperatives and their members to determine the manner in which patronage refund payments may be made.

HAROLD S. STIFFLER.

STATEMENT OF THE NEW JERSEY COUNCIL OF FARMER COOPERATIVES, INC., TRENTON, N.J., SUBMITTED BY ROBERT SOLUSKI, PRESIDENT

The New Jersey Council of Farmer Cooperatives wishes to express their opposition to the provision in Section 531 of H.R. 13270, Tax Reform Act of 1969, that will require cooperatives to pay at least 50 percent of their dividends in cash each year and the balance due in 15 years.

There are 88 cooperatives licensed to operate in New Jersey under existing State laws and these changes in the cooperative tax laws will cause untold financial problems. Several cooperatives in New Jersey are in the process of developing new programs that will involve capital expenditures. They will need to borrow money for these capital improvements, however, these new proposed regulations will seriously impair their ability to do so. Lending organizations will be wary of this 15-year limitation on patronage refunds and especially will they be wary of the 50 percent patronage refund. If the cooperative does not show a sizeable profit each year, loans long or short, will become almost impossible to obtain.

State Cooperative organizations have already gone on record by resolution, letters, and telegram to their Senators, opposing these changes that will completely disrupt the capital structure of cooperatives in this State and all across the land. We urge the committee to consider this situation very carefully and see to it that this section is deleted from the bill.

Statement of the Oklahoma Agricultural Cooperative Council, Submitted by Don Becker, President

The 1962 Revenue Act clarifies the tax treatment of cooperatives. Its provisions assure that 100% of the income of cocperatives is taxable.

Cooperatives pay taxes at the corporate rate on the portion retained by the cooperative and the members pay taxes at the individual rate on any allocation to them. This method of distribution is made pursuant to the By-Laws of the Cooperative-Corporation and these By-Laws are the sole responsibility of the members of the cooperative. If a person does not wish to continue patronage of the cooperative or become a member under these terms or conditions, he is not required to do so.

The memberships of many cooperatives have democratically voted to provide facilities for their use anticipating that payment would be made from the amount of patronage in excess of the 20% cash required under present law.

The tax reform bill of 1969, HR 13270, Section 531 contains provisions which cause serious concern to farmers and members of cooperative organizations. This house bill would require that at the end of a 10 year escalation period the cooperative will be required to pay 50% of its earnings as a cash allocation and that the remaining allocations be retired within a 15 year period. The provision of this new bill very tragically ring the death knell for many farm cooperatives at a time when the need is so great by the farmer for strength in the market place. This bill would change the nature of a patron's investment from equity to debt capital thus impairing the cooperative's borrowing power and reducing its operating capital.

Section 531 of HR 13270 is not tax reform and is not designed to increase revenue for the U.S. Treasury, but rather to impose harmful restrictions on cooperatives and farmers.

This legislation is opposed by all farm organizations.

Therefore be it resolved, that the membership of the Oklahoma Agricultural Cooperative Council in annual meeting September 11, 1969, strongly opposes Section 531 of HR 13270 and we urge and solicit the aid and support of all friends of the farmer, in the interest of agriculture, to help remove Section 531 of HR 13270.

FELCO,
September 15, 1969.

Re section 531 (cooperatives, H.R. 13[illegible]).

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: Section 531 of HR 13270 as it appears in the Tax Reform Act of 1969 passed by the House will be detrimental to farmer cooperatives. If a due date is placed on all retained savings, this will immediately hurt cooperatives. It will change what is now risk capital—an asset—to a debt obligation—a liability. It will reduce the borrowing capacity of a cooperative, and will at the same time add to its debt position. This would drastically affect the borrowing capacity of many farmer cooperatives. Thus, the first to be hurt would be the local farmers who are members of these cooperatives. Farmers are having a difficult enough time without this additional burden being placed on them. This, along with mandatory pay-out provisions, is a regulation which would be placed on the earnings of no other business. Since it is not a revenue producing measure, it constitutes unfair and punitive interference with the affairs of farmer cooperatives. Cooperatives are presently working within the 1962 Revenue Act, which was passed after much deliberation and consideration. It would be unfortunate for the farmers of our country if the method of financing were to be changed as drastically as proposed in the Tax Revenue Act of 1969.

Sincerely,

VERN MOORE,
Director, Administrative Services.

RESOLUTION ADOPTED THE 34TH ANNUAL MEETING, NATIONAL SOCIETY OF ACCOUNTANTS FOR COOPERATIVES, SUBMITTED BY MARTIN L. BLACK, JR., SECRETARY-TREASURER

Whereas, the National Society of Accountants for Cooperatives is an organization consisting of over 1,000 professional accountants serving principally in technical and administrative capacities for or in support of cooperative organizations, and

Whereas, the Society's membership, by virtue of its preponderantly professional and administrative posture and as a matter of policy, does not customarily express a position on the merits or demerits of policy questions arising in connection with the imposition of Federal income taxes on cooperatives, but

Whereas, the provisions of H.R. 13270 entitled "Tax Reform Bill of 1969", and particularly Subtitle D (Section 531) thereof, would impose technical and operating burdens on cooperatives, unrelated to revenue effects, which the Society believes inappropriate and unintended,

Now Therefore, be it resolved by the National Society of Accountants for Cooperatives, duly assembled at its annual meeting in Seattle, Washington on August 22, 1969, that:

(1) Without expressing a position on the merits of the concept embodied in the proposed amendments to Section 1388(e)(1) of the Internal Revenue Code, the Society believes that subparagraph (ii) of new paragraph (C) should be revised to read as follows if the proposed amendment is ultimately adopted:

"(ii) or in redemption (to the extent allocated by the payor to such patronage dividend for the purpose of meeting the requirements of this clause, if not allocated to any other patronage dividend) of any qualified written notice of allocation, *or patronage allocation issued for a taxable year to which Subchapter T was not applicable*, previously paid as a part of a patronage dividend, or such payments, for any taxable year, and" (new material italic)

(2) A copy of this resolution be forwarded to the Executive Vice President and the General Counsel of the National Council of Farmer Cooperatives.

By way of explanation, the Society points out that many cooperatives organizations have adopted by-law provisions or other systematic plans for redeeming or revolving their equity capital and that the enactment of the proposed amendment to Section 1388(c)(1), passed by the House of Representatives, would impose hardships and inequities for the following reasons:

(*a*) "Qualified written notices of allocation" were first introduced into the Internal Revenue Code by the Revenue Act of 1962, and therefore many presently outstanding patronage equities represent neither "qualified written notices of allocation," nor "non-qualified written notices of allocation", as these terms are used in the Internal Revenue Code. As an extreme, it should be noted that the various Banks for Cooperatives did not become subject to Subchapter T of the Internal Revenue Code until recently, principally 1969, and that "qualified written notices of allocation" could not have been issued by such banks prior to that time.

(*b*) In order to avoid an adverse tax impact from the proposed amendment to Section 1388(c)(1), those cooperatives with outstanding patronage equities issued before Subchapter T became effective, would be compelled to pay out a greater than normal percentage of cash as patronage dividends to their current patrons or else to redeem recent patronage allocations (namely, those constituting qualified written notices of allocations), to the detriment of patrons whose funds have been retained by the cooperative for a longer period of time.

(*c*) The enforced discrimination against longstanding patrons would create internal operating problems, and probably dissension among the cooperatives' patrons, with no compensating benefit to the Federal tax revenue, the cooperative community, the general business community, nor society in general.

STATEMENT OF WILLIAM O. DALEY, C.P.A.

TAXATION OF COOPERATIVES

SUMMARY

The fifteen year redemption provision of section 531, respecting taxation of cooperatives, is, for the following reasons, inadvisable and should not be adopted by the Committee:

(1) It would tend to make it more difficult for cooperatives to finance their operations adequately.

(2) It would present cooperatives with an arbitrary redemption requirement unrelated to business realty.

(3) It would force cooperatives into increased borrowings and, thus, make their financial situations less stable.

The statute should be amended to permit payments in cash as well as qualified per-unit retained certificates, so that the cash payments, in common with the certificate payments, are deductible during the taxable year if made within 8½ months after such year.

STATEMENT

My name is William O. Daley. I am licensed as a Certified Public Accountant in the states of Florida and Arkansas and am the senior member of W. O. Daley & Company, Certified Public Accountants, with offices in Orlando and Vero Beach, Florida. We specialize in cooperative accounting and tax practice, and represent approximately 80 percent of the cooperatives in Florida as well as some sizable cooperatives outside of Florida. Our office in Orlando, Florida, was established in 1944.

I would like to place before the Committee, on behalf of my firm and our cooperative clients, our considered judgments respecting H.R. 13270's section 531 which proposes certain changes in the taxation of cooperatives.

A. Fifteen year redemption requirement

The proposal requires that written notices of allocation and per-unit retain certificates be paid in money within fifteen years after issuance. We believe that the proposal, if enacted, would create a particularly hazardous situation for most, if not all, cooperatives.

1. Financing difficulties

The fifteen year pay-out requirement would cause a transfer of the cooperative members' investment (represented by the notices of allocation and per-unit retain certificate) from the equity section of a cooperative's balance sheet to the long term liability section. Thus, the provision would make it almost impossible for these organizations to obtain proper financing. This difficulty woud exist even for those cooperatives which may follow a practice of revolving the certificates over a ten or twelve year period. It is quite certain that financing institutions, such as the Bank for Cooperatives which makes sizable loans to cooperatives, would require a subordination of the fifteen year paper by each cooperative member holding such paper. Without such subordination, it is exceedingly likely that long term loans will not be made. In fact the subordination may often be required for short term loans. Considering the fact that cooperatives have normal changes in membership, the task of obtaining subordinations from a majority of members can often be insurmountable.

2. Arbitrary effect of forced redemptions

The fifteen year pay-out requirement would present particular difficulties for cooperatives that have wide variations from year to year in the amount of patronage dividends (notices of allocation), and/or per unit retains distributed. My firm has a number of farm cooperative clients in which the unit volume and dollar value of products marketed fluctuates as much as 50 percent from year to year. This fluctuation, which can be caused not only by the normal variation in the size of the annual crop but can be accelerated by the presence of hurricanes, freezes, dry weather, wet weather, short labor supply and other factors, may, thus, force irrational redemption requirements on a cooperative during a year when that cooperative is experiencing wholly different business conditions.

Under the present procedures, without the abritrary fifteen year pay-out requirement, a cooperative will redeem its paper if, as and when its financial condition permits. In addition, under current conditions a specific year's certificate may be redeemed in segments over a period of years. The current rule therefore fits snugly with the economic conditions as they exist and change from year to year. Cooperatives are not strait jacketed but may exercise reasonable judgment in securing their economic positions.

3. Forced borrowing

The mandatory fifteen-year redemption provision is not only abritrary in that it does not adequately recognize the year to year variations in a cooperative's performance and experience, but operates in a similar arbitrary manner in that it does not recognize the fluctuations in general economic conditions. For example, in many cases in order to meet redemption obligations, cooperatives will doubtless be forced to borrow additional monies from other institutional sources. In effect, such cooperatives will be placed at the mercy of the money markets and may be required to incur increasingly high interest rates and other unpalatable restrictions simply because of a statutorily directed redemption of their certificates. The net result of the higher cost to the cooperative will be a further reduction in the relatively low return to the farmer for his farm product.

Of perhaps more serious consequence is the fact that farmers' cooperatives today have difficulty in obtaining long-term financing from any source other than Banks for Cooperatives. If the cooperatives, by virtue of the fifteen year redemption requirement, put excessive borrowing demand pressure on the Banks for Cooperatives, such institutions may find that they do not have the resources to make all loans that may be necessary. Thus, certain cooperatives may be placed in the impossible position of being required by statute to redeem their paper and not have any reasonable possibility of obtaining the funds with which to make such redemption. The resulting condition would be no less than chaotic.

In view of the difficulties as described above, which may be caused by the enactment of section 531, we urge upon the Committee that the fifteen year redemption provision be struck from the bill which will be reported to the floor of the Senate.

B. Cash payments in lieu of per-unit retains

Moving, if we may, from the fifteen year redemption situation to a condition that exists under current law, we invite the committee's attention to a matter which we feel has a sizable arbitrary effect and needs immediate correction.

Under existing law, a marketing cooperative operating on a pooling basis can distribute to its members qualified per-unit retain certificates and receive the benefit of a deduction against ordinary income in the face amount of such certificates. At the same time the recipient member reports the face amount of the certificate in taxable income in the year in which he receives it.

The statute contains no specific guidance on the question of when such a qualified per unit retain certificate must or may be redeemed. It would appear that such a certificate may be redeemed by the payment of cash at any time on or after issuance. The cash might, conceivably, be paid to the member simultaneously with the issuance of the certificate or soon thereafter.

Alternatively, although the statute would seem to permit this quick redemption and conversion of cash, it does not permit an immediate direct payment of cash in lieu of a qualified per-unit retain certificate in a manner which would have the same retroactive deduction consequence, i.e., deductible in the prior taxable year if paid within eight and one-half months after the end of the year. This inconsistency is not merely arbitrary, as measured against a standard of pure logic, but results (1) in a totally unnecessary administrative burden (through the issuance of the interim paper) and, in most cases, (2) in the placing of a liquidity squeeze on the member.

The development of such a squeeze can be illustrated as follows: For technical reasons, the per-unit retain certificate for a given year cannot be distributed until the completion of the audit of the pooling cooperative's books and records for that year. This normally does not occur, at its earliest until 60 to 75 days after the conclusion of the year. Then it becomes necessary to prepare and mail to members the per-unit retain certificates. Following this step, the cooperative may redeem the certificates for cash.[1]

This entire process of audit, issuance of certificate and redemption for cash may often not be completed until four or five months following the end of the taxable year. During that time the member is deprived of the funds represented by the certificate and must obviously use alternative and much less favorable sources of financing in his farm business.

In order to avoid this anomaly and the unnecessary difficulty which it entails, we would urge that the statute be amended to permit the deductible issuance, at any time within the eight and one-half month period, of not only qualified per-unit retain certificates, which will subsequently be redeemed for cash, but also direct cash payments in lieu of such qualified certificates. Under this procedure cash could be distributed to members (in lieu of the certificates) immediately following the end of the taxable year. We are attaching to this statement an exhibit showing suggested statutory language to accomplish this proposal.

Thank you.

SENATE COMMITTEE ON FINANCE ATTACHMENT TO STATEMENT OF WILLIAM O. DALEY, HEARINGS ON H.R. 13270

Section 1382(b)(3) (relating to the determination of the taxable income of cooperative organizations) is amended to read as follows:

> (3) as per-unit retain allocations, to the extent paid in money, qualified per-unit retain certificates (as defined in section 1388(h)), or other property (except per-unit retain certificates (as defined in § 1388(g)) which do not constitute qualified per-unit retain certificates) with respect to marketing occurring during such taxable year; or

Section 1388(f) (relating to the definition of per-unit retain allocation) is amended to read as follows:

> (f) Per-Unit Retain Allocation.—For purposes of this subchapter, the term "per-unit retain allocation" means any allocation, by an organization to which part I of this subchapter applies, including payment in money, per-unit retain certificates, or other property to a patron with respect to products marketed for him, the amount of which is fixed without reference to the net earnings of the organization pursuant to an agreement between the organization and the patron.

AMERICAN COTTON SHIPPERS ASSOCIATION,
Memphis, Tenn., October 6, 1969.

HON. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate, Old Senate Office Bulding, Washington, D.C.

DEAR CHAIRMAN LONG: On behalf of the American Cotton Shippers Association, I wish to express our views on the legislation pending before the Senate Finance Committee which would institute certain tax reforms.

The American Cotton Shippers Association was founded in 1924, and is basically comprised of merchants, shippers, and exporters of raw cotton who are members of six federated associations, located in fourteen states throughout the cotton belt:

Arkansas—Missouri Cotton Trade Association
Atlantic Cotton Association
Oklahoma State Cotton Exchange
Southern Cotton Association
Texas Cotton Association
Western Cotton Shippers Association

The 678 member firms of the A.C.S.A. handle over 70% of the domestic cotton crop and 80% of the export market. Our members are tax-paying corporations, partnerships, and companies who compete on an equal basis with each other for this business.

On this occasion we desire a further balancing of the competitive structure, and we respectfully request that the Committee on Finance adopt the original recommendations of the House Ways and Means Committee, which would require

[1] Although the statute does not direct itself to the point, the Internal Revenue Service has taken the informal position that redemption of such certificates may not occur at any time prior to 30 days following issuance.

that cooperatives disburse a minimum of 50% of their annual patronage dividends, and that the remaining patronage dividends be paid within five years.

It is our opinion that section 531, as enacted by the House of Representatives in H.R. 13270, would only serve to prolong the protective status that cooperatives presently enjoy. These tax advantages originated at a period in our nation's history when cooperatives basically consisted of small groups.

At their inception, and even today, true cooperatives perform a service to their producer members. However, the conditions which existed at the time when the federal government extended tax and anti-trust exempt status to cooperatives. are no longer present.

Cooperatives are now a vibrant force competing in an agressive fashion with tax-paying businesses in similar fields of endeavor. The Farmer Cooperative Service of the USDA announced on July 16, 1969, that for the fiscal year ending June 30, 1968, farmer cooperatives showed a total business volume of $17.1 billion. (This figure does not include business transacted among the cooperatives or inter-cooperative business.) Immunity from federal taxes affords them a competitive advantage, which is obvious on its face.

The American Cotton Shippers Association strongly supports the provisions of section 5 of S. 2646, introduced by Senator Abraham Ribicoff on July 17, 1969, which would require cooperatives to be taxed to the full extent on their income.

Under existing law, cooperatives are permitted to make mere paper allocations of earnings to their member patrons, and unlike business corporations, the cooperatives pay no federal income tax whatever. A cooperative achieves this result despite the fact it has possible earnings of several million dollars and retains up to 80% of those earnings for expansion and other business purposes.

In an unprecedented era of high money cost, the farmer cooperative members can borrow money at 3.5% from the Commodity Credit Corporation while the CCC cost of borrowing is 7%; R.E.A. loans are available at 2% to the co-ops; and the cooperatives can borrow money from any of the regional cooperative banks at rates from 7.5% to 8.5% while the private sector in direct competition with the cooperatives must borrow money at rates from 9.5% to 11%.

Capitalizing upon their ability to generate tax-free earnings, cooperatives have become permanent large-scale institutions, separate from and in large measure independent of, their patrons, Many have developed complex corporate structures, closely resembling the parent-subsidiary organizational pattern of large corporations in the private business field.

Present tax law contains no satisfactory provision for the taxation of profits earned by cooperatives. For many years cooperatives and their owner-patrons were able to deal with each other and with the general public without, in many circumstances, the inconvenience of having to pay tax either at the cooperative level or at the owner-patron level.

The measure which was adopted, however, aimed only at securing a single tax from the cooperative and its owner-patrons. Thus, where the prescribed steps are taken to shift the tax to patrons, it is still possible for cooperatives to engage in broadscale business competition, earn large sums of income, and retain the major part of those earnings without paying tax on them.

We strongly recommend that the fundamental two-tier system of taxation now applicable to corporations and shareholders be extended to cooperatives and their owner-patrons. Cooperatives should be made fully taxable on income which they earn. No basic difference in the operations of cooperatives and corporations can be found, and it is only proper that their tax structures should be least closely parallel.

The American Cotton Shippers Association respectfully requests that this letter be included as part of the official proceedings in the Finance Committee hearings on tax reform.

Sincerely,

NEAL P. GILLEN,
Vice President and General Counsel.

STATEMENT OF FRED V. HEINKEL, PRESIDENT, MISSOURI FARMERS ASSOCIATION AND MIDCONTINENT FARMERS ASSOCIATION, COLUMBIA, MO.

My name is Fred V. Heinkel; I am president of Missouri Farmers Association and Midcontinent Farmers Association representing our many farmer members in the great midwestern part of the country. I wish to present this statement to the committee because of the most serious implication of certain proposals set forth in H.R. 13270, The Tax Reform Act of 1969.

Several provisions of the Tax Reform Act of 1969 are well conceived and are deserving of the support of this committee.

However, among the provisions of the proposed act is a matter relating to the internal operations of farmer owned and controlled cooperatives, which has no relation to the subject at hand and has nothing to do with the Internal Revenue of the United States Government.

I feel confident that most of the members of this committee and most of the members of the Senate will recall the year 1962 when the question of the taxation of cooperatives and its patrons came before the Congress of the United States. It was the feeling of the Congress, as demonstrated by the passage of the Revenue Act of 1962, that there should be some assurance that the net margins of a cooperative association would be taxed currently, either to the cooperative or to the patron. For the most part, this was accomplished by the Revenue Act of 1962. Very importantly in connection with the passage of this act was a certain feeling among the members of the United States Congress that this issue had to be finally resolved and thus the principal of current taxability, either in the hands of the member-patron or in the hands of the cooperative, was established.

Included within the provisions of the Revenue Act was one additional concept which really has nothing to do with the imposition of the tax, and that is the provision in the law that if patronage distributions are to be deductible a specified amount of the distribution must be made in cash. The theory behind such a provision was that if the farmer was to include the gross amount of the patronage distribution in his income, then a minimum payment in an amount sufficient to cover his basic tax liability therefor should be made. It is granted that the reasoning behind this appoach was paternalistics and was actually an interference in the farmer's operation of his own business. We would most respectfully remind the committee that even the mandatory 20% pay-out as contained in the Revenue Act of 1962 really has relatively little to do with the principle of taxability of current margins.

We would also like to remind the committee that the question of the taxation of farm cooperatives and their member-patrons was before this committee again in 1966 when the committee had before it the specific question of the tax treatment of per-unit retains. Once again the Senate affirmed the principle of the collection of a single tax currently.

In adopting this principle in relation to per-unit retains, the report of the Senate Finance Committee stated in part as follows:

"The patronage dividend provisions of the Revenue Act of 1962 were designed to assure that the amounts received by cooperatives in the course of their business activities with their patrons are included in computing the income tax of either the cooperative or the patron, thus subjecting these amounts to a single current tax. To accomplish this, the 1962 act provided detailed rules which specified the treatment which patronage dividends are to receive from the standpoint of both cooperatives and their patrons. It was hoped that these provisions would bring to an end the uncertainty that existed in the area of cooperative-patron income taxation and consequently bring to a halt the litigation that the uncertainty engendered. In this regard, the Revenue Act of 1962 has not been completely successful because of the uncertainty which continues to exist with respect to per-unit retain certificates. To remove this remaining uncertainty, the bill amends the provisions of present law dealing with patronage dividends to make them applicable, generally, with respect to per-unit retain certificates." * * *

We quoted the above langauge to indicate that the principle sponsored by the Congress has been that of a single tax, and this goal has been achieved.

The legislation pending before the Senate is not of this character. These proposals would use the Internal Revenue Code to regulate the internal affairs of a cooperative association and to limit the management of those affairs by the members. It is not tax reform at all. As a matter of fact, it is not even properly classified as tax legislation. This legislation seeks to impose these restrictions without regard to the needs of the cooperative or its members and without regard to the fact that the members of the cooperative own and control it. It is the farmer-members and their cooperatives who are going to be hurt by this legislation. The United States Government and certainly the Internal Revenue is really not affected one way or the other.

If this proposal could be characterized as anything, it must be classified as punitive legislation aimed at further limiting the ability of cooperative associations to serve their membership.

The impositon of these further restrictions and limitations on cooperatives is unwarranted, unnecessary, and unduly burdensome to cooperatives and their members.

We sincerely believe that the members of the Finance Committee of the United States Senate are completely knowledgeable in this area of the taxation of cooperatives and its members, because this matter has been before the committee repeatedly throughout the years. The members of this committee understand the operations of cooperatives and they also understand that the members have full control of those associations. I think the committee is well aware that any reference to "tax-free income" is plainly and simply false, because these net margins are currently subject to tax.

We are confident that this committee with its full understanding of this problem will take a proper course of action.

The announced goal of Congress in this area of tax legislation should be regarded as settled. These taxes are now being imposed, and I don't honestly believe that the Congress really wants to interfere in the internal affairs of cooperatives through the use of the Internal Revenue Code. Yet, that is what this legislation does in regard to these particular provisions.

We appreciate the opportunity to present this statement to the committee and also thank the committee for holding hearings on this matter. We regret that the House of Representatives saw fit to include these provisions in the Tax Reform Act without hearings.

We respectfully urge you to reject this portion of the proposed legislation and to delete these provisions in reference to cooperative associations and their patron-members from H.R. 13270.

CALIFORNIA CANNERS AND GROWERS,
San Francisco, Calif., September 16, 1969.

HON. RUSSELL B. LONG,
Chairman, Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: I am writing on behalf of our 1200 members in California and Wisconsin. To further identify California Canners and Growers, our cooperative is the largest grower-owned fruit and vegetable canning cooperative in the world. We market in this country and in 39 countries abroad. We are the largest exporter of California canned fruits. Our cooperative was organized in answer to the urgent economic need of growers and, in serving their interests, has also contributed strength and stability to agriculture and the nation's canning industry. The type of growth that we have exhibited is evidence of the need for associations such as ours. We are quality processors and aggressive, progressive marketers.

I would be derelict in my duty to our members if I did not protest as vigorously as I know how the pernicious Section 531 of H.R. 13270 now before your Committee. Its intent clearly is not "tax reform" but simply to impose damaging restrictions on the ability of agricultural cooperatives to generate working capital through their own efforts or to obtain additional capital from lending agencies. This is obviously a punitive measure. It originates with those who have long sought to curb the ability of farmers and ranchers to meet their economic problems through cooperation.

The provision requiring that all patronage dividends be repaid within 15 years would act to alter the entire character of a cooperative's capital funds, changing them from "equity capital" to debt and throwing a shadow on cooperative's financial stability so far as lending institutions are concerned. This is not only a damaging proposal but one which, so far as I can see, would raise no additional revenue, close no tax loopholes, and, in fact, have no effect to penalize cooperatives.

The provision which would require annual increases in the percentage of patronage dividends paid to members, until it reached fifty per cent, is again totally unnecessary if the object is tax reform, but would take from the hands of the duly-elected directors of cooperatives their right to determine repayment policy in the best economic interest of their members. The law already requires annual repayment of a generous portion of annual earnings. The additional requirement proposed would be a serious handicap particularly to smaller cooperatives which find their sources of working capital restricted and must depend to a large extent on their own resources. I can see no way in which this provision would contribute to tax reform. I can see that it would be harmful to farmers and ranchers who are attempting to use their own initiative and abilities cooperatively to secure their economic future.

I respectfully ask that you and the members of your Committee consider, with all objectivity, the point of view I have expressed. It is one that is shared by rural people throughout this country who can see in the two provisions mentioned above nothing but an attempt to handicap their cooperative efforts. I also request that this statement of our position be made a part of the printed record of your hearings on H.R. 13270.

Sincerely yours,

ROBERT L. GIBSON, Jr.,
President.

FS SERVICES, INC.,
Bloomington, Ill., September 17, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: FS Services is a regional cooperative furnishing farm production supplies to 150 local cooperatives in the States of Illinois, Iowa, and Wisconsin. These local cooperatives are serving approximately 300,000 farmers in these states. FS Services and its 150 member companies are opposed to Section 531 of the Tax Reform Act of 1969 (H.R. 13270) concerning the change in taxation of cooperatives on the following grounds:

1. The proposed legislation provides no additional revenue for the federal government.

2. The proposed legislation would jeopardize the financial status of many local cooperatives, and subsequently of farmers' income, at a time when farm income is already under a severe price-cost squeeze.

3. The proposed legislation purports to protect the farmer from the financial decisions made by his cooperative, when in actual practice the farmer makes the decisions in his cooperative.

4. The proposed legislation is discriminatory; it would force the cooperative to pay its dividends and finance its operation in a manner prescribed by Congress. Congress does not impose this restriction on other corporations. This seems to be an additional encroachment of federal power at a time the administration is advocating a new federalism.

5. The proposed legislation, by weakening the small cooperative, will put more economic power in the hands of the large conglomerate-type industrial corporations which is not in the best interests of either farmers or the general public.

6. The proposed legislation seems to be contradictory to the national policy of supporting and promoting self-help programs to alleviate rural poverty.

7. The proposed legislation will make it extremely difficult for the cooperative to provide both the equity and debt capital to finance the growing farmer demand for facilities and services.

For the above reasons, we urge your support in eliminating Section 531 of H.R. 13270. The attached supplement supports the seven points we have delineated above. We request the attached statement be included in the printed record of hearings on H.R. 13270.

Sincerely,

E. V. STEVENSON.

Re public hearings on section 531 (cooperatives), H.R. 13270.

STATEMENT

FS Services is a regional cooperative furnishing farm production supplies to 150 local cooperatives in the States of Illinois, Iowa, and Wisconsin. These local cooperatives are serving approximately 300,000 farmers in these states. FS Services and its 150 member companies are opposed to Section 531 of the Tax Reform Act of 1969 (H.R. 13270) concerning the change in taxation of cooperatives on the following grounds:

1. The proposed legislation provides no additional revenue for the federal government. Although H.R. 13270 has been dubbed a tax reform bill, the section affecting cooperatives is not tax reform. The cooperative would continue to be

allowed a deduction for patronage refunds and the farmer would continue to pay the tax on said patronage refund regardless of the percent of cash either distributed or received and regardless of the mandatory revolving date. The cooperative section of H.R. 13270 would more aptly be described as a mandatory financial plan.

2. The proposed legislation would jeopardize the financial status of many local cooperatives, and subsequently of farmer's income, at a time when farm income is already under a severe price-cost squeeze. The proposed legislation would convert the non-cash patronage refunds from equity capital to debt capital and substantially increase the cooperative's already difficult job of financing its operations. (This will be covered in more detail at a later time.)

This weakening of the cooperative's financial structure will have the effect of weakening the cooperative, reducing the cooperative's income, and reducing the cooperative's effectiveness as one of the farmer's off-farm tools.

This income becomes part of the farmer's total income and any action taken that would jeopardize this portion of the farmer's income contributes to his already severe price-cost squeeze. It has historically been the policy of both Democratic and Republican administrations to help the farmer achieve his fair share of our economic prosperity. This legislation seems to run counter to that policy.

3. The proposed legislation purports to protect the farmer from the financial decisions made by his cooperative, when in actual practice the farmer makes the decisions in his cooperative.

An excerpt from House Report No. 91-413 (Part I) of the House Ways and Means Committee to accompany H.R. 13270—Tax Reform Act of 1969—would seem to describe the committee's reasons:

"*General reasons for change.*—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 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. This 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.

"Your committee believes that patrons should be given assurance of a larger share of the patronage allocations that are included in their taxable income, and that amount retained by the cooperative which have been included in a patron's income, whether patronage allocations or per-unit retains, should be paid to him not later than 15 years after the close of the taxable year with respect to which the allocation is made or the retain certificate is issued."

The basic premise expressed by the Committee seems to be that the patron does not have an independent choice between reinvesting his patronage refund allocation in the cooperative or retaining for its own use. We believe this premise to be incorrect for the following reasons:

A. The farmer makes the ultimate choice when he patronizes his cooperative or does not patronize it. By continuing to patronize his cooperative he says, "Even if I receive a non-cash patronage refund, this is better than my next best alternative." We would contend this is free choice.

B. The farmer has an additional choice—convince the majority of his fellow farmers that the patronage refund policy followed by the cooperative should be changed. He can make these changes by voting a change in the articles and by-laws of the cooperative or by electing directors that believe changes in the cooperative practice should be followed.

Only to the extent that an individual farmer is not in agreement with the practices desired by a majority and continues to feel that the use of his cooperative is advantageous to him in spite of the patronage refund practice with which he does not agree is the farmer given no choice.

The Committee further states that the patronage refund policy followed by the cooperative might have come into effect prior to the farmer becoming a member. The present tax laws require the cooperative, prior to the patron becoming a member, to inform him of the patronage refund practices of the cooperative. If a farmer is not a member and still receives a patronage refund, the law requires that he give his consent to the patronage refund practices followed by the cooperative. If this practice is not advantageous to the non-member and he refuses his consent, the cooperative must pay federal income tax on the full amount of the patronage refund for which that member was eligible.

Additionally, this Committee seems to want to grant a right to the cooperative shareholder that is not granted to any other shareholder. There is nothing that forces a corporation to pay all or a portion of its dividends in cash and the corporate shareholder is given no right to have his stock redeemed at some specific point in time.

The cooperative is run on a democratic basis in the best American tradition—majority rules. The members of the cooperative must provide the basic equity capital needed by the cooperative. The cooperative is investing money in fixed assets to serve the farmer's needs and the life of many of these fixed assets exceeds the fifteen-year revolving period suggested by the Committee. This requires the cooperative to have a source of capital that extends beyond fifteen years. Other corporations couldn't operate if they were forced to return the stockholders' money in fifteen years.

Some have argued that the ability to issue part of its patronage refund in stock gives the cooperative an advantage in raising capital. In many respects, however, the cooperative already is at a disadvantage in raising capital. The proposed legislation would place the cooperative at an even greater disadvantage.

A cooperative has little, if any, way to attract equity capital other than from its members. It is limited to a dividend rate not to exceed 8 percent which in today's money markets cannot attract investment capital. It cannot offer a "growth stock" to investors. Except for dividends, the earnings of the cooperative belong to the customer, not the investor. For this reason, there is no way for a cooperative stock to increase in value. Because of this, the cooperative is at a substantial disadvantage in raising equity capital.

Non-cooperative corporations have access to major public markets to seek new equity capital if needed. They can offer growth stock and convertible debentures to the investing public and as an incentive to employees. They use the growth stock, warrants, convertible debentures, and other securities, sometimes quite exotic, to acquire other companies.

The majority of the conventional sources of acquiring capital that are available to the cooperative's competition are not available to the cooperative; hence, the cooperative must look to its members, the users of the cooperative, to provide this capital.

4. The proposed legislation is discriminatory. As was indicated earlier, the proposed legislation is not tax reform but is a mandatory financial plan—a financial plan that would force the members of a cooperative to follow the practices selected by H.R. 13270 rather than a financial plan the owners of the cooperative might select. This legislation would force the cooperative to pay up to 50 percent of its patronage dividends in cash. Congress does not dictate to other corporations in what form they will pay their dividends. They are free to pay them wholly or partly in stock if they so choose, or to pay no dividends at all.

The second part of the proposal may be more harmful. This portion of the proposal would make it mandatory that the non-cash portion of the patronage dividend be revolved in fifteen years or less. The effect of this is to convert all non-cash patronage refunds to long-term debt. Today the cooperative may select whether the non-cash patronage refund should be capital stock or debt. Congress does not impose this restriction on other corporations. This is a double restriction. It forces the cooperative to issue long-term debt rather than stock and additionally dictates the period the long-term debt may be outstanding. In no instance that we are aware does the federal government force a corporate issuer of debt securities to have their securities mature in fifteen years or less. There are numerous examples of corporate debentures with maturities of more than fifteen years.

5. The proposed legislation, by weakening the small cooperative, will put more economic power in the hands of the large conglomerate-type industrial corporations which is not in the best interest of either farmers or the general public. As a whole, it will be the small local cooperative that will be most dramatically affected by the proposed legislation—not the regional cooperative. It is these small cooperatives that are competing for the farmers' business with the large conglomerate-type corporations. There has been a great deal of misinformation on the size of farmer cooperatives and their share of the market. Based on the latest figures available from the Farmer Cooperative Service, a function within the Department of Agriculture, cooperatives have 28 percent of the marketing volume and 16 percent of the farm production supplies volume, based on 1966 figures.

These are the latest figures published by the Farmer Cooperative Service.

The Farmer Cooperative Service report for 1965–66 indicates aggregate cooperative marketing volume of $12 billion, and farm supply volume of $3 billion. These are impressive figures. Before drawing conclusions as to the size of farmer cooperatives, some evaluation and comparison is needed.

This volume is divided among 8,300 cooperatives. On a straight arithmetic basis, this would mean an average volume per company of $1.4 million in marketing and about $360,000 in supplies. If viewed on an average basis, cooperatives would be very much in the "small business" category in today's economy.

Averages are not too meaningful, however. Farmer cooperatives cover a broad range in size, in diversification, and in degree of integration. Ninety percent are classified by Farmer Cooperative Service as "local" organizations. The other 10 percent are classified as "regionals". The smallest local may involve only a few thousands of dollars per year. A number of the regionals exceed $100 million in annual volume. The largest single regional has a volume of about $500 million—made up of both marketing and supply volume.

We occasionally hear comments about the "huge" farmer cooperatives. Size is a relative thing, however. The largest farmer cooperative would rank in 175th place on FORTUNE's list of 500 industrials. The combined supply volume of *all 8,300* farm cooperatives is exceeded by *each* of the top 12 industrials, and by *each* of the top three merchandising firms in the FORTUNE list.

Twenty-six of the top 50 industrials in FORTUNE's list are now competitors with cooperatives for the farm market. Some have been in this market for years, but many of them are relative newcomers in the farm market. These twenty-six companies have combined sales of $79 billion, combined assets of $87 billion, and combined net income of $6 billion. The *after-tax net income* of these twenty-six companies is nearly *double the total supply sales volume* of the 8,300 farmer cooperatives. When people say farm cooperatives are getting too large, we are inclined to say, "Compared to whom"?

From the above information, it is obvious that cooperatives are a relatively small diversified portion of the businesses that serve farmers and that an inordinate amount of economic power is not in the hands of the cooperatives. Any action taken by Congress to weaken the cooperatives has to have a converse effect of strengthening these twenty-six industrial corporations. In light of the country's stated anti-trust policies, it would appear that weakening cooperatives is not in the public interest.

6. The proposed legislation seems to be contradictory to the national policy of supporting and promoting self-help programs to alleviate rural poverty. Cooperatives were one of the early forms of self-help programs developed by the rural community. The substantial weakening of these cooperatives can only contribute to a further siphoning-off of resources and self-sufficiency from the rural community.

The cooperative employs the non-farm rural resident. Its facilities are generally located in or adjacent to small towns and attract the farmer to these rural communities. Construction of the cooperative's facilities is generally done by small contractors. The profits or savings from the cooperative stay in the rural community, rather than being drawn to the major financial centers as is the case with the cooperatives' large corporate competitors.

Cooperatives have made, and continue to make, a substantial contribution to rural America, and help to reduce the problem of rural poverty. The weakening of cooperatives will just further contribute to an already difficult rural problem.

7. The proposed legislation will make it extremely difficult for the cooperative to provide both the equity and debt capital to finance the growing farmer demand for facilities and services.

Based on the proposed legislation, it would no longer be possible to use non-cash patronage refunds to provide a portion of the equity capital needed by the cooperative. Non-cash patronage refunds would have to be considered long-term debt rather than equity. This feature would make it very difficult for the cooperative to continue the use of long-term debt from other sources—banks, insurance companies, and the Farm Credit System—because the cooperative would have little if any equity capital. Financial institutions lend money based on the borrower's ability to repay and the security of the loan. Potential lenders would have little if any interest in making a loan to a cooperative that had little if any equity capital and a large amount of long-term debt coming due in a short period of time.

Today cooperatives that religiously follow the practice of revolving their stock in a stated period of time are able to attract long-term debt capital from institutional lenders because a cooperative is not under contractual obligation to resolve. The long-term lender if afforded protection in the event the cooperative suffers financial reverses. This would no longer be true if H.R. 13270 is passed. Sources of capital available to the cooperative would become extremely limited.

A Position Paper Concerning the Handling of Patronage Distributions by Tax Exempt Agricultural Cooperatives Prepared by Cranberry Corporation of America, 367 Main Street, Wareham, Massachusetts

INTRODUCTION

The Report of the Committee on Ways and Means, House of Representatives, on the Tax Reform Act of 1939 (H.R. 13270) has suggested changes in the handling of certain patronage distributions by cooperatives. (Section 531 of the Bill, and Section 1388 Internal Revenue Code, 1954.) The major change concerns certain amounts defined under the general heading of "Patronage Dividends" which are, in fact, retained by the cooperative entity for its own use, although the patron assumes as taxable income at the same time the stated dollar value of such retained amounts. These amounts are usually referred to as "Patronage Allocations" or "Per-Unit Retains" and in many instances the cooperative issues capital stock to the patron in consideration of retention of such amounts. The patron then assumes the stated value of such stock as taxable income at time of receipt. (These amounts together with patronage dividends paid in cash usually comprise the patron's annual gross income.) The Committee on Ways and Means has proposed that such allocations and retains be paid back to the patron not later than 15 years after the close of the taxable year wherein the allocation is made, or the retain certificate issued. The Committee has stressed that under the methods of consent currently available to the patron for inclusion of such amounts as income that,

> . . . the patron often does not have an independent choice between investing each patronage allocation or per-unit retain in the cooperative or retaining it for his own use. This 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.

This corporation, a patron-member of an exempt agricultural cooperative, agrees fully with the reasoning of the Committee, and suggests two related corrective actions by which cooperative patrons would be assured "full dominion" over the handling of their own income. These would include the reduction of the period available to the cooperative for repayment of retains from 15 years to 5 years, and the imposition of restrictions upon the cooperative regarding the funding of such repayments to eliminate possible use of excessive additional retains for this purpose.

IMPLICATIONS OF COOPERATIVE GROWTH

Federal income tax policy regarding agricultural cooperatives has historically taken into consideration the important role played by the cooperative as a marketing agent for the farmer, and as a stabilizing economic element in the affairs of its grower-patrons. This premise was well stated by the Internal Revenue Service in its statistical survey of cooperative income tax returns for the year 1963.

> In a sense the cooperative acts as an intermediary between the agricultural and non-agricultural sectors of the economy concentrating the buying and selling power of the farm community in a way intended to equalize its competitive position. (IRS Publication No. 386, November, 1966)

Agricultural cooperative organizations have been given specific exemption from Federal income tax if they operate on the basis of turning back to their patrons the proceeds of sales less necessary marketing expenses. (Section 101, IRC 1939; Section 521, IRC 1954.) It is in the area of "necessary marketing expenses" that the greatest transformation in cooperative structure has occurred in recent times. The larger cooperative organizations have evolved along lines very similar to the larger public and privately-owned corporations. Where the cooperative has combined the functions on handling, processing, and marketing the particular commodity, of necessity it has had to allocate resources to areas requiring the use of sophisticated marketing techniques for the creation and sustenance of consumer demand. Increased sales have generated the need for heavy capital allocations for new facilities. Growth has, in turn, produced a trend away from farmer management of the cooperative. In the words of one long-time student of the cooperative movement and related areas, R. L. Kohls of Purdue University,

> The technology and knowledge that is needed to run an effective business, cooperative or non-cooperative, in the United States today, however, is highly developed and specialized. The talented amateur has given way to the highly trained specialist. The 'good farmer' can no longer be expected to bring to the board room the prerequisites of a highly effective board member.

Where, in some instances, a board composed of members of predominantly agricultural background has been required to serve as guide and counselor to a technically oriented management, there has, in fact, developed an information/understanding gap, whereby the cooperative's board of directors is unable to assess the full import of management's decisions. The trend in this situation has been toward the board's serving as a rubber-stamp for management, as long as increased sales are generated. In such circumstances, there has emerged a divergence in attitude and program, reinforced by the lack of direct knowledge by the patron, during which the patron, willingly or not, has abdicated much of his control. Furthermore, the very policies designed by the Federal government to enhance management responsibility, at this point may serve as a catalyst rather than a constraint on this development. For example, the exemption from taxation allows a freedom of operation and allocation at the management level not to be found in the orthodox corporate structure. The term "necessary marketing expenses" contained in IRC Section 521 can cover a wide latitude in the absence of precise definitions. Ultimately, the patron must bear the financial burden of management's decision making, and to understand the full impact of these decisions upon him, it is necessary to examine briefly the nature of cooperative distributions.

PATRONAGE DISTRIBUTIONS

While the concept of cooperative patronage dividends derived from earnings is fairly simple, its application has frequently produced some confusion. Generally, a distribution made by an exempt cooperative organization qualifies as a patronage dividend if it meets 3 criteria set forth in IRC Section 1388. First, it must be paid to the patron on the basis of the quantity or value of business done by the cooperative in his behalf. Then, it must be based upon a pre-existent payment obligation executed between cooperative and patron. Finally, it must be determined with reference to the net earnings of the cooperative from business done with or for the patron. Prior to the Revenue Act of 1962 (Public Law 87–834), some courts had held that where a portion of patronage dividends was paid in non-cash allocations, such allocations were not includable in the taxable income of the patron, although they could be deducted by the cooperative. The Revenue Act of 1962 clarified by statute the position that qualified noncash allocations, including per-unit retains, were to be taken into the patron's income at face value.

The current bill before this Committee has recognized, in part, the potential inequity inherent in a policy of unlimited, unrestricted use of the patron's income by the cooperative. It has included the 15 year pay-out requirement referred to at the outset of this paper. Yet it does nothing to insure that such pay-outs will not be funded by means of the same mechanism through which the initial allocation was retained by the cooperative. In other words, under the proposed statute, a per-unit retain could conceivably be paid back to the patron at maturity by creation of an additional retain derived from the monetary portion of the current patronage dividend paid in the year of redemption. The short-run tax consequences of this Peter-Paul mechanism would be similar upon the patron: he is taxed whether the dividend is received as money or in the form of the per-unit retain. However, the intent of the reform is frustrated if the cooperative is allowed to pyramid allocations in satisfaction of prior indebtedness. The long-run tax consequences to the patron could be disastrous to the needs of his own working capital: the indefinite postponement, year after year, of redemption of per-unit retains upon which he pays a tax annually. Cleary this cannot be the intent of the measure, if one accepts at face value the importance attached by the Committee on Ways and Means to the theory of "full dominion" quoted in the Introduction.

CONCLUSION AND RECOMMENDATIONS

The relationship between the exempt agricultural cooperative and its patrons to the farming economy in general furnishes additional evidence of the importance of the corrective measures contemplated by the Ways and Means Committee. Perhaps this can best be illustrated with reference to material presently before this Committee for consideration. House Report No. 91–413 (Part 1) deals in part with the problem of offsets to non-farm income derived from farm losses. (Pages 62–65 of the Report.) The Committee on Ways and Means commented in the following manner on the general problem of farm losses from the point of view of their attractiveness as an investment offset:

> In addition to the increasing promotion of tax-motivated investments in farming operations, there is other evidence available to indicate the magnitude of the problem. Data prepared by the Treasury Department indicates that in the farming business, as distinguished from other types of business, it appears the trend toward losses increases as the taxpayer's adjusted gross income increases. In other words, it appears that the more adjusted gross income a taxpayer has, the more likely it is that there will be a loss on his farm operation.

The report then presents a table of income averages for farm returns for the years 1964 through 1966.

Unfortunately, the Report did not extend its analysis to the causes of this uncharacteristic result of economic growth. Had it done so, it would have found that in the progression from small farm to large agricultural enterprise, there enters a higher degree of cost awareness and a more accurate use of precise accounting methods. Frequently, the small farmer does not assess his own labor nor that of his family (assuming they work the farm) in his final computation of profit and loss. The result is a distortion of income on the high side. The larger enterprises, in more orthodox corporate style, assess a cost factor to every phase of the operation, and the inescapable conclusion emerges: farming in the United States, in the absence of internal or external support mechanisms, is a losing venture.

The cooperative is, in theory, an internal, voluntary mechanism designed to introduce economic viability into this situation. Regrettably, the smaller patron, like his counterpart in the non-cooperative sector of agriculture, is not usually a knowledgeable cost accountant. The larger patrons find themselves attempting to serve as the watchdog of cooperative management expenditures wherever possible. But it is obvious in this situation that prudence is not institutionalized, and what is designed as an association of equals has frequently become a tyranny of cooperative management. Such is the situation we feel the Committee on Ways and Means has glimpsed, but has not pursued to an effective solution.

This corporation feels that the pay-out period should be reduced from 15 to 5 years in which to repay the so-called "patronage allocations" or "per-unit retains," and further suggests that the cooperative be prevented from using the "pyramid" technique described above. The necessity of repayment over a 5 year period would constrain management from unbridled capital expansion and current expense which in at least one instance (documented in the Appendix) has resulted in the diminution of the stated par-value of stock by 50% as a result of the expansion of the debt to equity ratio. The "pyramid" technique could be prevented by insertion into IRC, Section 1382(b) or in Section 1388 wording to the effect that written notices of allocation, qualified or non-qualified, may not be used by the cooperative to redeem amounts decribed in Section 521, H.R. 13270, as "patronage allocations" or "per-unit retains."

APPENDIX

The following tabular information is derived from a 6 year consolidated balance sheet of Ocean Spray Cranberries, Inc., Hanson, Massachusetts, an exempt agricultural cooperative, of which this corporation is a patron. The ratios are provided as documentation to the position taken by this corporation on the question of patronage allocations and per-unit retains, and is meant to suggest that the problems raised in our position paper are not hypothetical.

While stock in the cooperative is nominally available only to patrons, and only at $25.00 per share (and reportable in gross income by the patron at that figure), it has been possible to establish the market price of such stock offered by brokerage houses during the 6 year period. From time to time, blocks of

Ocean Spray stock have found their way into the hands of non-patrons due to the sale and resale of cranberry properties without the accompanying stock transfers. This has had the effect of allowing an objective appraisal of par value by financial experts, and it striking to note how the price of this stock has proportionately decreased from $25.00 per share as the patrons' debt/equity ratio has increased. Quotations have been furnished by David E. Brill Co., 52 Wall Street, New York, New York.

OCEAN SPRAY CRANBERRIES, INC.—CONSOLIDATED BALANCE SHEETS, 1963-68

[In thousands of dollars]

	1963	1964	1965	1966	1967	1968
Assets:						
Current	5,889	4,737	6,920	9,448	13,612	13,984
Investments	214	245	230	260	247	499
Accounts, patrons	74	64	179	238		
Plant	4,893	5,734	6,745	8,622	16,985	20,736
Total	11,070	10,780	14,074	18,568	30,844	35,219
Liabilities:						
Total debt (current, mortgages, other)	3,000	2,983	5,516	9,701	22,405	25,808
Undistributed proceeds	880	598	1,961	2,009	1,237	(370)
Capital stock:						
4 percent preferred	2,527	2,561	2,534	2,421	1,976	1,675
4 percent preferred (2d)					55	1,150
Common	4,663	4,637	4,063	4,437	5,170	6,956
Total	11,070	10,780	14,074	18,568	30,844	35,219
Stockholders equity	7,190	7,198	6,597	6,858	7,201	9,781
Debt-equity ratio	5-12	5-12	11.5-12	18-12	37.4-12	32.1-12
Stock quotations: April 1968, $15.50. May 1968, $14.25. February 1969, $13.50 September 1969, $12.50.						

AGRICULTURAL COUNCIL OF CALIFORNIA,
Sacramento, Calif., September 15, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: Your Senate Finance Committee is currently holding hearings on the Tax Reform Bill, H.R. 13270, and, I understand, will soon be considering the sections affecting the taxation of cooperatives. I should appreciate it very much if you would make this letter, indicating our opposition to the inclusion of amendments to Section 531, a part of the record of your Committee hearings.

The Agricultural Council of California is an association of farmer-owned cooperatives engaged primarily in the marketing of California's wide variety of food and fibre products. Our farmers, through this association, have been actively engaged in working with the United States Congress in developing equitable tax treatment for cooperatives and their farmer owners. We feel that the Revenue Act of 1962 and the subsequent changes in 1965, which were all made after extensive hearings and debate, settled the question of taxation of cooperatives for some time; that cooperative management now could go about its business of operating the association in a manner which could help improve the farmer's net income. Then, without warning or opportunity for debate, the House of Representatives included in the Tax Reform Act of 1969 a section adversely affecting farmer cooperatives.

Title V, Subtitle D, Section 531 of H.R. 13270 affects farmer cooperatives in two basic ways. First, it increases the final cash payout on patronage dividends from the current 20% to 50% over the next ten years. The adoption of this change does not in any manner increase the amount of tax that would or should be paid. Under present law the patron pays all of the tax currently on any allocation of patronage dividends. The 20% cash figure was placed in the law in order to assist the taxpayer in actually paying the tax. The addition of 3% per year to this amount will not be of any economic significance to the individual farmer but will be very detrimental to the farmer's efforts to help himself through financing the cooperative he owns and controls.

If this section of the Tax Reform Act of 1969 is allowed to remain, farmers will be severely handicapped in starting or supporting new cooperatives. The very heart of farmer ownership financing will be pierced.

Secondly, Title V, Subtitle D, Section 531 of H.R. 13270 would place an unrealistic 15-year time limit on all per-unit retains. Again no additional taxes will be paid by farmers because already they are paying taxes currently on all allocations. However, cooperative financing will be adversely affected because equity capital contributed by the farmer-owners to their cooperatives will be transformed into debt capital. This will have an unfortunate impact upon the ability of a cooperative to borrow funds. The effects of this action will also be adversely felt by the banks for cooperatives and other farmer credit agencies.

The sections concerning cooperatives proposed in H.R. 13270 will not increase any taxes flowing to the Federal Government. The proposed changes will not "plug any loopholes" because all of these areas are now subject to taxation in the current year of allocation. The proposed changes are obviously "anti-cooperative" by design and can not be considered "tax reform."

On behalf of the membership of the Agricultural Council of California I thank you for including this letter in the record of the hearing by the Senate Finance Committee on the Tax Reform Act of 1969—H.R. 13270. I urge that the Committee delete from the proposed Act the sections pertaining to cooperatives.

Sincerely yours,

RICHARD JOHNSEN, Jr.,
Executive Vice President.

APPENDIX C

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECT OF STATE AND LOCAL BOND INTEREST

Written testimony received by the committee expressing an interest in the subject of State and local bond interest

STATEMENT OF HON. TOM BEVILL, A U.S. REPRESENTATIVE FROM THE STATE OF ALABAMA

Mr. Chairman, distinguished Members of the Committee, I appreciate the opportunity of appearing before you today to express my opinion with regard to Title VI of H.R. 13270 which passed the House on August 7, 1969.

As you know, state and local bond financing has long been granted tax-exempt status. With this assistance, state and local governments have been able to attract more favorable interest rates from investors, making it easier for them to move forward with many improvements; improvements such as new and expanded water and sewer systems, more and better streets, additional recreational facilities and improvements to hospitals.

Although I voted for passage of H.R. 13270 in the House, I am on record as opposing that portion of the bill dealing with state and municipal bonds. It is my best judgment that if this House-passed provision is allowed to remain in the bill, it will critically damage the ability of state and local governments to finance improvements at rates they can afford to pay.

It is also quite possible, that should H.R. 13270 be enacted with Title VI intact, there would be, for state and local governments, long periods of litigation placing the municipal bond market in jeopardy.

A great deal of attention has been focused on the need to eliminate glaring loopholes in our present tax laws which allow individuals or groups to escape paying any taxes despite the fact that they have sizable incomes. It has been implied that many wealthy individuals avoid paying taxes by investing in state and municipal bonds.

This assumption was clearly disproven by Mr. W. E. Tinsely, Executive Director, Municipal Advisory Council of Texas, writing in the August, 1969 issue of the Alabama Municipal Journal.

Mr. Tinsley declares that the public is being misled. The fact is that relatively few persons with large incomes who escaped paying any income taxes in 1967, the year in which most of the instances occurred, held more than relatively small amounts of municipal bonds.

Over the past several months, I have received thousands of letters from responsible state, county and municipal leaders expressing their deep concern and forceful objection to the removal of the tax-exempt status which is now afforded these bonds.

At this particular time in our history, most state and local governments are severely pressed to provide adequate services for their citizens. Any disruption of vital programs could only be detrimental to their growth and development.

It is my earnest hope that some long-overdue tax relief for our low and middle-income families will come from this legislation. I respectfully submit, however, that removal of the tax-exempt status on state and local bonds can only add to the burden of the average taxpayer.

Thank you!

STATEMENT OF HON. ALBERT P. BREWER, GOVERNOR OF THE STATE OF ALABAMA

Honorable Chairman Long, distinguished Senators of the Committee on Finance:

I am Albert P. Brewer, Governor of the State of Alabama. I thank the Chairman and the Senators for the opportunity to file with the Committee a Statement of Position on those sections of HR 13270, *A Bill to Reform the Income Tax Laws*, affecting State, County and Municipal financing. It is my privilege to present this

Statement of Position in behalf of the overwhelming majority of public officials at every level of government in Alabama. In support of this Statement of Position, a delegation of Alabama public officials were recently in Washington to attend your Committee's public hearings and to meet with Alabama's Senators and Congressmen. The names of and offices held by these gentlemen are listed in Exhibit "A" to this statement.

We wish to assure the Committee that State and Local Governments in Alabama endorse and suport the efforts of the 91st Congress to achieve meaningful tax reform; however, we respectfully submit that the ability of State and Local Governments to issue tax-exempt securities for the financing of capital improvements, and investor participation in such securities, have been wrongfully included in those abuses which the Congress is striving to correct.

Therefore, we call upon the Committee to recommend to the Senate elimination of those sections of HR 13270 that damage the integrity of the tax exemption privilege historically granted to State, County and Municipal obligations. It is the total preservation of this tax exemption privilege that we seek before you today, for any alteration of the existing mechanisms through which State and Local Governments have financed their capital improvement programs will result in higher interest costs to Local Government borrowers. Each citizen must ultimately pay his proportionate share of these increased borrowing costs, a situation that can hardly be regarded as providing relief or equity to the average taxpayer.

There is absolutely no question that the market for State and Local Government obligations—already under considerable stress from the inflationary psychology that has turned many investors away from fixed income securities to common stocks—has been weakened further by Section 301 (Limit on Tax Preferences) and Section 302 (Allocation of Deductions) of HR 13270, both of which significantly decrease the attractiveness of State and Local Government obligations to the individual investor. During the first six months of this year, as investment funds of commercial banks became increasingly limited, active participation by individual investors was the only sustaining factor in the market for State and Local Government obligations.

Chaotic conditions in the municipal bond market have forced Local Government borrowers to either postpone badly-needed capital improvement programs or to accept interest costs that will cut into revenues intended for operating purposes. Many Local Government borrowers have been unable to obtain bids for their obligations within Constitutional or Statutory limitations. This was experienced by two County Boards of Education in Alabama, prompting the Legislature of the State of Alabama to raise the interest rate ceiling for this type obligation from 6% to 8%.

Had our legislature not been in session, neither Board would have been able to permanently finance construction of additional classrooms. On September 4, 1969, Dale County, Alabama, which is in the Congressional District of the Honorable George Andrews, M.C., awarded $600,000 hospital bonds at an effective Net Interest Cost to the County of 7.14%, almost 2% higher than any previous bid accepted by the County or any of its agencies. A continuation of these high interest rate conditions is injurious to State and Local Government borrowers, and we entreat the Committee to act decisively against those sections of HR 13270 that have created a disruption of the market for State and Local Government obligations.

Should the individual investor continue to withdraw from the municipal bond market or to lessen his participation therein, the obligations of States, Counties and Municipalities must inevitably offer higher rates of return in order to compete for the institutional (banks and insurance companies) investment dollar. Such a pattern of withdrawal has been demonstrated previously by the life insurance companies, whose aggregate holdings of State and Local Government obligations have declined from $3.9 billion in 1961 to $3.2 billion in 1968. Because of litigation that resulted in the application of an Allocation of Deductions formula to the life companies, that industry, as a group, has been a net seller of State and Local Government obligations in every year since 1962, with the exception of 1968, when net holdings of State and Local Government obligations increased by only $49,000. Purchases by life companies of State and Local Government obligations in 1968 represented 0.58% of total new investments, down from 3.35% in 1959. To fully appreciate the potential impact of a sustained withdrawal by individual investors from the municipal bond market, it should be noted that individual holding of State and Local Government obligations are currently ten times that of the life companies at their peak.

The consequences of applying a Limit on Tax Preferences and Allocation of Deductions to interest income earned from State and Local Government obligations goes considerably beyond the individual investor; for should these provisions be enacted into law, what assurance can commercial banks and other financial institutions have that similar action will not be taken against their investments at some future date?

In the tentative proposals first announced by the House Committee on Ways and Means, banks and insurance companies *were* to be included among those taxpayers to whom a Limit on Tax Preferences and an Allocation of Deductions would be applicable, so institutional investor concern is both realistic and substantial. Should this concern be translated into a withdrawal from the municipal bond market of similar scope to that of the individual investor, there would be no competitive capital market in which State and Local Governments could finance their capital improvement programs. Thus, State and Local Governments would have to depend upon an overburdened Federal Government as the only remaining source of capital improvement funds.

Rather than a tax loophole, we respectfully submit that issuance of tax-exempt securities by State and Local Governments—and the purchase of such obligations by individual investors—have constituted a creative force in building a greater and better America. We are convinced that a continued withdrawal by individual investors from the municipal bond market would seriously impair the ability of State and Local Governments to independently finance their capital improvement programs. Therefore, we reiterate our opposition to the inclusion of municipal bond interest in a Limit on Tax Preferences or Allocation of Deductions as provided by Section 301 and 302, respectively, of HR 13270.

Our next area of concern involves Sections 601 and 602, which propose a direct Federal subsidy of interest payments to those State and Local Governments that voluntarily elect to issue taxable obligations. We submit that this proposal is totally incompatible with the best interests of State and Local Governments and in contradiction of the Nixon Administration's announced objective of establishing priorities in Federal spending. Our principal arguments are threefold:

1. *It is an absolute necessity that States, Counties and Municipalities preserve the complete integrity of the tax exemption privilege and the separateness of the market for State and Local Government obligations*—We feel that those State and Local Governments who are able to avail themselves of this fully taxable financing vehicle, i.e., the proposed Federal Subsidy Program, will be thrown into direct competition with Federal and Corporate borrowers. This unnecessary and self-defeating competition would come at a time when Federal, Corporate, State and Local Government borrowers are burdened with interest rates at historic highs. Alabama and the various State Authorities through which many of our major capital improvement programs are financed, I can assure you that we have no desire whatsoever to compete with Federal and Corporate borrowers for the fixed income investment dollar.

I believe, of course, that there would be a market for "taxable" State of Alabama bonds—and probably those of our Authorities, metropolitan counties and municipalities; however, the majority of our counties and municipalities would be unable to market their securities as "taxable" obligations except at prohibitive interest rates—even with the Federal subsidy.

2. *If the market for State and Local Government obligations is seriously impaired, the Federal Subsidy Program will become the only available financing mechanism, and its constantly increasing cost can only lead to eventual Federal control of all capital improvement financing by State and Local Governments.*

Turning now to the cost aspects of the FSP, the bill states that the subsidy percentage shall be not less than 30% prior to January 1, 1975. My Financial Advisors have provided me with what they consider to be a conservative computation of what the Federal Subsidy Program would cost during the period January 1, 1970–December 31, 1974:

Sate-County-Municipal Bonds issued in 1968: $16.0 billion

Assume 50% of this amount would elect FSP ($8.0 billion)

Assume that in order to compete with Federal and Corporate offerings, FSP issues would sell at an average interest cost of 8%

8% interest cost × 30% Federal subsidy=2.4% subsidy rate $8.0 billion× 2.4$ subsidy rate=$192.0 million×five years=$960.0 million in 1974.[1] Total estimated outlay, 1970–1974, inclusive: 2.88 billion.[1]

[1] Assumes no repayment of principal during the 1970–1974 period. Many State and Local Government financings incorporate some deferral of principal repayment.

Several Congressmen have voiced their support for a rigidly-fixed subsidy rate of 40%. It should be emphasized that the $16.0 billion figure (which my Financial Advisors have arbitrarily halved) represents only those issues that were advertised for public bidding and does not include negotiated financings. I am also informed that very few political subdivisions could expect to market "taxable" obligations at 8%. I cite these points to support the contention of my Financial Advisors that the above computations represent a conservative projection of the potential costs of FSP to the Treasury.

3. *No Federal Assistance or Subsidy Program of this magnitude can long remain free of Federal controls.* As Governor of Alabama, I am an ex-officio mem ber of most of our Authorities, which have historically financed their respective programs through the issuance of tax-exempt revenue bonds. Should one of our Authorities voluntarily elect to receive the proposed Federal subsidy, I must ask, "How 'automatic' will this subsidy be, if, by the end of the fifth year, FSP is costing the Treasury approximately $1.0 billion per year?" The obvious requirement of control for such an expenditure will entail the additional expense of yet another Federal Bureau or Agency; and the control by State and Local Governments of their financing programs will inevitably gravitate to Washington—and just as inevitably, it is the average citizen, the very individual HR 13270 purports to help. who will pay his proportionate share of an unnecessary Federal expenditure. This is not our conception of "meaningful" tax reform.

In your deliberations, I ask that you weigh carefully the potential effects of this legislation upon the future of State and Local Government. I join with my fellow Governors, and with public officials at every level of State, County and Municipal Government, in respectful but determined opposition to those sections of HR 13270 that would threaten our independence. I again thank the Honorable Chairman, Senator Long, and the distinguished Senators of the Committee for the privilege of presenting this Statement of position for your consideration.

Albert P. Brewer,
Governor of the State of Alabama.

Alabama Public Officials and Educational Leaders Attending Public Hearings Held by the Senate Committee on Finance, September 23 and 24, 1969

FIRST CONGRESSIONAL DISTRICT

Honorable E. Mark Ezell, Judge of Probate, Choctaw County
Honorable J. C. Davis, Mayor, City of Chickasaw
Honorable William B. Crane, President, Mobile County Board of School Commissioners

SECOND CONGRESSIONAL DISTRICT

Honorable Mack McWhorter, President, Montgomery County Board of Revenue
Honorable Robert B. Gentry, Commissioner, Montgomery County Board of Revenue
Honorable Earl D. James, Mayor, City of Montgomery
Judge Winston Stewart, Executive Director, Association of County Commissioners

THIRD CONGRESSIONAL DISTRICT

Honorable Otis W. Tuff, Chairman, Russell County Commission and President, Association of County Commissioners of Alabama
Honorable M. M. Dudley, Commissioner, Russell County Commissioner
C. Neal Pope, Esq., County Attorney, Russell County
Honorable E. H. Graves, Jr., Mayor, City of Eufaula

FOURTH CONGRESSIONAL DISTRICT

Honorable Hoyt B. Hamilton, Judge of Probate, St. Clair County
Honorable John Gaither, Mayor, City of Heflin
Mr. John F. Watkins, Prattville, Alabama and Executive Director, Alabama League of Municipalities
Dr. George Layton, Anniston; President, Alabama Association of School Administrators
Mr. John S. Casey, Heflin, Legislative Coordinator, AEA

FIFTH CONGRESSIONAL DISTRICT

Honorable Conrad M. Fowler, Judge of Probate, St. Clair County and President, National Association of Counties
Honorable William Tuck, Mayor, City of Eutaw
Mr. Lewis McCray, Director, Tuscaloosa Area Council of Governments

SIXTH CONGRESSIONAL DISTRICT

Honorable Thos. B. Pinson, Commissioner, Jefferson County Commission
Honorable George Seibels, Mayor, City of Birmingham
Honorable M. E. Wiggins, President of the Council, Birmingham

SEVENTH CONGRESSIONAL DISTRICT

Honorable Woodrow J. Stephens, President, Etowah County Board of Revenue
Honorable Les Gilliland, Mayor, City of Gadsden
Honorable Guthrie T. Smith, Mayor, City of Fayette

EIGHTH CONGRESSIONAL DISTRICT

Honorable Lawrence W. Cobb, Commissioner, Madison County Board of Commissioners
Honorable John T. Reid, Mayor, City of Scottsboro and President, Alabama League of Municipalities
Honorable Joe Davis, Mayor, City of Huntsville
Mr. Robert Gunn, Coordinator, Madison County Intergovernmental Relations

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STATEMENT OF THE HONORABLE JOHN DEMPSEY, GOVERNOR OF CONNECTICUT

Certain provisions of the Tax Reform Act of 1969 appear to represent a culmination of a series of recent proposals threatening the traditional immunity from Federal taxation which state and local government activities enjoy.

I refer to such proposals in recent sessions of Congress as the one which would have ended the exemption of state governments from the Federal excise tax on domestic air travel; or the one which would, in certain instances, have applied Federal taxes to the interest on state and local bonds issued to finance the construction of public waste treatment plants.

Now we are confronted with provisions of the Tax Reform Act of 1969 which would tend to discourage the purchase of state and municipal bonds because:

(1) A minimum tax would be assessed on the income derived from such bonds.

(2) A bondholder's deductions for Federal income tax purposes would be lessened, and

(3) State and local government bonds would become taxable, with a percentage of the interest paid by a Federal subsidy.

The interest subsidy provisions, apparently included to avoid the question of the constitutionality of taxing state and local bonds, by themselves do not appear to affect the market for these bonds adversely.

However, when these provisions are coupled with those which assess a minimum tax and which reduce the Federal income tax payer's deductions, the result is to destroy the market for these bonds.

The cost of financing public works construction will increase. The ability of states and municipalities to sell their bonds will be lessened drastically.

House passage of the Tax Reform Act in its present form already has had a disastrous psychological effect on the municipal bond market.

Should these provisions be enacted, it is obvious that states and municipalities will face the alternative of foregoing certain public works or seeking new sources of revenue.

New revenue sources can only mean levying new or increased taxes, an action to which almost all states and municipalities already have had to resort.

I endorse attempts to reform the Federal tax structure so as to eliminate tax shelters for upper income investors and to provide for a minimum tax.

Reform will be of no benefit to lower income taxpayers, however, if it simply shifts their burden from Federal Taxes to state and local taxes.

It is interesting and significant to note that the House Ways and Means Committee found that the tax returns of 154 millionaires who paid no income tax in 1966 included little income derived from state and local bonds.

In his message proposing a plan of limited revenue sharing, the President indicated that his purpose was to strengthen state and local government. He would do this by providing financial support which, to some extent, would allow states and municipalities to allocate their fiscal resources as they see fit.

By some of its recent actions, the Congress has indicated the same intent.

I submit, however, that enactment of these provisions of the Tax Reform Act of 1969 will have consequences on state and local government that are opposite to what the President and the Congress intend and to what the states and local government desire.

I would also add my belief that there is a serious question about the constitutionality of legislation allowing the Federal government to tax the interest on securities issued by state and local governments for public purposes.

The immunity of state and local governments to such taxation is a time honored principle.

Any challenge to it deserves the most serious and careful consideration by your Honorable Committee.

Statement of Hon. Richard J. Hughes, Governor of the State of New Jersey

SUMMARY OF PRINCIPAL POINTS

— State and local government are faced with enormous capital needs in the areas of housing, education, transportation and health. These needs are primarily financed by the issuance of tax-exempt State and municipal bonds.

— H.R. 13270 would greatly increase the cost of local borrowing. Even with the proposed subsidization of borrowing costs, the net effect will be an increase in State and local taxes. Thus, in the name of increased equity, in the Federal income tax system, local taxpayers would have to pay the increased costs through State and local tax systems which are often inequitable. Moreover, this measure, along with others, would aggravate the already existing imbalance between private and public capital expenditures.

— Failure to meet these immense capital needs will hit the urban areas of our country hardest. If, in fact, we are to give a first priority to the crises in our cities, we should not deprive State and local government of the traditional means of capital financing. Federal legislation too often gives with one hand what it takes away with another. The effect of numerous Federal programs in aid of local government would be greatly reduced by the operation of HR 13270.

STATEMENT

Mr. Chairman, Members of the Committee, I come before this Committee as the Governor of this nation's most urbanized State. New Jersey's cities suffer from lagging economic growth and a sadly deteriorated physical plant. These problems have been aggravated by rural legislative interests long neglectful of urban needs. The roads of our State are clogged with traffic; our commuter railroads are near bankruptcy. Concentrated industrialization has brought polluted rivers and noxious air.

Despite recent efforts of great magnitude, our response has not been sufficient to cut the backlog of public need. If the record is to be improved, all levels of government must jointly raise the monies to renew and rebuild.

The proposals incorporated in H.R. 13270 regarding a limitation on tax preferences and allocation of deductions strike a serious blow at the capacity of State and local government to meet the needs of our times. I do not feel that the present terms of H.R. 18270 to subsidize the borrowing costs of State and municipal government are adequate to remedy the harm done. Moreover, when the impact of this measure is taken in conjunction with other recent events, the impact of all of these measures is truly appalling.

This bill must be weighed in the context of other steps recently taken or proposed by the Federal government. I am referring particularly to the combined impact of the monetary and fiscal policies that have been adopted to control inflation. These diverse and separate actions appear to me to reflect a fatal blindness on the part of too many public officials to two fundamental facts.

—First, we persist in neglecting public needs in capital construction, a neglect which has resulted in overcrowded schools, housing, roads and pollution of air and water. There is a serious imbalance between this nation's capital expenditures for public goods and services and its expenditures for private consumption.

—Second, our cities represent a particularly acute manifestation of this lack of investment in public facilities, and their deteriorated capital condition is such that some cities are faced with physical collapse of antiquated sewer systems. We need new schools, hospitals and housing, if the attendant social consequences created by physical decay and stagnation are to be dispelled.

On the other hand, the Federal Reserve Board has adopted a sound and necessary policy of tight monetary controls. The impact of this policy, however, has fallen more severely upon the public sector than on the private sector. While interest costs have risen for all borrowers, the interest costs of local government have risen at an even greater rate. Perhaps this is inevitable, given the nature of the monetary tools available to the Federal Reserve Board. Nonetheless, the cost of this increased borrowing cost for the municipalities and school districts for the nation is borne by the local taxpayer through a regressive property tax structure.

No such effect, however, is inevitable as regards the fiscal policies of the Federal government. Instead of proposing that additional funds be made available to local government through revenue-sharing, we are offered across-the-board tax cuts, such as are contained in HR 13270, with $1.4 billion of the tax cuts for persons with incomes over $15,000. Instead of incentives to public investments in schools, hospitals and roads, we are offered a cut in corporate tax rates, which will cost $1.6 billion in lost revenues, revenues that could go to meet urgent urban needs. And what will we get in return? An incentive to produce a third car for overcrowded roads; color televisions instead of schoolbooks; and medical insurance plans for corporate executives instead of hospitals.

The effect of these proposals and the continued inversion of our public priorities is, in turn, aggravated by the decision of the President to slash Federal capital construction and proposed restraints on State and local capital projects.

In short, we are faced with public capital needs on an enormous scale, and HR 13270 represents an attack on the only mechanism which State and local government can be sure provides any hope of meeting them.

The Joint Economic Committee of this Congress concluded in 1966 that State and local government *annual* capital outlays of $40.7 billion between 1965 and 1975 would be required if basic needs were to be met. Yet, in the 1967 fiscal year, State and local government had a capital outlay of only $24.5 billion. The total debt outstanding in the same year equaled only $114.6 billion. In short, we are coming nowhere near meeting our needs.

Last year, we established a distinguished Commission to Evaluate the Capital Needs of New Jersey. It was composed of businessmen, bankers and attorneys, The Commission estimated that New Jersey's capital needs exceeded $1.95 billion for State government programs alone. It made no attempt to estimate the capital needs of county and municipal government, although indicated that they would be proportionately greater. Despite this estimate from a respected and conservative body of men, our State Legislature felt free to authorize only a $1.25 billion program of capital construction. "Half a loaf" is better than none, but we have been giving the public sector "half a loaf" far too long.

The effect of taxing income from presently tax-exempt State and municipal bonds will be to compound these miseries. HR 13270 gives State and local government the option of issuing tax-exempt bonds or taxable bonds with a federal subsidy. I am advised that the option is illusory. Even if we bypass all of the substantial problems of constitutionality, administrative difficulty,* and financial soundness, we are still confronted with the basic problem: this proposal will raise enormously borrowing costs for our units of local government. Some estimates have placed the average increase at at least one percent.

But, unfortunately, we are not dealing with averages. In New Jersey we are dealing with 1,363 local bond-issuing units, many of which have no bond rating or a bond rating below Baa. Whatever may be said for the interest-subsidy proposal when we are dealing with the AAA issues of the State of New Jersey, or the Port of New York Authority, it is certainly true that the same cannot be said for the Newarks and Camdens of New Jersey; nor can it be said for the even smaller

*In New Jersey, the Treasury Department will be confronted with a creaky and inefficient machine for raising capital, composed of 1,363 units of local government legally entitled to issue bonds. The picture is not much different elsewhere.

municipalities with no bond ratings. I am advised that the present terms of Sections 601 and 602 of HR 13270, which provide for a subsidy of interest charges for State and municipal bonds, will not cover completely the increased costs of borrowing resulting from the issuance of taxable bonds. In other words, *even with the subsidy*, local government's borrowing costs will be increased. The reasons for this conclusion are technical, and I will leave them to the technicians to elaborate. They have to do with the small amount, low-credit rating, and maturity structure of local government issues. Documentation will be provided in a statement to be submitted to this body by the New Jersey Department of the Treasury.

State and local government are repeatedly confronted with legislation which gives with one hand, what it takes away with another. If it weren't so serious, it would take on the humor of a huge shell game.

For example:

—This bill is directed at increasing the equity of the Federal tax system. It concludes, and I share completely in the conclusion, that every possible loophole must be closed. But then it proposes an indirect means of taxing State and local government bonds, which even with the subsidy proposed, will increase the burden borne by the local homeowner. That burden must be paid through the far more inequitable tax structures of State and local government, by people who are hardly millionaires.

—This tax reform bill also proposes to confer sizable benefits upon low and moderate-income persons, yet it indirectly takes away some of these benefits. Moderate-income housing built through revenue-bond financing must add $19 per unit per month to their rent for every one-percent increase in their interest costs. Almost $200 million worth of public housing may not be built because interest costs have exceeded statutory interest ceilings.

—A program of revenue-sharing is proposed which will eventually distribute $5 billion to State and local government. Yet, in the first year, New Jersey will receive $15.5 million, of which $6.2 million will be passed through to local government. An increase of only one-half of one-percent in local borrowing costs will consume $1,000,000 of the amount to which local government is entitled during that first year. In the case of a city like Camden, which will receive $70,000 under revenue-sharing, revenue-sharing will not even cover one-quarter of the increase in debt-service due to H.R. 13270 on a relatively small $3 million issue.

We declare our intention to eliminate water pollution. Indeed, even HR 13270 provides a tax incentive for pollution contrcl devices. With full congressional appropriations, 45% of the cost of pollution control must be financed through local and State government by the issuance of bonds. The cost of these projects may, of course, be increased by the taxation of the interest of tax-exempt municipal bonds which, in itself, is bad enough. But then the Congress authorizes appropriations which give New Jersey less than one-fifth of the amounts authorized. In fact, New Jersey voters will probably approve in November more funds for anti-pollution projects than the Congress has appropriated for the entire nation. Finally, insult is added to injury if these projects must fall within the 75% of all federally-aided construction that the President would ask us to delay.

Lack of effort is not responsible for the backlog of problems I have described. State and local governments simply do not enjoy the taxing power of the Federal government. The per capita debt and tax burden imposed by State and local government has grown at a much more rapid pace than is true of national debt and taxes. While Federal tax reform is essential and laudable, it should not be achieved at the price of weakened local governments.

The first step is to allow State and local government to continue to use the time-tested device of tax-exempt bond financing. It is their constitutional right; it is their only escape from deterioration and disaster.

Thank you for having allowed me to share these views with you.

THE STATE OF WISCONSIN,
Madison, September 29, 1969.

HON. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: In lieu of my personal appearance before your committee. I wish to have the following statement inserted in the record in opposition to the provisions of H.R. 13270 (the Tax Reform Act of 1969) relating to federal tax treatment of state and local government bond interest:

I admire the efforts of Congress to create tax reform legislation designed to improve the fairness of the federal income tax laws. However, when such efforts result in proposals which appear to have the potential to be highly damaging to state and local government by creating a threat of an even greater burden upon the average taxpayer, I must strongly object to such proposals.

The provisions contained in H.R. 13270, specifically sections 301, 302, 601 and 602 have the capability of adversely effecting the ability of states and local governments to finance programs and projects by means of public borrowing. Sections 301 and 302 propose changes which can seriously undermine the confidence of sophisticated investors in the tax exempt municipal bond market and ultimately force borrowing costs to levels current on fully taxable debt securities.

The federal interest subsidy provisions contained in sections 601 and 602 do not provide assurance sufficient to instill long-term investor confidence. In addition, these sections seem to propose a new level of federal control over state and local financing which is totally in opposition to the concept of the federal system. States require greater flexibility and freedom of program selection, not the restrictions and controls which could result from enactment of these sections of the bill.

Wisconsin and its local governmental units are proud of a long history of prudent and cautious use of public debt. Our financial posture is sound and national credit ratings excellent. We recognize the necessity for judicious borrowing when the needs of our citizens and progress demand. I strongly support the present tax exempt status of state and local bond interest and urge that this full exemption be retained.

I cannot believe that Congress in its efforts to write a progressive federal income tax law more related to persons ability to pay, would want to force states and localities to lean over more heavily on sales and property taxes—both of which tend to be regressive.

Sincerely,

WARREN P. KNOWLES,
Governor.

STATE OF RHODE ISLAND & PROVIDENCE PLANTATIONS,
Providence, September 23, 1969.

HON. RUSSELL B. LONG,
Chairman, Committee on Finance,
New Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: As Governor of the State of Rhode Island, I would like to submit for consideration by the Senate Committee on Finance my views on H.R. 13270, the Tax Reform Act of 1969.

Since H.R. 13270 indirectly but very effectively limits the tax exempt status of state and local bonds and notes, we in state government believe that it will result in a considerable increase in our costs of borrowing money. This, in turn, could adversely affect the marketability of the notes and bonds issued by our cities and towns.

Historically, the current tax exempt status has proved extremely beneficial because it has enabled us to obtain the funds necessary to provide public services of greater number and better quality in areas such as education, sewage facilities, and roads. Unfortunately, this situation is endangered by H.R. 13270, which would place state and local bonds into direct competition with the private sector, thereby threatening our ability to secure sufficient funds for these public service efforts.

To be more specific, placing state and local bonds and notes on an even footing with corporates would result in a 43% increase in debt service costs to our governments. For example, Rhode Island currently has unissued bonding authority amounting to $71,743,000. When the State sold longterm bonds last spring (i.e., 15 and 20 year maturities), the interest rate was 5.2%, the highest rate on our current records. Without the benefit of tax exempt status, this rate would have been 7.43%, thereby producing a debt service increase of 42.86%.

Applying this kind of increase to the spring issuance, the state would have incurred debt service costs of some 15 million dollars more than under the tax exempt status now in effect.

To offset this cost increase, H.R. 13270 includes a system of subsidies. Under these provisions, the range of subsidy assistance would go from a minimum of 30% to a maximum of 40%. On January 1, 1975, however, the 30% minimum would drop to 25%. Of particular concern to me is that the minimum subsidy will be dropping, while the maximum will not be increasing.

Also, the maximum rate of 40% is below the anticipated 43% increase in debt costs. Consequently, from the preceding illustration, even with a subsidy, the added cost to the state would run anywhere from $1 million to $4,600,000 more than under the current conditions of tax immunity.

If the state were to be adversely affected by this legislation, it appears that our local governments, because of their smaller size and their more limited resources, would be even more acutely affected. It might even be anticipated that because of these factors some local governments might not be able to compete at all in the market for money.

In conclusion, H.R. 13270's effort to close one particular tax loophole will actually result in a substantial increase in state-local tax burdens. Thus, while I heartily endorse both the objectives and so many of the particulars of the tax reform legislation, I must take exception of those provisions adversely affecting the tax exempt status of state and local securities.

Sincerely,

FRANK LICHT,
Governor.

THE STATE OF NEVADA,
Carson City, Nev., August 15, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: I am informed that your committee will conduct hearings on the Tax Reform Bill commencing September 4, 1969.

While I will be unable to attend the hearing, I do want to express my opposition to any proposal to eliminate the current exemption from tax of the interest income from state and local bond issues.

Such action would cause the interest rates on state, county, school district and municipal bond issues to skyrocket and this drastic increase in cost of needed improvements would be immediately passed on, in the main, to the already overburdened lower and middle income taxpayers.

While the basic equity of having governmental units compete on an equal footing with commercial and industrial concerns for available capital may not be subject to question, the hard fact remains that, due to the regressive nature of the property tax, the bulk of this increased financial burden will not be shared proportionately by those individuals and corporations in the higher income tax brackets.

Any change in the exemption status would necessitate revisions to countless statutes on the State and local levels which now limit the interest rate payable on bond issues. The dislocation stemming from this alone is self-apparent.

In addition, in Nevada, in those areas of the State, such as Las Vegas, where we find an extremely rapid economic expansion, and planned and authorized issues total in the area of $59 million for additional school construction alone, any change in the exempt status could well create financial havoc.

In the light of these considerations, I can only voice my strong objections to any proposals to eliminate the current exemption of interest income on bond issues.

I am well aware of the desire for tax reform that exists throughout the country. I strongly support such reform. However, in weighing such reform against the possible consequences stemming from drying up the public bond market, I find I must express my concern.

Thank you for the opportunity of expressing myself on this vital matter.

Sincerely,

PAUL LAXALT,
Governor of Nevada.

STATEMENT OF HON. WILLIAM G. MILLIKEN, GOVERNOR, STATE OF MICHIGAN

The minimum tax and allocation of deductions provisions of H.R. 13270 have already had a substantial adverse impact on the ability of Michigan and its local units to finance needed capital improvements. These provisions, which threaten the traditional tax exempt status of state and municipal bonds, have created uncertainty and chaos in the bond market and have caused interest rates to rise above Michigan's present legal limit for state and municipal bonds.

The final enactment of these provisions would be disastrous to Michigan's "clean water" bonding program designed to eliminate pollution from the state's waters. Elimination of the tax exempt status of these bonds would greatly increase the cost of Michigan's recreation and housing programs and the public improvement programs of local units throughout this state.

Congressional attempts to destroy the traditional immunity of state and local bonds to federal taxation would result in prolonged litigation on the constitutional issues involved and would cause further chaos for several years.

There are presently authorized bond issues in Michigan totaling nearly one billion dollars. The failure of Congress to continue the tax exempt status of these bonds could cost Michigan and its municipalities hundreds of millions of dollars in interest costs over the life of these bonds. These costs would be borne by Michigan citizens in the form of higher property taxes, income taxes, sales taxes and utility charges.

I agree fully with Michigan Congressman Charles E. Chamberlain, a member of the House Ways and Means Committee, who stated:

"This fundamental alteration of our Federal system is wrong in concept, is proposed at the worst possible time, goes far beyond any proposals that are needed to achieve tax equity, and is essentially irrelevant to the purposes of this legislation."

Prompt action by the Senate to restore the tax exempt status of state and municipal bonds is urgently needed.

Thank you for this opportunity to present Michigan's position on this critical matter.

Office of the Governor,
Frankfort, Ky., September 25, 1969.

Hon. Russell B. Long,
Chairman, Committee on Finance,
Old Senate Office Building,
Washington, D.C.

Dear Senator Long: This letter is written to express to your Committee my strenuous opposition to any tax, direct or indirect, on municipal bond interest. I am opposed for the following reasons:

(1) In my opinion, such a tax is unconstitutional.

(2) It would increase state and local borrowing costs and thus require an increase in state and local taxes.

(3) It must ultimately lead to greater demands on the Federal Treasury and to centralized control of local financing and capital investment functions.

You are no doubt aware of the constitutional question raised by the municipal bond income taxation provisions of H.B. 13270. Permit me to emphasize by reiteration.

Taxation of the states' securities or the income therefrom strikes at the very heart of the dual sovereignty on which our Federal system rests. The United States Supreme Court as early as 1819 (McCullough v. Maryland) recognized "that the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; that there is a plain repugnance in conferring on one government a power to control the constitutional measures of another. . . ."

Again in 1895 in Pollock v. Farmers Loan and Trust Co. (157 U.S. 429), the Supreme Court said about a Federal income tax on the interest from state, county and municipal securities:

". . . . it is obvious that taxation on the interest therefrom would operate on the power to borrow before it is exercised, and would have a sensitive influence on the contract, and that the tax in question is a tax on the power of the states and their instrumentalities to borrow money, and consequently repugnant to the Constitution."

The Sixteenth Amendment, which became effective 1913, states: "The Congress shall have power to lay and collect taxes on income from whatever source derived . . . ." The broad language of this amendment notwithstanding, every case which has touched on the problem has accepted the Pollock case as good law.

In case after case after ratification of the Sixteenth Amendment, the Court has recognized that any taxation on interest from state and local securities would adversely affect the borrowing power of the issuing government. As in Willcuts v. Bunn when speaking of the obligations of a state, the Court held:

"These obligations constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the Government."

In Helvering v. Gerhardt, which held salaries of employees of the New York Port Authority taxable, the Court said:

". . . . It (the immunity) has been sustained where. . . . the function involved was one thought to be essential to the maintenance of a State government: as where the attempt was . . . to tax income received by a private investor from State bonds, and thus threaten impairment of the borrowing power of the State. (Citing Pollock)

"The basis upon which constitutional tax immunity of a State has been supported is the protection which it affords to the continued existence of the State."

From the above, it would appear that the objective of the taxation of municipal bonds—to establish equity among taxpayers—will not be realized. To say that the holder of a tax-exempt bond is evading all tax is not completely true. He pays a penalty in the form of a lower yield on investment than he might get from competing non-exempt securities. The difference in this lower interest cost and the higher rate which will be demanded for non-exempt bonds accrues as a savings to the local government.

Reliable estimates indicate that about $10 billion in state and local bonds are issued each year. The current Bond Buyers Index is 6.25 per cent. Assuming a 43 per cent interest cost increase if exemption is removed, the new interest rate would be about 8.90 per cent. Annual interest cost would amount to approximately $890,000,000. The interest subsidy proposed by H.B. 13270 would require payment of up to 40 per cent of this total interest cost or $356,000,000 Reports on the Bill have made it appear that this subsidy would be paid to states and local governments each year without questions or controls. Can you believe that? Nor can I.

History has taught us that when the Federal government participates to any extent in a local project, it will establish and require, as a condition of its participation, strict controls over all phases of the project. This means that when any one of the estimated 80,000 state, county, city, town, school district, water or sewer district issuers of municipal bonds determines at the local level that a given project is needed, it will be told whether, what, when and how it will build. I am unalterably opposed to this continuing encroachment upon the prerogatives of the local taxpayers.

In addition to the taxation of municipal bond interest, there are two other provisions in H.B. 13270 which will adversely affect the borrowing power of state and local government.

First is the proposal to tax net gains from the sale of bonds by financial institutions as ordinary income instead of as capital gains. Commercial banks now hold about 38% of the outstanding municipal bonds and therefore, comprise the largest single category of bond purchases. If the tax treatment of capital gains from investment in bonds is changed, the banks will obviously turn to other long-term investments or to short-term investments with greater yield. Depriving state and local governments of 38% of their potential bond market must be considered to "operate on the power to borrow before it is exercised".

The second objectionable provision is the one that gives the Secretary of the Treasury the right to declare "arbitrage" bonds of a state or political subdivision fully taxable. The bill does not define "arbitrage bond" but past actions of the Treasury Department indicate that it will include advance refunding bonds in such a definition. Advance refunding bonds are bonds which are issued in advance of the first call date of an outstanding issue with a high interest cost. The issuer invests the proceeds of the bonds at a profit and holds the money in escrow until the first call date of the refunded bond issue. This permits the issuer to sell in a good market rather than forcing him to sell in the market at the call date. If adopted, this provision can cost local governments millions of dollars. The bonds which have sold in today's high-interest market could not be refunded in advance of the first call date even if and when the market is more advantageous to the issuer. Since this proposal is of little consequence in today's market, it has received little attention. However, the Committee should give it a careful study because of its implications for the future. Again, I insist that *any* tax on the income from municipal bonds, either an initial issue or a refunding issue, is a violation of the constitutional immunity of the sovereign states.

The proposal to tax municipal bond interest must be decisively defeated—a defeat which will reassure the municipal bond market that the Congress of the United States continues to respect the sovereign immunity of the states.

Sincerely,

LOUIE B. NUNN,
Governor.

In James v. Dravo Contracting Co., Mr. Chief Justice Hughes said:

". . . (The doctrine of immunity with respect to Government bonds) recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (citing Pollock) and which would directly affect the Government's obligation as a continuing security Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit. . . ."

Why has the Court been so consistently concerned with protection of the states' borrowing power? It is obvious that the Court understands what the Congress ought to understand and that is that any abridgment of the states' power of the purse (ie., the power to borrow and the power to tax) is a threat to their existence.

The power to borrow money is almost as essential to the existence of both the Federal and State Governments as is the power to tax. Witness a Federal debt in excess of $359 billion and a debt of States and their political subdivisions in excess of $125 billion, each immune to taxation by the other sovereign. These twin powers of the purse are essential to every sovereign's existence.

That the tax as proposed in H.B. 13270 would impair Kentucky's power to borrow is beyond doubt. Kentucky's state, county, municipal, and other subdivisions such as school districts are controlled by a statutory maximum interest rate. The threat to municipal bond purchasers posed by the legislation under consideration has already forced interest rates above this ceiling, prevented the sale of bonds, and necessitated the delay of construction projects which are vital to the welfare of citizens of this state.

The only question remaining is the extent of the increase in borrowing costs. Research by economists indicates that states are normally able to borrow at about 30 per cent less interest costs because of the exemption. This means that removal of the exemption would increase financing costs about 43 per cent. This higher cost would require an increase in taxes if the money were borrowed through general obligation bonds or an increase in tolls, rents or rates if the debt were in the form of revenue bonds.

If the market for long term municipal bonds is not destroyed completely, it is only logical to assume that the bond buyer will demand a higher interest rate or a greater discount at the time of purchase in order to achieve his old rate of return on his investment and to pay the new tax. This higher rate must be paid by the local taxpayer. Since state and local taxes are primarily based on the sales tax and property tax, the impact of the new tax will fall on the lower income groups—the very people for whom both the Federal and State governments are now trying to provide tax relief! In effect, revenue to the Federal government from the taxation of municipal bonds is taken from the local taxpayer.

STATE OF NEW HAMPSHIRE,
Concord, September 17, 1969.

HON. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR LONG: The effects of certain provisions of H.R. 13270, the so-called "Tax Reform Act of 1969," are of great concern to me, and my main concern is directed towards the provision that would alter the tax exempt status of state and local government bond issues. State and local government officials are distressed by this proposal for several reasons:

1. The United States Supreme Court has said that the taxation of the states by the Federal government constitutes a powerful regulatory instrument and

should, therefore, be rejected as an unconstitutional subversion of our Federal System.

2. If H.R. 13270 is enacted into law as passed by the House of Representatives, the provisions for the taxing of state and local government bonds will mean increased interest costs to local governments, which must then be passed on to the general citizen and taxpayer in the form of higher property taxes, other taxes, or as a reduction in local services.

The problem of the much publicized 154 millionaires who paid no taxes in 1966 has been suggested as the basis of the rationale behind the recommendation to tax municipal bond interest, but I doubt that Congress has received any evidence to indicate that millionaires in general have invested in state and local government bonds to escape Federal income taxes. The minimum income tax proposal appears to be an attempt to reach tax sheltered income at roughly one half the regular income tax rates, that is, up to thirty or thirty-five percent. Over the years an investor in tax exempt bonds has accepted close to one third less in income than he could have received from taxable obligations; thus the investor in tax exempt bonds has already paid his minimum income tax and has paid it in advance.

Without the assurance that the tax subsidy will continue in the future, the bill gives an option to state and local government issuers to receive a tax subsidy if they agree to issue their bonds on a fully taxable basis. In the past the Federal government has passed legislation and then not provided sufficient funds with which to finance the new law. A case in point is the Clean Water Act of 1965. At the present time the State of New Hampshire is in the process of issuing bonds so as to prefinance the Federal government's share of Sewer Pollution Control Grants. There is the question as to whether or not the 92nd Congress will eliminate the tax subsidy plan and thereby throw on the laps of local governments the total cost of the increase from the elimination of tax exemption.

When the Congress first passed legislation imposing a Federal income tax, it excluded the interest earned on municipal bonds. With this a part of the tax laws ever since 1913, such interest is regarded as exempt from Federal taxation under the constitutional doctrine on reciprocal immunity. If passed, this proposal would undoubtedly be tested in court, and while awaiting the outcome of a court ruling on the constitutionality of this proposed legislation, the municipal bond market would be in chaos.

To prevent the intervention of the Supreme Court and to preserve the Federal System, I would urge the Congress not to pass this legislation.

Most sincerely,

WALTER PETERSON,
Governor.

Statement of Hon. Nelson A. Rockefeller, Governor of New York

The interest on State and local bonds has long been exempt from Federal income taxation, but intergovernmental immunity in this area is not just a matter of traditional tax principle or technical constitutional theory. It is one of the cornerstones of sovereignty which enables state and local governments to fill their vital roles in our Federal system.

On April 10, 1968, before the Subcommittee on Air and Water Pollution of the Senate Committee on Public Works, and again on April 24, 1968, before the Subcommittee on Rivers and Harbors of the House Committee on Public Works, I expressed my unalterable opposition to the blanket denial of this traditional exemption on obligations which deeply affect the public interest. My concern, then and now, is that the withdrawal of this exemption, in whole or in part, would result in a dangerous unsettling of the delicate balance in our Federal-State-Local relationship.

I recognize that those who suggest elimination or modification of the exemption are motivated by concern over either Federal revenue not realized from exempt interest or the alleged disproportionate tax advantage which may accrue to holders of state and local obligations. But eliminating or altering the interest exemption, while alleviating the burden on the Federal taxpayer, would increase the burden of the state and local taxpayer as a result of the higher interest rates involved.

I realize, of course, that the pertinent provisions of H.R. 13270 do not involve a blanket elimination of the tax exemption. However, in addition to their inherent weaknesses and to the havoc they can wreak upon an already badly shaken municipal bond market, I am fearful that these proposals are a major first step toward total elimination of the exemption.

Apart from this general concern, I should like to make some observations concerning the specific provisions of H.R. 13270 affecting municipal bond interest.

LIMIT ON TAX PREFERENCES AND ALLOCATION OF DEDUCTIONS

Two provisions of H.R. 13270 directly affect the individual bondholding taxpayer, as well as estates and trusts. First, under the limit on tax preferences provision, no more than 50 percent of a taxpayer's total income (adjusted gross income plus tax preference items) can be excluded from tax. The tax preference items include tax-exempt interest on both old and new issues of state and local bonds to be accounted for over a 10-year period at a rate of one-tenth of the interest per year. Second, the allocation of deductions provision requires that an individual allocate his personal deductions between his taxable income and his tax preference items, to the extent that such items exceed $10,000. The tax preference items include tax-exempt interest on state and local bonds issued after July 12, 1969.

As contained in H.R. 13270, the combination of the limit on tax preference and allocation of deduction provisions seems certain to increase the cost of issuing municipal securities. There are two basic reasons, in my view, for the predicted increase.

First, there will undoubtedly be a legal test of the constitutionality of taxing municipal bond interest, at least under the limit on tax preference provision. In all likelihood the final constitutional decision will have to be made by the U.S. Supreme Court.

During the interim between the initial court test and the Supreme Court ruling, the municipal bond market would be in a state of uncertainty and the net effect would be a reduction in bond purchases by individuals. There may even be disinvestment in anticipation of an unfavorable court decision.

Banks and other institutional investors may also curb municipal bond purchases in fear that they may be next in line to have bond interest taxed.

Marketing bonds in the face of such uncertainty would necessitate higher interest rates to overcome the investor's reluctance to invest.

Secondly, a combination of the limit on tax preferences and the allocation of deductions provisions would reduce the net income from municipal bonds. This means that the after-tax interest differential between municipals and other forms of investment would also be reduced.

Individual investors will evaluate the differential in terms of whether or not it is great enough to warrant further purchases of municipals. In many instances, the decision will be to forgo buying state and local bonds. The market for municipals would b› reduced and state-local government interest costs increased.

As John F. Thompson (Vice President of Morton and Co., Inc. of New York) said before a Municipal Finance Officers Association meeting in Toronto last May:

> . . . tax exemption is not simply a gift from the Federal Government to certain investors. It is a *quid pro quo* for the acceptance of lower rates of return than the investor could obtain on alternative investments. . . . An investor in tax-exempt bonds has accepted close to one-third less income than he could receive from taxable obligations—that is what he has paid for the tax exemption. Thus, in a very real sense, and certainly in terms of equity, the investor in tax-exempt bonds has *already paid* his minimum income tax and he has paid it in advance.

To sum up, the impact of the two proposals, one directly taxing municipal bond interest income and the other indirectly affecting the after-tax yield from such bonds, is to:

(a) Penalize the individual municipal bond investor;

(b) Reduce individual, and possibly some institutional, investment in municipals;

(c) Increase the cost of borrowing to state and local governments; and

(d) Pass on the increased cost of borrowing to state and local taxpayers.

ELECTION TO ISSUE TAXABLE BONDS AND INTEREST SUBSIDY

A third provision of H.R. 13270 grants state and local governments the option of issuing taxable obligations. The resulting higher interest costs would be offset by a Federal subsidy ranging from 30 to 40 percent of the interest yield on bonds issued up until 1974, and from 25 to 40 percent thereafter.

Such a subsidy scheme, however, would give to the Federal government a dangerous degree of control of state and local bond financing. For Federal approval of a bond issue would be necessary in order for that issue to win a Federal subsidy.

Much of the support for a direct Federal subsidy on taxable municipal bonds rests on the argument that the revenue loss to the Federal Treasury stemming from the exemption of state and local obligations exceeds the interest saving on them and, hence, the present system is inefficient. For example, the House Ways and Means Committee Report accompanying H.R. 13270 estimates the annual interest saving in interest charges to state and local governments a $1.3 billion, while the estimated annual revenue loss to the Federal government has been estimated at $1.8 billion. It is then said that a more rational system would tax the interest.

Since Federal tax collections would exceed the increased interest cost, advocates of this proposal further contend that the Federal government could afford a subsidy and everybody would be better off. This is questionable.

High-bracket taxpayers, individuals, commercial banks and fire and casualty insurance companies, currently benefiting from tax-exempt bonds, might very well shift to other investment alternatives if some municipal bonds were made taxable and the offerings of tax-exempts were to become more limited and less attractive. Lower-bracket taxpayers, many life insurance companies and savings institutions, as well as individuals and non-taxpayers, such as pension and retirement funds and foundations, would be indifferent between taxable state and local bonds and other equivalent taxable investments. They might purchase the newly taxable municipals, or they might continue to buy tax-exempts, as dictated by their self interests. In effect, those interested in the tax-exempt market would be able to play a "heads-I-win: tails-you-lose" game with the Treasury. The resulting taxes collected might well be less than the subsidies paid. Furthermore, the administrative and fiscal problems involved in an optional approach would be enormous.

Such an arrangement would be unlikely to meet with Congressional or Treasury approval for too long. The temptation would be great to eliminate the option entirely and, perhaps, the subsidy as well.

POSITION PAPER SUBMITTED BY HON. ROBERT D. RAY, GOVERNOR OF IOWA, ON PROPOSED STATE AND MUNICIPAL BOND TAXATION

Our position on taxing earned interest on state and municipal bonds, as proposed in a Congressional Tax Reform proposal (HR13270) is identical with that expressed at the National Governors' Conference at its late-summer meeting in Colorado Springs. This opinion was forwarded to President Nixon on September 2, 1969. It reads as follows:

"The National Governors' Conference affirms the basic constitutional principle that neither the federal nor state governments without mutual agreement have the authority to tax the other. The Conference therefore asserts that state and local bonds issued for general governmental purposes must remain tax exempt. The Conference also strongly opposes those aspects of the tentative House Ways and Means proposal announced July 11, 1969 which would adversely affect the market-ability of state and local securities and thus the provision of needed public services and facilities."

The bill, as passed by the House of Representatives of the Congress, will drastically increase the cost of financing such local facilities as schools, hospitals, sanitary facilities and all other necessary public improvements—because of the proposed removal of the tax-exempt feature of municipal bonds.

Iowa State Treasurer Maurice E. Baringer estimates that taxable municipal bonds will cost Iowa cities and towns about one-third more in interest charges than they now pay on issues of tax-exempt bonds. Local bond issues that have been sold by Iowa governmental units within the last few weeks have required interest payments nearly forty percent higher than those sold less than a year earlier. Further, Treasurer Baringer emphasizes, such increased interest costs must be passed along to the citizens of Iowa in the form of higher property taxes, sales taxes and other local taxes or in reduced local services. Thus, the proposed tax reform bill is regressive. It will hurt the very persons it purports to help: lower and middle-income citizens, and the higher cost to these citizens will extend over the long period during which the bonds are outstanding.

Further, the so-called Federal subsidy proposed by the bill permits too much discretion on payments to municipalities by the Federal government. Uncertainty throughout the investment community is at a maximum, both among bond dealers and investors. The result thus far is a complete breakdown of local financing. It threatens to grow worse, if the bill passes.

Within the week of September 14, 1969, proposed bond issues of three Iowa communities failed to attract any bidders. The current market is such that Iowa municipalities soon will be forced to reject any bids that *are* forthcoming because of our 6 percent statutory limit on municipal and school issues.

Another adverse effect for small governmental units is their probable inability to compete with corporate and governmental issues should municipals become taxable, whereas now many of the municipal and school issues are intermediate between relatively short term Federal government fiscal needs and long term commercial requirements for capital investment funds.

It is our observation that there is a wide disparity in figures used to denote ownership of government bond portfolios. Unofficial estimates range from 80 per cent ownership by banks—to 80 percent ownership by individuals. The most official reckoning we have been able to find comes from a U.S. Treasury report on estimates of ownership published in *The Bond Buyer* on March 14, 1968:

	Amount	Percent
Individuals	$39,800	35.12
Commercial banks	45,600	40.24
Insurance companies	15,500	13.68
State and local funds	4,200	3.70
Corporation	4,800	4.23
Miscellaneous investors	2,100	1.85
Mutual savings banks	300	.26
U.S. Government investment accounts	1,000	.92
Total	113,000	100.00

We believe any major tax revision by the Congress should be aimed at increasing the ability of state and local governments to finance their own needs. Therefore, we strongly advise retention of the tax-exempt state and municipal bond program, which has served well for many years as the basic mechanism for meeting those needs.

STATE OF UTAH,
Salt Lake City, September 11, 1969.

Mr. TOM VAIL,
Counsel,
U.S. Senate Committee on Finance,
New State Office Building, Washington, D.C.

DEAR MR. VAIL: I quite agree with you that it would serve no useful purpose to have the Governors of 40 States appear before the Senate Finance Committee in regard to the proposal to make interest on municipal bonds subject to the federal income tax.

I am sure that position of all Governors is substantially the same, and much of what we would say would be repetitious. I understand that there will be a representative group of Governors appear before the Committee to represent the position unanimously adopted at the recent National Governors Conference in Colorado Springs.

It is my opinion that it does not represent good judgment for the federal government to tax the interest from municipal bonds at the same time the national government is making substantial grants to the states for many programs, including those relating to capital improvements.

I would appreciate it, therefore, if you make this letter a part of your record.

Sincerely,

CALVIN L. RAMPTON, *Governor.*

STATE OF NORTH CAROLINA,
Raleigh, September 19, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate,
New Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: Please accept this written statement in lieu of my appearance before your Finance Committee in opposition to certain portions of the Tax Reform Act of 1969 (HR 13270).

I strongly oppose any action by Congress which would impair the tax exempt status of State and local bonds, and advocate early resolution of the provisions of the Act relating to the taxation of interest from securities issued for bona fide public purposes.

As Governor of North Carolina, I have been highly encouraged by the Administration's stated purpose of strengthening State and local governments; however, the proposals which would remove the tax exempt status of bonds issued by these governments proceed directly away from this stated purpose. It is apparent that the recent dramatic increases in interest rates have been accelerated by the proposals before the Congress to remove the tax exempt status and to retroactively tax the interest which has been earned by investors. The confidence of these investors has been seriously shaken, and the ability of State and local governments to secure acceptable financing for capital improvements has resulted in a greater tax burden being passed to the tax-payers at the local levels. I have serious doubts regarding the constitutionality of such retroactive tax measures, and a great concern for the financial plight in which our cities and counties find themselves because of investor apprehension over this proposed Congressional action.

North Carolina has made it a habit to have good government. We have kept our fiscal house in order at the State level, and have promoted and encouraged strong and self-sufficient governments at the municipal and county levels. My administration is dedicated to positive and responsible action in support of strong local government. Maintenance of responsible and effective local governments will be possible only to the extent that the Congress preserves the independence of fiscal policies at each level of government. The proposals to remove tax exempt status from these State and local bond issues will weaken the foundation of local government financing.

We are deeply concerned about the effect of proposed changes with respect to the reduction in the allowable deduction of charitable contributions to educational institutions and charities. Our institutions of higher learning, as well as our charitable organizations, depend in large measure upon such contributions for their operating revenue and their building programs. Recent figures show that private institutions are receiving in the neighborhood of 8¾ million dollars annually from contributions. Public four year colleges and universities are receiving about one-half that amount. Our General Assembly has recently appropriated $350,000 for the current biennium for additional support in the medical schools of two private universities. Wake Forest University and Duke University. Even with all of the support that can be given from the various levels of government the need is increasing, and the removal of inducements to contributions poses a serious blow to the hope that public and private colleges and universities will be able to continue their mission at the present levels of operation. Elimination of the present tax advantages, particularly those relating to unlimited contribution deductions, transfer of income to charitable organizations by means of the two-year trust, use of present market value in determining the amount of deductions for donations, and permitting deductions for the use of property, will necessarily curtail the flow of funds to these institutions from private sources. Loss of such substantial sources of funds, in many of our private institutions, would be disastrous; it would cripple our effort to provide a wider and more comprehensive educational base for our citizens.

We join in the concern that our growing needs require ever increasing governmental support. However, in keeping with the President's statement that cooperation of all levels of government in partnership with private enterprise is essential to our effort to meet these needs, we suggest that removal of tax exemption on local governmental bonds, and removal of the inducements for contributions to institutions of higher learning will result not in cooperative partnership, but in increasing the importance of local governments, and the enlargement of federal direction over local governmental affairs. We urge that degree of cooperation of which the President has spoken; we suggest that it will be possible only if local and State governments are left with independence of fiscal policy sufficient to meet their share of the cooperative endeavor.

Cordially,

ROBERT W. SCOTT, *Governor.*

COMMONWEALTH OF PENNSYLVANIA,
Harrisburg, September 23, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR CHAIRMAN LONG: You have given me the opportunity to submit a Statement for the Record concerning certain provisions of the Tax Reform Act of 1969. I thank you for this opportunity. All of us are aware of the need for reform in many areas and it should be a comfort to all Americans that the depth, background, and acknowledged expertise of your full Committee is being brought to bear on this important issue.

I can say unequivocally that I support all measures which will bring about equity of tax treatment for all our taxpayers. It is the achievement of this purpose, tax equity, which must be paramount in our thinking when recommendations for reform are considered. It is my conviction that one of the elements of the tax reform proposals will not achieve this purpose. I am referring specifically to my opposiiion to those provisions of the Tax Reform Act of 1969 which will alter or modify the present tax-exempt status of State and municipal bonds.

I am not alone in my contention that these provisions are not in the public interest. The Nixon Administration as well as elected officials and public-minded organizations throughout the country have also registered their objections. Why has such a response been forthcoming on such a broad front?

At the present time, we are rapidly approaching an important juncture in our Federal system. One the one hand, we have an enlightened Congress diligently working to devise means to allow State and local governments to solve their problems at their own levels, where the problems are best known. On the other, we have a constantly increasing capacity and willingness at the State level to assume our proper burdens, and a virtual renaissance in local government in developing solutions to the problems which face us, particularly in urban areas. A significant source of financing for many projects designed to meet these problems has been State and municipal bonds. This effort is fundamental to a concept of Federalism which views Federal, State and local governments as partners in serving our people, and this concept must remain intact.

The National Governors' Conference in 1968 stated that "the reciprocal freedom of the states and the Federal government from taxation from each other is essential to the survival of our Federal system of dual Federal-State authority." The Conference went on to declare that "this freedom necessarily encompasses the immunity of State and local government obligations from Federal taxation."

This statement was based on a long history of Supreme Court decisions and a realization that any Federal mechanism that tampered with the tax-exempt status of State and local bonds, whether it be subsidies, guarantees, or taxation on interest, would weaken our Federal system and perhaps violate the Constitution interest, would weaken our Federal system and perhaps violate the Constitution.

It is also important to realize that this provision will produce inequities for those whom the Tax Reform Act is designed to help. The impact of this proposed legislation has already had a damaging effect on the market for all local government securities. Prices have dropped and interest rates have increased. The State of Ohio, for example, recently was forced to market its bonds at 5.94 percent. If these securities had been sold prior to the proposal of the legislation, it is estimated that the taxpayers of Ohio would have been saved approximately $1 million in interest over the time the bonds will be outstanding. This is one example of one small issue in one State. Nationally, the passage of this provision could result in the almost total collapse of the municipal bond market. Locally, the slack will have to be taken up by the average tax-paying citizen.

State and local governments have often been criticized for their lack of a stable tax base. We have been called regressive because we have had to rely principally on property and sales taxes. On top of these, several localities have enacted so-called nuisance taxes, such as occupational privilege and head taxes. We are, however, taking steps to establish a more stable and equitable tax base.

If the tax exempt status of bonds is changed and the market for these securities disappears, any steps that we may take to alleviate regressive taxes and to eliminate nuisance taxes will be thwarted. Another source of financing will be needed at State and local levels. What I am saying is that the effect of this provision on State and local government will be regressive. Ultimately, the individual taxpayer will have to pick up the tab, and not necessarily our wealthier citizens.

It should also be noted that our wealthier citizens are not escaping most of their Federal taxes by investing in State and local bonds. The fact is that these bonds constitute ten percent or less of the holdings of millionaires as a class. Banks, insurance companies, and other institutions, which do not pay a graduated income tax at all, hold twice as many of these bonds than do individuals.

We must also bear in mind that those individuals who hold the minor proportion of available municipal securities do so at a price. They could invest in comon stocks and other issues which provide a greater hedge against inflation and have the possibility of higher yields. They do invest in municipals because they believe that the lower interest rates which they accept are offset by the tax benefits which accrue to these securities. In effect, they find a small but important advantage in helping to underwrite the costs of government and the economic development of our communities.

This partnership between public leadership and private enterprise must be encouraged and strengthened. We at State and local levels have difficulty financing our present needs without any new burdens by loss of tax exemption. Some have described our present predicament as a fiscal crisis. If local securities are attractive because buyers obtain a net advantage, we must realize that the price is worth it. If some interpret this arrangement as a subsidy, let us regard it as a subsidy to State and local government, and not as a tax shelter for a few individuals.

In conclusion, let me reiterate that my opposition to modifications in the tax-exempt status of State and local bonds is based not on a desire to perpetuate the status quo, but on the belief that it will not achieve its purpose. If we are striving to provide tax equity for all our citizens, as we must, then we must preserve the ability of State and local governments to finance much needed public projects from other than regressive and nuisance-type taxes.

I oppose this provision because I feel it could damage our system of Federalism and possibly violate the Constitution.

I oppose it because I believe that solutions to many of the problems which face us can better be found at the State and local level, and not at the Federal level. The formulation of these solutions requires imagination, initiative, and financial resources. There is, perhaps, too little of all these to do the job that must be done. However, we are making progress and anything that impedes our progress, such as this provision of the Tax Reform Act, must be labeled as such—and defeated.

It is my hope that these remarks will assist you in making your judgments. I recognize the importance, and the difficulty, of your task in devising tax reform proposals, and I think you for allowing me to submit my views on this subject.

Sincerely yours,

RAYMOND P. SHAFER, *Governor.*

STATEMENT OF HON. PRESTON SMITH, GOVERNOR OF TEXAS

The objectives of those provisions of H.R. 13270 which treat with bonds of state and local government can be more accurately described as spiteful and coercive than as reformatory.

Spite is obviously directed towards a handful of investors who, in lending money to state and local government at a much lower rate of return than could have been realized elsewhere, have minimized their Federal income tax liability and stand accused of taking advantage of a loophole.

Coercion is aimed at states and their political subdivisions in what amounts to a surtax on their borrowing to the end that they will be driven into involuntary dependence upon the monster of bureaucracy.

It is patently clear that the architects of this plan had in mind Sections 301 and 302 as agents of destruction—destruction of the market for state and local government bonds—while Sections 601 and 602 were designed to provide an agent of rescue: the Federal bureaucracy as the sole remaining source of capital funds for state and local government. If H.R. 13270 is enacted into law in the form passed by the House of Representatives, I say that eminent but deplorable success will be attained by those who conceived this scheme. Centralism will have at long last prevailed over local home rule.

An emergency exists in my State of Texas today—an emergency brought on entirely by the passage in the House of Representatives of H.R. 13270. The only remedy is the deletion of those four sections from the bill. Even then recovery will be slow. We shall bear the scars for months and years to come.

Texas is endowed with a combination of rich natural resources and an energetic and resourceful citizenry, which has resulted in a rate of economic development somewhat above the national average. For this we are grateful, although it produces an ever growing problem for those who are charged with providing capital funds for the myriad public works and facilities demanded by an expanding population and a standard of living whose course is progressively upward.

In the year 1968 the agencies of state government, our state supported institutions of higher learning, and our local governmental units issued bonds in the aggregate of almost $1 billion. Still we lost ground in the race to meet our needs for expanded educational plants, water resources development, water pollution control, hospital facilities, airport construction, roads and streets, and all of the other purposes for which state and local bonds are issued. (With only about 5% of the nation's total population, we do, year after year, account for 7% to 8% of the annual volume of long term financing by state and local governments in the United States.)

The march of inflation together with a general tightening of credit had steadily pushed the cost of borrowing for capital improvements upward; then came Viet Nam, and we truly began to learn the meaning of high interest costs on borrowed capital. Money for schoolhouses which formerly cost 8% had moved up to 5½% and 6%. Hospitals, built during the earlier part of this decade at reasonable interest costs, were being financed at interest rates which had more than doubled. All but the larger cities, the counties with major population centers, and the school districts with unusually large tax bases, found themselves in a position of being unable to sell bonds—because of restraints in our statutes on maximum interest rates which could be paid legally.

In my message to the 61st Texas Legislature which convened in Regular Session in January, 1969, I submitted one, and only one, emergency recommendation: corrective legislation to increase the maximum legal interest rate on all bonds, where governed by statute, to 6½%. The Legislature responded quickly. We soon had a statute on the books which permitted local governmental units to proceed with the financing of their badly needed construction programs.

But the efficacy of this remedy was short lived. Within six months there were delegations representing some of the largest municipally-financed projects in our State calling at my office imploring me to submit to a called session of the Legislature, then in session, additional legislation designed, this time, not to increase interest rate limitations again, but to remove them entirely.

Our prolonged economic boom has produced an inflation of all costs, including the cost of borrowing money, and the strain on our economy resulting from the Viet Nam conflict has exacted its toll. These things, though, we could have coped with. We tightened our belts, and we tackled the necessary—if unpleasant—chores of increasing assessment ratios of taxable property, of increasing tax rates, and of boosting user charges for those projects financed with revenue bonds.

We could have met the crisis, and we could have survived except for one thing: so-called tax reform measures under consideration by the House Ways and Means Committee. The bad publicity, the misleading propaganda, and the half-truths which have come out of these machinations (there were no hearings), have virtually destroyed the market for bonds of state and local governments.

The only course left open to us was to remove all limits on local governmental bond interest rate, and this we have now done in Texas. The municipal bond market has become so utterly shattered, and the morale of investors so undermined by actions of the Federal government, that state and local government must now compete with private industry for capital. There are worthy projects in Texas which must be financed regardless of borrowing costs; hence the removal of limitations on interest rate.

But this is not the answer. There remain those public facilities which can be financed only through a pledge of user charges, and which become economically infeasible when the sponsoring governmental agency is obliged to pay 7%, 8% or more in annual interest rates. Consider also the plight of units of local government with a rigidly limited debt service budget. To illustrate: a small school district which needs a $1 million school building can finance it with a debt service budget of $66,050 per year if it can sell 30-year bonds at an interest rate of 5%. The total final interest cost is $981,500.

Increase the interest rate to 6%, and that same $66,050 debt service budget requires an amortization period of 45 years on a $1 million bond issue and an ultimate interest cost of $1,972,250. But what happens when the bond market reaches such a chaotic state that an interest rate of 7% is required to make the bonds on our hypothetical district saleable? Interest alone on a $1 million 7% school bond issue is $70,000 per year. Of what help to this district is a statute which removes the legal limit on interest rate?

The securities industry in this country is in the hands of some of the most astute persons within the business community, and the same is generally true of those who invest in state and local government bonds. The industry and the community which it serves has kept an apprehensive eye on the Washington scene for several years, particularly since the Supreme Court's ruling in the Atlas Life Insurance Company case in which the Court, in interpreting the Life Insurance Company Income Tax Act of 1959, denied the right of full exemption on interest income from municipal bonds held by a life insurance company. Within a span of about six years the percentage of investments of all life insurance companies represented by state and local government bonds has shrunk from more than 6% to less than 1%.

Apprehension grew into alarm as the tax-exempt bond sector of the securities market saw the handwriting on the wall with such unfortunate happenings as the testimony given to the House Ways and Means Committee in November, 1968 concerning 154 individuals in the country who, despite annual incomes in excess of $200,000, paid no Federal income taxes; the impression was allowed to spread abroad that this was accomplished with interest income on tax-exempt municipal bonds. No publicity at all was given to later testimony before the same committee showing that there was not a single person out of these same 154 who used municipal bond interest as the principal tax reducing factor.

The market for state and local government bonds has been, for all practical purposes, destroyed. We in Texas are confronted with such problems as the plight of America's sixth largest city, Houston, which, in an attempt to secure $24 million in capital funds for emergency enlargements and extensions to its waterworks system, was unsuccessful in receiving a single bid for its bonds notwithstanding a permissible interest rate of 6½%. For all of this we can thank the House of Representatives for its passage of H.R. 13270 and its inclusion of Sections 301 and 302.

Proponents of the measure point, of course, to other provisions of the bill, the rescue device, the free money subsidy afforded by Sections 601 and 602. In view of the enormity of the problem, the extent of the emergency, it would appear at first blush that there is really no other alternative but to walk into this trap which the architects of the scheme have provided.

Even if we were willing to go to this extreme to meet the real emergency which exists, and even if we were willing to transfer the whole local decision making process to the Washington bureaucracy, would it work? The answer is no. We have not yet really seen any chaos in the area of state and local government capital financing until an attempt is made to set that scheme in motion.

Myriads of legal questions immediately present themselves, as well as some very practical ones such as enabling legislation in each of the fifty states, et cetera. A snarl of gargantuan proportions will be the inevitable result; a paralysis in the market where the private sector is afraid to proceed and where the bureaucracy is enjoined from operating is bound to occur. This must not be allowed to happen.

Aside from the inconvenience and the actual endangering of human life and property resulting from a shutdown—or even a major slowdown—in the construction of public works and improvements financed with state and local government bonds, there is to be considered the cost, the economic loss, direct and indirect.

This threat to the tax-exempt status of state and local government bonds has been in the making for at least a year. In my state we have issued bonds during that year to the extent of about $1 billion. The most conservative estimate I have had from reliable sources is that the additional interest rate resulting from this disturbing factor in the bond market is at least 1%: and most estimates are higher. But with the addition of only 1%, the proponents of this measure have already cost the State of Texas and its political subdivisions not less than $150 million in ultimate interest charges. The corresponding figure for the country as a whole would be about $2.4 billion, and please bear in mind that this is just *one year's* borrowing.

Not only is the self-reliance of local governments in meeting their own needs at stake, but also confidence in governments . . . the credibility of governments which already have sold tax-exempt bonds.

I urge the Committee to delete Sections 301, 302, 601, and 602 of the bill.

PRESTON SMITH, *Governor of Texas.*

SENATE OF PENNSYLVANIA,
Harrisburg, September 25, 1969.

Hon. RUSSELL B. LONG,
Senate Office Building,
Washington, D.C.

MY DEAR SENATOR LONG: I wish to protest the changing of the tax-exempt status of State and municipal bonds, as proposed by the Congress of the United States.

Yesterday, the Pennsylvania Senate Banking Committee had a meeting with respect to raising interest rates on State municipal bonds. We had present three nationally known representatives of the banking profession. We are absolutely amazed to hear the chaos facing State and municipal bonds, due to the move by certain people in the Congress to make such bonds taxable for income tax purposes.

If these bonds are made taxable, there will be a partial collapse in the construction of highways, hospitals, schools, public housing and other public construction. Sewers so necessary for clean streams can be forgotten.

The Congress of the United States has already done great damage to the interest rates of State and municipal bonds. The bankers are demanding more interest because there is now a calculated risk of Federal taxability.

This is a vicious situation that can benefit no one.

Very sincerely yours,

CLARENCE D. BELL, *Senator.*

SEPTEMBER 18, 1969.

Mr. TOM VAIL,
Chief Counsel, Senate Finance Committee,
New Senate Office Building, Washington, D.C.

DEAR MR. VAIL: As Mayor of the City of Providence, I am deeply concerned with the effects of the proposed tax on the interest received from holders of municipal bonds. I had our finance department do a preliminary study of the impact such a tax would have upon the tax rate in the City of Providence. On the basis of this study the following conclusions were arrived at:

The City of Providence currently has authorized but not yet bonded 80 million dollars in new issues.

On the basis of projection of these figures over the next five year period ending in 1975, the tax rate increase to the Providence tax payer resulting solely from the effect of the tax on interest from municipal bonds would be approximately $.63 the first year, $1.86 the second year, $3.02 the third year, $4.11 the fourth year, $5.15 the fifth year and $6.00 by the end of the fifth year.

These figures were derived at simply by considering the 80 million dollars already authorized and not yet issued. This does not take into consideration any new future issues. We allowed merely for the differential in the interest payments which would have to be made up to holders of these bonds. Therefore, by using an interest rate of 10% rather than the present 5% return, the net result would be to raise the tax rate in the City of Providence by the amounts listed above. Such a tax increase to the residents of the City of Providence would come at a most inopportune time when additional and increasing demands are being made by the teachers, police and fire and the municipal employees; and the costs of municipal services as a whole are increasing. Since most cities are experiencing the same demands for increased services at higher costs, the added burden of additional interest payments to holders of municipal bonds would cause our local tax rates to sky rocket. This in turn would most likely affect the low income and middle income tax payer. Also, the City would have to turn more and more to the federal government for alternative means of financing which would mean shifting more local control to the federal level.

I urge you to carefully consider the potentially dire effects such a tax would have on local governments before approval is given.

Very truly yours,

JOSEPH A. DOORLEY, Jr.,
Mayor of Providence.

CITY OF GRAND ISLAND,
Grand Island, Nebr., September 30, 1969.

Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
New Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: The City of Grand Island, Nebraska, objects to these three specific provisions in H.R. 13270:

1. To include the interest from municipal bonds in an allocation of deductions rule.
2. To include interest from municipal bonds in a limit on tax preference.
3. To establish a bond interest subsidy program for bond issuers who waive their tax exemption.

The passage of this bill by the House has already demoralized the present holders of and the prospective purchasers of municipal bonds.

We have some $20,000,000 plus of bonded indebtedness at the present time. Most of this was issued for water and electric operations. Ironically, our citizens voted approval for $1,425,000 bond issue this Spring. This was the first bond issue approved for municipal purposes since 1938, in our City. This issue is the City's share of matching funds for a HUD grant for a storm sewer project. Storm sewer proposals have been defeated three times prior to this election.

Now we *cannot* sell our bonds because of a maximum state interest ceiling and HR 13270. The first reason will be rectified in late December, when the new legislation removing the ceiling, becomes effective. You hold the reins on the latter.

The Senate Finance Committee should, in our opinion, take a stand to oppose the retention of the above three provisions immediately. This would help to stabilize the municipal bond market and reduce interest rates again to make them saleable. Please request this of your committee.

We respectfully urge that no change be effected in the present tax exempt bond law for governmental issues.

Sincerely yours,

JOHN DITTER, *Mayor.*

STATEMENT OF HON. CLYDE DOYAL, MAYOR, PASADENA, TEX.

Hon. Russell Long, members of the Senate Finance Committee, gentlemen, I make this statement as the chief elected representative of more than 100,000 Americans and, I believe, on behalf of cities with small and medium populations throughout Texas and across the Nation as well. The provisions of the "Tax Reform Act of 1969", H.R. 13270, affecting the tax exempt status of municipal bonds spell disaster for the financial structure of local government, if not for the entire concept of local government as it functions today. I *urge* you to eliminate all reference to municipal bonds in the tax reform bill and to do so promptly in order to ease the turmoil already evident in the bond market.

It is not my intent to cite an interminable list of statistics showing the detrimental effects of H.R. 13270 upon interest rates and the bond market, should you adopt it in its present form, nor do I wish to discuss the constitutionality of taxing the instruments of a governmental agency. Undoubtedly, you have received, or will, volumes of testimony and technical data on these issues. I choose to leave discussions of economics to economists, of constitutional law to constitutional lawyers and of bond markets and interest rates to fiscal experts. I speak to you as one experienced in local affairs; as one who deals in local problems on a day to day basis; as one who is concerned for the local taxpayer; and I say to you that the proposals contained in H.R. 13270 with regard to municipal bonds pose a threat to the cities of this country potentially greater than any they face today.

Certainly you, and all of us, are aware of the many problems of substantial magnitude challenging our urban areas. Problems in health, housing, crime, streets, education, race relations and pollution to name but a few. You in the Congress and we at the local level are working diligently to solve these problems. Some problems have their roots in the precepts upon which our society was founded and their solution requires time and education. Others are not so difficult to solve. All that is needed is money.

A shortage of funds has always been the city's particular cross to bear. Most cities are dependent upon the property tax for the bulk of their revenues. A substantial amount, if not a majority, of property tax revenues are contributed by the homeowner. And the homeowner (read: electorate) has very nearly reached the saturation point with regard to increased taxes of any kind and in particular, the property tax. If favorable interest rates on municipal bonds are lost, then property taxes must necessarily be increased in order to meet increased debt service requirements. I sincerely believe that the people (your constituents and mine) would balk at paying increased property taxes while levels of municipal service remained the same. The results of this condition can be foreseen to be (1) property taxes will remain basically unchanged and municipal services drastically curtailed, (2) property taxes will be increased and municipal services will remain unchanged or (3) property taxes will remain basically unchanged and no bonds will be sold. None of these predictable results could be considered progress by any stretch of the imagination.

It is my understanding that a provision of H.R. 13270 provides for the Federal Government to pay to local governments a certain subsidy to offset the increased interest rates anticipated to result from the elimination of the tax exempt status of municipal bonds. I simply cannot see the logic of this procedure. Will the revenue gained from taxing our bonds be used to pay this subsidy? Will it be adequate? If the revenue from the proposed tax is used to subsidize the increased interest upon municipal interest, what has been gained? If the revenue from the proposed tax is not sufficient to pay the interest subsidy, what has been gained? Subsidies suggest guidelines and controls. Who is to determine the controls upon which the subsidy would be contingent? Most bond issues are approved by election. Would the Secretary of the Treasury be able to reject the will of the people by rejecting a subsidy?

Let me close by stressing one final point. Local government is the government closest to the people. Local government provides the most services to the people. Local government is the most responsive to the needs and demands of the people. As a local official, I meet and talk with the people every day. I do not get information second or third hand. I am not bothered by lobbyists and special interests. Every local public official experiences the will of the people at first hand. Citizens rarely call Washington, but they frequently call City Hall. We respond to the will of the majority and it is this will that I am attempting to relay to you. The people oppose anything which will adversely effect local tax structures as certain provisions of H.R. 13270 will. Certainly, each of us would like for everyone to pay his fair share of the taxes necessary to support this great country. But the question of what is fair can be exceedingly complex and in this instance the elimination of a small inequity afforded by tax exempt bonds would result in an enormus injustice to the millions of Americans living in cities. I ask you to work with us in solving the problems of urban America, not compound them through the adoption of those provisions of H.R. 13270 effecting the tax exempt status of municipal bonds.

Respectfully submitted.

CLYDE DOYAL,
Mayor, City of Pasadena, Tex.

PRESENTATION BY HON. MILTON H. GRAHAM, MAYOR OF PHOENIX, ARIZ.

Mr. Chairman and Members of the Committee, I am submitting these remarks to express my deep concern at the impact that certain provisions of the Tax Reform Act of 1969 will have on my City, and indeed on all local and state governments in our country.

The City of Phoenix is a rapidly growing City which has made every effort to meet the service needs of its citizens. In order to build streets, parks, police facilities, water systems, libraries and deliver other essential services, we have, in accordance with sound management practices, borrowed—that is, turned to the issuance of bonds to meet the needs as they arise.

To build needed facilities now, and enable future residents to help pay for them, we have incurred bonded debt that now totals $139 million. We have plans to issue additional bonds totaling almost $200,000,000 over the next few years. However, certain provisions of H.R. 13270, if passed, will have a critical effect on the marketability and costs of municipal bonds. As a matter of fact, these effects are so serious that just the threat of removing the tax exempt status of municipal bonds, as implied by House passage of the bill, has been disastrous to many American communities.

I refer specifically to the section of H.R. 13270 which includes the Allocation of Deduction Rule and the Limit on Tax Preference. Local governments have, up to now, enjoyed one great advantage in keeping down their costs and therefore the taxes of our citizens while supplying needed services. As you know, the interest on municipal bonds is not subject to the Federal Income Tax, permitting these bonds to be sold at much lower interest rates than taxable corporate bonds. The allocation of Deduction Rule and the Limit on Tax Preference is, in effect, an indirect tax on municipal bonds that will eliminate the favored position of these bonds.

After careful study and deliberation, the City Council and I find that strong opposition to these measures is our only alternative.

Aside from the grave Constitutional question posed by these provisions, the net effect will be the creation of a new form of security which will compete with corporate bonds, if it can compete at all. I am sure that other opponents of this provision have pointed out that it will increase the interest rates paid by state and local governments on bonds by at least 50%, or 2 to 3 percentage points on the rate itself. Anyone who has bought a home recently can tell you what such an increase does to the monthly payments on a home. It does not take much imagination to project such an effect to the cost of municipal capital improvements—already at an all time high because of increased construction costs and *presently* high interest rates.

To illustrate the effect in more meaningful terms, our research staff computed the additional interest costs, from just a 2% rise in the interest rate, on our presently authorized bonds.

They found that our citizens would be faced with *additional* taxes or service charges totaling $50,432,000 to pay for this increase in the rate, of the bonds can be sold at all because of constitutional limitations on interest rates pair by state and local governments. This increase of almost $2 millioin per year in the costs of local government can hardly be called tax relief.

The total of $185,000,000 in authorized bonds analyzed by our research staff includes bonds for practically every municipal purpose—police and fire facilities, storm and sanitary sewers, airports and water system improvements, municipal office and maintenance buildings, sanitary landfills, and park, library and civic center improvements. Most of these bonds were authorized this year by over two-to-one margins, incidating the urgent need for the facilities.

It is interesting to note that the additional interest costs annually caused by removal of the tax exempt status of municipal bonds would be *more* than we have been able to receive from existing categorical grant-in-aid programs. This is not the kind of help our cities need from the Federal Government.

Of course, the increased cost of borrowing that would result from ending the traditional tax exemption status of municipal bonds is recognized in H.R. 13270. A feeble attempt is made to offset it with the inclusion of an Interest Subsidy Program. At first glance, this proposal appears to be a harmless method of transferring a portion of the added costs of borrowing from the local municipalities to the Federal Government. This would seem to make everybody happy except the taxpayer who reputedly benefits from the tax-free interest on municipal bonds.

The Secretary of the Treasury would administer the provision utilizing monies from annual appropriations provided by the Congress, and therein is a major objection to this provision. What will happen when the Secretary of the Treasury finds himself unable to cover the increased interest of all future state and local bonding programs as a result of inadequate appropriations or other critical Federal needs?

The answer is quite clear. Well-intentioned Federal bureaucrats will be forced to set priorities in order to determine what bonding programs *they* will fund, in much the same way as they now do with existing grant-in-aid programs (none of which have ever been adequately funded). If this provision is retained in the bill, the result will be that local bonding programs voted upon by the people will, in effect, be nullified.

Even if congressional appropriations are adequate to meet the borrowing needs of the 90,000 cities, counties, school districts, states and special districts in the United States, how could such a program be administered? Any one who has ever been involved in a Federal program knows the paperwork, confusion, indecisions and countless delays that are inherent in each program. And these programs each involve only a few hundred cities. But virtualy *all* local governmental units borrow money through bonding, many every year.

It is difficult to imagine how the Secretary of the Treasury could ever administer such a program in such a way as to meet the needs of local government. Each bond sale requires months of planning and consultation with financial advisors and bond attorneys, weeks of actual preparation, legal advertising, and countless details. A delay or mistake in any one of these areas could void the sale.

It would be unthinkable to superimpose another uncertainty—whether or not the Federal subsidy is applicable, and how much it is—on this complicated process.

Some may say that this would not happen. To me, it is a certainty, and not a possibility. I have found no one that even understands the subsidy provision as it is written. I cannot believe that a provision that cannot be understood can be effectively administered.

The provision in H.R. 13270 which removes the tax exempt status of municipal bonds should be removed immediately. Our financial advisors indicate that just the *threat* of this bill becoming law, as caused by House passage, has caused interest rates to rise by ⅝%. Because of the already high interest dates caused by inflation, this increase has destroyed the bond sales of hundreds of local government units with 6% interest rate limitations.

Unless the threat is removed immediately, it will destroy a sale scheduled in Phoenix for late October. This is a small sale—only $4,000,000—but it is urgently needed to construct needed improvements for the remainder of this fiscal year.

CONCLUSION

The problems of Amerca's cities are well known, as are the promises of Federal officials to help solve them. It will be ironical if the Federal Government, which has not yet faced up to its obligations to the cities, intensifies these problems by passage of this bill as it is now written.

Thank you for your consideration of my comments.

Statement by Gordon L. Larson, Mayor, City of Chadron, Nebraska

SUMMARY

We oppose all provisions of HR 13270 relating to taxation, direct or indirect, or subsidy and tax waiver agreement. Results will be loss of local governmental interest and control, and freedom of choice; loss of economical operation and increased financing costs.

Taxation of municipal bonds is not tax reform but constitutional reform, and is unwise. The subsidy provision is part of this reform, and is opposed as not necessary and confusing and costly and unwise.

Pure arbitrage is wrong, but seldom a problem. Most legitimate financing programs of revenue bonds require investment in U.S. Government securities and refinancing oftentimes required for equal lien or economical issuance of subsequent revenue bonds. Be cautious in this area.

Publicity relating to municipal bonds, probably from misleading statements of the Treasury Department, tend to lessen objections which would otherwise be strongly in opposition. Any legislation in this area will cause higher interest rates out of proportion to any possible value to the U.S. Government.

STATEMENT

Mr. Chairman, members of the committee: By a resolution unanimously adopted, the Council of the City of Chadron, Nebraska went on record as being opposed to the inclusion in HR 13270 of any provision which would directly or indirectly tax bonds of a state or any municipal subdivision thereof, and opposed to the inclusion in said legislation of any material which in any way would provide for a waiver of the tax exemption of the income on bonds of any such municipality or state in return for a subsidy or supplement to cover higher interest, whether paid to the city or to the investor. The City also objects to any provision which in any way would deny the right of cities or municipalities to invest proceeds of the issuance of bonds issued for legitimate purposes in Government Bonds on an interim basis, commonly referred to as arbitrage.

I was also authorized by the Mayor and Council on behalf of myself and the Council to send Harry Dutrow to Washington, D.C. to appear at the Nebraska Congressional Breakfast on September 23, 1969 to present to the Senators and Representatives of the State of Nebraska our strong feelings. Mr. Dutrow did appear and was presented to your Committee with other Nebraskans attending the session by Senator Curtis when North Platte made their presentation. Thank you for this appearance.

We feel that self-government on the level of the state and municipality is as important now as it was when our constitution was drawn, and has been the major factor in the growth and prosperity of our nation.

We fell that the inclusion of the matter of taxation of the income of municipal bonds is constitutional reform or political reform, rather than tax reform. If proponents want this reform, it should be in the form of a constitutional amendment rather than in the form of legislative enactments. We feel that the consequences of this type of legislation and the true content of the bill as it relates to taxing municipal bonds was not understood by our representatives in the House. Otherwise, even though it was a closed vote with no right of amendment, they would not have voted in favor of the legislation as they did.

In our discussions with school officials, and with county officials at all levels in our area and elsewhere, we have found universal acceptance of this idea, and universal rejection to the taxation of municipal bonds. We have, however, found that the misleading publicity in connection with the overall aspects of the bill, in particular in relation to the taxation of municipals, implies that the bill only gives the city the right to waive or not to waive immunity and be taxed in return for compensation for higher rates. When in Chadron, Representative Martin gave this explanation as his reason for voting for the bill. As you know, this is only one provision in the bill, and under the allocation of deductions and the minimum preferred income provision the income of the bonds *is* taxed directly or indirectly; and its impact has been felt here for some time in the form of higher rates.

Treasury statements regarding the problem and solution are misleading. They state the situation as:

Problem I.—Municipalities benefit approximately $1,300,000,000; Federal Government loses $1,800,000,000; loss of $500,000,000.

Problem II.—Municipalities sell bonds to invest in Government Bonds at a higher rate for profit, involving arbitrage.

Solution.—Give the municipalities the voluntary power to waive their tax exemption and the Federal Government will pay the increased interest costs as determined by the Secretary of the Treasury.

You have to go to the foot notes for references to sections of the bill involved in order to know that taxation on a non-voluntary basis is included in the bill. This misleading statement of the problems and solutions has apparently been an excuse for approval of the bill. We trust that your committee knows the full impact of this bill and pray you will eliminate all provisions referred to above.

To issue bonds only to invest in Government Bonds at a higher rate is wrong and probably illegal in most states. This abuse should be curbed. Caution must be exercised, however, since almost all legitimate financing programs require the issuance of bonds in anticipation of construction programs, and investments in U.S. Government Bonds may be the only logical or legal or safe investment of funds pending progress payments under contracts. Many times market conditions dictate early or timely issuance of bonds, prior to construction. Refunding of bonds prior to option is another abuse, but in many instances is required for equal lien and economical financing of revenue bonds, where outstanding bond convenants are too restrictive or outdated. It would seem that any cure in arbitrage should be restricted to specific areas of complete blatent abuse, and exclude from the arbitrage restrictions financing plans with legitimate and logical ends.

Others have given the economic effect of this attack on the governmental subdivision's immunity from taxation. This we leave to the experts. But we wish to lend our views in opposition to this legislation, of the idea of self-government on the state and local level.

Thank you.

Statement by Hon. Harry P. Andersen, Mayor City of Millard, Nebr., on Behalf of City of Millard, School District of Millard, and Airport Authority of Millard

SUMMARY

The City of Millard, Nebraska, School District of Millard, Nebraska, and the Airport Authority of Millard, Nebraska, in the written statement of which this is a summary, go on record as objecting to all provisions of H.R. 13270 relating directly or indirectly to the taxation of state or municipal bonds, to all references in the law relating to plans for waiver of constitutional immunity of taxation and related Federal Government assumption of excess costs in interest, and finally as objecting to restrictions on investments in Government Bonds or any penalties in relation to its tax exempt status in connection with such investments.

The City feels the legislation relating to municipals above referred to is constitutional reform rather than tax reform; is unwise; will involve higher financing cost to the municipalities, forcing dependence on the Federal Government and the loss of independent self-governing status.

It is also argued that the system as we enjoy it is efficient, economical, timesaving, and can be a means of solving problems which cannot be solved by the Federal Government.

STATEMENT

Gentlemen: I have been the Mayor of the City of Millard since it was a small village and have been involved with the financing necessary to have it grow into a city approaching 10,000 people, a large city for Nebraska. I have been involved in the appointment of an airport authority for the construction of airport facilities to serve the City of Millard and Suburban Omaha, and have watched the school district grow from a small district to one of the largest in the State of Nebraska. The growth has been orderly; it has been done economically, within our ability to pay, and financed from the issuance of municipal bonds for all utilities, street improvement, recreational facilities, airport improvements, school buildings, etc. All work has been under the supervision of competent consulting engineers and architects many times used by the State and Federal Government. All improvements have been of a standard required by the State of Nebraska or the Federal Government aided projects, have been without red tape, when needed, and without delay.

We are just one small community, but this ability to organize and grow and to develop and to finance in an orderly manner the necessary mundane ordinary improvements can be multiplied a million times over our nation. We feel that the United States Government has shown by its development of bureaus, by its red tape, by its complications, by its multiplicity of programs and by every other measure, that it would be completely incapable of duplicating what has and can be done with local self-government. We think this is proven by the excess of bureaucracies in England, France, Italy and other nations with a strong nationalistic centrally-controlled government.

In addition to this orderly, efficient method of acquisition of needed capital improvements on a state : nd local level, we feel that the cost to the taxpayer of improvements timely made has been greatly reduced, not only from the standpoint of inflationary influences but from the standpoint of lower construction costs because of local control, lack of red tape and efficiency. The taxation of municipal bonds will raise the interest cost to a point which will be substantially higher than the borrowing costs of the Federal Government. If such a tax were in effect, local governments would have no other place to look for financing or money than to the Federal Government. We know from experience that either guarantees or grants or loans from the Federal Government ultimately entail Federal Government requirements, priorities, and controls, and other requirements many times not related to the problems involved. Many times priorities are political and delays have sound reasons, but more often delays and priorities can be traced to bureaucratic inefficiency. Taxation of our bonds, we feel, would not only destroy self-government and the tremendous free contributions of those involved in local government, but because of bureaucratic involvement would be either a major inflationary influence or would restrict the construction of facilities, and is unwise.

The governmental subdivisions which I represent go on record in opposition to all provisions in H.R. 13270 including all references in Title III Section 301 and 302 and Title IV Section 601 and 602, and any other provision which might relate to arbitrage or the taxation of municipal bonds. We believe in local self-government. In addition to being opposed to the taxation, we strongly oppose any statute which would involve a waiver of the constitutional immunity from taxation and with a resultant responsibility of the Federal Government in connection with local financing, whether it be by interest subsidy or guarantee or otherwise.

There are many problems today facing all cities, particularly large metropolitan areas, which involve areas of national concern and involve expenditures far in excess of the ability of the localities to pay, and where Federal aid is recognized as necessary—such as poverty and slum areas, deterioration of care areas of cities, air pollution, water pollution, mass transportation, highway construction. With grants in aid and a working relationship between the Federal Government and state and local governments, these can be solved, and tax exemption for the cities' share will be an asset rather than a hindrance.

We do not argue against aid where the problem is national and ability to pay is insufficient. We know where aid and grants are made, control follows; and on national problems it is logical. We do argue about the taxation of our securities or the control of legitimate areas of self-government, and the furnishing of required facilities and services authorized by state constitutions and state laws, and the loss of which would result from such taxation.

1 appeared on behalf of the City at the Nebraska Congressional Breakfast on September 23, 1969 to express our views to our Senators and Representatives, and was privileged to stand and to be introduced to your committee at the time North Platte gave their testimony. Thank you for your consideration.

THE CITY OF NEW YORK
OFFICE OF THE MAYOR,
New York, N.Y., September 23, 1969.

HON. RUSSELL LONG,
Chairman, Committee on Finance and Taxation,
Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: I want to place the City of New York clearly on the record as being strongly opposed to the proposals now before your committee to tax the interest on municipal bonds.

The proposal to tax interest on municipal bonds would damage the cause of the nation's cities and states far more than it could possibly benefit the U.S. Treasury. Nor will this unwise measure achieve equity among taxpayers.

I estimate that the cost of the proposed measure—at a minimum—will amount to an extra $5 million per year for New York City alone, or the cumulative effect will be such that it will cost $50 million more a year in ten years. This would be the result if it caused only a 1% rise in our interest rates: the actual cost could turn out to be far higher.

This costly penalty will not be paid by the high-income individuals whose tax-free status the Congress is justifiably trying to end. Instead, it will be paid by the hard-pressed middle-income taxpayers of this city. This is clearly shown in the testimony given by the Assistant Secretary of the Treasury on April 22, 1969: the much-publicized cases of high-income individuals who pay no taxes did *not* come about through the use of tax-exempt municipal bonds to avoid taxation.

This City, and the other great urban centers of the nation, are in urgent need of more, not less, help from the Congress. I urge you to oppose ending tax exemption on municipal bonds and thus bring to a stop the uncertainty that has already forced up interest rates on municipal bonds in the market. There are many steps that can be taken to assure greater equity for all Americans through tax reform. The ending of tax exemption on municipal bonds is not one of them.

Sincerely,

JOHN V. LINDSAY, *Mayor.*

STATEMENT OF THE HONORABLE JAMES H. NORICK, MAYOR OF OKLAHOMA CITY, OKLA.

Gentlemen: The City Council of the City of Oklahoma City has authorized me to file for record and consideration a statement setting forth the unalterable opposition of the City of Oklahoma City to all those provisions of H.R. 13270 which have to do with the Taxation of the Interest on Municipal Bonds or attempts to ameliorate the effect of any such tax.

Members of the Oklahoma City Council attended the hearing before you gentlemen on September 23, 1969 and the printed testimony and additional statements received on that date have been examined.

In the interest of brevity I wish to express our general concurrence in the above testimony and statements. We particularly concur in the statements, made by the several Governors and Mayors, and join them in urging immediate action.

Whether through design or by inadvertence the proponents of this phase of H.R. 13270 have proceeded from a concept that is both unwarranted and untenable. Tax exempt interest on Municipal Bonds does not constitute a loop-hole in the tax laws. It cannot be used to reduce the tax on income earned from other sources. It is not a deduction nor a tax credit. It stands apart from all other exclusions on its historical basis as a recognition of the continued existence of the Federal System. There is no "loss" to the Federal Treasury by reason of its existence. To assert such a "loss" is to assume that there is a legal compulsion on investors to invest and that all such investments will be profitable. The absurdity of such ideas is self evident.

Oklahoma City, as a matter of policy, has elected to participate in many of the Federal programs which have for their purpose the making of urban life more tolerable. We have voted general obligation bonds and through our established Authorities, are prepared to issue Revenue Bonds to accomplish these purposes. Due to the combination of inflation and the threat of this Legislation our bonds cannot be marketed and these projects must soon come to a halt unless relief is granted.

While to some it appears to be politically appealing to talk of making everyone pay some tax, punitive legislation rarely proves sound and sooner or later, backfires. Inevitably, this will prove true unless the historical tax exemption of interest on Municipal bonds remains unchanged.

The additional costs (amply illustrated in other testimony) will fall on the ad valorem tax payer and the user of the publicly owned services and utilities, the vast majority of whom are the small taxpayers. The glee with which one might momentarily greet the idea that the rich have been soaked, will soon be gone when his ad valorem tax statement and his water and other utility bills let him know that he has been drenched.

The testimony of others on this subject in pointing up the chaos which has resulted from the threat to remove this tax exemption has illuminated a path to an area of true tax reform which will redound to the benefit of the small taxpayer. Just as we have seen that the possible narrowing of the market for Municipal Bonds has increased the demanded interest rate thereon, so would a broadening of this market reduce the interest rate on such obligations. Regardless of size, this interest is paid by most of the small taxpayers.

This would seem to commend itself to all members of Congress as a matter for Legislation. We would respectfully urge that the suggestions heretofore made to this Committee, that a way be found to permit Municipal Bonds to compete with corporate bonds in the Pension Fund market. We would further urge that a new look be taken at the Life Insurance Income Tax Act of 1959 in light of the fact that Industries investments in Municipal Bonds have fall from 6% to 1% of its investments. Without a doubt, study will show other markets now closed which could be opened.

In conclusion and summation, we urge immediate consideration be given to the almost universal opposition to these provisions of H.R. 13270 so that the breath of life will again come to the Municipal Market. We further urge immediate consideration to Legislation broadening the Municipal market so that a new source of money at a reasonable price to the taxpayer will become available for the construction and development of those projects undertaken as a part of the overall Federal Program of Municipal and Environmental Improvement, as well as other Capital needs.

Respectfully submitted on behalf of Oklahoma City, Oklahoma.

JAMES H. NORICK, *Mayor.*

OFFICE OF THE MAYOR,
Lake Charles, La., September 29, 1969.

HON. RUSSELL LONG,
CHAIRMAN, SENATE FINANCE COMMITTEE.

In my capacity as Mayor of the City of Lake Charles, Louisiana, and as President of the Louisiana Municipal Association, I file this statement in strong opposition to the provisions of H.R. 13270 proposing to limit and restrict the exemption afforded municipal bond interest under the current income tax laws of the United States. Passage of H.R. 13270, as presently written, will cripple the municipal bond market and will financially hurt most of the very people the proponents of this legislation are trying to help.

The major argument being made is that the principal beneficiaries of the present interest exemption are the wealthy, who by investing in municipal bonds can reduce their federal income tax liability. In point of fact, however, the true beneficiaries of the exemption are the millions and millions of lower and middle income property owners. The very purpose of the exemption was to enable state and local governments to borrow money to finance roads, schools, hospitals, recreational facilities, etc. for considerably less total cost than they could if the interest paid on the money they were borrowing was subject to Federal Income Tax. Since in large measure, these facilities are paid for by local homeowners through property taxes, these are the people who truly reap the benefits of the exemption.

If the tax reform bill is enacted in its present form and the interest exemption is either limited or eliminated, costs of local public improvements are going to be very substantially increased—and our people will either have to assume larger property tax bills—or do without much needed capital facilities, many of which are being fostered by Congress.

It is important, too, that the Committee keep in mind the fact that individuals and institutions that invest in municipal securities pay for the income tax exemption the bonds afford. They pay for it by accepting considerably lower interest yields than they could obtain by investing in other types of securities.

Recent studies, moreover, indicate that the number of individual investors who derive any appreciable amount of income from tax exempt securities is extremely small. One recent study, conducted by the Michigan Survey Research Center, indicated that of persons surveyed in income tax brackets of $315,000 and more, 65 per cent held some municipal bonds, but only 18 per cent derived as much as 10 per cent of their revenue from that source and only 6 per cent derived as much as 25 per cent.

I fully agree that the upper income people in this country should bear their fair income tax burden, but subjecting state and local bond interest is not the way to go about accomplishing this. There are numerous other ways that the federal government could tax the incomes of these people. In view of this, it would be very wrong for the Congress to penalize the vast majority of the American people, which limiting the state and local bond tax exemption would do, just to get to a handful of the extremely wealthy and to provide the federal government with a few more dollars (which is doubtful).

In view of these constructions, I strongly implore the members of this Committee to delete the provisions of this bill which would bring this about. Municipal governments today already have more problems than they can effectively produce solutions for, and this Congress and those of the last two decades have recognized this fact and have seen fit to institute numerous grant-in-aid programs to help the Cities with these problems; so please do not permit a financial barrier to be built, over which none of us could climb. I plead with you to bury these proposals and lay them to rest forever.

Thank you.

Respectfully submitted,

JAMES E. SUDDUTH,
Mayor of Lake Charles, President of the LMA.

CITY OF BOSTON, OFFICE OF THE MAYOR,
Boston, October 2, 1969.

Senator RUSSELL B. LONG,
Chairman, Finance Commission, U.S. Senate,
New Senate Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: Although I was hopeful that your schedule might permit me to testify before the Committee, I fully understand how the large number of such requests made such an opportunity impossible. I would, however, appreciate your making this letter a part of the Hearings record so that my concern regarding the tax status of municipal bonds be a matter of public record.

In brief I am opposed to any proposal which would involve the taxation of municipal bonds in the absence of a reliable alternative to the financial loss resulting from such a measure.

I am of course aware that interest subsidies have been considered. Unfortunately, subsidies which must survive the annual scrutiny of the appropriations process are not the answer. An interest subsidy which would pledge the long-term obligation of the U.S. Treasury (for the maturity period of the bond) is the type of substitute which alone can compensate the already hard-pressed cities for the loss of their tax free status.

Many of the devices being considered such as minimum tax, etc. are not satisfactory answers to the plight all local officials will encounter when their citizens are asked to carry additional tax burdens caused by higher interest rates from municipal bonds that are no longer tax exempt.

Sincerely,

KEVIN H. WHITE, *Mayor.*

STATEMENT OF G. T. BLANKENSHIP, ATTORNEY GENERAL, STATE OF OKLAHOMA

This is a statement for the consideration of the United States Senate Finance Committee on certain aspects of the tax bill currently under advisement. I wish to thank the Chairman and members of this committee for the opportunity to express my views.

To give an indication of the extent to which Oklahoma would be affected by certain of the proposals, consider the following:

Oklahoma has an annual appropriated budget of approximately $200,000,000.00. During the years of 1967 and 1968 the State and its various political subdivisions issued in excess of $250,000,000.00 in bonds for building schools, public health facilities, court houses, water and sewage systems, colleges, school buses, other public buildings, and myriad other public works projects which amount to more than 62% of our appropriated budget each year.

This type of financing is definitely increasing because of the problems a state or political subdivision continually faces in raising an ever-increasing amount of revenue to meet the need and demand for an ever-increasing number of services. It is then quite proper to project that within relatively few years the bond financing technique will equal or exceed in amount appropriated expenditures.

No one can seriously doubt that the effective removal of the tax exempt feature of municipal bonds would have a catastrophic effect on the financing of public works in my state. The mere consideration of this bill by the Congress has already caused increased interest costs to the states, and in some instances has apparently caused bond offerings to fail for want of a single bid from a buyer.

In many states, and in my own, the legislators are having to give consideration to changes in legislation to raise the established maximum interest rate, with all the attendant delays, because in many instances the chaos resulting from concern over this tax bill makes present interest limitations totally unrealistic, and renders it unlikely that the bonds could be sold. We are thus already in fact suffering the effects of the tax bill.

There are many philosophical, political, and policy considerations which mitigate against these tax proposals.

The first is that our Senators and Congressmen are elected by the people of their states to be the people's representatives in Washington, and have the attendant duty to represent the interests of their states. To pass such a measure with such drastic adverse effects on the states, especially without any significant monetary gain (but with substantial increase in the national government's power) is contrary to the fundamental tenets of federalism.

It cannot be seriously advocated by any student of government that the projects imperiled by this bill in 50 different states with significant variations in laws, institutions, geography, and economies, can be better administered on a national level. Local administration is axiomatically more responsive to local needs. It would be extren .ly impractical to implement the interest subsidy proposals for the simple reason that to determine the amounts of subsidies within the proposed percentages allowable requires either arbitrary, or practically administratively impossible, evaluations of "micro" government on the "macro" governmental level. The effect then is an effective step toward the crippling, or destruction, of a highly responsible (local) and correlatively more efficient and effective municipal financing system grounded on 100 years of experience. The proffered substitute is an untried, unproven, briefly considered proposal, the expressed intention of which is to "get" some tax avoiders, most of whom are taking greatest advantage of other tax preferences, rather than mainly exploiting the exemption on income from municipal bonds.

Let us consider alternatives facing the states. The most drastic possibility is the potential collapse of the present municipal bond market, forcing states into competition with corporate bonds at a correspondingly higher interest cost, at a time when we can least afford it.

Another is initially an indirect Federal subsidy (i.e. reimbursement) followed eventually by direct Federal subsidy (for the project itself) with the attendant bureaucratic interference with local programs, the net result being that state and local government will be less rather than more responsible, which is not desirable.

Another alternative is the concept of advance funding, forcing the states to operate on a cash-in-hand basis. The states would then be placed in a position of curtailing services for years to accumulate enough cash to finance projects in a time of spiraling inflation, and labor and material costs.

There are legislative alternatives available for the Congress. Among these are the so-called Urbank, and the proposed Municipal Bond Guarantee Corporation. Evaluation and criticism of these proposals have already been made. A serious and critical suggestion was offered by the Honorable Norbert T. Tiemann, Governor of Nebraska, that any proposal in this area be studied carefully. I think that proper evaluation would necessarily involve the private as well as governmental sector. The considerations are too significant to lack proper thorough examination.

The inclusion of municipal bond income in gross income to determine a minimum income tax or for the limit on tax preference would seem ultimately to work a tremendous hardship on local government without necessarily removing any inequities in income tax assessment. That is, a persuasive argument can be made that the buyer of tax exempt bonds takes them with less interest cost to the issuing government (then less tax dollars) in exchange for the reduction in his income tax liability; if the tax exempt feature is removed, such bonds will not be sold without increasing the income to the purchaser (to offset his tax liability) and thereby directly increasing the amount of tax money needed to be spent to pay the higher interest costs, thus placing the increased tax burden on the middle-income taxpayer who supplies the vast bulk of tax dollars. The effect, then, of removing the tax exemption feature of municipal bonds is to place another indirect tax on the ordinary taxpayer.

There ~re significant constitutional questions to be raised concerning the attempt to place an income tax on municipal bond interest. Our United States Supreme Court has thwarted one such prior attempt in the *Pollack* v. *Farmers' Loan & Trust Company* case.

The Court maintained that position in *National Life Insurance Co.* v. *United* States. See also *Macallen* v. *Massachusetts.*

If this proposal is adopted the states will be forced into an unwanted posture. If the national government could constitutionally abrogate state sovereignty by taxing municipal bond income, cannot the states in turn tax the income on federal securities? Will the effects of this proposal work so drastically on the states that they will be forced to bring about explicit constitutional protection? The implications of this legislation are too profound to warrant adoption without extensive inquiry being made into methods by which the hardship would be worked upon the states and the taxpayers could be avoided, and the interests of the people be protected.

STATEMENT OF FRANCIS B. BURCH, ATTORNEY GENERAL, STATE OF MARYLAND, ON BEHALF OF NATIONAL ASSOCIATION OF ATTORNEYS GENERAL

I am Attorney General of the State of Maryland. I am a member of the Executive Committee of the National Association of Attorneys General which I represent here. Our Association consists of the chief law officers of each of the 50 States and also of the Territories.

Our Association is proud that in 1938 it fathered the Conference on State Defense, which is the coalition of the national organizations of state and local governments and of the respective executive, fiscal and law officers of the States and local governments. They join together at our invitation to preserve the exemption of state and local government institutions from federal taxation.

Each time in the past three decades when attempts were made to withdraw the tax exemption of state and local government bond income, we have appeared here by one of our number and protested. We are gratified that the announcement of the present hearings contains no proposal for the withdrawal of this exemption on a non-optional basis. We are committed to resist any such attempt.

We agree with the fiscal and economic position of the other state officers' associations represented on this panel. But as the chief law officers of the States, our special competence is as to the legal aspects of proposals in this field. In 1939 the State Attorneys General of that day submitted a brief to this Committee asserting the unconstitutionality of any federal tax on our broad interest without state consent. (Incidentally, the present Chief Justice of the United States Supreme Court was one of the signatories—he was then Attorney General of California.) We commend that brief to you and submit that nothing has happened in the intervening 30 years to change its conclusions.

I know that law is a prediction of what a court will do in fact and that some good lawyers do not predict as we do. But we submit that any retreat from the doctrine of the reciprocal constitutional immunity from the federal and state governments' taxation of each other reached its high water mark in 1938. From then on the trend has been toward increasing reaffirmation of reciprocal constitutional immunity.

It remains true that the Supreme Court unanimously held unconstitutional any federal taxation of state and local government bond interest in *Pollock* v. *Farmer's Loan & Trust Co.*, 157 U.S. 429. From that proposition the Court has never retreated.

Cases in the 1930's imposed a qualification on the general doctrine of immunity, when it was sought to apply it to the profits of construction contractors and tenants and the salaries of public officers. (*James* v. *Dravo Contracting Co.*, 320 U.S. 134; *Helvering* v. *Mountain Producers Corp.*, 303 U.S. 376; *Helvering* v. *Gerhardt*, 304 U.S. 405). The qualification, in the case of governmental functions, is that the immunity cannot be claimed unless the tax in question threatens to burden the conduct of state and local governments unduly. As for bond interest, it is unquestionable that income tax would constitute such an undue burden.

Indeed, I must note that for that reason, among others, we will be supporting a modification by the Congress of its mislabeled definition of industrial development bonds in the Revenue and Expenditures Control Act of 1968. That matter, we understand, will be the subject of separate hearings and we will be back with our suggestions at that time.

You will note that as I stated our legal opinion it was that state and local government bonds may not be taxed by the Federal Government without State consent. Conversely, if a State consents, Congress may lawfully tax its bonds and those of its municipalities. If, then, the enumerated proposals on the Committee's agenda under this subject are unequivocably kept optional for each state, it will avoid the stated constitutional obstacle.

We have one qualification, however. It is addressed to any proposals which might make it optional to individual municipalities to trade the exemption of their bonds for a promise of a federal interest subsidy. For that to be legally possible the *state* of which the municipality is the agency must give its authorization by state statute.

The constitutional immunity inheres in the sovereignty of the States. In the case of political subdivisions, it is derived from their nature as state instrumentalities. Thus the cities may not themselves yield the immunity unless their respective states consent.

This is illustrated by the two Federal municipal bankruptcy act cases, which involved the bonds of political subdivisions. The first municipal bankruptcy act was held unconstitutional because it did not call for state consent to federal adjustment, in bankruptcy, of municipal obligations. *Ashton* v. *District No. 1*, 298 U.S. 513. When the act was amended to require state consent, it was upheld. *United States* v. *Bekins*, 304 U.S. 27.

It is difficult to exclude policy considerations from legal appraisals. That is why we caution you against the dangers of federal control of state and local policies in the area of exclusive state and local responsibility. The two proposals identified by your press release can hardly avoid these dangers.

They both call for taxation of our obligations, directly in the first proposal and indirectly in the second, with the Federal Government paying the additional cost of borrowing on a taxable basis.

With the Federal Government called on to make annual appropriations for this purpose, no one can be certain that sooner or later conditions will not be attached, and that these conditions reflecting the Federal policy of the moment, would not displace state and local government policy in matters that the Tenth Amendment to the Constitution reserves to the States.

We also frankly fear lest any plan subvert state and local governments free access to the conventional tax exempt any market. Any option to the States in a tax proposal will be a *real* option only if the private tax-exempt market continues viable and strong.

We note that the states' constitutional immunity rests upon a policy judgement by the Supreme Court that taxation of state and local government borrowing can weaken the States as independent sovereignties and as the repository of local self-government in this country, and that such weakening violates the constitutional framework of our federal system.

That policy is at least as valid for you gentlemen, as legislators. The Congress is well advised to stop far short of the line of rupture which forces the Court to intervene to preserve the federal system.

As we appraise these two identified substitutes for or supplements to tax exempt borrowing, we ask if they are worth the risk. As to the first proposal—direct taxation with federal subsidy—we are convinced the risk is too great. As to the second proposal—indirect borrowing through a subsidized federal institution—you must understand that we continue skeptical. The proponents have an uphill fight to avoid the dangers I have mentioned. If they cannot avoid those dangers, the plan would be unacceptable.

In marketing our obligations through these conventional channels we have had a minimum of delay. For example, in Maryland, our 1968 First Series was approved by the Board of Public Works (consisting of our Governor, Comptroller and Treasurer) on July 3, 1968 and the sale was held only 13 days later on July 16 with the settlement held on August 14. Our 1969 First Series was approved December 17, 1968 and the sale was held January 21, 1969 with settlement on February 19. We cannot expect such expedition if Federal administrators must be added to the processing of our bond issues particularly if we have to negotiate differences in viewpoint.

Delay at best postpones the realization of needed public works. Sometimes it can be very costly in money as well. For example, the 1968 issue I mentioned produced a net interest cost to the State of 3.9491% in the July, 1968, sale. The 1969 issue, only six months later, cost us 4.3254%.

STATEMENT OF MACDONALD GALLION, ATTORNEY GENERAL OF ALABAMA

Those provisions of the tax reform bill pending before the Finance Committee of the United States Senate which changes the tax exempt status of municipal bonds can cause economic havoc and place an additional burden on the already overburdened individual taxpayer. Removing the tax exemption on municipal bonds will automatically shift the extra cost to local taxpayers in the form of additional taxes. To call this "tax reform" is a cruel hoax in attempting to mislead the American people into believing such legislation will help the "little man." Not only must the increased cost be met by higher property taxes, but citizens can expect to pay higher water bills, public hospital costs and all public facilities which have been financed by the issuance of municipal bonds. On the other hand is a stagnation of progress in public projects direly needed in almost every municipality, both large and small.

As Attorney General of Alabama I am strongly opposed to a change in the existing Federal law. The tax-weary people of Alabama can hardly bear additional tax yokes hung about their necks. This is the inevitable result of the contemplated action of changing this law.

STATEMENT OF LOUIS J. LEFKOWITZ, ATTORNEY GENERAL, STATE OF NEW YORK

This statement is addressed to the provisions of H.R. 13270, now being considered by this honorably body, which drastically alter the tax treatment of interest on state and municipal bonds.

As Attorney General of the State of New York I wish to state my strong opposition to these provisions on the following grounds:

1. Taxation of the interest on state and local bonds operates on the power to borrow before it is exercised. However this tax is imposed and whatever guise it takes, it is a tax on the power of the states and their instrumentalities to borrow money and is consequently repugnant to the United States Constitution. The power to tax, as our Supreme Court stated early in our history, is the power to destroy. Any impairment of the direct execution of the powers of a state, in particular, of the power to raise monies required for the fulfillment of sovereign obligations and the exercise of sovereign functions, is in my view clearly unconstitutional. Furthermore, it is my opinion that any infringement of the preferential nature of state and local debt would undermine the traditional and undoubted power of the states and their municipalities, reserved to them by the 10th Amendment to the Constitution, to deal independently with state and local policies and problems and the needs of their citizens.

2. In addition, this altered tax treatment would impose an intolerable burden on the ability of states and local governments to finance capital programs. Since, under such legislation, the State and its agencies, as well as the municipalities, would be in direct competition with private, non-exempt bond issues, it is apparent that the interest rate on public bonds would rise to the level of that commanded by the private issues. Clearly, such an eventuality would frustrate billions of dollars of local and State capital projects except at a doubling or tripling the cost. Such a result, in the face of the existing financially straitened circumstances in which the State and its cities are already operating, would inevitably bring about the cancellation of many necessary programs. Our citizenry evince an unwillingness to pay more in State and local taxes than they now pay; we are already faced with what amounts to a tax revolt. Both on the State and local levels we are presently operating under austerity budgets. To create a situation in which even more of the burden is thrown upon the State and its cities is inconceivable.

3. As a practical proposition I suspect that the additional income tax which would inure to the federal government would be less than the additional costs which would be imposed upon the State and cities, so that if the federal government were to assume "in lieu" subsidies to cover the differential in cost, it would find itself paying out a greater sum that the amount it receives as a result of the altered tax treatment of tax exempt interest. Moreover, if consideration be given to the costs of administering such an "in lieu" program plus the inevitable frictions and delays which relate to such a program, it is apparent that any "net" revenue to the national government would be questionable if not nonexistent. I must note also that such subsidization implies a greater and greater centralization of power in Washington and less and less freedom in local and State control over what are essentially *non-federal* projects.

In summary, federal incursions of this character into the area of state and local powers are constitutionally unjustifiable. Of equal importance, is the inescapable fact that they would render raising of funds by the states and municipalities even more difficult, if not impossible, at a time when the requirement for such funds is almost overwhelming. For all of the foregoing reasons, I respectfully suggest that the provisions relating to the tax treatment of interest on state and local bonds should not be enacted.

This statement will be supplemented by a memorandum of law dealing with the constitutional aspects of the proposed legislation. Our memorandum will be filed on or before October 1, 1969.

Dated: September 19, 1969

LOUIS J. LEFKOWITZ,
Attorney General of the State of New York.

MEMORANDUM PRESENTED TO U.S. SENATE IN OPPOSITION TO PROPOSAL TO TAX STATE AND MUNICIPAL BOND INTEREST—THE CONSTITUTIONAL IMMUNITY OF STATE AND MUNICIPAL SECURITIES

This memorandum, submitted in opposition to the enactment of the local bond interest provisions of H.R. 13270 and in supplementation of my statement presented to the Senate Finance Committee on September 22, 1969, deals with the absence of power in the Federal Government, under the Constitution of the United States, to impose such a tax.[1]

The fiscal and economic effects of Federal taxation of interest upon bonds issued by the State and its local subdivisions were presented by Governor Nelson A. Rockefeller of New York State and by me by written statements filed with the Senate Finance Committee on September 22, 1969.

Such effects, it has been shown, would be to add staggering amounts to the cost of State and municipal financing. The additional cost would be so formidable a burden upon the people of the State that the certain, inevitable effect would be to put a halt to the provision of essentially necessary facilities for the people, by the State, is counties, cities, towns, villages, school districts, improvement districts, fire districts and Authorities. Public housing, the elimination of water pollution, the building of State hospitals, State highways and other public projects could not go on. The local communities—many desperately requiring new facilities because of growth in population and urban deterioration in recent years—could not provide the schools, hospitals, streets, transit, sewage, water supply and fire fighting facilities that they so urgently need. Not only could the increased cost not be absorbed but the tax exempt feature, gone, the municipals particularly and the State bonds as well, would lose their sales appeal, and the source of State and local funds by borrowing would be vastly and seriously limited.

Thus, it is indisputably clear that such a tax would place a burden, actual, substantial, direct and tangible, in nowise merely conjectural or uncertain, upon the State in the performance of the functions which in the very nature of our constitutional system of government are those of the State and local units of government. It is a judicially recognized fact that the imposition of such a tax which would cut off the ability of State and localities to provide these facilities for the people, both by making the cost burden one that cannot be met and by impeding the power to borrow, could spell the end of State and municipality as vital units of government.

Under the Constitution of the United States, such a tax may not be levied. The Supreme Court of the United States so holds.

Immunity has its source in basic constitutional provisions and principles

Proposals to tax State and municipal bond interest have been before the Congress recurringly during the last several decades, but the Congress has either declined to consider such measures or rejected them after consideration.

The invalidity of such a tax is implicit in the basic framework of our Federal system of government. Our government was formed of a "union" of states (Preamble to the Constitution; cf. Mr. Justice Frankfurter in *Graves* v. *New*

[1] For an authoritative and exhaustive review of the subject see the brief prepared under the aegis of the Attorneys General of the United States and Counsel for Certain of Their Municipal Subdivisions entitled "The Constitutional Immunity of State and Municipal Securities—A Legal Defense of the Continued Integrity of the Fiscal Powers of the States" (1939; 420 pages).

York ex rel. O'Keefe, 306 U.S. at p. 488; Mr. Justice Douglas in *New York* v. *United States*, 326 U.S. 594, 596-597). It was not a central government in its origin, divided into units by a central power. It was the States through which the people spoke in ratifying the Constitution. The National Government is one of delegated powers. The people and the States which united to form that National Government retained all powers except those which they surrendered to the Federal Government (10th Amendment). Governmental power over internal affairs is, by the Constitution, distributed between the National Government and the several States (*United States* v. *Belmont*, 301 U.S. at p. 330). Each is sovereign in its own sphere.

From this basic concept the courts have drawn and developed the principle that taxes may not be imposed by the Federal or State governments, the one upon the other, which would burden and obstruct the operations of either.

In order that this Federal system, to include the states, cities and other units of government shall endure, in order to protect "the continued existence of the state" (*Helvering* v. *Gerhardt*, 304 U.S. at p. 421), no taxes by the Federal Government may be levied which would straiten them by depriving them of the means of performing those functions which it is their province to exercise for the people (Mr. Justice Douglas in *New York* v. *United States*, 326 U.S. at p. 598).

The immunity of the States from Federal taxation, which would hamper them from performing their essential functions, flows from the same basic principles as the Federal Government's immunity from State taxes which would have the same effect. The necessity of that immunity to the National Government, as essential to permit it to function, is one of which the Congress is acutely aware.

I

To preserve our dual system of government, Congress has the responsibility not to enact a law which would hamper and ultimately destroy the ability of the States to exercise the powers expressly and deliberately reserved to them in the Constitution (10th Amendment).

The responsibility of the Congress to preserve our dual system of government, particularly to preserve and maintain the integrity of the States and their governmental subdivisions, is profound. It is a responsibility which is primarily that of the Congress. Only if the Congress has not fulfilled that responsibility, is it, the province of the courts to declare its action unconstitutional. The United States Supreme Court approaches the construction of statutes which present the issue of encroachment of the Federal Government upon the States, on the assumption that the representatives of the States in the Congress would decline to surrender the independence of the States. So in *Helvering* v. *Gerhardt*, 304 U.S. at p. 416, the Court said:

> "The very fact that when they [representatives in Congress] are exercising it [the national taxing power] they are taxing themselves, serves to guard against its abuse through the possibility of resort to the usual processes of political action which provides a readier and more adaptable means than any which courts can afford, for securing accommodation of the competing demands for national revenue, on the one hand, and for reasonable scope for the independence of state action, on the other."

See, also, *New York* v. *United States*, 326 U.S. at p. 582.

Thus, the courts point to the initial duty of the Congress to abide by the declaration of the Constitution (10th Amendment) that those powers not granted to the government of the United States are reserved to the States and, abiding by that constitutional declaration, not to enact any law which would render that reservation meaningless by stripping the States of the wherewithal to exercise the powers which the people declined to surrender to the National Government and were deliberate in reserving to the States.

"The ultimate touchstone of constitutionality," said Mr. Justice Frankfurter in the *O'Keefe* case (306 U.S. at p. 491) is "the Constitution itself." It is the constitutional duty of the members of Congress to refrain from the imposition of taxes which would render the States powerless to function by making the cost so excessive that it cannot be met, and by reducing dangerously the ability to raise money through sale of bonds. For so the existence of the States as free, independent units of government which the Constitution intended and provided, could end. The United States Supreme Court has said:

> "It rests on the law of self-preservation, for any government, whose means employed in conducting its strictly governmental operations are subject to the control of another and distinct government, exists only at the mercy of the latter." (*Ambrosini* v. *United States*, 187 U.S. 1, 7)

That is simple fact for the Congress to consider carefully and seriously.

II

The United States Supreme Court has never departed from the principle that the Congress may not enact a law which will obstruct the functioning of State government.

The several opinions of the United States Supreme Court in *New York* v. *United States*, 326 U.S. 572 (1946), make it indisputably clear that the Court deems the States immune from Federal taxation where such taxation would impede or curtail them in the performance of their sovereign functions.

In one of the prevailing opinions, Justices Reed and Burton concurring, Chief Justice Stone unmistakably forecast that the Court would disapprove any Federal tax which would:

> "so affect the State, merely because it is a State that is being taxed, as to interfere unduly with the State's performance of its sovereign functions of government. The counter-part of such undue interference has been recognized since Marshall's day as the implied immunity of each of the dual sovereignties of our constitutional system from taxation by the other. *McCulloch* v. *Maryland*, 4 Wheat. 316."

The issue in that case was considered and determined by the Court on the premise that a tax is invalid which "unduly interferes with the performance of the State's functions of government" (p. 588), and declared it "plain" that a tax is invalid which "infringes" "in some manner" upon the State's performance "of its functions as a government which the Constitution recognizes as sovereign" (p. 588), continuing (pp. 589–590):

> "The problem is not one to be solved by a formula, but we may look to the structure of the Constitution as our guide to decision. * * * neither government may destroy the other * * * or * * * seriously * * * impair * * * the appropriate exercise of the functions of the government affected by it. *Metcalf & Eddy* v. *Mitchell, Supra*, 523–524."

Another opinion in that case said squarely (p. 584):

> "All agree that not all of the former immunity is gone."

The dissenting opinion in the case, written by Mr. Justice Douglas, in which Mr. Justice Black concurred, was strong in its emphasis upon the sovereignty of the States in our scheme of government and upon immunity from Federal taxation as an essential concomitant of that sovereignty. He said (taking as granted that the Constitution gives to the States "immunity from a tax on the issuance of securities" [p. 591]):

(p. 592):

> "* * * the sovereignty of the States * * * has been understood throughout our history."

(p. 592):

> "Woodrow Wilson stated the starting point for me when he said that 'the States of course possess every power that government has ever anywhere exercised, except only those powers which their own constitutions or the Constitution of the United States explicitly or by plain inference withhold. They are the ordinary governments of the country; the federal government is its instrument only for particular purposes.' "

(p. 592):

> "It is antagonistic to the very implications of our federal system to say that the power of Congress to lay and collect taxes, Article I, § 8, includes the power to tax any state activity or function so long as the tax does not discriminate against the States."

Going back to earlier decisions of the Court, he quoted:

(pp. 592–593):

> "As stated in *United States* v. *Railroad Co.*, 17 Wall. 322, 327–328, 'The right of the States to administer their own affairs through their legislative, executive, and judicial departments, in their own manner through their own agencies, is conceded by the uniform decisions of this court and by the practice of the Federal government from its organization. This carries with it an exemption of those agencies and instruments, from the taxing power

of the Federal government. If they may be taxed lightly, they may be taxed heavily; if justly, oppressively. Their operation may be impeded and may be destroyed, if any interference is permitted.' "

Specifically, State and Municipal securities were to him *a fortiori* constitutionally immune from Federal taxation:

(p. 593):

"Can it be that a general federal tax on the issuance of securities would be constitutional if applied to the issuance of municipal securities or of state bonds or of the securities of public utility districts organized by the States?"

(p. 592 footnote):

"As stated in *United States* v. *California*, 297 U.S. 175, 184, 185, the immunity of state instrumentalities from federal taxation 'is implied from the nature of our federal system and the relationship within it of state and national governments, and is equally a restriction on taxation by either of the instrumentalities of the other.' "

He cautioned:

(pp. 593–594):

"A tax is a powerful, regulatory instrument. Local government in this free land does not exist for itself. * * * Local government exists to provide for the welfare of its people, * * *. If the federal government can place the local governments on its tax collector's list, their capacity to serve the needs of their citizens is at once hampered or curtailed. The field of federal excise taxation alone is practically without limits. Many state activities are in marginal enterprises where private capital refuses to venture. Add to the cost of these projects a federal tax and the social program may be destroyed before it can be launched. In any case, the repercussions of such a fundamental change on the credit of the States and on their programs to take care of the needy and to build for the future would be considerablւ. * * * the power to tax lightly is the power to tax severely. The power to tax is indeed one of the most effective forms of regulation. And no more powerful instrument for centralization of government could be devised."

(p. 594):

"The Constitution was designed to keep the balance between the States and the Nation outside the field of legislative controversy."

He recalled:

(pp. 594–595):

"The immunity of the States from federal taxation is no less clear because it is implied. The States on entering the Union surrendered some of their sovereignty. It was further curtailed as various Amendments were adopted. But the Tenth Amendment provides that 'The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to he people.' The Constitution is a compact between sovereigns. * * * If the power of the federal government to tax the States is conceded, the reserved power of the States guaranteed by the Tenth Amendment does not give them the independence which they have always been assumed to have. They are relegated to a more servile status. They become subject to interference and control both in the functions which they excise and the methods which they employ. They must pay the federal government for the privilege of exercising the powers of sovereignty guaranteed them by the Constitution * * *."

Worthy of particular note is his view that a tax which would curtail State acivity in many fields would have an adverse effect on the *Federal* tax burden:

(p. 598):

"There is no showing whatsoever that an expanding field of state activity even faintly promises to cripple the federal government in its search for needed revenues. If the truth were known, I suspect it would show that the activity of the States in the fields of housing, public power and the like have increased the level of income of the people and have raised the standards of marginal or submarginal groups. Such conditions affect favorably, not adversely, the tax potential of the federal government."

See also: pp. 594, 596–597.

Thus, the United States Supreme Court maintains the sovereignty of the States and the attendant principle of immunity from Federal taxation as an indispensable essential of that sovereignty and, indeed, of their continued existence.

Between Chief Justice Marshall's statement of this unalterable truth as arising from the fact that "the power to tax is the power to destroy", and Mr. Justice Douglas' statement of the reason as that "the power to tax is indeed one of the most effective forms of regulation. And no more powerful instrument for centralization of government could be devised" (326 U.S. 594), have been a long succession of decisions affirming and reaffirming the doctrine of immunity.

The argument of those who urge a tax by the Federal or State government is based on a mistaken or wishful theory that the Supreme Court in recent years has eroded the immunity doctrine to the point of extinction. It is not so.

Following *New York* v. *United States*, from which we have quoted at length, *supra*, the Supreme Court in *Wilmette Park District* v. *Campbell*, 338 U.S. 411 (1949), affirmed the principle that a tax does not offend the principle of immunity *only* " 'when the burden on the state is so speculative and uncertain that if allowed it would restrict the federal taxing power without affording any corresponding tangible protection to the state government' " (p. 419). The opinion (p. 420) also indicated unmistakably that a tax which would cause "the volume of its [the State's] revenues" to suffer, would be unconstitutional.

In *United States* v. *Allegheny Co.*, 322 U.S. 174, it was held distinctly that "the trend of recent decisions" was not in the direction of "impairing the immunity of the state or nation itself" (p. 186; see also p. 194).

In *Alabama* v. *King & Boozer*, 314 U.S. 1. in an opinion in which, of the present Court, Justices Black and Douglas concurred, Mr. Justice Stone made clear his acceptance of the doctrine that a tax would be invalid where "the economic burden" thereof would fall upon the Government (p. 12) or where it was "an infringement of the Government immunity" (p. 14).

Going back to 1938, and 1939, to *Helvering* v. *Gerhardt*, 304 U.S. 405, and *Graves* v. *N.Y. ex. rel. O'Keefe*, 306 U.S. 466, the cases which held that the salaries of State employees are taxable by the Federal Government and the salaries of Federal employees are taxable by the States, the opinions in those cases leave unimpaired the immunity of the States from a Federal tax, where the burden upon the State function is "actual and substantial" (*Helvering* v. *Gerhardt*, 304 U.S. 421). The Court in the *Gerhardt* case recognized that "the basis upon which constitutional tax immunity of a State has been supported is the protection which it affords to the continued existence of the State", and that a tax is invalid which "precludes or threatens unreasonably to obstruct any function essential to the continued existence of the State government" (304 U.S. at pp. 421, 422; see also p. 424).

In the *O'Keefe* case, the Court was again explicit in expressing its continued acceptance of the doctrine of immunity. At pages 477–478 it said:

> "The theory of the tax immunity of either government, state or national, and its instrumentalities, from taxation by the other, has been rested upon an implied limitation on the taxing power of each, such as to forestall undue interference, through the exercise of that power, with the governmental activities of the other."

See also page 480 where the Court recognized "the purpose" of the immunity as one "to avoid interference with the functions of the taxed government", and page 481 where the Court pointed out that the argument for constitutional immunity would be "that the economic burden of the tax is in some way passed on so as to impose a burden" "tantamount to an interference by one government with the other in the performance of its functions". At pp. 483–4 the Court again said that the "purpose of the immunity" is "to prevent undue interference with the one government by imposing on it the tax burdens of the other". Finally, at page 486, the Court accepted the principle of immunity where the effect of the tax is that a "tangible or certain economic burden is imposed on the government concerned." Justice Black concurred in the majority opinion in this case.

The concurring opinion declared (p. 488) that:

> "neither [the State nor Federal government] through its power to tax can be allowed to cripple the operations to the other. Therefore state and federal governments must avoid exactions which discriminate against each other or obviously interfere with one another's operations".

Shortly before the decision in the *Gerhardt* case, the Court in *Helvering* v. *Mountain Producers Corp.*, 303 U. S. 376 (1938) tested the validity of a tax by whether it was "a direct and substantial interference" with State government (303 U. S. at pp. 384, 387). See also, *Helvering* v. *Therrell*, 303 U. S. 218, 233.

That the principle remains unchanged and is as viable today as the first day it was judicially uttered is attested by a decision rendered but two years ago. In *State of Maryland* v. *Wirtz*, 269 F. Supp. 826 (D. Maryland, 1967), the Court said (at pages 848–9):

> "Limitations on the taxing power have been recognized when the exercise of that power would unduly interfere with the governmental activities of the States. This principle is implied from the independence of the national and state governments within their respective spheres and from the provisions of the Constitution which look to the maintenance of a dual system."

And the Court added (at page 849):

> "The limitation on the taxing power—under interference with a State's performance of its sovereign functions of government—responds to Chief Justice Marshall's famous dictum. The power to tax involves the power to destroy. * * * The potentially destructive power of taxation lies in the ability of one sovereign to impose an economic burden upon the functions of the other too great to be borne, thereby, curtaining or eliminating a particular activity."

The foregoing decision was affirmed by the Supreme Court in 392 U. S. 183 (1968). Although the cited case involved an extension of the Federal power over interstate commerce, Mr. Justice Douglas, in dissent, reiterated the long-established views of the Court as to taxes. He said (p. 204):

> "In the area of taxation, on the other hand, the Court has recognized that the constitutional scheme of federalism imposes limits on the power of the National Government to tax the States. *E.g.*, *New York* v. *United States*, 326 U. S. 572. The Court will not permit the Federal Government to utilize the taxing power to snuff out state sovereignty, *Metcalf & Eddy* v. *Mitchell*, 269 U. S. 514, recognizing that the power to tax is the power to destroy. *M'Culloch* v. *Maryland*, 4 Wheat. 316, 431."

He added, in holding against the proposed extension of the commerce power (p. 205):

> "If all this can be done, then the National Government could devour the essentials of state sovereignty, though that sovereignty is attested by the Tenth Amendment. The principles which should guide us in this case are set forth in the several opinions in *New York* v. *United States*, *supra*. As Mr. Chief Justice Stone said there, the National Government may not 'interfere unduly with the State's performance of its sovereign functions of government.' 326 U.S., at 587. It may not 'impair the State's functions of government,' *id.* at 594 (dissenting opinion of Mr. Justice Douglas, joined by Mr. Justice Black). As Mr. Justice Frankfurter observed, '[t]here are, of course, State activities * * * that partake of uniqueness from the point of view of intergovernmental relations.' *Id.* at 582."

Thus, it is abundantly clear that in the last fifty or more years, through depression years, defense years, war years and the uneasy post-war years, on examination and reexamination of the theory underlying immunity (*Graves* v. *New York ex rel. O'Keefe*, 306 U.S. at p. 483) by a Supreme Court of changed personnel, there has remained the basic doctrine of immunity of the States from taxation by the Federal government, where that taxation will interfere with the performance by the States of their functions. There has remained the appreciation by the Supreme Court that such interference would endanger the very existence of the States as such. There has remained the cognizance by the Court that the Constitution designed a role for State government as well as for the National government. There has remained the respect by the Court for the role of the States in our constitutional scheme of government.

No serious question exists in any mind as to the strength of the doctrine of immunity prior to 1938. Therefore to keep this memorandum within temperate bounds, we merely list without discussion or quotation some of the numerous cases, never overruled, that have sustained it:

Trinityfarm Co. v. *Grosjean*, 291 U.S. 466. See especially page 471.

Indian Motorcycle v. *United States*, 283 U.S. 570. See especially page 475.

Willcuts v. *Bunn*, 282 U.S. 216. See especially pages 224–225.

Metcalf & Eddy v. *Mitchell*, 269 U.S. 514. See especially pages 521, 522, 523.

Ambrosini v. *United States*, 187 U.S. 1. See especially page 7.

McCulloch v. *Maryland*, 4 Wheat. 316. See especially pages 429–430, 431.

Brush v. *Commissioner*, 300 U. S. 352. See especially page 354.

South Carolina v. *United States*, 199 U.S. 437. See especially page 452.

Pollock v. *Farmers' Loan and Trust Co.*, 157 U.S. 429. See especially pages 583–854, 603.

United States v. *Railroad Co.*, 17 Wall. 322. See especially page 327.

See also the decisions cited in Point III *infra*.

III

A Federal tax on State and municipal bond interest is, under express decisions of the United States Supreme Court, an unconstitutional direct burden on the States.

The United States Supreme Court has consistently held, from its earliest decisions on the subject to the present day, that to tax the interest on government bonds, Federal, State and municipal, would be to disastrously affect the borrowing power of these governments, and thus under the Constitution to be mutually prohibited.

The power to borrow money is so indispensable to government that it is expressly provided for the Federal Government in the Constitution of the United States (Article I, § 8) and like provision is made in State constitutions. It is that power which a tax upon State and municipal bond interest would endanger.

In *Smith* v. *Davis*, 323 U.S. 111 (1944) the Supreme Court in a unanimous opinion noted that interest-bearing securities of the government are tax exempt and this for the reason that they would "diminish" "the market value or the investment attractiveness" of the obligations issued to "secure necessary credit" (p. 117). The Court cited cases reaching back to early decisions of the Court sustaining such tax immunity (p. 115). See also Mr. Justice Douglas' opinion in *New York* v. *United States*, *supra*, 326 U.S. at pages 591, 593.

Smith v. *Davis* was in turn cited in *N. J. Ins. Co.* v. *Div. of Tax Appeals*, 338 U.S. 665 at page 675.

Decisions by the United States Supreme Court holding government bond interest tax exempt because of the deleterious effect on governments' borrowing power are legion.

An opinion which enjoys high prestige with the Court, *James* v. *Dravo Contracting Co.*, 302 U.S. 134, held (p. 153, Chief Justice Hughes):

> "That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' (*Pollock* v. *Farmers' Loan & Trust Co., supra*), and which would directly affect the Governments' obligation as a continuing security. Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit, * * *."

In *Helvering* v. *Mountain Producers Corporation*, the Court pointed out, 303 U.S. at p. 386:

> "* * * the interest payable on state and municipal bonds has been held to be invalid as a tax bearing directly upon the exercise of the borrowing power of the Government (*Weston* v. *Charleston*, 2 Pet. 449, 468, 469; *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U.S. 429, 586)."

In prior cases, whose authority, as we have seen, is undiminished, the United States Supreme Court has repeatedly voiced this view. We quote from just a few of the very many cases that are in accord:

Indian Motocycle Co. v. *United States*, 283 U.S. 570 at pages 576–577:

> "It has been adjudged that bonds of the United States issued to raise money for governmental purposes, and the interest thereon, are immune from state taxation, because such a tax, even though inconsiderable in amount and imposed only on holders of the bonds, would burden the exercise by the United States of its power to borrow money. *Weston* v. *Charleston*, 2 Pet. 449, 468; *The Banks* v. *Mayor*, 7 Wall. 16; *Home Savings Bank* v. *Des Moines*, 205 U.S. 503, 513; *Northwestern Ins. Co.* v. *Wisconsin*, 275 U.S. 136, 140. * * * It also has been adjudged that bonds of municipal corporations in the several States issued to raise money for public municipal purposes, and the interest thereon, are immune from federal taxation, and this on the ground that * * * under the implications of the Constitution the governmental agencies and operations of the States have the same immunity from federal taxation that like agencies and operations of the United States have from taxation by the States. *Pollock* v. *Farmers Loan & Trust Co.*, 157 U.S. 429, 584–586, 601, 652, 653; s. c. 158 U.S. 601, 618, 693."

Willcuts v. *Bunn*, 282 U.S. 216 at pages 225, 226–7:

"* * * a tax upon the obligations of a State or of its political subdivisions falls within the constitutional prohibition as a tax upon the exercise of the borrowing power of the State. *Pollock* v. *Farmers' Loan & Trust Company*, 157 U.S. 429, 584–586; *id.*, 158 U.S. 601, 618; *National Life Insurance Company* v. *United States*, 277 U.S. 508, 521.

* * * * * * *

"In the case of the obligations of a State or of its political subdivisions, the subject held to be exempt from federal taxation is the principal and interest of the obligations. *Pollock* v. *Farmers' Loan & Trust Company, supra.* These obligations constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the government. In *Weston* v. *Charleston*, 2 Pet. 449, 468, 469, where the tax, laid under an ordinance of the city council upon United States stock which has been issued for loans made to the United States, was held invalid, the principle was thus stated by Chief Justice Marshall: 'The right to tax the contract to any extent, when made, must operate upon the power to borrow, before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct government. To any extent, however inconsiderable, it is a burden on the operations of government. * * * The tax on government stock is thought by this Court to be a tax on the contract, a tax on the power to borrow money on the credit of the United States, and consequently, to be repugnant to the constitution.' This language was applied by the Court in *Pollock* v. *Farmers' Loan & Trust Company, supra* (157 U.S. at p. 586) in holding invalid federal taxation 'on the interest' from municipal securities."

Missouri v. *Gehner, et al.*, 281 U.S. 313 at pages 320 321:

"It is elementary that the bonds or other securities of the United States may not be taxed by state authority. * * * The power of Congress to borrow money on the credit of the United States would be burdened and might be destroyed by state taxation of the means employed for that purpose. As the tax-exempt feature tends to increase and is reflected in the market prices of such securities, a state tax burden thereon would adversely affect the terms upon which money may be borrowed to execute the purposes of the general government."

The Macallen Company v. *Massachusetts*, 279 U.S. 620 at pages 624, 629:

"Of course, in respect of United States securities, the statutory exemption is superfluous. A state tax, however small, upon such securities or interest derived therefrom, interferes or tends to interfere with the constitutional power of the general government to borrow money on the credit of the United States, and constitutes a burden upon the operations of government, and carried far enough would prove destructive. The principle set forth a century ago in *Weston* v. *Charleston*, 2 Pet. 449, 468, has never since been departed from by this Court:

" 'The right to tax the contract to any extent, when made, must operate upon the power to borrow before it is exercised, and have a sensible influence on the contract. The extent of this influence depends on the will of a distinct government; to any extent, however inconsiderable, it is a burden on the operations of government. It may be carried to an extent which shall arrest them entirely,' *Home Savings Bank* v. *Des Moines*, 205 U.S. 503, 513.

* * * * * * *

"In the consideration of such legislation, the controlling principle, constantly to be borne in mind, is that the state cannot tax the instrumentalities or bonds of the United States, or, what is the same thing, the income derived therefrom, directly or indirectly—that is to say, it cannot tax *them* in any form."

National Life Insurance Company v. *United States*, 277 U.S. 508 at page 521:

"It is settled doctrine that directly to tax the income from securities amounts to taxation of the securities themselves, *Northwestern Mutual Life Ins. Co.* v. *Wisconsin*, 275 U.S. 136. Also that the United States may not tax state or municipal obligations. *Metcalf & Eddy* v. *Mitchell*, 269 U.S. 514, 521."

Farmers Bank v. *Minnesota*, 232 U.S. 516 at pages 526–7;

> "But we deem it entirely clear that a tax upon the exercise of the function of issuing municipal bonds is a tax upon the operations of the government, * * *. And to tax the bonds as property in the hands of the holders is, in the last analysis, to impose a tax upon the right of the municipality to issue them. (Quoting from *Western* v. *City Council of Charleston*, 2 Pet. 449, 466, 468; *McCulloch* v. *Maryland*, 4 Wheat. 316.)
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> * * *
>
> "It is on this ground that United States bonds have always been held exempt from taxation under authority of the States. By like reasoning it has come to be recognized that bonds issued by the States are not taxable by the Federal Government, and it was upon this ground that this court held in *Pollock* v. *Farmers Loan & Trust Co.*, 157 U.S. 429, 584, that the income tax provisions of the act of August 15, 1894, were unconstitutional in that they imposed a tax upon the income derived from municipal bonds issued under the authority of the States."

Hibernia Savings & Loan Society v. *San Francisco*, 200 U.S. 310 at page 313:

> "The efficiency of the Government service cannot be impaired by a taxation of the agencies which it employs for such service, and, as one of the most valuable and best known of these agencies is the borrowing of money, a tax which diminishes the slightest degree the value of the obligations issued by the Government for that purpose impairs *pro tanto* their market value."

It is unnecessary to quote from the pioneer cases holding that government bond interest may not be taxed because of its burden and inevitable effect upon the power to borrow the necessary funds for the operation of government, even to the point where it could "arrest them entirely" (*Pollock* v. *Farmers' Loan & Trust Co.*, 157 U.S. 429, 586. See also pages 585, 601, 652, 653; s. c., 158 U.S. 601, 618, 693). Their frequent citation in the later cases has made them and the well-known subsequent cases familiar, e.g., *Weston* v. *City of Charleston*, 2 Pet. 449; *Bank of Commerce* v. *New York City*, 2 Black 620; *The Banks* v. *Mayor*, 7 Wall. 16; *United States* v. *Railroad*, 17 Wall. 322; *Pollock* cases, *supra; Home Insurance Co.* v. *New York*, 134 U.S. 598; *Home Savings Bank* v. *Des Moines*, 205 U.S. 503, *Smith* v. *Kansas City Title Co.*, 255 U.S. 180, 213; *Metcalf & Eddy* v. *Mitchell*, 269 U.S. 514, 522; *Northwestern Ins. Co.* v. *Wisconsin*, 275 U.S. 135, 140; *Hale* v. *State Board*, 302 U.S. 95, 107.

It is thus clear beyond doubt that the United States Supreme Court has held and holds that to tax the interest on government bonds is to tax "the means" (*James* v. *Dravo Contracting Co.*, 302 U.S. at p. 153) by which government raises the money without which it cannot function, because such tax would not only increase the cost of government but would inevitably curtail the market for the bonds. The disaster that would be the product of such tax is one that the National Government may not constitutionally visit upon the States and their subdivisions—the partners in our governmental system as created by the Constitution.

CONCLUSION

This memorandum is but a summary of the principles under which a Federal tax upon State and municipal bond interest is unequivocally unconstitutional. An extended study developing these principles and citing other principles supporting the conclusion of unconstitutionality would but be laboring the point, and we have therefore confined the length of our discussion.

There is not a member of the Congress who would forfeit the existence of his State, his county, his city, town or village. If he were to impose the proposed tax he is on the way of doing just that. He is imperiling the highways, schools, hospitals in his home State and community, the needed fire fighting facilities, the public housing development—all the essential and enterprising activities of his home State, his home city or village. He is stopping their progress and growth on the day he votes for this tax. For by imposing costs that he knows full well his State and community cannot meet, by taking away the ability of his State, his county, his school district to market their bonds holding out the attraction of freedom from Federal tax on the very modest interest rate which the purchaser receives, he is drying up the funds of his home State and community without which they cannot continue to progress.

The framers of the Constitution recognized that such is the danger is surrender of State power to the National government, and reserved therein the powers of the States. The Courts translated that principle into immunity of the States from National taxation which actually and substantially places a burden on the States' functions. Holding that immunity essential to the independence of the States—and the independence of the States the essence of our form of government—the Courts have to this day held a Federal tax constitutional only when its impact upon the States is merely "conjectural" and uncertain. They have held it invalid and unconstitutional when the impact upon the States would be to hamper them in the exercise of their powers as the vital units in our system of government that they are.

> "* * * the very nature of our constitutional system of dual sovereign governments is such as impliedly to prohibit the federal government from taxing the instrumentalities of a state government, and in a similar manner to limit the power of the states to tax the instrumentalities of the federal government.
>
> * * *
>
> "* * * recourse may be had to the reason upon which the rule rests, * * *. * * * it rests on the conviction that each government, in order that it may administer its affairs within its own sphere, must be left free from undue interference by the other. * * * neither government may destroy the other nor curtail in any substantial manner the exercise of its powers."
>
> (*Metcalf & Eddy* v. *Mitchell*, 269 U.S. 514, 521, 523.)

Dated: September 29, 1969.

Respectfully submitted,

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Attorney General of the State of New York,
The Capitol, Albany, N.Y.
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Statement of Crawford C. Martin, Attorney General of Texas

Texas is one of the states in which bond issues of state and local government are examined as to legality by the attorney general. During 1968 my office approved approximately 700 separate bond issues, the principal amount of which aggregated more than $950 million. So I am acutely aware of the grave threat to the financial welfare of local government which is the inevitable result of any Congressional tampering with its historic right to issue bonds which are exempt from Federal income taxes.

Aside from the practical and economic handicap on capital financing by state and local government, H.R. 13270 presents two gravely disturbing aspects when viewed from the standpoint of the Attorney General of Texas.

1. The myriad of legal questions so obviously inherent in the bill makes certain that prolonged litigation, extending over a number of years, will be an unavoid-debt service charges in relation to legal limitation on generation of revenues by the courts, the examination of new bond issues must be suspended while hard pressed local governmental units are denied access to capital funds to meet their ever increasing needs.

2. Even in those instances where the obstacle of litigation might be overcome, it can be confidently predicted that because of the threat of loss of tax exemption, interest rates on state and local government bonds will soar to the point that debt service charges in relation to legal limitation on generation of revenues by many governmental units will preclude the approval of their proposal bond issues.

Texas has many classes of bonds which are payable from limited ad valorem taxes; bonds of cities, county bonds for a number of purposes, hospital districts and other districts. These all have rigidly limited budgets for payment of bond interest and principal. The seriousness of just the threat to tax exemption on bonds of these governmental units is illustrated by the case of a hospital district which, for example, might have a taxing power which fixes the limit on its debt service budget of $3250,000 annually. This will amortize a $5 million hospital bond issue provided bonds can be sold at a 5% interest rate. But increase the rate of interest to 7½% (the Second Called Session of the 61st Texas Legislature has just enacted a bill which removes all statutory limits on interest rate of local governmental agency bonds), and the maximum amount of bonds which can be amortized within the same period with this same $325,000 annual debt service budget is automatically reduced to $3,940,000. This is the maximum amount of bonds which can be legally issued. Where is the missing $1,060,000 to come from?

The same principle applies with respect to hundreds of revenue bond issues examined by my office annually. The various types of public projects which are financed in Texas by the issuance of revenue bonds are numbered in the dozens: water supply, sewage treatment, college dormitories, hospitals, transit facilities, recreation facilities, and many others which are essential under conditions of economic expansion such as we are experiencing in Texas. Since projects financed with revenue bonds are secured by a pledge of the net operating income of the project, established usually by past experience, then any increase in interest rate operates to reduce the amount of principal which can be paid within the limits of available income. This condition is aggravated, of course, by the continuing increase in construction costs.

During the first eight months of 1968 my department had examined and approved bonds of state and local governmental agencies in the aggregate of $645 million. During the corresponding period of 1969 this volume amounted to only $409 million, a reduction of 34%. I am informed by authorities in this field that this failure on the part of local government to finance public facilities at a rate at least equal to 1968 (all other economic indexes in Texas are up) is directly attributable to a declining bond market brought on, in the municipal sector, at least, almost entirely by Congressional activities centering around H.R. 13270.

I consider it entirely safe to predict that should this bill be enacted in its present form, or with any provisions which attack the historic right of states and local governmental agencies to accomplish their capital financing with tax exempt bonds, that financing of public facilities essential to the health and welfare of the citizens of Texas will shrink for at least a period to an annual volume which is not more than 10% of that experienced in 1968.

The ultimate threat in this measure is the triumph of the forces of centralism over local home rule, and the transfer of the local decision making process to the Washington bureaucracy: it endangers the democratic principles under which our federal system has operated for almost 200 years. The more immediate threat is equally as serious. Through interference with the ability of state and local government to provide the essential needs for public facilities, it endangers the health and welfare of the citizens of our State.

Statement of Hon. John A. Kervick, Treasurer, State of New Jersey

I wish to express my thanks for the opportunity to testify concerning the tax reform proposals that have been submitted to the Senate Finance Committee for consideration and, in particular, to the provisions of H.R. 13270 which will affect the ability of the State and its municipalities to obtain the capital needed to finance the construction of schools, hospitals, highways and similar essential facilities. I have read the explanation given by Mr. Mills, Mr. Kleppe, and Mr. Byrnes of the effect of H.R. 13270 as it pertains to State and municipal bonds, reported in the Congressional Record (House) on August 7, 1969, and with due respect for these gentlemen wish to suggest to you that there is a lack of understanding concerning the mechanics of the bond market and the manner in which the capital required by the State and municipalities is obtained. The theory of public finance suggests that State and local governments should employ issues of bonds for one basic purpose: to finance capital projects. In fact, in New Jersey the State Constitution and State Laws limit the issuance of bonds to that purpose and require that State and school district bond issues must be submitted to referendum and approved by the voters.

On February 5, 1968 Governor Richard J. Hughes convened a Commission composed of its citizens of the State of New Jersey to study and evaluate the capital needs of the State. The introduction to the report of this Commission contains the following statement:

"New Jersey has not been as progressive in its capital expenditures as have been its sister urbanized states. There has been no capital program because there has been little or no long term capital financing. Given the opportunity to provide for sufficient capital construction to keep New Jersey a first class State, the choice was made to keep State levied taxes at a minimum. The price of these years of inactivity in capital appropriations is now very large. But it must be paid if we are to prevent further atrophy and create a viable and progressive State.

Everywhere that this Commission looked, it saw the tragic results of years of neglect. Passenger rolling stock is on the verge of collapse. Railroad stations are dark and dilapidated. Highways are choked. A severe drought brought us to the brink of real peril. Prisons and mental health institutions are patched and worn, with many positively inhumane facilities. Secondary and elementary schools are overcrowded and many of the older ones are sadly in need of repair or replacement. Our colleges and universities can accommodate only a fraction of our applicants, forcing most of them to go out of our state. Our rivers are polluted and our cities are pockmarked with crumbling ghettos.

These conditions are all very serious in themselves, but they are also serious beyond themselves. Lack of adequate capital funds has undoubtedly contributed heavily to our racial problems and to the decline of our cities as centers of industry and culture.

Our Commission foresees a serious weakening of the economic and social stature of New Jersey if this regressive fiscal philosophy continues. We are deeply disturbed to see one of the wealthiest states in the nation apparently condoning conditions which would ultimately destroy it.

The people of New Jersey have two great responsibilities to fulfill now. First, we must eliminate the enormous backlog of capital deficiencies. Second, we must build toward the future. We must guarantee for ourselves a a growth which will keep pace with our future obligations. Prudent expansion and preventive maintenance must be substituted for virtual stagnation in new construction and a massive accumulation of deferred maintenance."

The Commission reported that the immediate capital requirements for State projects alone amounted to $1,948.9 million itemized as follows:

Recognized Capital Requirements—(Financing required in addition to projected Federal aid and State appropriations)

	Millions
Education (Elementary and Secondary, including Vocational)	$227.5
Education (Higher)	492.4
Educational Broadcasting Network	17.4
Institutions	100.0
Water Pollution Control	190.6
Conservation	121.0
Transportation	800.0
Total	1,948.9

On November 5, 1968, the voters of the State appoved the sale of $990 million of bonds to finance the construction of facilities recommended by the Commission in the areas of transportation and school and hospital buildings construction. In November 1969, the voters will be asked to approve the sale of $271 million of bonds to finance water pollution control and the development of additional water supplies. The construction of the above facilities will take place over the next five years and it is expected that the State will sell approximately $250 million of bonds each year to pay for the construction cost. State tax dedicated to repayment of the principal amount of the bonds and the interest on the bonds are the motor fuels, emergency transportation, and sales taxes.

There is no report available concerning the capital requirements of the municipalities and school districts within the State. It is probable that some municipalities have been more progressive than the State in the construction of schools and other necessary municipal facilities; however, many others have not. There are a total of 1,363 jurisdictions within the State, each with its own capital needs and each able to issue bonds to finance its needs.

These jurisdictions are classified as follows:

Counties	21
Municipalities	335
Townships	232
School Districts	593
Special Districts (Garbage, Fire, Light, Sewer and Water)	71
Authorities	111
Total	1,363

Gross Local Debt, including authorized, issued and unissued obligations, totals $2,369.9 million as shown hereunder:

GENERAL OBLIGATIONS ONLY

[In millions of dollars]

As of Dec. 31—	General municipal	School	County	Total
1968	585.4	1,393.4	391.2	2,370.0
1967	530.4	1,291.6	336.8	2,158.8
1966	466.0	1,196.3	291.4	1,953.7

The typical debt instrument is a serial bond with an approximately equal principal amount maturing each year for 25 to 30 years. During the twelve months period, August 1, 1968 to August 1, 1969, hampered by rising interest costs and poor market conditions, a total of 131 issues were sold in the total amount of $195,117,000. The average size of each issue was $1,489,000 and, by actual count, there were 97 issues below $3,000,000 in size, and only 4 issues exceeding $10,000,000 in size. The credit rating of the issues sold is summarized as follows:

	Number of issues
No rating	51
Ba	15
Baa	35
A	19
Aa	11
Total	131

It will be seen that the average New Jersey municipal issue is approximately $1,500,000 in size and carries a credit rating below Baa in quality. Also, it will be seen that gross local debt has been increasing at the rate of approximately $200 million per year and the probability is that this rate of increase will continue for some time into the future. Revenues needed for the repayment of this debt and the interest on the debt are derived from local property taxes.

The combined capital needs of the State and its municipalities require the sale of $450 to $500 million of bonds each year. In marketing such a supply of bonds it is in the State's best interest for the Congress to consider legislation which will stimulate investment in tax exempt bonds rather than to propose changes in the tax laws which remove the incentive for such investment. In considering the manner in which the tax changes incorporated in H.R. 13270 remove the incentive for such investment, it is helpful to keep in mind the various types of investors in tax exempt securities and the proportions of the total supply which each has purchased in the past. The following analysis published on August 29, 1969 by Salomon Brothers & Hutzler shows the net purchases of State and local securities during the first half of each year for the period 1966 through 1969.

[In billions of dollars]

	1966	1967	1968	1969E
Nonbank financial institutions:				
Savings banks	0	0	0	0
Life insurance companies	−.3	−.1	0	.2
Fire and casualty companies	.1	.6	.9	1.0
Public retirement plans	−.1	−.1	−.1	−.1
Subtotal	−.3	.4	.8	1.1
Commercial banks	2.9	5.7	3.0	.1
Business corporations	.4	.4	0	.1
Residual: Individuals and other	.4	−.9	.6	3.9
Net increase publicly held[1]	3.4	5.6	4.4	5.2

[1] Excludes small amounts purchased by sinking funds and U.S. Government accounts.

This table shows that during the years 1966, 1967, and 1968, over 80% of all tax exempt issues were purchased by commercial banks. In 1969, due to credit restrictions, the commercial banks were unable to purchase tax exempt securities and it was necessary for interest rates to be raised sufficiently to induce individuals to return to the tax exempt market and absorb the available supply. Sales of State of New Jersey obligations are in sufficient size so that the effort required on the part of the underwriters to achieve distribution to individuals can be accomplished without great difficulty. The interest cost on State issues did rise from 4.49% on Jan. 7, 1969 to 5.70% on August 19, 1969, but the marketability of the bonds was never in question. However, the situation with respect to the bond issues of the municipalities is quite different. The size of the average issue, $1.5 million, and the relatively poor credit rating tends to restrict the sale of such obligations to local banks and individuals within the State who are acquainted with the community. In fact, many local banks purchase the obligations of the local community or school district as a service to the community.

One provision of H.R. 13270, and one which I consider harmful, is the proposal to make both the profit and loss transactions of commercial bank investment portfolios answerable to the same tax liability—the corporate income tax rate. It is my belief that if this provision is enacted and becomes law, the commercial banks will limit investments to short-term securities on which no loss need be sustained and avoid the purchase of long-term obligations of the local community. I wish to express my strong opposition to any change in the tax laws which will have that effect.

There is general agreement that the limit on Tax Preferences and allocation of deductions provisions of H.R. 13270 have added a minimum of ½ of 1% to the interest cost of State and municipal borrowing. This estimate is based upon the sale of bonds of excellent quality such as the recent State of Oregon issue. The fact is that the borrowing cost of municipalities of relatively poor quality has probably increased more than ½ of 1%. For example, an interest cost of 7.20% was incurred by the Piscataway School District in selling $6,000,000 of school bonds rated Baa on September 3, 1969. An interest cost of 5.35% was incurred by the Cherry Hill School District in selling $3.5 million of similarly rated bonds on May 5, 1967. This represents an interest rate increase of 1.85% whereas the Bond Buyer Index of 20 bonds increased 1.20% during the same period.

This increase in interest cost is not related in any way to the amount of additional tax which will be paid by the purchaser of municipal obligations if the two provisions become law. On the contrary, it is a premium required by the purchaser to compensate for the new element of risk concerning the future value of his purchase. Obviously, if the present Congress can alter the value of tax exempt income, some future Congress can alter the value further. Typical of the reaction of individuals to this new risk factor is the following letter received in connection with the recent sale of State bonds:

2675 Red Oak Lane,
Smoke Rise Butler, N.J., *August 21, 1969.*

Treasurer,
State of New Jersey, Trenton, N.J.

Dear Mr. Treasurer: I live in New Jersey. My capital is invested in state and municipal bonds, mostly of New Jersey. I would have subscribed for this new issue of 37½ m.d. except that I fear being whipsawed—i.e., buy the bonds at relatively low interest rate, because they are said to be tax-free, then find the Feds. taxing them anyhow. Can you not make Senators Case & Williams see this?

(signed) Lyle T. Alverson.

An increase of ½ of 1% in tax exempt interest rates will add $6,250,000 per year to the cost of financing the State's present construction program. On the basis of an average life of 15 years this will add $93,750,000 to the debt service charges which must be paid by New Jersey taxpayers.

An increase of ½ of 1% in interest cost will add $1,000,000 per year to the cost of municipal financing. Assuming that New Jersey municipalities will continue to sell $200,000,000 of bonds each year, the additional interest cost will build up to $15,000,000 per year before new bond sales and old bond maturities reach equilibrium. Revenues to cover this additional cost must be obtained by increasing real estate taxes through the State. In other words, the impact of H.R. 13270, if it should become law, upon the taxpayers of New Jersey will be to increase motor fuels, sales and real estate taxes by at least $21,000,000 per year and some experts predict the increase will be double that amount.

The option, provided by H.R. 13270, to issue a taxable bond and receive a compensating interest subsidy payment from the Federal Government is illusory and without real substance. The fact is that:

1. The acts authorizing the sale of State bonds which were approved by the voters in November 1968 limit the interest rate to 6%. It may be necessary to hold a new referendum before bonds can be sold at the higher rates applicable to taxable issues.

2. There is no present market for taxable bond issues of the size and credit rating offered for sale by the average New Jersey municipality. There are only five or six municipalities within the State that can offer bonds for sale in sufficient size to compete with corporations in the taxable bond market. For the average New Jersey municipality the option provided by H.R. 13270 is meaningless.

I wish to reaffirm my contention that the capital requirements of the State and its municipalities are so great that new devices and new incentives for investment in State and municipal securities are needed and that the Congress should consider constructive measures as opposed to the destructive provisions of H.R. 13270.

One constructive measure which might be considered by the Congress is revenue sharing so conceived that the total amount of municipal financing is reduced. The present volume of municipal financing is approximately $16 billion per year. A reduction of $5 billion in this amount would provide a powerful stimulus, reducing interests costs and enabling the average municipality to market its bonds with far less difficulty. This could be accomplished by channeling the shared revenues through the State Departments of Education for the construction of schools in those communities demonstrating the greatest need, with the proviso that the entire cost of construction must be paid and bond indebtedness avoided.

The State of New Jersey is attempting to assist the smaller municipalities within the State in marketing bond issues by the creation of a State operated Municipal Bond Bank. Legislation providing for the establishment of such a bank has been introduced in the Senate with the expectation that it will be acted upon favorably when the Legislature reconvenes in November. The purpose of the bank would be to combine a number of small municipal issues in one package so that an issue of sufficient size to attract wide interest can be marketed with a consequent reduction in the interest cost paid by each municipality.

Also, the State is considering a proposal for the sale of State and Local bonds in small denominations through payroll deduction plans. At the present time, such bonds can be offered for sale at interest rates which would be competitive with the rates paid on the Series E bonds offered by the U. S. Treasury. The market for any substantial quantity of small denomination bonds is problematical. However, there is evidence to support the contention that many residents of the State would welcome an opportunity to invest in the obligations of the State or of their municipality if a small denomination bond was offered to them.

In conclusion, I wish to restate my opposition to all of those provisions in H.R. 13270 which affect either directly or indirectly the tax exempt status of State and municipal obligations. The effect of the provisions will be to increase State taxes and local property taxes. This is not a desirable result.

STATE OF NORTH CAROLINA,
DEPARTMENT OF THE STATE AUDITOR,
Raleigh, N.C., September 23, 1969.

Hon. RUSSELL B. LONG,
Chairman, Committee of Finance, U.S. Senate,
New Senate Office Building,
Washington, D.C.

Subject: H.R. 13270, Tax Reform Act of 1969

DEAR SENATOR LONG: Please accept this written statement if lieu of my appearance before your Committee in opposition to the portion of the Tax Reform Act of 1969 which relates to the tax exempt status of state and local bonds.

The levy of a Federal income tax on the interest received from state and local bonds would unquestionably curtail the ability of state and local governments to finance necessary public facilities. Direct, open market tax exempt financing is essential to responsible and efficient local administration. The level of government that is given the responsibility of raising revenues will assume the privilege of determining priority of expenditures and the role of the local official will become ministerial only.

I therefore reaffirm my position of long standing that Congress should take no action which would remove the tax exempt status of state and local bonds or in any manner unsettle or destroy the functioning of the tax exempt market as an independent source of capital for local improvements. Also, I elect to rely upon the presentations and briefs of others having having a common interest that the proposed tax levy is unconstitutional.

North Carolina and its counties and cities have historically followed the principle of pay-as-you-go, using borrowed funds only as and when absolutely needed. While I personally deplore abusing the tax-exempt privilege, I take pride in defending the policies and practices of our States' legislature in acting as guardian of public credit in North Carolina.

I offer the assistance of my office in providing you with further procedural and statistical information upon request.

Sincerely yours,

HENRY L. BRIDGES,
State Auditor.

STATE OF NORTH CAROLINA,
Raleigh, N.C., September 18, 1969.

Hon, RUSSELL B. LONG,
Chairman, Committee of Finance, U.S. Senate,
New Senate Office Building,
Washington, D.C.

Subject: H.R. 13270, Tax Rerform Act of 1969: Senate Finance Committee Hearings Beginning September 23, 1969

DEAR SENATOR LONG: This statement is an opposite to that portion of the Tax Reform Act of 1969 relating to the tax exemption presently afforded state and local bonds under Section 103 of the Internal Revenue Code. Said opposition is based primarily upon the following contentions:

1. That the principle of tax immunity of the states and local governments is vital to the preservation and continuation of their capacity and ability to serve the people of their community.

2. That the proposed amendment is contrary to the long and well established policy of Congress to uphold the reciprocal freedom of the states and the Federal government from taxatiton by each other.

3. That the fear of the investor that Congress will remove or modify the tax exempt status of state and local bonds is a plague to the municipal bond market and is serving to increase disproportionately the cost of using borrowed to funds in providing the public facilities so critically needed.

4. That the State of North Carolina through its self administered program of fiscal responsibility is providing for its people the best possible government at the lowest possible cost.

We mention with pride the well established objective of the State of North Carolina as to promote and encourage strong and self-sufficient local government. We think the North Carolina way of providing funds for valid public purposes is unique and far superior to the proposals that heretofore have been submitted to the Congress. We think the North Carolina approach supports the new direction of strengthening Federal-state relations and we therefore take the liberty of presenting a brief description of the State's program of public finance.

The Local Government Act of 1931 gives the State of North Carolina through the Local Government Commission, which functions as a division of the Department of the State Treasurer, the responsibility of approving and supervising the issuance of bonds or other evidences of indebtedness by the local units of government. This responsibility involves working with the representatives of the local units and other agencies of the State and Federal governments in planning the projects o be flanced and finally serving as issuing agency for the bonds and notes.

In administering the provisions of the Local Goverenment Act, the Commission examines the necessity and expediency of the local bonds or notes as proposed, the adequacy of amount and the ability of the issuing unit to make repayment.

The Commission's supervision assures investors that correct procedures have been followed and that the fiscal data presented in the offering circular is based upon reliable sources. The local units benefit through lower interest costs that result from the underwriter's knowledge of Commissiion standards and the uniformity of offering procedures.

The Local Government Act carefully spells out the procedural requirements to be followed in the issuance of bonds by a local unit. Briefly, the Act provides that before any local unit may issue its bonds or notes, the unit's governing board must file an applicatiton with the Local Government Commission requesting its approval of the issuance of the proposed bonds or notes. In the event the bond proposal is required by the Constitution or by the statutory law to be submitted to the voters of the unit for approval, such application must be filed at least forty days prior to such election. Notice of the unit's intent to file the application must be published at least ten days before filing the application with the Commission.

The law provides for objections by private citizens and public hearings by the Commission on proposed bond issues, but under the law no bond or notes is valid unless it bears a signed certificate to the effect that its issuance has been approved under the provisions of the Local Government Act.

North Carolina, being one of the thirteen original states, has a tradition of local self-government. It is believed to be unprecedented for the General Assembly of North Carolina to have adopted a measure centralizing in Raleigh the degree of authority over the financial affairs of its counties, cities, towns and other political subdivisions. In fact North Carolina is among four states—along with Michigan, Louisiana and Virginia—that assists or oversees the borrowing operations of its local units. The Virginia Commission does not offer aid or advice unless requested by the locality, but in North Carolina the units are required by law to proceed through the Local Government Commission.

The local governmental organizations in North Carolina having authority to issue bonds and notes include 100 counties, 425 municipalities and 263 special taxing districts for a total of 788 units of local government. As of June 30, 1969 the bonded indebtedness of the local units exceeded $1 billion while the bonded indebtedness of the State of North Carolina was almost $500,000,000 making the combined indebtedness of the State and its local subdivisions in excess of $1.5 billion.

The states and local governments throughout the nation rely heavily on bond issues to finance capital improvements. In North Carolina, the state and local governments have generally followed the practice of borrowing for prudent and necessary purposes and at times when borrowing was considered economically wise. A study of the trend of state and local debt shows that North Carolina and its local units of government have followed a well-balanced program—using both pay-as-you-go and borrowed capital. On a per capital basis, North Carolina ranks 48th among the fifty states in state and local indebtedness.

The immunity of the states and local governments from Federal taxation is vital to the preservation of our dual sovereignty which characterizes our system of government. As important as the interest savings may be to local governments, and as important as the revenue loss may be to the Federal government because of the tax-exempt character of municipal bonds, these factors are secondary to the preservation of the sovereignty of our states and the integrity of our local governments.

Those who purchase municipal securities do so with the full understanding that the interest received from such securities is exempt under existing Federal income tax laws. To levy an income tax retroactively would seriously damage investors' confidence in the integrity and good faith of the Federal government. Furthermore, unless there is an early and decisive conclusion to the threat of Congressional action neither present investors in municipal bonds, prospective investors, nor banks and other institutions that purchase municipal obligations for their portfolios would have sufficient confidence in the tax exempt status of municipal bonds to take a chance on future investment in such securities. Once this principle is breached, there is theoretically no limit to the extent to which the interest could then be taxed by succeeding Congresses. This would, of course, result in a total collapse in the market which would unquestionably force the states and municipalities to seek financial relief from Washington.

If the tax exemption on interest from municipal and state bonds were eliminated, the cost of public works to the taxpayer would increase. Investors would continue to buy the bonds. They are the most secure of investments, but they would demand a higher interest rate to compensate in part at least for the taxes levied on the interest. The local property taxpayers would foot the bill.

There can be no doubt that financial relief is sorely needed by the states and their subdivisions, but the proposals presently before the Congress would appear to create more problems than they solve. The economists today are saying that in the years to come local governments will be one of the major "growth industries". Through the years the objective of the State of North Carolina has been to encourage local units to assume full initiative and responsibility allowing the role of the State to be mainly that of advisor and counselor.

Stability goes to the heart of character and the legislatures of the State of North Carolina have given our peopjle and our bondholders a stable fiscal policy.

Sincerely yours,

HARLAN E. BOYLES,
Deputy State Treasurer and
Secretary of Local Government Commission.

STATEMENT OF E. B. DAVIS, STATE AUDITOR, DEPARTMENT OF AUDITS, ATLANTA, GA.

The Senate Finance Committee is at this time holding hearings in consideration of House Bill 13270, the "Tax Reform Act of 1969." I wish in this statement to stand in complete opposition to a portion of this Bill which provides for the taxation of interest paid on state and local government obligations.

The National Association of State Auditors, Comptrollers and Treasurers adopted unanimously on September 3, 1969, a resolution voicing their full opposition to this proposed taxing by the Federal government of state and municipal bond interest. I approve and support fully this resolution which is attached hereto.

The arguments supporting the removal of the tax exempt status for state and municipal obligations seem to be made principally around the cliche "Tax the rich." It certainly isn't going to result in any savings for the Federal budget and in my opinion it isn't going to do much damage to the rich. The fact is that it will do untold damage to state and municipal financing and capital outlay programs and will actually result in higher taxes on the small local taxpayer. The supporting evidence for this argument is clear and has been presented time and time again to the Committee along with many other strong and well documented arguments. The mere prospect that the Bill may become law has proven the point and already cost local taxpayers millions which can never be recovered.

There is one point, however, that has not been clearly brought to the Committee's attention and in many ways concerns me more than anything else about this Bill. Along with the provision to tax state and municipal bond interest is a proposal to provide state and local governments with a subsidy to somehow make up for the increased financing costs that will result from this legislation. We are told that this "plum" will make up for all the bad things that will happen to us. All we have to do is ask for it. It seems so easy. Gentlemen, what you are really providing is a means by which a Federal agency or agencies will be able in time to *control and dictate* all state and local financing programs. One-page applications will turn into a hundred-page legal document. Duplicates will pile on top of duplicates; whole states and cities will be at the mercy of minor clerks and approvals will become an instrument of Federal policy. This may sound extreme, but history tells us it will follow and there will be nothing Congress or anyone else can do about it, once put into effect. For the sake of a cliche, we may very well be wrecking our Federal system of sovereign states within a sovereign nation. If you want complete central control of government, you have in this Bill the means of providing it. I just can't believe you really want this, so please consider the real cost, very carefully before you act on this proposal.

RESOLUTION 3.—TAXATION OF STATE AND MUNICIPAL BOND INTEREST

Whereas, proposals in H.R. 13270 (a bill to enact a so-called "Tax Reform Act of 1969") would impair the exemption of state and local government obligations: and

Whereas, these proposals have already precipitated a dramatic increase in interest rates which state and local governments must pay to finance schools, hospitals, highways and all other necessary public improvements: and

Whereas, such increased interest costs must be passed on to the general citizen and taxpayer in the form of higher property taxes, sales taxes and other local taxes or in reduced Local services: and

Whereas, therefore, the said proposals to impair the exemption of state and local government bonds, do not constitute true reforms in that their burden ultimately fall on the average citizens across the nation, including practically every person of modest means, and

Whereas, the Congress has received no evidence that millionaires have generally invested so heavily in state and local government bonds as to escape federal income taxes, and, in fact the statistics as to the much publicized 154 millionaires who paid no tax in 1966 contain no showing that they held state or local government bonds; and

Whereas, any purchaser of state and local government bonds in prior years has accepted a lower interest rate in reliance on his expectation that the interest would not be taxed, and the amount he has thus paid for his exemption is 30% to 35% of the interest he could have received on an equally secure private taxable obligation; and

Whereas, this thirty to thirty-five per cent payment is exactly equal to the highest tax rates proposed by H.R. 13270 on other forms of income labeled as "tax preferences" by the bill; and

Whereas, therefore, there is absolutely no argument in tax equity for subjecting state and local government bond interest to the "tax preference" treatment proposed for sheltered income which has *not* thus made a contribution to the cost of government; and

Whereas, as members of the present Supreme Court have said, taxation of the states by the Federal Government constitutes a powerful regulatory instrument, and should therefore be rejected as an unconstitutional subversion of our federal system;

Now Therefore:

Be it Resolved by the National Association of State Auditors, Comptrollers and Treasurers this 3rd day of September, 1969 that this Association urges upon the Congress of the United States the defeat of all proposals to impair the exemption of the interest on state and local government bonds, including the following provisions of H.R. 13270:

(a) the inclusion of such interest in the base of the limit on tax preferences as proposed by Section 301:

(b) the inclusion of such interest in the base for the allocation of deductions as proposed by Section 302;

(c) the taxation of interest on "arbitrage bonds" without a statutory definition as proposed by Section 601(b) and

(d) the taxation of the interest on all otherwise exempt obligations in exchange for a preferred Federal "subsidy" as proposed by Title VI.

STATE OF NORTH CAROLINA,
Raleigh, September 16, 1969.

Subject: H.R. 13270, Tax Reform Act of 1969

Hon. RUSSELL B. LONG,
Chairman Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR LONGS Please accept this written statement in lieu of my appearance before your Committee in opposition to that portion of the Tax Reform Act of 1969 which relates to the tax exempt status of State and local bonds

As Treasurer of North Carolina and ex officio Director of Local Government, I wish to state my opposition to any effort on the part of the Congress to directly or indirectly tax interest on State and municipal bonds.

The mere fact that Congress is considering taking such action has literally brought chaos to the market for our securities. It has taken many years to build up the confidence of the investing public in our bonds, and it would be tragic if this confidence were undermined and even destroyed by the well-intentioned action of Congress taken in the name of tax reform.

Actually the removal of this exemption, in whole or in part, will mean ultimately a heavier tax burden upon the people of our State, our counties, our cities and our towns. In fact, it is estimated that, exclusive of the increased cost to the State, there would be approximately $25 million annual additional interest cost to our local governments, which would be the equivalent of an ad valorem tax levy of between 15–20¢ per $100 valuation.

Recently much has been said about the *New Federalism*, which, as I understand it, would offer a true partnership between the national government and the fifty States. In my judgment, to take from the State and local governments this very precious privilege of tax exemption, would strike a blow at local pride and initiative, and would really violate the proposed spirit of such *New Federalism*. I believe that Congress should preserve the exempt status of our State and municipal bonds as a great traditional privilege which has been a part of our inheritance as declared in the landmark case of *McCulloch vs. Maryland*, which preserved the fiscal independence of the States and municipalities.

Due to the very high interest rates that we are now experiencing, in part because of this threat to our exempt status, I hope for an early resolution of this matter by Congress. In my opinion, prolonged debate serves to strengthen the fears of potential investors. Incidentally, the retroactive effect of this proposed legislation is, in my judgment, morally and constitutionally indefensible.

I wish to endorse the briefs that are being filed in behalf of the States and local governments by the National Association of State Auditors, Comptrollers and Treasurers, the National Association of Counties, the League of Cities-Conference of Mayors, Inc., and other organizations concerned with Federal-State relationships, including, of course, the National Governors' Conference.

Respectfully submitted,

EDWIN GILL,
Treasurer, State of North Carolina and
ex officio Director of Local Government.

THE STATE TREASURER, STATE OF NORTH CAROLINA—SUMMARY OF POWERS AND DUTIES, 1969

The State Treasurer is a Constitutional officer of North Carolina *elected by tho people* for a term of four years running concurrently with the term of the Governor.

The State Treasurer is actually the State's banker, serving as the chief financial officer of the State. He receives and disburses the funds of the State, administers the bonded indebtedness program and serves as investment officer for all State funds. In addition, he has certain supervisory functions over local government finances. The State Treasurer also advises with the General Assembly and the Governor at all times concerning the financial condition of the State and its fiscal problems.

The State Treasurer is, under the Constitution, a member of the Council of State and of the State Board of Education. By statute, he is ex officio Chairman of the Local Government Commission, the Banking Commission, the Tax Review Board, the Retirement Systems for Teachers and State Employees and Local Governmental Employees. He is also an ex officio member of the Law Enforcement Officers Benefit and Retirement System.

The present incumbent, Edwin Gill, has served in this capacity since 1953. Mr. Gill began his service in State government in 1929 as a member of the General Assembly and has served in many capacities since that time, including seven years as Commissioner of Revenue of North Carolina.

TREASURY DEPARTMENT,
STATE OF TEXAS,
Austin, September 19, 1969.

Mr. TOM VAIL,
Chief Counsel, Committee on Finance,
New Senate Office Building,
Washington, D.C.

DEAR SIR: I want to express my strong opposition to the proposals in the Tax Reform Act of 1969 which, if enacted, will remove or modify income tax exemption on municipal bond interest.

The main beneficiaries of the present system of tax exemption on municipal bond interest are those people who comprise the direct taxpayers or contributors of the issuing municipality.

To eliminate the tax exemption would now sorely distress, if not halt, practically all proposed issues, and would eventually result in much higher local taxes on all tax issues and much greater patronage charges on all revenue issues.

The confusion inherent to such proposals would hamper the orderly progress of programs of municipalities, schools, water districts, states and other governmental entities. On all those programs partially completed it would be like changing rules in the middle of the game.

Again, I strongly urge all concerned not to enact legislation that will change the tax exempt status on income to municipal securities.

Sincerely yours,

JESSE JAMES,
State Treasurer.

STATE OF MICHIGAN,
DEPARTMENT OF TREASURY
Lansing, Mich., September 18, 1969.

Mr. TOM VAIL,
Chief Counsel, Committee on Finance
2227 New Senate Office Building,
Washington, D.C.

DEAR MR. VAIL: In accordance with the recommendations set forth in your telegram of September 7 Governor Milliken and I are agreeable to your suggestion permitting a six man panel of the Governor's Conference to make the oral presentation before the Senate Committee on Finance.

We are in full agreement with the position taken by the Governors' Conference in opposition to the taxing by the Federal Government of state and local government bond interest. In addition we are submitting the following observations for the Committee's consideration.

1. The proposals in H.R. 13270 have already precipitated a dramatic increase in interest rates which state and local governments must pay to finance schools, hospitals, highways, drains, and all other necessary public improvements. On September 8, 1969, Michigan borrowed 42 million dollars on one year general obligation notes at an average annual rate of 6.234 percent. In our judgement, this rate would have been from ½ of one percent to a full percentage point lower if the municipal bond market were not faced with the uncertainty created by the passage of H.R. 13270 by the House of Representatives.

2. Increased interest cost, such as this, must be passed on to the general citizen and taxpayer in the form of higher property taxes, sales taxes, income taxes, and other local levies or the level of services must be reduced. We therefore believe that these proposals to impair the tax exempt status to state and local government bonds, do not constitute tax reform in that the burden ultimately falls on the average citizen across the nation. We therefore urge upon the Senate Committee on Finance and the Congress of the United States the defeat of all proposals to impair the exemption from taxation the interest on state and local government bonds. In our judgement, failure to take this action could very well cost Michigan and its municipalities additional interest running into the hundreds of millions of dollars on the presently authorized bond issues totaling nearly one billion dollars.

We appreciate this opportunity to set forth our position on this question and are prepared to furnish additional data if desired.

Sincerely,

ALLISON GREEN,
State Treasurer.

STATEMENT OF FRANCIS GEOGHEGAN, DIRECTOR, STATE OF MISSISSIPPI COMMISSION OF BUDGET AND ACCOUNTING

The proposed actions contained in Sections 301 and 302 of the above bill would break a long established principle that state and municipal bonds are not subject to Federal taxation. If these sections are enacted it would, no doubt, cause long periods of litigation and would seriously interrupt the states and local governments abilities to obtain capital funds for purely local projects. In my opinion, the taxing of one group of bond holders and not taxing another group is of doubtful merit.

The proposal in Section 601 of House Bill 13270 to provide a tax subsidy plan for local and municipal tax exempt bonds appears utterly without merit. If approved this would put the Federal Government in the position of controlling purely local and state projects and would, no doubt, result in greater cost to the U.S. tax payer. In addition, the delays in obtaining Federal Government's approval would seriously slow down the obtaining of capital funds for immediate urgently needed local and state projects.

For the above reasons, I respectfully request that the Senate Finance Committee delete the above sections from the Tax Referendum Bill now under consideration.

STATEMENT OF ARTHUR LEVITT, COMPTROLLER, STATE OF NEW YORK

I am Arthur Levitt, Comptroller of the State of New York. My office is elective, for a four-year term, and I am currently serving my fourth consecutive term.

As Comptroller of the State of New York my duties include management of the State's financing, both temporary and capital. I am also required to supervise the financing of the State's agencies; and I audit and advise most of the municipalities, school districts, and other special districts within the State. Thus, the general supervision of State and local financing procedures and programs is a primary concern of my office.

My purpose today is to oppose any taxation, direct or indirect, of state and local obligations by the Federal Government. Specifically, I would urge this

Committee to exempt the interest on municipal bonds from both the minimum income tax and the base for allocation of deductions proposed in H.R. 13270. In my opinion any significant change in the existing tax immunity of the interest derived from state and municipal obligations would seriously undermine the complex special market structure on which state and local governments rely to finance their capital requirements, and thus would impose upon the average homeowner an additional burden of interest cost and resulting taxation for which he would receive no compensating benefits.

It is paradoxical, but in my opinion a fact, that the effect of the proposed levies on investors in state and municipal bonds is that of a regressive tax. By diminishing the investment appeal of municipal bonds, the levies would force municipalities to pay higher rates of interest for their operating and capital funds. In order to meet these higher costs, the municipalities may be obliged to increase their real estate and sales tax rates, directly burdening homeowners and lower income groups.

The State of New York and its agencies and municipalities have committed capital programs totaling more than $10 billion, which are being financed at the rate of $2 billion a year. If the level of interest rates in the municipal bond market is raised by 1% in reaction to the indirect taxation of hitherto exempt securities—and I believe that to be a conservative estimate—this would add $100,000,000 a year to the cost of borrowing $10 billion. For an average loan life of 15 years, that means a tax burden increase of $1.5 billion for the existing programs in New York State alone.

I cannot believe that the Federal Government's added revenue from the minimum income tax and the allocation of deductions combined would amount to anything more than a fraction of the total increase in state and local interest costs.

The mere proposal of indirect taxation of municipal bonds through a minimum income tax and the allocation of deductions has already disadvantaged the states and their municipalities by forcing them to defer financing or to pay rates of interest much higher than warranted by quality comparison with taxable borrowers. And as yet, there is no general appreciation of the ultimate effect of these proposals, which would shock and disillusion investors who have relied upon the tax status represented to them when they bought their municipal bonds. The very complexity of the proposed new provisions for calculating liability to both the minimum income tax and the allocation of deductions would create strong resistance to future purchases of state and municipal obligations.

Furthermore, once the long-standing exemption of municipal bond interest is breached, however subtly or indirectly, investors as a matter of prudence must assume that the burden of taxation could and probably would be increased in the future by further amendments to the tax law.

It is unavoidable that the investment value of tax exemption of the interest on municipal bonds varies according to the taxable income of the investor. The proposed amendments would intensify such differences by making municipal bonds taxable in varying degrees to some individuals, while continuing their exemption for other individuals, depending upon the allocation of their individual investment funds. Because of the resulting discrepancies, the adverse impact of these amendments upon the bond market would probably be greater than warranted by the actual change of status.

In my judgment, the case for continuance of the present exemption of municipal bond interest from all Federal taxation rests on two solid bases, which should not be summarily and suddenly cut away in an impetuous drive to penalize these investors who have made long term loans to their state and local governments.

The first of these bases is the importance to the national economy, and the effectiveness of the existing structure of the specialized market for state and local bonds.

It has taken fifty years to bring this market to its present level of ability to accommodate the tremendous requirements of state and local governments, for capital funds to build schools and institutions and all of the utilities that can never quite keep pace with expanding demands of our growing population. The very minimum effect of passage of the proposed amendments to the tax law would be to plunge the municipal bond market into a long period of uncertainty while the new provisions are litigated as they certainly would be. The resulting disruption of orderly marketing procedures would handicap the efforts of our local governments to overcome the deficiencies in schools and housing which are exacerbating problems of social and racial unrest.

Similarly, any attempt to divert municipal financing into new channels by encouraging the issuance of taxable bonds would, in my opinion, create serious problems of adjustment in the format and pricing of municipal bond issues. It would require a major redirection of underwriting and sales efforts. I do not believe that the same investors who now supply the major volume of long-term credit to state and local governments could be counted upon to buy these obligations in taxable form. And to the extent that municipalities might succeed in competing for investment funds which do not value tax exemption, the diversion of such funds would be at the expense of the U.S. Government, its agencies, private industry and the mortgage market. I would ask, what is to be gained to warrant the risk to our whole economy of creating a situation which could only mean higher rates on mortgages and Government debt? The tax exempt municipal bond is the only sector of the fixed-income market which has competed with the equity market for individual investment funds.

The second concept supporting the existing system is that of the reciprocal sovereignty of the state governments vis a vis the Federal Government. The area of finance is one in which the state governments and their creature municipalities should be completely independent of Federal intrusion if it could conceivably lead to Federal control. Beginning with Chief Justice Marshall's oft-quoted opinion handed down in 1819, the power to tax the means of borrowing money has been regarded as the power to destroy. Whether the tax be direct or indirect, it inhibits and potentially controls the ability of state governments to exercise their financing powers as determined by their own several constitutions.

It is especially frustrating, at a time when the Federal Government proposes to increase its assumption of proportions of the cost of social problems which are essentially national, and at a time when there is renewed emphasis on the decentralization of administration of our civic and social problems, that there should appear a major tax amendment moving in exactly the opposite direction. Just when the states are encouraged to expect some relaxation of their long-deferred hopes for a greater share in national revenues, they are suffering instead a crushing blow to their ability to meet their existing needs for public improvements.

I am aware of the concept that exemption of the interest on municipal bonds is an uneconomic subsidy or a misallocation of national resources; but even if this charge can be proved statistically, I should hope that this Congress, like all of its predecessors who have approached this question, would propose to meet the issue squarely by submitting a constitutional amendment to remove the exemption from all future issues. Such an amendment would present a clear choice, with definable consequences. I am very clear and positive on the point that any attempt to tax *outstanding* State and local bonds, whether by legislation or by constitutional amendment, would be a grevious blow to the honor and credibility of both the Federal Government and the State governments.

I do appreciate the opportunity to record my views with this honorable body, and in conclusion I respectfully urge that you continue in full effect the existing exemption of the interest on State and local bonds from all taxation now or hereafter imposed by the Federal Government.

Form C.O. 504 15M

RICHARD J. DALEY
MAYOR
OTTO H. LOSER
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September 29, 1969

To The Honorable Members of the
United States Senate Finance
Committee Conducting hearings
on House Bill # HR 13270

Gentlemen:

As City Comptroller of the City of Chicago and, as President of the Municipal Finance Officers Association of the United States and Canada with a membership of approximately 4400 representatives of states, cities and counties of the United States, Canada, Puerto Rico and Virgin Islands, I requested permission to appear before your honorable body to testify on tax reform as it pertains to interest on municipal bonds. Due to the large number of witnesses who desire to testify on tax reform and the short time available for such hearings, the Chief Counsel of the Senate Finance Committee requested that I submit copies of my written statement to the Committee for consideration.

My comments follow:

States, Counties and Municipalities are continually beset by new problems -- requests for greater services, mounting costs of construction and administration and a struggle to obtain the revenues needed to provide the services and capital improvements. Now a new problem has been thrust upon us - "Tax Reform" in the form of H.R. 13270. Together with inflation, this has played havoc with many capital improvement plans. The principal item in the "Tax Reform" so far as it affects governmental units is the proposal to tax the interest on State and Municipal Bonds. Various proposals have been made as to the method of taxing municipal bonds:

A. Providing a minimum tax on the interest from all municipal bonds outstanding as well as new issues.

B. Allocation of allowable tax deductions of the taxpayer between taxable income and certain previously considered non-taxable income including interest on municipal bonds.

Interest Rates

As a result of the tax reform provisions as they effect interest on municipal securities, the municipal bond market has tightened to a degree where it has become almost impossible for municipalities to obtain funds.

Due to high interest rates, The Bond Buyer estimates $1,749,991,000 of municipal bond issues were cancelled, postponed or displaced by failure to receive bids and rejection of bids received during the period September 3, 1968 to August 22, 1969.

Interest rates since 1968, particularly since the taxing of interest on municipal bonds has been brought to wide public attention, have risen from 1-1/2% to 2%. Many states and municipalities have interest rate ceilings of 6.00% which were set by referendum or by State Legislatures years ago. Consequently they are unable to sell their bonds in a market which provides rates as high as 8-3/8% on AAA rated utility bonds with rates of 7-3/4% on other industrial bonds.

Few cities and states enjoy a triple A rating. Take the City of Chicago, for example, whose bonds have an A rating from Moody's Investment Service and AA from Standard and Poors Investment Service. On July 29, 1969 we tried to sell $25,500,000 of General Obligation Bonds, backed by the full faith and credit of the City of Chicago, which has never been in default on any obligation, at a rate of not to exceed 6% over the life of the bonds with varied maturities up to 20 years. The only bid received was 6.2202% which we could not accept due to 6% ceiling. On September 22, 1969 a member of one of the underwriting groups checked the New York and Chicago financial districts to ascertain whether these bonds would have a market at 6%. The answer came back that the best probable bid would approximate 7%.

Interest On Tax Anticipation Warrants

In Illinois taxes are levied during the year following the year in which appropriations for operating expenses are expended. In other words, in 1969, taxes are collected to cover 1968 expenditures. It, therefore, becomes necessary to substantially finance our general operations in each year through the sale of tax warrants (or tax notes) which become payable upon the collection of taxes during the ensuing year. Approximately $100,000,000 of tax warrants will be sold by the City of Chicago, excluding the six independent taxing bodies, in 1969 to finance its general operations and which will be paid off commencing June 1, 1970 when property tax installments become payable by the taxpayers. A year ago we sold such warrants to banks at 4-3/8% to 4-5/8% interest. Recently a group of largest Chicago Banks quoted a 7% interest rate on this type of paper.

Municipal bonds have enjoyed lower interest rates than industrial bonds in the past but, if the interest on such bonds becomes taxable in one form or another, the rates will rise to approximate those on industrial bonds.

The following schedule sets forth the approximate financing required by the City of Chicago and its six related taxing bodies during 1969 and 1970:

	Tax Anticipation Warrants		General Obligation Bonds	
	1969	1970	1969	1970
Chicago Junior College	$ 4,700,000	$ 9,500,000	$ -	$ 15,000,000
Chicago Sanitary District (1)	31,630,000	32,000,000	60,000,000	60,000,000
Chicago Park District	23,500,000	24,000,000	9,500,000	-
City of Chicago, Board of Education	148,200,000	148,700,000	-	-
Forest Preserve District	3,500,000	3,500,000	15,000,000	15,000,000
Public Building Commission of Chicago	-	-	35,000,000	165,000,000
City of Chicago:				
City - General Operations	100,000,000	100,000,000	-	-
Urban Renewal Preliminary Loan Notes	63,255,000	*63,000,000	-	-
Water Revenue Bonds (3)	-	-	-	30,000,000
Chicago O'Hare International Airport (3)	-	-	70,000,000	160,000,000
Electric Street Lighting (2)			2,000,000	-
Municipal Buildings			1,500,000	16,000,000
Public Transportation			6,500,000	-
Sewer			6,500,000	9,000,000
Garbage & Refuse Disposal			5,500,000	1,500,000
Redevelopment & Urban Renewal			3,500,000	26,500,000
Cook County	36,000,000	36,000,000	30,000,000	9,000,000
TOTAL	$410,785,000	$416,700,000	$245,000,000	$507,000,000

(1) A telegram to the Illinois Senators and Congressmen under date of August 1, 1969 from John E. Egan, President of Metropolitan Sanitary District of Greater Chicago (representing the City of Chicago and over 80 smaller metropolitan towns and villages in the Chicago Metropolitan area within Cook County, Illinois) reads as follows:

"The taxpayers of Metropolitan Chicago are committed to issue $380,000,000 in bonds to combat water pollution and meet federal water quality standards. We have not received the federal financial assistance we need to accomplish this task. Please do not add to our burden by removing our tax exemption."

(2) To complete installation in progress since 1966

(3) Revenue bonds (not general obligations of the City)

* Estimated renewals

Assuming a 2% increase in interest rates has resulted from proposed tax reforms, the additional annual interest cost in 1970 to the Chicago-Cook County taxpayers on 1969 issues alone will approximate:

	Interest Payable	On Tax Warrants And Preliminary Loan Notes	On Bonds
On 1969 Issue	1970	$8,215,700	$4,900,000

The bonds are scheduled to mature in 2 to 20 years with an average life of 10 years; hence, added interest costs continue in reducing amounts over 20 years.

The States of Connecticut and Ohio, the City of New York, and many local governments which could not postpone their bond sales will pay millions of dollars more in interest over the life of the bonds sold in the current market.

Inability to Finance the Needs of Government

The effect of the attempt by Congress to tax the interest on municipal securities has been a reluctance on the part of bond dealers and bankers to bid on an issue. Early in 1969, we attempted to sell approximately $70,000,000 of bonds; we had to reduce this by 50% and reschedule the issue in order to obtain a bid. In a later attempt to sell bonds, we had to agree that the sale would become void if Congress passed the tax bill in its present form before the bonds were delivered to the purchasers.

Even the United States Government is having trouble selling its guaranteed obligations. On September 10, 1969, $156 million H.A.A. Notes were unsold due to the 6% interest limitation. On the same day, $10 million Jefferson School District, Louisiana bonds failed to sell.

Investors are unwilling to purchase municipal securities until they can ascertain what the federal legislation will be. No investor wants to purchase a 6% or 7% bond (in a market where utility AA and AAA rated bonds bring 8% to 8½% and some Canadian bonds 9%) only to learn at a later date that the interest on his municipal bonds is partially or wholly subject to Federal Taxes on Income.

The big question is whether it has become necessary for Congress to "Cripple the Financing Power of States and Municipalities".

The Need for Municipal Financing

The needs for financing were never greater. Due to the population explosion and changing desires of the people there is a nation-wide need for:

A. New schools, new high schools, new or enlargments of colleges

B. Hospitals. Medicare and greater population has created a need for new hospitals and new equipment. Medicare has helped to create an unprecedented demand for hospital care. Greater attention is being paid to mental diseases. This requires additional clinics and hospitals giving this specialized care.

C. Transportation. The advent of larger airplanes has made many airports obsolete or partially so. To provide for the handling of the large airplanes, which will make their first appearance this Fall or early next year, require additional runways and other airport facilities. The railroads have given up much of their passenger service, adding to airline travel. The largest airports are so congested that flights are frequently delayed from one-half hour to more than an hour in takeoffs and considerably delayed in landing on the ground with extended delays before they can taxi to the terminals for debarkation. It is estimated that $300 million a year Federal funds will be needed for airport expansion. Local costs will exceed that figure.

Local transportation needs have outgrown existing facilities. Better transportation and extensions to accommodate the poor people of the community require outlays running to millions of dollars.

Most large cities and the states require superhighways to relieve local and through transportation for automobiles with outlays of many millions of dollars.

Severage systems require extension and enlargement to provide for increased population.

Model Cities Programs, Urban Renewal and Redevelopment plans require huge outlays to preserve our cities and to alleviate discontent of the poorer segments and middle class segments of the population. While Federal Grants provide some of these funds, the Cities must provide certain amounts as matching funds.

All of the foregoing require financing and much of the financing is an immediate need. Why should Congress on the one hand provide grants for the use of municipalities and then make it practically impossible for municipalities and states to finance their share of the costs. The very idea is "fantastic".

Higher Interest Rates Will Be Reflected In Construction Costs

As a result of higher interest rates, the costs of construction are rising. Taking into consideration higher interest cost and the effects of inflation, municipalities which appropriated amounts for Capital Improvements a year ago now find their appropriations inadequate.

Major capital improvements must be planned several years in advance and construction takes several years. Construction once started must be completed or the contracts must be escalated considerably to cover inflation and changing money rates. All this adds to the burden of the local taxpayers with no increasing benefit due to the delayed completion of the project.

The Boomerang Result Is Increased Local Taxes

The unavoidable result of the increased interest costs is higher state and local taxes or reduced public services -- or both. The most obvious result would be HIGHER REAL ESTATE TAXES since most of the bonds subject to the taxes are local government bonds and local governments must still rely on real estate taxes as their main source of revenue. Thus the "Reform" will mean higher costs of owning a home or apartment. The irony of this part of the "Reform" Package Legislation, touted to be a response to the demands of the "little people" is that it will boomerang right back on the average American homeowner and citizen it is supposed to pacify.

It is true that reforms have been demanded, but they need not be boomerang reforms. Mr. Average American was not asking for "reforms" to increase his cost for new schools, new hospitals and other improvements or to increase his sales taxes or his state income tax. That is exactly what he is being offered as a result of House Bill 13270.

Equity or Inequity

There isn't even an argument in "tax equity" for including municipal bond interest in the tax base of the bill. The bill identifies certain classes of "tax preference" income and proposes a minimum tax on them. For people in the top tax brackets -- 60% to 70% -- the minimum tax would be half, or not over 30% to 35%.

By coincidence, 30% to 35% is exactly the amount municipal bondholders have traditionally "paid" by accepting lower interest rates on municipal bonds instead of buying equivalent private obligations (that is, municipals have sold in recent years at yields of 65% to 70% of corporates).

As a result the municipal bondholder has already in effect, "paid" his minimum tax at the top bracket rates which the bill sets for other "sheltered" income. Thus in the case of municipal bond interest alone, the bill would impose a double levy by taxing the residual balance (the interest) by another 30% to 35% at top bracket rates. Few people find anything but inequity in taxing the interest on bonds already outstanding, as the House Bill plans to do.

What About The Tax Free Millionaires

The alleged present "taxpayers' revolt" was procured by adroit propaganda concerning 154 millionaires who paid no income tax although they had at least $200,000 in adjusted income. But when the details about their tax returns came out, THERE WAS NO SHOWING OF THE AMOUNT OF MUNICIPAL BOND INTEREST RECEIVED by them. Nevertheless, the House Ways and Means Committee report subtly juxtaposes the recommendation fo. taxing municipal bond interest with a recital about 154 millionaires.

I have seen estimates to the effect that the Federal Government would collect $88,000,000 a year by taxing interest on local government bonds. You can be assured that the additional property taxes which would be paid by all property owners as a result of the higher interest costs on bonds would offset this income tax many fold.

There is Doubt As To Constituitionality

The Attorney General of the United States has stated that grave consititutional problems are raised by including municipal bond interest in a "minimum tax" base. Therefore, the administration did not recommend such inclusion. But the House has now overridden the constitutional objection. The inevitable litigations, if this measure is finally passed, are expected to unsettle the municipal bond market for years. Attorneys General over many years repeatedly taken stands against the taxing of interest on municipal bonds.

Tax Subsidy Plan

House Bill 13270, having ended traditional "tax exemptions", then purports to give an option to state and local government issuers to receive a "subsidy" if they agree to issue their bonds in a fully taxable basis.

The most obvious flow in this plan is that the Secretary of the Treasury is given the authority to determine the measure of the "subsidy" which is supposed to make the states and cities financially whole. The floor under the amount he can select (25% of the taxable rate after 5 years) is lower than the traditional benefit which states and cities have enjoyed in issuing their bonds. They could hardly expect to avoid loss under such a subsidy plan -- coupled as it is with mandatory taxes (LTP and allocations) on bonds issued under the alternative "option".

The Ready Marketability Of Local Government Bonds Would Be Impaired

The tax legislation now before the Senate, if enacted into law, will mean that new buyers must be found for from $10 billion to $20 billion annually of new debt securities of the local sector of the economy according to a survey of the financial community opinion made by "The Bond Buyer".

Prior to the attempt to tax the interest on local government bonds, governmental bodies with reasonable credit ratings could readily dispose of their bonds. Based upon the experience of many municipalities in dealing with the Federal Government, endless delays would be encountered in attempting to sell municipal securities to any Urban Development Bank formed by the Federal Government for the purpose of purchasing such bonds as an aid to the local governments.

Investors' Crisis

The members of the Senate Committee and the United States Senate are respectfully requested not to turn the uncertainty which has seized the tax-exempt bond market into a crisis which will curtail drastically the much needed social improvements in all sections of the country for years to come. The only way to avoid this is to veto the bill which will tax in whole or in part the interest on municipal bonds.

The Cities will have three choices if this bill goes thru:

1. To curtail much needed improvements and spread them over a longer period of years. This means "Retrogression" and not "Progress". No large city can afford this.

2. To pay the higher interest rates on their bonds, passing them on to the taxpayers in the form of property taxes.

3. To obtain a greater amount of financing for improvements by including the estimated cost of improvements in the current year's tax rates. Property taxes already are so high that some municipalities face a taxpayers strike.

Respectfully submitted,

Otto H. Loser
City Comptroller

Statement of Mary Evelyn Parker, Treasurer, State of Louisiana

INTRODUCTION

I am submitting this statement as Treasurer of the State of Louisiana and also as Chairman of the Louisiana State Bond Commission which has the statutory responsibility of issuing all state and state agency municipal bonds. Our primary concern is the consideration now being given by the committee to those provisions of H.R. 13270 which directly and indirectly affect the interest income of municipal bonds, specifically Sections 301 and 302 of the bill.

The State of Louisiana and its political subdivisions have traditionally relied upon the existing constitutional concept of inter-governmental immunity in issuing municipal bonds for its capital improvements. I say without reservation that each and every aspect of state and local programs of education, health and transportation have benefited from the tax exempt feature of municipal bonds and the future progress of these programs is dependent upon the continuation of our ability to finance such projects through the issuance of fully tax free bonds.

Complete exemption is and has historically been the rule of our land and we believe that long established rules should not be abandoned except for good reasons which are conspicuously absent in the present proposals.

SECTIONS 301 AND 302 OF THE BILL

Reasons Given For Tax Reform Bill

We have analyzed the justifications presented in the House passed Tax Reform Bill and conclude that the majority of them are not applicable to municipal bonds, and where purported to be, the reasons are based on erroneous presumptions.

The arguments advanced in the majority report that tax reform is essential as a matter of justice and taxpayer morale, to prevent misallocation of resources and to redirect investment toward employment efforts certainly cannot be applicable to municipal bonds. It can be said conclusively that justice is now served by the capital improvements made possible through tax exemption bonds for the benefit of taxpayers and to restrict these programs would reduce taxpayer morale rather than enhance it. It can also be stated conclusively that tax exempt bonds have not resulted in a misallocation of resources or the misdirection of investments for there is little question that no programs exist that are more important to the welfare of our nation than education, health and transportation which are the areas where the majority of these monies have been expended. Investments in municipal bonds make possible public improvements and at the same time the funds provide employment for many people and benefit the community, the state and the nation as much, if not more than those funds invested in so-called unsheltered areas.

The argument advanced that it is believed that the tax preference of municipal bonds permits a minority of high income individuals to escape payment of taxes resulting in a loss of revenue greater than the advantage it affords state and local governments is erroneous. First, of course, no loss has occurred in federal tax revenue since the federal government cannot lose that which it never had. Secondly, no evidence has been presented that the additional tax collections would be greater or even equal to the savings in interest to state and local governments. In addition, we feel that investors in municipal bonds have been taxed and that the tax was paid by the investor at the time of the issue through the sacrifice of interest income. Tax exemption of municipal bonds is a tax prepayment which has the great advantage of saving the cost of collection and results in what we feel to be meaningful tax sharing.

Undesirable Effects of the Bill

To use an over-quoted principle, "The power to tax is the power to destroy." The pending proposals have created the most chaotic municipal bond market in history and resulted in the increase in interest rates in what we believe to be in excess of 1%. If the bill is adopted in its present form we feel that the interest rates will soar another 1½% or 2%. These increased costs have delayed many local programs and in some cases the increased cost will no doubt make the project prohibitive. Lousiana has scheduled for sale $15,000,000 in Capital

Improvement Bonds on September 30, 1969. Because of the pending proposals and our 6% interest limitation, it now appears that no bids will be received on these bonds. Louisiana and its political subdivisions during the next two year period will need in excess of $600,000,000 for planned capital outlay and this financing can only be accomplished through the issuance of municipal bonds. The pending proposals if adopted would without question delay and thereby destroy these programs as they were originally conceived.

Constitutional Questions and Alternative Proposal

We contend that short of a constitutional amendment, Congress has no right to tax municipal bonds without the consent of the states. The constitutionally mandated doctrine of reciprocal immunity which is designed to permit the free functioning of federal, state and other local governments without interference from the others is valid and is violated by both the provisions of the bill which require that municipal bond interest be included in the base of the minimum tax and those provisions that require that itemized deductions be allocated between taxable and tax exempt income. The result is a direct tax and an indirect method of taxing the resources of state and local government and this power to tax has not been delegated to the United States by the constitution and is prohibited without the consent of the concerned governmental unit. These constitutional questions, which I have perhaps over simplified would probably take years to settle and could cause substantial delays in capital improvement programs. Because of the chaotic conditions which would occur during this period, we think that the question should be settled now by exempting municipal bond interest from Sections 301 and 302 of the bill.

In the alternative, if two-thirds of the members of the United States House of Representatives and Senate feel that there is some justification for removal of the tax exempt feature of municipal bonds, we would suggest that a constitutional amendment be adopted and submitted to the states for ratification. There is little question but that such an amendment would fail to receive the required three-fourths vote necessary for ratification. This would, however, give the states, and thus its citizens, an opportunity to voice an opinion and make the decision rather than relying on the U. S. Supreme Court.

SECTIONS 601 AND 602 OF THE BILL

The alternative of issuing taxable bonds and receiving an interest subsidy is certainly no answer to the admittedly higher interest cost which will result from the other provisions of the bill. The ability to issue tax exempt bonds for local building programs is one of the very few areas of local government functioning which the states have been able to retain. The federal interest subsidy is no more than another step in what appears to be a continual effort on the part of our national government to encroach upon the sphere of action of our state and local governments. Our local programs should not and cannot become more dependent upon our federal government.

CONCLUSION

Those aspects of Sections 301 and 302 of H. R. 13270 which will restrict the tax exempt feature of municipal bonds will be of no benefit and would have the effect of increasing the cost of and deterring needed capital improvement programs. In addition, Sections 601 and 602 relating to federal interest subsidies would complicate and increase the cost of these programs and are extremely undesirable.

Interest income received on municipal bonds should be specifically excluded from the provisions of Sections 301 and 302 of the bill, and Sections 601 and 602 of the bill should be deleted.

STATEMENT BY COMPTROLLER MARIO A. PROCACCINO OF NEW YORK CITY

Gentlemen, as Comptroller of The City of New York, I urge the amendment of H.R. 13270 relating to hitherto tax-exempt municipal securities. This bill imposes two new taxes on individuals receiving interest on state and municipal bonds. One is a "minimum tax" plan which applies to outstanding bonds; the other denies the municipal bondholder his full personal deduction otherwise allowable.

I am opposed to any proposal that would affect unfavorably or destroy the tax-exempt status for municipal bonds for many reasons:

First, the constitutionality of this proposed legislation is very questionable. I am afraid that any litigation that would eventually reach this decision would carry through many years. During this time, investors in municipal bonds, uncertain of the final outcome, would manifest interest only if a high yield gave them a protection against the probability of these bonds being taxed.

Secondly, it will deter corporations, banks and institutional investors from investing in municipal bonds. They would justly feel, "The individual investor now, we will be next."

Thirdly, it will be disastrous to the capital construction program of New York City. Our bonds will require such a high interest rate that the municipal taxpayer may find it most difficult to meet the resulting growth in real estate tax burden. Also, the investors may be so disillusioned, or so fearful, that they may not invest in the bonds of our City, or any city, but choose instead other forms of investment than state or municipal bonds.

In the year 1968–1969, New York City issued over $500 million in serial bonds for the following municipal purposes:

	Millions
Schools and colleges	$89.9
Transit	81.6
Health services	51.6
Water supply	17.7
Docks and piers	10.2
Recreational and cultural	24.1
Public safety (police, fire)	44.2
Streets and sewers	59.2
Housing development, urban renewal, model cities	48.7

This is the general pattern of bond issuance of this City. H.R. 13270 would cause a drastic reduction in the construction of new schools, colleges, hospitals, health centers, police precinct houses, fire houses, parks, streets, sewers, transit lines, docks and piers, and their major rehabilitation or re-construction, in our City. Rehabilitation and rebuilding of our slums through neighborhood conservation, model cities program or neighborhood development renewal would also suffer.

It is estimated that eliminating the tax-exempt status of municipal bonds would increase the market interest rate two percent. The threat embodied in H.R. 13270 has already pushed up rates one percent. In arriving at my estimate of increase in cost, it may well reach 1½ percent, but I will apply 1 percent.

Thus, borrowing in one year of $500 million for such vital capital improvement would involve at least $5 million in added interest costs the first year. With an average life of 7 years for the bonds issued, the House bill would add about $35 million in interest over the life of just one year's issue. Over a period of 10 years, estimating a new issue of $500 million each year, which provides no increase in expenditure, the additional burden would be an extra $350 million for capital improvements.

Such a burden would practically stifle New York City's proposed transit improvement plan of new lines to areas in desperate need of such lines in Brooklyn, Bronx, Queens and lower Manhattan. The total capital cost of this program is $1.4 billion, of which the City would spend $800 million.

Faced with increased costs of construction, the added cost of interest on bonds to finance these improvements will price this program out of reality.

Loss of this program will not only affect seriously our City's total economy and hurt all the City's taxpayers, but it also will cut down the return in added taxes to the Federal Government which a more prosperous community can generate.

In addition to the bonds mentioned, New York City has sold approximately $2.8 billion in Notes in 1968–69, for the following purposes:

(1) $719 million in Revenue Anticipation Notes, pending the receipt of federal and state aid, and about $1,427 million in Tax Anticipation Notes.

Under H.R. 13270, the added interest cost for these short-term borrowings with an average maturity of 6 months would cost New York City's taxpayers about $11 million extra a year. These costs must be charged to the Expense Budget which is subject to a tax-incurring limitation, and provides for operational expenses. This can only result in a serious cut in City services, affecting the number of police, teachers, hospital and health services and services in other vital areas. Our City desperately needs more funds in these areas, not less. At this time of "the crisis of the cities," we need more help from the Federal Government, not such destructive action as H.R. 13270 which would worsen the fiscal plight of our City, and every other city in their efforts to provide adequate services.

(2) We also sold $615 million in Bond Anticipation Notes, for the support of middle income housing. The increase which H.R. 13270 requires in the interest cost of these Notes results in higher rents for middle income tenants. They had to absorb some $6 million annually in added interest because of the threatened loss of the tax exemption on these bonds.

(3) On August 20, 1969, the City sold over $215 million of Bond Anticipation Notes, with maturities of up to one year, at annual interest costs of 7.43 percent and 7.48 percent, depending upon the term of the Notes, the highest in the City's history for short-term obligations. We attribute this shocking rate largely to the pendency of H.R. 13270.

(4) Abcut $87 million for Urban Renewal Notes were sold for the rehabilitation of manv of our City's rundown areas. Even though the Federal Government is aiding with Model Cities and Neighborhood Development funds, this is far from enough. The City must contribute not only its share of the aided programs but much more to make even a dent in what must be done.

These added interest costs from taxing city bonds must be borne by our already over-burdened taxpayers. The only alternative is to reduce vital public services. Every taxpayer, renters as well as property holders, would share in this burden, no matter how modest his means.

The House bill provides for a limit on tax preferences which would apply to bonds outstanding. But the holder of these bonds has already paid, by accepting reduced interest income, for his tax exemption. In buying these bonds he gave up the opportunity of investing his money in higher paying corporate securities. If an investor cannot be certain of his return at the time of commitment, he will certainly consider possible adverse future changes in tax status. Here those dangers are so fully apparent that his loss of confidence would reflect itself in the higher yield of the securities. This is why the market is reacting so violently to the pendency of this bill.

Many people have been led to believe that the tax-exempt securities were added to the "tax-reform" package because of about 154 individuals with adjusted gross incomes of $200,000 or more, who paid no tax in 1966. However, an examination of these tax returns indicated that the tax-free income was achieved by other tax shelters, and not by the use of tax-exempt municipal bonds.

The House bill provides an option for state and local government issuers to receive a "subsidy" if they agree to issue their bonds on a fully taxable basis. However, the Secretary of the Treasury is given the authority to determine the rate of this "subsidy." The floor under the amount he can select (25% of the taxable rate after 5 years) is actually lower than the benefit which states and cities have enjoyed in issuing their bonds—some 30% to 35% in the past few years.

How can New York City or any other city, state, or other local government sensibly base its financing on such an escalating uncertainty?

Why should a City be compelled to gamble its present and future development and urban renewal on a promised subsidy that could eventually evaporate? Particularly when it involves added administrative costs on the city.

Due to the inability of state and local governments to finance projects at reasonable interest costs, many of them have cut back and deferred bond issues at a time when there are great needs for additional schools, hospitals, transit, air pollution and other capital needs. Projections have been made that the potential costs to state and local governments over the life of estimated issues of $19.5 billion would increase interest costs by over $2.5 billion. It cannot be deemed true reform to thrust this on our local and state taxpayers, with attendant increase in regressive local tax burdens and reduced essential services.

Gentlemen, I have been listening with hopeful expectation to reports about Washington's concern about the plight of urban communities. This plight is real and Federal concern is fully justified. But how can we square that concern with such a destructive measure as the curtailment of tax exemption for our City's bonds?

I urge that your Honorable Body continue its deliberations on real tax reform, particularly in tax relief to middle and low-income persons. But I strongly believe that in the interest of those same persons, the exemption of interest on municipal securities must be preserved. The huge financing burdens that state and local governments are faced with for much needed improvements should not be jeopardized by the uncertainty into which the municipal bond market has been thrust by this bommerang "tax reform" with its inevitable additional interest costs that will have to be borne for the most part by over-burdened taxpayers of modest means.

I know that your Committee will give the most serious evaluation to this proposal and its effect on the capital development and renewal efforts of New York City.

I express my appreciation to your august Body for this opportunity to submit this presentation. I offer you my cooperation in any area relative to this most important issue.

STATEMENT OF JAMES A. FITZPATRICK, CHAIRMAN, POWER AUTHORITY OF THE STATE OF NEW YORK

On behalf of Power Authority of the State of New York, of which I am chairman, I respectfully urge your committee not to include in any tax reform legislation provisions similar to those of §§ 301, 302, 601 and 602 of H.R. 13270.

The Power Authority is a non-profit public benefit corporation consisting of five trustees appointed by the Governor for five-year overlapping terms. Its operations are entirely self-supporting, financed through the issuance of tax-free revenue bonds which must be repaid from the sale and transmission of electricity. The Authority has no other source of revenue. Its obligations are not guaranteed by the State or any other governmental body.

The sections of H.R. 13270 to which the Authority objects (i) impose a tax on part of the income of certain individuals derived from state and municipal bonds [§ 301], (ii) disallow a portion of the deductions otherwise available to any tax-payer if he obtains income of $10,000 or more from state or municipal bonds or other sources not ordinarily taxed [§ 302] and (iii) apparently recognizing the disastrous effect of these provisions on the ability of state or local governments to finance their operations, establish a scheme for subsidizing state or local governments which issue fully taxable securities [§§ 601, 602].

Other witnesses have pointed out that those provisions are not needed to accomplish the objectives of H.R. 13270 and that they are of very dubious constitutionality. In the latter connection, as a lawyer as well as an administrator, I wish to endorse the statement submitted to you by Hawkins, Delafield & Wood, bond counsel to the Power Authority and to a large number of other public agencies in many parts of the country.

The purpose of my statement is to describe to you the role of the Power Authority in helping to meet the present and future power requirements of the State of New York and the effect on our operations which even the threat of legislation like H.R. 13270 has already had, and will continue to have until the Congress has acted decisively to dispel the threat.

The Power Authority was created in 1931 during the administration of Governor Roosevelt to harness the hydroelectric potential of the Long Sault Rapids in the St. Lawrence River. In 1951 under Governor Dewey it was given the added responsibility of redeveloping the power potential of Niagara Falls as authorized by the 1950 Treaty with Canada. In 1968 the Authority was given further responsibilities to which I shall refer later.

Federal and international authorizations for the St. Lawrence Project were obtained in 1953. The Authority constructed the Project between 1954 and 1959 in partnership with the The Hydro-Electric Power Commission of Ontario at a cost of about $650,000,000 which was shared equally by the two entities. This project constitutes the basic core of the St. Lawrence Seaway. It turned Long Sault Rapids into a lake and thus made deep water navigation possible.

The Authority financed its share of the cost through the sale of $335,000,000 of revenue bonds, bearing interest at an average rate of 3% per annum.

Congress in 1957 passed a bill specifically mandating the Federal Power Commission to issue the Power Authority a license to utilize all the Niagara water available to the United States under the 1950 Treaty with Canada. The Federal Power Commission issued the license in January 1958. First power from the project was produced in February 1961. The project was completed in 1963.

The cost was $740,000,000, paid through the issuance of revenue bonds bearing interest at an average of approximately 4¼% per annum.

The total firm capability of the Authority's two completed projects is 3,200,000 kw. That is equal to about 1/6 of the present total electric capability of New York State, which is about 19,500,000 kw. I should point out, however, that the Authority sells 150,000 kw in Vermont and 100,000 kw to rural electric cooperatives in Pennsylvania. It therefore normally supplies only about 15% of the power generated in New York. However in emergencies, which have been frequent recently, it has supplied more than 20% of the load.

Both the state and federal statutes require the Authority to sell power at the lowest possible price. This is precisely what it does. It sells power at cost. Cost consists solely of operation and maintenance expenses and interest on and amortization of bonds which paid for the projects.

The latter is by far the largest element of cost. About 90% of the Authority's revenues go for bond interest, bond retirement and reserves.

Thanks to the low interest costs I mentioned, the Authority is able to sell electricity at the bus-bar for $1 per kilowatt per month plus 2.67 mills per kilowatt hour.

These are the lowest rates in the State and probably the lowest anywhere in the country outside the Tennessee Valley or the Pacific Northwest.

State and federal law require the Authority to market power from its hydroelectric projects primarily for the benefit of domestic and rural customers. Municipalities and cooperatives have preference in the purchase of Authority power. The Authority supplies the full requirements of all the cooperatives in the state and all the municipal systems which have asked for power, which is 86. The Authority also sells power to utility companies for the benefit of their rural and domestic customers.

Both State and Federal law recognize that the Authority must sell part of its power output to industry near the sites of the projects for the benefit of the economy of the areas and to keep the price of electricity down. The federal law specifically requires that 445,000 kw be sold to industries on the Niagara Frontier to keep down the cost of industrial power there. The economy of the Frontier was founded on low cost hydro-power 75 years ago, and is still almost entirely dependent on it.

The Authority supplies an additional 250,000 kw to Niagara industry, and 374,000 kw of firm power and 108,000 kw of interruptible power to the aluminum industry on the St. Lawrence. It also supplies 12,000 kw to a satellite plant of General Motors near Massena which utilizes aluminum produced there.

All this power was sold by 1963. Until last year the Authority had no authorization to produce any additional power to meet growing industrial and utility requirements. The increased needs of municipalities and cooperatives had to be met entirely by withdrawing power from other customers.

By 1967 the potential demand for new low-cost industrial power, which the Authority had no way to supply, amounted to about 600,000 kw. The tax-paying utilities in the state were and are unable to supply such industrial demand at rates which would be competitive with other parts of the country for high-load factor industries using power around the clock.

These facts, and other facts showing the need for additional production by the Power Authority, were submitted to a committee on power appointed by Governor Rockefeller. The committee recommended that the Authority be given the right to build pumped storage and nuclear plants.

The Governor accepted the committee's recommendations, and the Legislature enacted them into law in May 1968. The law authorized the Authority to construct pumped storage hydroelectric plants "to supplement the [state's] supply of electric power and energy" and nuclear power plants:

"(i) to supply sufficient supplemental energy to make possible optimum use of the generating capacity of the authority's Saint Lawrence and Niagara hydroelectric projects, (ii) to supply low cost power and energy to high load factor manufacturers which will build new facilities in the authority's area of service or expand existing facilities provided such power and energy is made available to them, and (iii) to supply the future needs of the authority's existing municipal electric and rural electric cooperative customers."

The Authority moved promptly to carry out its new legislative mandate. In August 1968 it applied to the Federal Power Commission for a license for a 1,000,000 kw pumped storage hydroelectric project in Schoharie County. The license was granted in June of 1969. The project is to produce some power in 1972 and be completed in 1973 at a cost of about $142,000,000.

In December the Authority filed application with the AEC for a construction permit and operating license for an 800,000 kw nuclear plant on Lake Ontario. That plant will cost upwards of $225,000,000. It is scheduled for completion in 1973. It can be completed that soon only because the Authority took over commitments of Niagara Mohawk Power Corporation which had been entered into in 1966 for a proposed plant on the Hudson River which is no longer contemplated.

Thus in the next four years the Authority will add 1,800,000 kw to its capability, increasing it to 5,000,000 kw.

During that same period the State's power requirements are expected to increase by about 5,000,000 kw. That means 6,000,000 kw of new generating capacity must be added just to take care of new load and to maintain the reserve margin we now have, which is about 18%. I am sure you will all agree that this summer that 18% margin proved to be inadequate.

To restore the 29% reserve margin we had in New York two years ago—which we need to maintain dependable, adequate service—8,000,000 kw of new capacity will be needed by 1973.

The construction of so much new capacity places a heavy burden on the rate structures of the State's utilities. The two largest have already had to seek rate increases this year.

If it were not for the anticipated contribution to be made by the Power Authority, the cost of power in New York might well escalate to the point where the survival of some industries heavily dependent on electric power would be doubtful.

As I pointed out before the Authority's power costs and power rates depend almost entirely on interest costs.

So far we have not issued any bonds for our two new projects. They are being financed temporarily through the sale of short term notes, which will be repaid from the proceeds of revenue bonds when the bonds are sold, probably next year.

The Authority sold $50,000,000 of notes in September 1968 at an interest rate of 3.8%.

When these notes came due a year later—after the impairment of the tax-exemption of State and municipal bonds had been suggested—we were forced to sell 9-month bond anticipation notes at a rate of 7¼% per annum.

That is more than three times what the Authority paid on short-term notes in 1958 and only about 1 point less than a private utility might expect to pay. In other words as far as the market is concerned our bonds have lost most of their tax exemption already.

If the Authority had had to pay that sort of interest rate in 1954 or 1959–62, when it sold bonds for the St. Lawrence and Niagara Projects, it is doubtful whether the projects would have been built. Certainly if they had been built at all the power they would have produced would not have been low-cost power.

The amount of new capacity the Authority can economically add to its system in the future may be substantially reduced if we are forced to continue to pay interest rates based on the market's assumption that our bonds may be taxed.

The Authority has no legal authorization to issue federally subsidized taxable bonds if such subsidies should be authorized by the Congress. There is no likelihood of its obtaining such authorization soon enough to be of any use in financing projects now under construction. Nor is there any assurance that such subsidized securities would turn out to be practicable and acceptable to the market.

I see no chance of any improvement in the situation unless or until the Congress makes it unequivocally clear that the century-old tax exemption of state and municipal bonds is not about to be destroyed. I respectfully urge that your committee go on record against any impairment of that exemption.

JAMES A. FITZPATRICK, *Chairman.*

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DETROIT-WAYNE COUNTY
PORT COMMISSION

F. CLIFTON LIND
PORT DIRECTOR

AREA CODE 313
224-5656

3216 GUARDIAN BLDG. DETROIT, MICHIGAN 48226

September 17, 1969

Senate Finance Committee
2227 New Senate Office Building
Washington, D. C. 20005

Attention: Thomas Vail, Chief Counsel

Gentlemen:

The Detroit-Wayne County Port Commission, the county agency vested by Michigan law with responsibility for the economic welfare of the Detroit-Wayne County Port District, wishes to file for the record of the Senate Finance Committee, in its current hearings on H.R. 13270, the following statement:

This Commission is strongly opposed to any attempt, directly or indirectly, to tax state and municipal bonds.

It is, therefore, unalterably against the passage of Sections 301, 302, 601 and 602 of H.R. 13270 for the following reasons:

1. The sections in question do not carry out the stated purposes of the bill.

Sponsors of the bill have repeatedly indicated that it is intended to close tax loopholes which presently cause great inequities in tax burden among various classes of taxpayers.

The Treasury Department claims that the tax exempt status of interest received by holders of state and municipal bonds constitutes such a loophole. In an attempt to substantiate this claim it cites 154 cases of individuals, having incomes of more than $200,000 per year, who pay no taxes.

However, in every one of the cited cases, the tax-free status was a result of interest, charitable contributions and other deductions, not through holdings in municipal bonds.

Under today's economic conditions, the person who becomes free of tax liability as a result of placing all his funds in municipal bonds probably is a hypothetical fiction. An investor would have to be extremely naive to follow such a course, when he would be forced to accept approximately 30% less in interest from municipal bonds than good business judgment would require from comparably rated corporate obligations only to find that bonds which he acquired only a relatively short time ago at the then current interest yields, have suffered substantial declines in market value due to general interest rate increases in corporate bonds.

These sections would fail to carry out stated purposes of the bill for yet another reason.

The Report of Proceedings in the present hearings, September 4, 1969, P. 184 indicate that Treasury believes the application of Section 301 would net $45 million in annual tax revenue. The real effect would be to increase costs to state and municipal taxpayers by multiples of this amount each year. These increased costs would be required to be met by increases in local taxes. This would be neither equity nor tax reform.

Furthermore, these increased local taxes would be fully deducted on Federal Income Tax returns, resulting in a net loss to the Treasury.

2. If adopted, these sections would raise serious constitutional questions.

Most tax deductions are based on government policies which encourage philanthropy, stimulate needed investments, foster discovery of natural resources, and the like. Exemptions are the result of entirely different considerations.

In the case of municipal bonds, the exemption on interest received stems from the established constitutional principle of intergovernmental immunity. This principle has been followed throughout the nation's history in order to preserve the continued functioning of States and their political subdivisions in the stable framework of our Federal system of government.

If adopted, these sections would immediately raise constitutional questions as to the power of Congress to indirectly tax income from state and local obligations. They would inevitably produce litigation lasting anywhere from three to five years. Such litigation could be counted upon to thoroughly disrupt the municipal bond market which is already greatly hampered by the mere threat of passage of these provisions.

3. Adoption of the sections would have a crippling effect on the ability of state and local governments to fund capital projects.

State and local government construction of vitally needed schools, hospitals, water and anti-pollution facilities, streets, sewers and other public improvements would be made even more difficult, and, in many significant instances, impossible.

In a period when State and local governments are faced with tremendous problems of preserving and improving environmental conditions for an ever expanding population, the average taxpayer would bear a significantly increased burden if local governments are to continue to combat environmental problems. A great many of these taxpayers will find this burden unbearable, if they are employed in construction industries, because they will face unemployment as well.

In conclusion, we oppose the above cited sections because they would increase local tax burdens; because their proposal has already disrupted the municipal bond market and their adoption would bring utter chaos; because their adoption would destroy the ability of local governments to provide for public needs.

Senate Finance Committee
2227 New Senate Cffice Building
Washington, D. C. 20005

Adoption of these sections would entail the serious jeopardizing of a bond market which funds some $15 billion in public improvements each year, in exchange for an illusory $45 million gross tax revenue to the Treasury annually, which actually amounts to a substantial net loss after deductions.

Adoption of these provisions would be infeasible, inequitable and, would not be tax reform.

Respectfully submitted

Detroit-Wayne County Port Commission

F. Clifton Lind
Port Director

FCL:ap

PORTLAND PUBLIC DOCKS,
Portland, Oreg., September 26, 1969.

Mr. TOM VAIL,
Chief Counsel, U.S. Senate Finance Committee,
Washington, D. C.

DEAR MR. VAIL: Please be advised that The Commission of Public Docks, an autonomous arm of the municipal government of Portland, Oregon, is strongly opposed to a change in national tax policy which would eliminate the tax exempt status of municipal bonds.

The Dock Commission is charged with the operation of the seaport of Portland, Oregon, and with the provision of physical facilities to accommodate the harbor's maritime commerce. Funds for capital construction projects on Portland's public waterfront are derived from the sale of municipal general obligation bonds and of municipal revenue bonds.

Elimination of tax exempt status for such bonds would result in an immediate and substantial rise in the cost of borrowing funds for needed capital improvements and would place the increased interest burden on the already overburdened local taxpayer. Such a change in national tax policy would have a crippling effect on the future of publicly financed waterfront construction in Portland, Oregon.

We respectfully request that the position of the Portland Commission of Public Docks be made known to the members of the Senate Finance Committee and that this letter be made a part of the official record of the hearings on this matter.

Very truly yours,

THOMAS P. GUERIN, *General Manager.*

STATEMENT ON BEHALF OF THE WASHINGTON PUBLIC PORTS ASSOCIATION, SUBMITTED BY LEWIS R. HOLCOMB, EXECUTIVE SECRETARY, OCTOBER 1, 1969

INTRODUCTION

The Washington Public Ports Association is a state-chartered agency under provisions of Chapter 31, Laws of 1961 of the State of Washington. The Association is the authorized coordinating agency for all public ports of the state with, at present, forty-three active members. Its purpose is to assist, through various programs, economic and trade development of our ports, with attendant benefit to our local communities, our state and the nation. Washington state ports construct, maintain and operate marine terminals, docks, wharves, airports, industrial sites and improvements, and recreation areas in 32 of the 39 counties of the state. These port districts are municipal corporations, managed by boards of commissioners elected by the voters of the district.

The Washington Public Ports Association, managed by a board of trustees representing the 43 member ports, is vitally interested in the municipal bond provisions of HR 13270 now being considered by Congress. We appreciate this opportunity to present our views and to have them made a part of the official record of the Senate Finance Committee hearings on this matter.

STATEMENT

An on-going program of trade promotion and expansion, and construction of facilities to provide for increased trade, has placed the ports of the State of Washington in an impressive position. In this four-state Pacific Northwest region, world trade exceeds $3 billion annually, and the State of Washington accounts for more than 65% of that total. The contribution of the trade generated by the ports of Washington which is made to the nation's balance of payments is a significant one. Also, it is estimated that more than 10% of the state's employed labor force have jobs related to the export-import trade program.

This is made possible by an aggressive program of local public investment in new and improved terminal facilities.

A function of the public ports of Washington is the development of land and facilities for the growth, expansion and diversification of industry within our state. In this our ports have been extremely successful and the resultant boost to the state's economy is very significant.

This is a program principally financed through the issuance and sale of bonds.

Washington public ports have provided more than thirty recreational boating marinas, boat basins and launching sites, and provide moorage space for approximately 7,000 pleasure boats. Plans are already drawn to nearly double these facilities.

In the majority of cases these facilities were constructed with funds provided by revenue or general obligation bonds.

Our airport facilities, owned and operated by public ports, deal with many millions of passengers each year and the number is growing fast. Already plans are being discussed for the construction of two more major air facilities. Current expansion activities for existing facilities will cost in excess of $100 million.

Funds for these projects must come from municipal bonds.

Public ports are not generally producers of substantial net revenue return. Capital improvements of the nature and magnitude necessary for the future cannot be supported by tolls, fees and tariffs, but must rely upon bonds for funding. Any additional costs imposed by higher bond interest rates will, of necessity, reduce the capacity of these units of local government to provide the necessary services.

In Washington state the interest ceiling on public bonds has been 6%. In a bond market which was called "a disaster in a catastrophe" it became impossible to market tax-exempts at that rate. The 1969 legislature raised the ceiling to 8%. Already that figure appears somewhat unrealistic. Only last month the lowest bid offered for $22 million in Washington State Board for Community College Education bonds was 7.4%. Those are tax-exempts. It is obvious that the House-passed measure (HR 13270) has already had a serious impact on the bond market. If this bill passes the Senate with the onerous interest-tax provision still intact, we fully expect bond interest rates to rise to such a degree that all public agencies in this state will be absolutely unable to issue bonds. If that occurs, then the inevitable result will be to turn once again to that tired, overworked, unelastic and inequitable revenue source—the property tax.

If it is the intent of Congress to put the burden of this bill's bond provisions on the wealthy, as has been stated, then it very clearly misses the mark. The wealthy will just insist on, and receive, higher interest rates for the bonds and "poor old John Doe" will again have his pocket picked to provide the difference. It will again be the average homeowner who pays.

A quick glance at the plans of only eleven of Washington's public ports shows capital expenditures programed for the next few years totalling in excess of $244 million. These are to be funded almost exclusively from bonds. They are vitally needed projects that must not be jeopardized. Removal of the tax-exempt status of state and local bonds would generate only $100 million to the treasury, but would seriously threaten the public financial status of local government units.

Local units of government in this and other states have proved their capability to provide almost all appropriate necessary services. This is particularly true of ports. An additional provision of HR 13270 would allow municipalities the option of retaining their tax-exempt bond status or taking an "interest subsidy" approach. This could only result in an increase in the dependence of all municipalities on the federal government. Such a course should be avoided.

The Washington Public Ports Association wishes, by this statement, to register its opposition to any form of direct or indirect taxation of interest on municipal bonds. Local government is dependent on such bonds for progress and stability. Action such as proposed by HR 13270 can only result in the destruction of the independence and growth of states and municipal government entities.

Statement of the Delaware River Port Authority, Camden, N.J., Submitted by C. H. McWilliams, Secretary and Deputy Executive Director

An immediate and primary impact of the tax reform legislation presently being considered by the Senate Finance Committee would be the impairment of the attraction of municipal bonds in the open market including the fear that Congress might eventually eliminate the tax exempt feature altogether. If enacted, a breach of faith to municipal bondholders would occur and certainly these investors will lose confidence in the security of municipal bonds as investments. The net result would be that all investors in municipal bonds would demand higher interest rates as a hedge against tax losses if, indeed, they still found municipal bonds attractive investments at all. Following this would be the impact on states and localities who would be faced with higher borrowing costs and the potential inability to sell bonds. This could well lead to the pushing of capital financing costs for urgently needed public works beyond legal or economic limits.

In its quest for tax reform, Congress through its apparent attempt to tax a very small number of individuals who receive substantial interest from tax exempt bonds, is in effect shifting the tax burden of higher financing costs to millions of local tax payers-voters whose property and other taxes will have to be increased to meet these new and added costs.

The Delaware River Port Authority is a public corporate instrumentality of the Commonwealth of Pennsylvania and the State of New Jersey created in 1931 under the name of Delaware River Joint Commission, by Compact between said Commonwealth and State, and consented to by the Congress of the United States.

Its purpose in being is to exercise an essential governmental function which includes, among other things, the establishment, construction, operation and maintenance of railroad and other facilities for the transportation of passengers across any bridge or tunnel owned or controlled by the Authority, the improvement and development of the port district for port purposes, cooperation with all other bodies interested in development or use of the Delaware River, construction acquisition, operation and maintenance of other bridges and tunnels across or under the Delaware River, promotion as a highway of commerce of the Delaware River, the establishment, maintenance, rehabilitation, construction and operation of a rapid transit system between points in New Jersey communities within a 35 mile radius of the City of Camden and points within the City of Philadelphia, Pennsylvania, and the performance of such other functions which may be of mutual benefit to the Commonwealth of Pennsylvania and the State of New Jersey insofar as concerns the promotion of the Delaware Valley.

The attached map shows existing facilities operated by the Delaware River Port Authority and proposed sites for new projects (the numbers shown correspond with those shown on the map).

9. Benjamin Franklin Bridge—a Bridge across the Delaware River between Philadelphia and Camden, New Jersey. Opened for traffic in 1926.

1. Walt Whitman Bridge—a Bridge across the Delaware River between South Philadelphia and Gloucester, New Jersey. Opened for traffic in 1957.

5. Chester-Bridgeport Ferry—a ferry operation across the Delaware River between Chester, Pennsylvania and Bridgeport, New Jersey. Operated by the Authority since May, 1965.

14. Rapid Transit System—a high-speed transit facility between Philadelphia and Lindenwold, New Jersey, a distance of 14.5 miles. Opened for passenger traffic in January, 1969.

4. Chester-Bridgeport Bridge—a Bridge across the Delaware River between Chester, Pennsylvania and Bridgeport, New Jersey to replace the Chester-Bridgeport Ferry. Scheduled completion September, 1972.

12. Philadelphia-Pennsauken Bridge—(called Delair Bridge on map) a Bridge across the Delaware River between Philadelphia and Pennsauken, New Jersey. Scheduled completion September, 1972.

13. Improvements to Existing Facilities—improvements to existing and construction of new approaches to the Benjamin Franklin and Walt Whitman Bridges. New Centralized Maintenance Building.

The Authority at present enjoys a strong and healthy financial condition. It's revenues adequately cover the combined costs of operation, maintenance and debt service. As of August 31, 1969, the outstanding bonded indebtedness aggregated $140,000,000. These Bonds were sold on April 23rd of this year at an average interest cost of 5.623% in order to accomplish one half of our financing program. The purpose of this financing program is principally to construct two new bridges across the Delaware River to prevent traffic congestion from strangling the economic well-being of the Delaware Valley. The proceeds of these Bonds provided moneys in which, together with other funds available, were sufficient to (1) refund the then outstanding $65,054,000 1953 Bonds, (2) redeem the then oustanding $60,000,000 1968 Notes issued for construction of the Rapid Transit System, (3) provide the balance to pay the remaining costs of the Rapid Transit System increment now nearing completion, (4) pay a portion of the cost of constructing the Chester-Bridgeport Bridge and the Philadelphia-Pennsauken Bridge, and (5) to provide funds for certain other projects and financing costs. Additional bonds in the amount of approximately $140,000,000 were expected to be issued later this year or thereafter to pay the remaining cost. Because of the deteriorating market conditions for tax-exempt municipal bonds caused in part by the clouds of uncertainty created by the proposed tax reform bill, we have determined to delay permanent financing pending more stable market conditions.

The principal and interest for these Bonds are payable solely from the tolls and fares charged for the use of the facilities of the Authority. The Authority has no power to levy or collect taxes. Our Financial Advisors, Drexel Harriman Ripley, Incorporated and Elkins, Morris, Stroud & Co., have advised us that if $140,000,000 of bonds were sold today, the interest cost to the Authority would approximate 6.75%. Add to this the possibility of a greater interest cost to the Authority because of this legislation affecting the tax exempt status of our outstanding and proposed Bonds, we are of the opinion that the individual user of our facilities—the daily commuter—would have to bear the burden in the form of higher tolls and fares. In addition, any substantial lessening of revenues and/or increase in construction costs would have a marked effect on our now existing toll and fare schedules in order to raise the necessary funds to complete our financing program.

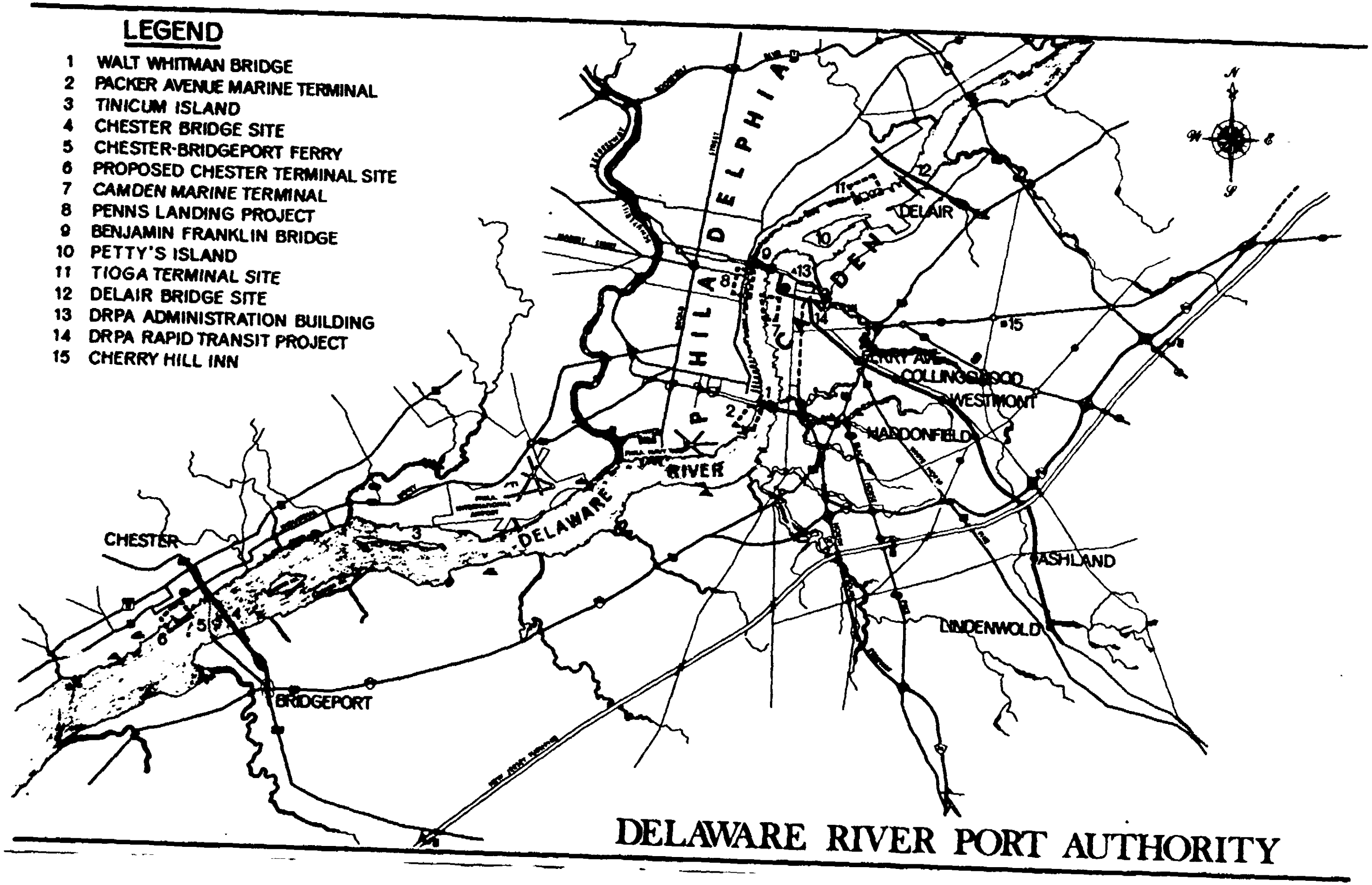
The attached tabulation attempts to point out statistically the statement concerning the daily commuter's use of our facilities.* It is necessary to make some basic assumptions in order to draw certain conclusions. These are (1) that the Estimated Net Revenues available for Bond Service will be substantially as projected by our Traffic Engineers, Coverdale & Colpitts, in the Authority Official Statement dated April 23, 1969 (copy attached), (2) that $140,000.000 will be adequate to complete our financial program, (3) that the proposed bonds would all be issued as of January 1, 1970, and finally, (4) that in order to successfully market the proposed bond issue, bond service coverage would have to approximate 1.30 times bond service in 1973 (the assumed first full year of operation of all facilities).

Assumption A is taken directly from the Official Statement used to sell our Bonds last April. This was our best judgment at the time as to the effect of a Second Series Bonds on bond service coverage. Since that time, as previously stated, market conditions have deteriorated. Assumption B shows bond service coverage following the issuance of bonds in a bond market as it exists today. It is our opinion that if the Federal Government makes inroads upon heretofore tax-free bonds, the interest rates will further deteriorate. Assumption C shows bond service coverage in a bond market as it might exist if tax exemption is seriously impaired.

To bring Assumption C up to the standards of bond service coverage shown in Assumption B, namely 1.29 times bond service in the anticipated first full year of operation of all facilities (1973), approximately $3.000,000 in additional revenues annually would have to be raised. Coverdale & Colpitts, Traffic Engineers to the Authority, have estimated that a 10% across the board increase in tolls would have to be implemented in order to establish revenues at the desired level.

Notwithstanding the fact that projects of the Authority already started may be affected, it is the Authority's conclusion that higher interest rates due to infringement upon the tax-exempt status of interest on municipal bonds will result in the individual user—the daily commuter—paying higher tolls and fares.

*The tabulation referred to was made a part of the official files of the committee.



LEGEND

1 WALT WHITMAN BRIDGE
2 PACKER AVENUE MARINE TERMINAL
3 TINICUM ISLAND
4 CHESTER BRIDGE SITE
5 CHESTER-BRIDGEPORT FERRY
6 PROPOSED CHESTER TERMINAL SITE
7 CAMDEN MARINE TERMINAL
8 PENNS LANDING PROJECT
9 BENJAMIN FRANKLIN BRIDGE
10 PETTY'S ISLAND
11 TIOGA TERMINAL SITE
12 DELAIR BRIDGE SITE
13 DRPA ADMINISTRATION BUILDING
14 DRPA RAPID TRANSIT PROJECT
15 CHERRY HILL INN

PHILADELPHIA
CAMDEN
DELAWARE RIVER
DELAIR
COLLINGSWOOD
WESTMONT
HADDONFIELD
ASHLAND
LINDENWOLD
CHESTER
BRIDGEPORT
N
E
S
W

DELAWARE RIVER PORT AUTHORITY

DELAWARE RIVER PORT AUTHORITY
ESTIMATED BOND SERVICE COVERAGE
UNDER VARIOUS ASSUMPTIONS
(000'S OMITTED)

		Assumption A			Assumption B			Assumption C			Bond Service Coverage		
	Estimated Net Revenues Available For	First Series Bonds	Second Series Bonds	Total Bond	First Series Bonds	Second Series Bonds	Total Bond	First Series Bonds	Second Series Bonds	Total Bond	Assumption		
YEAR	Bond Service(1)	P & I (2)	P & I (3)	Service	P & I (2)	P & I (4)	Service	P & I (2)	P & I (5)	Service	A	B	C
1970	$21,219	$ 7,741	$ 8,050 (6)	$15,791	$ 7,741	$ 9,450 (6)	$17,191	$ 7,741	$11,900 (6)	$19,641	1.34	1.23	1.08
1971	21,336	7,741	8,050	15,791	7,741	9,450	17,191	7,741	11,900	19,641	1.35	1.24	1.09
1972	21,783	7,741	8,050	15,791	7,741	9,450	17,191	7,741	11,900	19,641	1.38	1.27	1.11
1973	22,222	7,741	8,050	15,791	7,741	9,450	17,191	7,741	11,900	19,641	1.41	1.29	1.13
1974	23,526	8,741	8,050	16,791	8,741	9,450	18,191	8,741	11,900	20,641	1.40	1.29	1.14
1975	24,915	9,817	8,050	17,867	9,817	9,450	19,267	9,817	11,900	21,717	1.39	1.29	1.15
1976	23,985	9,086	8,050	17,136	9,086	9,450	18,536	9,086	11,900	20,986	1.40	1.29	1.14
1977	24,652	9,560	8,050	17,610	9,560	9,450	19,010	9,560	11,900	21,460	1.40	1.30	1.15
1978	25,542	10,304	8,050	18,354	10,304	9,450	19,754	10,304	11,900	22,204	1.39	1.29	1.15
1979	26,278	10,828	8,050	18,878	10,828	9,450	20,278	10,828	11,900	22,728	1.39	1.30	1.16
1980	26,920	11,266	8,050	19,316	11,266	9,450	20,716	11,266	11,900	23,166	1.39	1.30	1.16
1981	27,503	11,668	8,050	19,718	11,668	9,450	21,118	11,668	11,900	23,568	1.39	1.30	1.17
1982	28,039	11,935	8,050	19,985	11,935	9,450	21,385	11,935	11,900	23,835	1.40	1.31	1.18
1983	28,604	12,274	8,050	20,324	12,274	9,450	21,724	12,274	11,900	24,174	1.41	1.32	1.18
1984	28,866	12,476	8,050	20,526	12,476	9,450	21,926	12,476	11,900	24,376	1.41	1.32	1.18
1985 – 2008	29,027	7,695 (7)	10,899 (7)	18,590	7,695 (7)	11,940 (7)	19,635	7,695 (7)	13,856 (7)	21,551	1.56	1.48	1.35

(1) From Official Statement Dated April 23, 1969, Page 21

(2) Actual

(3) For Purposes of Illustration the Second Series Bonds are assumed to be $140,000,000 5 3/4% Term Bonds Dated November 1, 1969 and due January 15, 2009.

(4) For Purposes of Illustration the Second Series Bonds are assumed to be $140,000,000 6 3/4% Term Bonds Dated January 1, 1969 and due January 15, 2009.

(5) For Purposes of Illustration the Second Series Bonds are assumed to be $140,000,000 8 1/2% Term Bonds Dated January 1, 1969 and due January 15, 2009.

(6) Interest only for the years 1970 through 1984.

(7) Level Bond Service at assumed or actual rates for the years indicated.

September 17, 1969

Statement of J. Eldon Opheim, General Manager, Port of Seattle, Seattle, Wash.

The Port of Seattle is a special purpose municipal corporation of the State of Washington established for the purpose of owning and operating marine and air terminals within the area of Seattle and King County. The Port founded in 1911 is under the management of a five-member non-partisan, non-salaried Port Commission elected by the voters of King County. The Port owns 15 working ocean terminals, a grain elevator, special facilities for container vessels, related warehousing, three small boat harbors for pleasure and fishing craft and the Seattle-Tacoma International Airport. Current book value of the Port of Seattle facilities after depreciation exceeds $150 million and gross operations in 1968 were in excess of $12 million.

Currently, the Port has under way an airport expansion program which will require expenditures in excess of $100 million during the next three years. This program includes the construction of the second parallel runway, major terminal enlargements and highway improvements.

The Port also has under construction a new grain elevator, estimated to cost in excess of $13 million, several new marine terminals and additional warehousing and other improvements related to its waterfront operations.

The Port of Seattle wishes to register its protest to the enactment of H.R. 13270 as approved by the House of Representatives. It is our considered opinion that the measure which is now before the Senate destroys the independence of states and municipalities. No amount of argument by Treasury officials nor committee members can change the fact that this measure is aimed at destroying the municipal bond market, and has already had a serious impact on that market and made exceptionally more difficult the problem of financing important local public works.

The principal argument presented by the Treasury officials and by others supporting this measure is that certain citizens have used the tax exempt municipal bond to avoid paying their fair share of taxes. It should be noted, however, that for the privilege of buying municipal bonds these individuals have received materially lower interest rates. Presumably the market place has reflected only the saving in tax to the individual and that individual always had the option to purchase the more lucrative securities of the taxable market which would as a practical matter yield him approximately the same net return.

The effect of the Treasury's proposal which is contained within H.R. 13270 is to enrich the Federal Treasury at the expense of local property taxpayers who underwrite the majority of the municipal bonds sold in the United States. In the long haul, these property taxpayers will be the ones who will pay the added burden, the wealthy will simply receive a higher interest rate. It is clear, therefore, that this legislation, so far as municipal bonds are concerned, does not tax the wealthy. Instead, it taxes the average citizen. The average homeowner will end up paying higher taxes to support his schools, roads, public hospitals, ports, et cetera, and the wealthy will receive a higher interest rate to compensate them for the added tax. If the wealthy do not get the higher rate, they simply will not enter the municipal market at all. They will invest their money as they have always been able to do in premium corporate securities which pay substantially higher rates of interest.

Statement Submitted by John W. Simmons, Executive Vice President and General Manager, Sabine River Authority of Texas

Gentlemen: My name is John W. Simmons. I live in Orange, Texas. I am the Executive Vice President and General Manager of the Sabine River Authority of Texas, a Governmental Agency of the State of Texas, with legislatively directed responsibilities for Water Resources development in the Texas Sabine River Basin.

I am also the Texas Director of the National Reclamation Association, and a National Director of the National Rivers and Harbors Congress.

Because of the most serious concern over certain provisions in the Tax Reform Act of 1969 and the dire consequences which will come about if these proposals are written into law, your Committee is receiving numerous statements and expressions from many knowledgeable and experienced men in the fields of State and local government operations and finance, in which opposition is voiced to the removal or modification of the tax exempt status of "municipal bonds".

It has been my privilege to attend numerous conferences on this most serious matter. In addition, I have read many related articles, papers, letters, and brochures on this subject of nationwide concern.

On the basis of careful analysis, it is my considered opinion that the passage of legislation that will remove or impair the present Tax Exempt status of Municipal Bonds or negate the fundamental Constitutional Doctrine of Reciprocal Tax Immunity, will cause far-reaching and adverse alterations in Federal-State Local relationships which have developed over the years and have been the driving force in the overall progress of our Nation.

In the years ahead, in order to provide the stimulus for permanent improvements that our expanding economy—and population—will demand; for construction of public facilities, highways, airports, water supply projects, water quality control treatment facilities, schools, hospitals, to list just a few, we must have all the initiative that our nation can muster and a all levels of government—Federal, State and Local, if we are to meet the objectives and goals of the future.

Certainly, therefore, any measures which conceivably might tend to weaken and ultimately destroy these importantly significant cooperative relationships at Federal, State and Local levels, should be most carefully studied and considered with one thought in mind: even though some temporary benefits may possibly accrue from the enactment, will the ultimate and long-range effects actually bring about calamitous conditions seriously affecting the attainment of our National objectives?

I am confident that in your wisdom and judgment you will apply this sound test to the proposed legislation that would remove the time-honored and Constitutionally recognized Tax Exempt status of Municpal Bonds.

The testimony whi h I now respectfully submit in opposition to such legislation is based on the experiences of one local unit of state government, which by legislative direction is limited exclusively to the issuance and sale of revenue bonds to carry out our assigned function and responsibility to develop the Water Resources in the Sabine River Basin in Texas. We have no taxing powers, whatsoever, and the very nature of our existence—our planning, construction and operation of water development projects—have been solely dependent on our ability to finance such Projects as the Iron Bridge Water Supply Dam and Reservoir, The Toledo Bend Hydroelectric Dam and Reservoir and the Orange Canal Water Distribution System, completely on the basis of financing received from the sale of State and Local Revenue Bonds, with revenues from the sales of water, hydroelectric power and recreation being the sole sources of income to amortize the costs of these important adjuncts to the Local, State and National economy.

In the course of our operations over the past twenty years, the above mentioned capital improvements programs have been accomplished at the State-Local level, and, at all times with enthusiastic cooperation from the Federal Establishment. Even for these relatively small projects: Iron Bridge, $17.5 million; Toledo Bend, $70 million (with Texas and Louisiana sharing equally in the cost) and Orange Canal, $1.5 million, the tasks have been demanding in order to secure favorable Revenue Bond financing. In each case, financing has been intricate and complex and in order to secure the optimum rates required to establish feasibility, much advance planning, careful work scheduling and "poor boy" ingenuity, and operations have been absolutely necessary, all the way.

Had we not been "blessed with" and able to receive the advantages of the Tax Exempt status of our Bonds, it is extremely doubtful—in fact, almost certain, that these essential Water Development Projects would not have been constructed.

Several projects that we now have in the planning stage are virtually at a standstill simply because of the uncertain status of the Revenue Bond market and the consequent depressed market conditions of Municipal Bonds. The extremely high yields at which municipals are now being sold has just about priced us out of the market insofar as future water developments requiring capital improvements are concerned.

Water Supply dams and reservoirs, regional sewage treatment facilities, recreational developments and municipal water supply systems, all of which are in the National interest and conform to National goals, are being held up indefinitely because of the uncertain status of the Tax Exempt Bond market.

It is imperative that this condition of uncertainly be rectified soon if we are to continue to fulfill our responsibilities for Water Development.

And we are only one of many who are now confronted with this demoralizing situation.

The removal of the Tax Exempt status on Revenue Bonds might well place us in such a vulnerable position that future urgently needed capital improvements for worthwhile water development projects would become a financial impossibility.

I respectfully request your most serious consideration of the dilemma in which our State Agency, along with countless other similar Agencies, as well as States, Cities, Hospital and School Districts, Airports and Port Authorities, will be placed by the removal or impairment of the Tax Exempt status of State and Local Bonds.

STATEMENT ON BEHALF OF THE BRAZOS RIVER HARBOR NAVIGATION DISTRICT, BRAZORIA COUNTY, TEX. (FREEPORT HARBOR, TEX.), BY MINOR M. SMITH, ATTORNEY

Mr. Chairman, Members of the Senate Finance Committee, I am submitting this statement on behalf of the Brazos River Harbor Navigation District of Brazoria County, Texas, in firm opposition to those provisions of H.R. 13270 which would tax the interest on municipal bonds. We urge the rejection by your Committee on each section of that bill which would in any way tax municipal bond interest. It is our view that such taxes would cripple the ability of local governments and agencies to finance needed public projects and would unconstitutionally impair state-federal relationships.

This latest, ill-advised attack on municipal bonds—in the name of tax reform—has hit home in our area. The new tax proposals have particularly alarming consequences for our port—Freeport Harbor—for it is through the revenue bond that our major dock improvements are financed. With the proposed tax legislation pricing these bonds out of the market, we foresee tremendous difficulties in financing our future needs.

In terms of national scope, we are a small port. However, our financing problems are similar in many ways to agencies which maintain pier facilities in large coastal or Gulf cities, in terms of providing the necessary docks, warehouses, equipment and services our tenants and shippers need. Our Navigation District is a political sub-division of the State of Texas, our governing body being elected by the voting public. Through the years, we have worked hard to meet our commitments to the local community. We have developed a fine self-supporting port which has expanded the flow of imports and exports through our harbor.

The movement of goods through our port has helped create industry and employment and has helped the surrounding area to grow and prosper. It is not always easy—as some of the Committee can well understand—for a port of our size and limited resources to successfully maintain a flourishing harbor and yet keep pace with the new demands that are being placed upon us—demands for expanded services, equipment and facilities. Nonetheless, we approach the operation and development of our port district with the same kind of dedicated effort as do other port communities larger in size and facilities. For us this kind of enterprise unquestionably will be stifled with passage of the proposed tax and our determination to innovate and grow will certainly be undermined.

It is clear to us that if any of the new proposals become law, our ability to meet capital requirements for the port facilities we will need will be crippled. Already, there is a strong indication of the developing disaster. Nearby Houston, for example, failed to attract any bids for a $24 million bond for its water system. We read reports everyday about the increasing problems relating to the sale of municipal bonds all over the nation—in Chicago, Jacksonville, New York, as far off as Hawaii. As long as the tax bill remains a matter of debate in Congress, or if the bill is passed, as long as these provisions are litigated in the courts, we can expect more of the same kind of shrinking bond market and higher interest rates.

It seems to us that this effort to tax our bonds is replete with irony. On the one hand, the federal government tells state and local governments to assume new responsibilities, with Washington proposing to share federal revenues with the states in order to encourage greater local efforts. And then along comes this new tax proposal which will certainly negate efforts to make us stronger, more flexible fiscal partners for the federal government. As a result, we envision a weakening of state and local government control which, among other things, would limit our choices in constructing the kinds of projects we know have local priority, being nearer to home as we are.

If the federal government assumes the power to tax financial operations of the states and municipalities—and that is what it would be doing if our bonds were to become taxable—it will be assuming powers expressly reserved to the states under the Constitution. Thus the basic structure of our state-federal relationship will be gravely disrupted. This infringement upon the Constitutional prerogatives of state and local government would be a setback of major proportions to the mutual growth of governmental balance.

In conclusion, we want to re-emphasize the critical nature of the proposals before you. We feel sure that unless the sections of the proposed House bill jeopardizing the tax exemption of state and local government bonds are rejected, the financial capabilities of our bond community will be seriously damaged, at great cost to our citizens and their economic welfare. We deeply hope you will heed our recommendations and those of the representatives of state and local government and of the many other public-spirited citizens who have come before you in recent weeks to urge the exclusion of these bonds from any form of federal taxation. Thank you.

DELAWARE RIVER BASIN COMMISSION,
Trenton, N.J., September 15, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Old Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: At the request of the state members of the Delaware River Basin Commission, speaking for their respective governors, I am writing to express our concern over certain provisions in H.R. 13270. The sections to which I will confine my comments are Sections 301, 302, 601 and 602.

Specifically, Section 301 (c) (1) (C) would have the effect of including interest on municipal securities, heretofore tax exempt, as subject to federal income tax. You have already received a great deal of testimony on the negative effect that this would have upon state and local government financing for public purposes and I will not add further statistics to those already furnished. I would like to say, however, that it is the considered opinion of the Delaware River Basin Commission that certain provisions of Section 301 would operate ultimately to destroy the efficient conduct of municipal financing for all public works. Insufficient evidence has been presented to show that the benefits which now accrue to state and local governments, by virtue of the power to issue tax exempt securities. are more than offset by estimated federal tax losses. We believe that the bill, if favorably acted on in its present form, would result in increases in costs to state, local and federal government.

The issue, of course, is constitutionally unsettled and, during the rather prolonged period which would be involved before any definitive Supreme Court ruling is obtained on this, the municipal bond market—because of uncertainty—would be at a standstill. The retroactive feature of Section 301 which would apply to interest on securities issued prior to December 31, 1969, would throw into disrepute a current $130 billion worth of securities already held and, as such, can be regarded as a breach of historical commitment. The capital losses to be anticipated in subsequent trading in municipal securities might produce a tax disadvantage far offsetting any increase in revenue resulting from making this interest taxable. Both the investor and the government would stand to lose, along with the borrower.

This Commission, therefore, wishes to go on record as wholeheartedly favoring the position of the current Administration, as stated by Treasury Secretary Kennedy on September 5, 1969, which would continue the exclusion of municipal securities from federal income taxation.

With respect to Section 302, which deals with the allocation of deductions, we feel that this proposal does not involve the same constitutional questions and does not directly impose a tax upon other governmental agencies. The Atlas Life Insurance Company case, 381 U.S. 233, distinguishes the issue, and the Court specifically held that the purpose of the doctrine of intergovernmental immunity was not violated by the Life Insurance Company Income Tax Act.

With respect to Section 601, under Title VI, technical changes would be required if the provisions relating to Section 301(c) (1) (C) were eliminated. The necessity for Section 601(a), Election to Issue Taxable Bonds, would be unnecessary. However, subsections (b) and (d), having to do with arbitrage obligations, could be technically conformed to accomplish their purpose.

Section 602 provides for a permanent appropriation to furnish a federal subsidy to those state and local securities to make up the difference in interest penalty between taxable and non-taxable. Again, the necessity for this section disappears with the elimination of the aforesaid Section 301 (c)(1)(C) and it should be omitted.

I am authorized to state for the Commission that this proposal of subsidized federal financing of the interest penalty would, in its judgment, create far more problems than it would solve. It would necessarily involve the Federal Treasury in a far more voluminous and complex financial operation than it is now engaged in, with consequent added costs and, inevitably, added bureaucratic complications and delays. Most importantly, it would put unwise and cumbersome restraints upon the financial discretion of state and local government to such an extent that it could well bring about a cessation of all local government activity in the field of public works. There could develop a gradual shift to the Federal Government of this responsibility, and with the shift of responsibility would go control. This would compromise, perhaps fatally—certainly seriously—the present federal system as we now know it.

The fundamental concern was stated by Judge Cooley in his Principles of Constitutional Law, as follows:

"The power of tax, whether by the United States or by the states, is to be construed in the light of and limited by the fact that the states and the Union are inseparable, and that the constitution contemplates the perpetual maintenance of each with all its constitutional powers, unembarrassed and unimpaired by any action of the other. The taxing power of the Federal Government does not therefore extend to the means or agencies through or by the employment of which the states perform their essential functions; since, if these were within its reach, they might be embarrassed, and perhaps wholly paralyzed, by the burdens it should impose. 'That the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; that there is a plain repugnance in conferring on one government a power to control the constitutional measures of another, which other, in respect to those very measures, is declared to be supreme over that which exerts the control, are propositions not to be denied.' It is true that taxation does not necessarily and unavoidably destroy, and that to carry it to the excess of destruction would be an abuse not to be anticipated; but the very power would take from the states a portion of their intended liberty of independent action within the sphere of their powers, and would constitute to the state a perpetual danger of embarrassment and possible annihilation. The construction contemplates no such shackles upon state powers, and by implication forbids them."

For the reasons above stated, the Commission earnestly recommends striking the provisions of Section 301 (c)(1)(C), modifying Section 601 to reflect such action, and eliminating Section 602.

Respectfully,

James F. Wright.

Oakland County Drain Commissioner,
Pontiac, Mich., August 25, 1969.

Special Bulletin

To: Oakland County Michigan Communities concerned in the construction of Drainage, Sewage and Pollution Control Projects under the provisions of Act 40, P.A. 1956, as amended and Act 342, of 1939, as amended.

The Office of the Oakland County Drain Commissioner has, over the years, under proper petition, been able to construct needed Drainage and Sewage facilities for petitioning Municipal Corporations. However, recently conditions have become altered to the degree that this office no longer can give firm construction deadlines to insure both citizen and community of progress toward facility installation. Let us examine those problems which are causing delay.

(1) INABILITY TO SELL BOND ISSUES

This is a matter over which neither this office nor its agents have any control. In recent months three issues have been offered and no Bond Bid received. The most recent offering of record involved the Horton Drain (Southfield City) and the Mullen Drain (West Bloomfield Township), August 14, 1969. Both Bond Counsel and Financial Advisor to the Drainage Board were of the opinion that general market conditions, tight money policies, the Vietnam War, and the passage by the U.S. House of Representatives on August 7, 1969 of a Bill proposing changes in the tax treatment of State and Municipal Bonds, contributed to the bid stalemate. They also assured the Drainage Board that this is not a local condition but is nationwide in impact.

While on the subject of bond sales it might be well to mention that the state drain statutes are limited to 6% Bond Issues. It may well be advisable to consider amending these statutes in the 1970 Legislature should continued failure to market 6% bonds so dictate. This matter may cause considerable delay, however, the County must rely upon expert Counsel.

(2) OBTAINING RIGHT-OF-WAY AGREEMENTS

Several years ago, few problems were encountered in the obtaining of proper Rights-of-Way for Drain and Sewer Construction, at least no problems of long duration. And it may also be added that all Rights-of-Way in the past have been obtained without the need for condemnation proceedings. Such proceedings are extremely time consuming and expensive. However, times have changed, suburbia has spread across the land making the obtaining of Rights-of-Way and even a feasible engineering route an incredible task. And land values have increased to the extent that obtaining a Right-of-Way through desirably zoned property is a matter of computing the land costs by the square foot and with the enclosed structures required by such properties, acres are involved. While it is true that we have been able to successfully conclude such needed Rights-of-Way, because they must be fitted to the land use plans of property owners, many months of time have necessarily been expended.

Another Right-of-Way problem increasingly common is the inability to demonstrate adequate outlet for a proposed drainage project. It seems that development takes place initially in the upper reaches of a drainage basin which causes the extensive flooding problems upon those properties not having adequate drainage outlets. In the lower reaches of the basin failure to show benefit to a property owner (when future flooding can be forecast) does not encourage agreement to construction Right-of-Way.

(3) CHANGES IN ENGINEERING DESIGN

Because the consulting Engineer must of necessity design a drainage facility to be a gravity installation, he will accordingly design the Drain to coincide with the natural drainage course. At that time it is not known the obstacles to be involved in Right-of-Way negotiations. As the negotiators proceed following the initial engineering route, changes are made between property owners and the Drain Office to insure the parcel owners proper utilization of properties. Some owners refuse outright to negotiate for easements. In such an instance, engineering evaluations are made toward avoiding such property entirely, thus bypassing the problem or, in the event no solution may be found, condemnation must be advocated. A serious problem involves the obtaining of temporary construction easements. These are easements required for a short period of time for the storage and movement of machinery and materiel. Property owners are understandably reluctant to permit such a use of their property which constantly involves the removal of mature trees and shrubs, as well as grass areas. And let us face facts, while every attempt is made to restore disturbed areas to as nearly as possible the original condition, such is not always the case and years are required, in addition to considerable money outlay to heal the scars.

Drainage structure requirements are not the same as water and sewer easement requirements. Water and sewer mains and conduits are small and shallow installation. Normally such installations are placed in the streets and highways. Drain facilities are large and deep, requiring heavy construction machinery and a considerable expanse of property for both temporary construction and permanent easement. It is unfortunate that only occasionally may a road or highway be utilized for such construction. The majority of the time we must construct on back property lines or side property lines and as such, must heavily rely upon the civic mindedness and tolerance of the community. Permission to construct in streets and highways may be granted by the appropriate road authority, which involves few problems. Constructing on private property is considerably different and much more time consuming.

(4) PERMISSION TO ISSUE BONDS

It is increasingly difficult to take construction bids on projects and hold such bids firm until authority has been granted by the Municipal Finance Committee to the Drainage District to issue bonds. The Drainage Board has a policy of holding the successful construction bid firm for a period of 120 days or four months. It may now be necessary to increase this period to six months since the Michigan Municipal Finance Commission has been forcing the Drainage Board to exceed that time limitation by not swiftly processing issues presented to the Commission. This, of course, may result in higher construction bids because of costs incurred in waiting for an order to proceed with the project.

(5) RELUCTANCE OF LOCAL CITIES, VILLAGES AND TOWNSHIPS TO PETITION FOR NEEDED PROJECT

The hands of the County Drain Commissioner are tied and he is powerless to aid either the individual or the community until a petition is received from the local unit of government to proceed with a project under State Drainage Statutes. In order to demonstrate this reluctance to which I refer, I am going to, by way of illustration, describe several specific instances involving local community lack of action, or request to suspend action.

Quite recently this office was brought under criticism by the present Mayor of Clawson for failure to progress more rapidly with the processing of the Halfpenny Drain to be located within the Municipal boundaries of the City of Troy. Eleven years ago this Drain was designed by this office under the name of Wrey Drain. For ten years the Drain Commissioner attended council meeting of the City of Troy in an effort to nudge the city into signing a petition for this needed project. Finally, on May 17, 1968 the petition was received and the project subsequently initiated. Securing of Rights-of-Way is currently in progress. The Mayor of Clawson in his some four months tenure is in no position to evaluate progress.

In 1963 the Township of Farmington petitioned for a Drain in an area known as Franklin Knowles Drain. The Drainage Board held its hearings and declared the Drain necessary for the public health and practical and that it should be constructed. The Engineers were retained and the project administratively was underway. The Township Officials then requested the Drainage Board to halt the proceedings until ordered to again proceed. The Project is still in limbo and the problem is still in existence and the suspension order is still in force and the citizens are still bailing water from their basements.

On September 22, 1967 the City of Troy and the City of Madison Heights jointly petitioned for a Drain now known as the Henry-Graham Drain. The Drain is near design completion, Right-of-Way negotiations are about to commence, apportionment of cost hearings are about to be instituted and the City of Madison Heights by Municipal Resolution has requested to withdraw from the petition and project. The Drainage Board intends to hold the city to it's commitment but legal involvement may delay the Drain.

The U.S. Army Corps of Engineers are not approving Drains to be served by the Red Run Drain until plans for the Red Run Drain Improvement are at a point recognized as irreversible. This policy also is being enforced within the area served by the Clinton River because of river inadequacies. Fortunately, the Inter-County Drainage Board is processing projects to improve the river and the Red Run Drain so that prohibition of Drainage projects within the basin will be a short-lived problem. It must be pointed out, however that the Inter-County Drainage Board preached improvement sermons since 1960 to municipal units of government and civic associations. Improvement petitions were only received on February 19, 1969.

Presently under processing is a Drain known now as the Varner Relief Drain, a Drain proposed to relieve a long standing problem in an area of the Township of Avon known as the Brooklands Area. The first petition to establish a County Drain was received in the office of the Drain Commissioner in April 1943. Because of Citizen opposition and township reluctance to pursue a solution, the proceedings were outlawed. Similar attempts through the ensuing years also met the same fate. However, the township and the citizens are now of one accord and the project is moving forward as swiftly as the statute permits.

Lastly, we must in passing mention the long delay in the construction of the Twelve Towns Relief Drains in Southeastern Oakland County. Years of litigation of State Drainage Statutes brought about by the City of Troy and the City of Madison Heights caused untold suffering from flood damages within the Drainage District and undoubtedly higher construction costs.

As any Municipal Officer or Administrator is aware, there are many small and sometimes irritating delays in the formulation and processing of a project. The intent of this bulletin is not to sing a song of sour grapes or to further burden you with a seemingly great amount of almost insoluble problems which actually reside properly in this office. It is rather intended to be informative to both your commissions and your citizens regarding project status of community concern, as well as reasons for project delay. It is also meant to, in a small way, answer the sometimes public charges that the Drain Commissioner is "Dragging His Feet."

Additionally, I think it is time to install a better system of dispensing information to municipal authorities. I am ordering bulletins to be issued each two months geared to reporting project progress. Enclosure #1 to this letter lists the projects presently under processing by this office. They are listed by name and municipality. These projects in dollar volume easily exceed $100,000,000.00, and administering to each as a separate municipal entity is sometimes difficult and time consuming. Please accept this as a project status report. Future reports will be more detailed.

Sincerely,

Daniel W. Barry.

City of Clawson, County of Oakland, Mich.

Minutes of a regular meeting of the City Council of the City of Clawson, County of Oakland, Michigan, held in the Council Chambers in said City on Tuesday, the 16th day of September, 1969 at 8:00 P.M., Eastern Standard Time.

Present: Mayor Palmer, Councilmen Anderson, Le Pla, Patterson and Saylor.

Absent: None.

Moved by: Councilman Saylor.

Supported by: Councilman Patterson.

Whereas the City of Clawson, a Municipal Corporation is materially effected by the provisions affecting tax-exempt Municipal bonds contained in the Tax Reform Act of 1969, and

Whereas the Congress of the United States of America has now under consideration Tax Reform Act of 1969, and

Whereas the United States Finance Committee has taken testimony and considered deletion of tax-exempt interest from Municipal bonds, and

Whereas the passage of such legislation would eliminate the tax-exempt status of Municipal bonds, and

Whereas such elimination would materially effect the market-ability of the aforementioned bonds: Now, therefore, be it

Resolved, That the Council of the City of Clawson strongly opposes the termination of tax exemption on Municipal bonds and any impairment of the basic exemption of local government securities.

ADOPTED.

Yeas: Anderson, Le Pla, Palmer, Patterson and Saylor.

Nays: None.

State of Michigan,
County of Ooakland, ss.

I, the undersigned, do hereby certify that the foregoing is a true and complete copy of a portion of the official minutes of proceedings taken at the meeting above indicated, the original of which is on file in my office.

Gertrude Cadger,
City Clerk.

Dated September 24, 1969.

OAKLAND COUNTY DRAIN COMMISSIONER,
Pontiac, Mich., September 23, 1969.

HON. WILLIAM S. BROOMFIELD,
U.S. Representative.

DEAR SIR: Please find as Enclosure #1 to this letter, official copies of the Minutes of several Oakland County Drainage Boards, Municipal Corporations under Michigan law. As you will note these Minutes deal with the problem of selling drainage district bonds.

There seems to be no doubt that present Congressional thinking to make municipal bonds taxable has undermined the bond market making such bonds non-saleable. The acumulative effects of such a policy will be locally catastrophic.

This letter and enclosure will serve as the local protest of the several drainage districts in Oakland County, Michigan. It is urged that you, our responsible representatives in Congress make every effort to defeat legislation presently pending to tax municipal bonds.

Sincerely,

DANIEL W. BARRY

MINUTES OF THE MEETING OF THE DRAINAGE BOARD FOR THE MULLEN DRAIN, SEPTEMBER 15, 1969

A meeting of the Drainage Board for the Mullen Drain, Oakland County. Michigan, was held in the office of the Oakland County Drain Commissioner, 550 South Telegraph Road, Pontiac, Michigan, on the 15th day of September, 1969 at 11:00 o'clock A.M., Eastern Standard Time.

Present: Daniel W. Barry, Chairman, Oakland County Drain Commissioner, Daniel T. Murphy, Chairman of the Oakland County Board of Auditors.

Absent: Charles B. Edwards, Jr., Chairman, Oakland County Board of Supervisors.

Also present: James R. Nicholos, Chief Deputy Drain Commissioner, James E. Pemberton, Chief Engineer and Deputy, E. Price Kimbrough, Julius Pochelon, John A. Everhardus, Bond Counsel, Charles R. Moon, Bond Counsel.

The Chairman read the minutes of the meeting of the Drainage Board held on August 14, 1969. The minutes were unanimously approved and ordered filed.

The Chairman presented to the Drainage Board the order of the Municipal Finance Commission, dated July 8, 1969, approving the issuance by the Drainage District of $1,110,000 Mullen Drainage District Drain Bonds, to be dated April 1, 1969, and approving the form of notice of sale of said bonds.

By unanimous consent, the same was ordered filed.

The Chairman announced that this was the time set for the opening of proposals for the purchase of the above-mentioned bonds as advertised in The Pontiac Press, and The Daily Bond Buyer on August 29, 1969.

The Chairman presented the following proposals which had been received by him on or before 11:00 o'clock A.M., Eastern Standard Time, on this day, which proposals were then opened by the unanimous consent of the members of the Board present, and as to interest rates and premiums were as follows:

No bids were received.

The following resolution was offered by Mr. Murphy and seconded by Mr. Barry:

Whereas since August 7, 1969, when the House of Representatives passed the so-called tax reform legislation, the financing of necessary school and municipal facilities in the State of Michigan has, for all practical purposes, been halted because it is impossible to sell any bonds;

Whereas the Mullen Drainage District has attempted to finance the construction of the Mullen Drain with bonds in the amount of $1,110,000 and on August 14, 1969, and September 15, 1969, no bids for these bonds were received, although in the past similar bonds have always received bids: Now therefore, be it

Resolved, That the Drainage Board for the Mullen Drain, Oakland County, Michigan, respectfully urges the Senate of the United States to reject any proposals which change in any manner whatsoever the tax exempt status of bonds issued by the Mullen Drainage District; and be it further

Resolved, That the members of the Drainage Board for the Mullen Drain consider the taxing of these bonds a serious invasion of the rights guaranteed by the Constitution of the United States and, therefore, urge that immediate action be taken by the Senate of the United States to defeat any proposal for taxing obligations of the separate states and municipalities.

Adopted: Yeas, 2; Nays, 0.

Upon motion by Murphy, seconded by Barry and unanimously adopted, the meeting was adjourned.

DANIEL W. BARRY, *Chairman.*

CARLSBAD, N. MEX., *September 16, 1969.*

Mr. TOM VAIL,
Chief Counsel, Senate Finance Committee,
New Senate Office Building, Washington, D.C.

DEAR MR. VAIL: As Chairman of the Eddy County New Mexico Board of Commissioners, we respectfully urge you to prevail upon the Senate Finance Committee to maintain the status quo on the tax free feature as to interest on city, county, state and school bonds, or other obligations of these entities. In these instances, where debt is created by the people of an area affected, they voluntarily pay the bill, and the tax free feature on interest is the principal factor in the sale of the bonds which provide needed capital for various local needs. Any change in this self-government feature will more than double local costs and retard local development by many decades.

Again, let me say that we urge the preservation of our American Heritage by allowing people of this Country to create constructive debt on themselves without having the interest on their obligations being taxed.

Respectfully submitted.

JOHNNIE BOWMAN,
Chairman, Eddy County, N. Mex., Commissioners.

STATEMENT OF CECIL S. BRUBAKER, GENERAL COUNSEL, METROPOLITAN UTILITIES DISTRICT, OMAHA, NEBR.

SUMMARY

1. The District recently built $16 million addition to water plant serving 100,000 patrons in Omaha and vicinity.
2. Sale of long-term bonds not possible because of excessive interest rates in early 1969, caused by general inflation plus threat of removal of tax exemption.
3. District able to get only one-year financing, and must sell these bonds in early 1970
4. Provision for government subsidies in H.R. 13270 would be threat to sovereignty of states and subdivisions.
5. Need quick action striking out provisions of H.R. 13270 which in any way disturb the tax exemption of municipal bonds, so that District bonds can be sold without additional penalty of higher interest caused by present threat of loss of tax exemption.
6. Resolution of Board of Directors.

STATEMENT

Mr. Chairman and Members of the Committee, my name is Cecil S. Brubaker. This statement is made on behalf of the Metropolitan Utilities District of Omaha, Nebraska, of which I am General Counsel. Metropolitan Utilities District of Omaha is a political subdivision and municipal corporation of the State of Nebraska, created under state law to operate, manage and control the water system and the gas system supplying residents of the City of Omaha and its environs. Under statutory authority the District issues bonds for major improvements to the gas and water systems.

The District has recently completed an addition to its water plant for which it was necessary to borrow Sixteen Million Dollars ($16,000,000.00). During attempts by the District representatives in the last year to find purchasers for long term bonds, it became increasingly evident that not only was it going to be impossible to find purchasers for long term bonds at an interest rate within our statutory limit of six percent (6%), but that possibilities were increasing that the bonds could not be sold at all. No buyers could be found for short term bonds or obligations in excess of one year, and the District was forced to accept one year financing. The story of what has happened to municipal bond sales since our fortunate sale in June, 1969, is familiar to all members of this Committee, I am sure, and demonstrates that our fear that bonds could not have been sold at all were well founded. Many issues from other muncipalities have found no buyers at all.

In addition to the general inflation in the market place, our representatives were told that purchasers were not to be found because of the uncertainty of the situation with relation to tax exemption of municipal bond interest. The truth of these statements has been borne out by the market situation since the sale of bonds by our District.

The principal and interest on the bonds which we have issued and which we must issue for a long term in the very near future, must be paid for by the users of water in our District. This includes all of the people, regardless of their economic status, whether well-to-do or poverty stricken. These people must have water. Any increase in the cost of this necessity of life caused by taxation therefore has the ugliest result that any regressive tax can have. It penalizes even the very poor.

The passage of H.R. 13270 by the House of Representatives and the provisions of that proposed legislation relating to taxation of interest on municipal bonds has already had some effect upon the cost of money to the people of our District, and in the state of the market at the present time, it appears that the penalty our patrons will suffer will exceed that they are now paying by a considerable amount.

Just the consideration by Congress of the removal of tax exemption has been upsetting in the marketplace, and has made buyers hesitant and jittery, with the consequence that interest payments have necessarily gone far beyond traditional figures, and have added to the inflationary trend which the Congress and the administration appear to wish to end, and has raised the cost of necessary public improvements, to the injury of the taxpayers and voters whom the Congressmen and Senators represent.

This Committee will no doubt be furnished statistics by other opponents of the taxation of municipal bonds, which will demonstrate that the cost to the American public in general of the removal of tax exemptions will far exceed the benefits of increased revenue to the Federal Government. The "evil" which is thus sought to be corrected by these provisions, would appear to be a political straw man, not worth the price.

The provisions of H.R. 13270 which relate to limited taxation and possible subsidy to the municipalities issuing bonds in exchange for a waiver of tax exemption have disturbed our Board of Directors because of the necessary intrusion into local affairs which would result from these provisions, and which would of necessity result in relinquishment of local control and would replace local decisions on local issues with nationally centralized decisions.

For those of us who are even slightly familiar with the doctrine of "reciprocal immunity" and the historical position of the Supreme Court of the United States holding that taxation of interest on municipal bonds is not permitted under the Constitution, it is puzzling why the Congress gives so much consideration to this seemingly indefensible legislation. The expectation is that this Committee will immediately and definitely strike from the "tax reform" bill H.R. 13270, the offensive sections which threaten the sovereignty of the states. The people of the United States do not need any more cause for unrest and uncertainty than other current events now supply in overabundance.

After its recent experience in the market place, the Board of Directors of our District adopted a resolution on August 6th, 1969, which protests and deplores any legislation by the Congress designed to eliminate or jeopardize the existing exemption from taxation of municipal bonds, including any proposal of a Federal subsidy. A copy of that resolution is attached to this statement.

Gentlemen, the bond issues of the Metropolitan Utilities District of Omaha are small indeed compared to many, many others. We are convinced that the market needs all of the buyers it can possibly get for small bond issues, as well as large ones. Individual buyers should not be discouraged nor eliminated from the purchase of long-term tax-exempt bond issues, or the competition for such bonds will be seriously and dangerously impaired, with consequent increase of interest costs. Metropolitan Utilities District of Omaha is one of those unfortunate municipalities caught in the unrest and uncertainly caused by H.R. 13270. It is costing our 100,000 patrons money. The situation in the market can be brought back to a state of normalcy only by restoring the confidence of the buyers of municipal bonds in the continuing exemption from taxes.

There is some possibility that the debates and consideration of H.R. 13270 will extend for some time, even into the next year. We hope, for the sake of the residents of the Omaha, Nebraska metropolitan area and for all others caught in this situation, that action of this Committee will come *soon* rejecting all of the provisions of H.R. 13270 which in any way infringe upon or compromise the traditional immunity from taxes of state and local securities.

RESOLUTION

Whereas the Metropolitan Utilities District of Omaha, a political subdivision and municipal corporation of the State of Nebraska, has urgent need to issue $16,000,000 of Water Revenue Bonds for the improvement of water supply facilities serving Omaha and its immediate area, now being financed by a short term arrangement, and has been experiencing difficulties in marketing long-term bonds in the present climate surrounding such transactions, and

Whereas it has recently come to the attention of the Board of Directors that traditional buyers of such bonds are hesitating to purchase such bonds because of the uncertainty and fear surrounding the bonds, and that the offering of very high interest payment is unable to develop a market for such bonds, because of the threat of the removal of such tax exemption, and

Whereas the Board of Directors believes that the removal of tax exemption from interest payments on bonds of this District and any other municipal corporation will seriously affect the market for such bonds, and increase the costs of public improvements, to the injury of every tax-paying citizen and every customer of municipally-owned utilities, far in excess of any benefits to the Federal Government which might be realized by removal of such tax exemption; and

Whereas any proposal of a Federal guarantee or subsidy of a local bond issue, in exchange for a waiver of tax exemption, would mean a relinquishment of authority by the local government body to a Federal Bureau, and would be a serious step toward the destruction of local government: Now, therefore, be it

Resolved by the Board of Directors of Metropolitan Utilities District of Omaha, That this Body, acting in behalf of its more than 100,000 customers, protests and deplores any legislation by the Congress of the United States designed in any way to eliminate or jeopardize the traditional and constitutional exemption from Federal taxation of municipal bonds of State and local government, and urges each and every member of the Nebraska delegation in the 91st Congress to actively oppose any change in the existing tax exemptions of municipal bonds.

Adopted August 6, 1969.

STATEMENT BY BENNETT R. BOLEN, PRESIDENT, TEXAS CHAPTER, MUNICIPAL FINANCE OFFICERS ASSOCIATION

Whereas there has been considerable discussion of the Tax Reform Act of 1969, its many ramifications, its aims, its advantages and disadvantages as President of the Texas Chapter of the Municipal Finance Officers Association, I address my remarks to the effect of the proposals in their relationship to Municipal Finance and the average citizen.

In its zeal to affect reforms in the collection of Federal Income Taxes, the House of Representatives has already complicated the financial problems of the Municipalities throughout the Country. The fear that Congress will modify or remove tax exemption on Municipal Bond Income has depressed the bond market to an extent that such bonds are selling at prohibitive interest costs, and in many cases beyond what Cities are legally authorized to pay.

It is imperative that the Senate fully understand that H.R. 13270, as it currently exists, will adversely affect the average home owner and citizen to a far greater degree than the individual in the high income bracket at whom some of the reforms are directed.

The sale of Bonds for construction or improvement of needed facilities has had to be postponed. In those cases where such sales can not be postponed, States and Municipalities will be forced to pay millions of dollars more in interest over the life of the bonds—dollars which may only come from increased local taxes.

It is most unfortunate that an impression has been formed that many individuals in the very high income brackets have used municipal bond interest as a tax "loop hole", whereas data gathered by Michigan Survey Research Center and others does not support this conclusion.

It is estimated that of approximately $125 billion in municipal bonds outstanding, commercial banks are the largest owners, holding about 38% of the total. Personal trusts and individuals are credited with 32%, with insurance companies accounting for 17%. Pension funds, sinking funds and all others make up the balance of 13%.

There can be no question but that in the past the tax exemption feature has strengthened the market for municipal bonds. Statistics show that Municipalities have normally been able to borrow at about 30% less interest cost than comparable non-exempt borrowers. It follows that removal of the tax exempt feature would increase financing costs of Municipalities by approximately 43%. An increase which must be passed on in higher local property and sales taxes unless subsidized by the Federal Government.

With an unprecedented demand for schools, water and sewer systems, hospitals and other public facilities, governmental units are faced with an ever increasing problem in financial planning. Capital facilities construction programs require careful advance planning and scheduling of work. Continuity at the local level is facilitated through the issuance of bonds used to finance a great proportion of these improvements. Federal assistance however well conceived, or intended, must necessarily carry adherence to criteria developed for the general good and may require readjustments resulting from conditions not controllable at State-local levels.

It must be recognized that our appeal for the elimination of these objectionable provisions of the bill is not to favor special interests or wealthy individuals, but honestly seeks to avoid increasing burdens of our already over-taxed average citizens. Our appeal, made in the name of government at the local level, is made in fulfillment of our responsibility to maintain financial stability for those citizens who have had no voice in the formulation of policies which will directly affect them.

STATEMENT BY GIL M. BARRETT, COMMISSIONER, DOUGHERTY COUNTY, GA.

As a member of the Dougherty County Board of Commissioners in the State of Georgia, I am naturally vitally interested in the efforts of this Congress to overhaul our nation's tax laws. In my opinion, such a reform is long overdue. But in such matters where the political impact is strong, especially in this day of a flighty economy, the old adage, "Haste makes waste" comes strongly to mind. What on the surface may appear to be a move toward an equalization of tax burdens can, on reflection, have an opposite, hurtful effect.

Certainly, I feel that a second, serious look should be taken at the proposal on the tax exemption status of city, county and state bonds. Supporters for this change have contended that this tax immunity is a "loophole" because holders of these bonds avoid taxes on the interest. In short, wealthy persons are the primary target. For the first time interest from the public securities would be taxable through what is termed a "minimum income tax" imposed on all taxpayers, or through a complicated allocation of interest-expense deductions between taxable income and tax-exempt interest.

Neither method, in my view, fits the needs of the situation. In my area, for example, where urban growth, with its attendant problems, is coming swiftly due to the change in our agricultural economy, any upward movement on the interest costs on municipal bonds would be virtually ruinous.

Construction costs in my area of Georgia have been rising about 6 to 8 per cent annually over the past few years. Consequently, my County and City Governments must issue more bonds each year just to finance the same physical volume of projects that were undertaken at an earlier date. The conclusion is inescapable. We can barely meet public needs at the present, with the exemptions permitted. Removal of exemptions would mean that higher costs would have to be passed on to taxpayers in higher local or state taxes. And we all know that today borrowing costs are at their highest levels in history.

Informed economists have stated in several national publications that taxation of state and local bonds would raise the cost of municipal borrowing by as much as two or three percentage points. My government could not bear such a cost without increasing already strained tax rates on property.

Just two years ago, local governments in our country raised in excess of $25 billion from property taxes representing over 65 per cent of all local revenue collected from our own sources. In my mind, based on my own governmental experience, this is excessive—and yet it does not do the job in the way of meeting heavy service demands, physical obsolescence, rising costs and Federal pressure to finance Governmental programs equal to the needs of our citizens.

A breaking point is inevitable, particularly as we read of the larger cities in the nation freely admitting to bankruptcy. These localities can only turn to the States and Federal Government for help since their tax resources are so severely limited by law.

The property tax is the major source of revenue in my area, and it will remain so since my local Governments have generally been deprived for one reason or another of the use of broader based taxes. And yet, as we must recognize, this tax unfairly penalizes one group in our society. Those supporters of a change in the tax exemption law on the basis of tracking down a few rich investors are, in reality, putting a gun to the heads of already over-burdened local property taxpayers.

Local financing these days is one big headache. Anything that will bring about higher interest rates on borrowed money can only mean a reduction of vital community services for a rapidly expanding population. On the local level, as in other levels of Government, we must have capital to survive. If the tax exemption incentive were no longer available, such capital might well be diverted into other spheres of investment. If that takes place, what is today critical could easily become intolerable.

I agree wholeheartedly that there is a need for general tax reform. But granting this need, I see no reason why a long-held principle of our Federal system—namely the independence of policy-making of each level of Government—should be summarily discarded because of heavy economic pressures. And, in my mind, this vital principle could not survive if the Federal Government were to jeopardize the preferential character of city and county debt.

In considering the constitutional power of the Federal Government to tax the interest paid by States and political subdivisions upon their borrowings, what is being dealt with is a direct obstruction to the power to borrow money. Without that power, local rule might as well be thrown out the window. This is hardly in keeping with current political thinking that cities, counties and states should have a larger hand if effecting administrative decision.

I have always been a strong believer in the theory and practice of keeping Government as close as possible to the individual citizen. This time-tested system will be seriously impaired if the last and sole remaining independent avenue of finance left available to cities, counties and states to pay for capital improvements is tampered with.

City of Pawtucket, R.I.,
Department of Finance,
September 22, 1969.

Hon. Russell B. Long,
Chairman of Committee on Finance,
New Senate Office Building, Washington, D.C.

Dear Sir: Due to the urgency of the situation as pertains to H.R. 13270, the so-called Tax Reform Act of 1969. I am writing to ask that you personally oppose the portion of this act which changes the historical tax exempt status of municipal bonds. When the Internal Revenue Code was enacted in 1913, the framers of this legislation specifically exempted the interest on municipal bonds as not being in the public interests on the principle that it serves no useful purpose for the Federal government to tax city or state securities or for the state or local governments to tax Federal holdings.

Since the House Ways and Mean Committee first began consideration of this bill last May, the bond market, insofar as state and local government bond interest is concerned, has been deteriorating rapidly until at this point, we are forced to pay the highest rate of interest ever experienced in this country since prior to Civil War days.

Any change in the tax exempt status of municipal or state securities will increase the burden to all of our taxpayers and will reflect a direct increase in governmental costs at both state and local levels. It is, therefore, imperative that the Senate Finance Committee and the United States Senate as a whole realize the irreparable damage that will be done to the cities and towns of our nation should this bill be enacted in its present form.

Once again, I urge you to do all in your power to preserve the tax exempt status of state and municipal obligations to the end that millions of dollars may be saved by the taxpayers of this country. As finance officer of the City of Pawtucket, I firmly believe that it is not in the public interests for the Federal government to effectuate either direct or indirect taxation that will increase the financing costs of the cities and towns to a greater degree than that normally sustained in the competitive market.

Yours very truly,

PAUL E. BASSETT,
Director of Finance.

NEW YORK STATE THRUWAY AUTHORITY,
Elsmere, N.Y., September 19, 1969.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance, Old Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: We have been advised that H.R. 13270, which has been adopted by the House of Representatives, is now before the Senate Finance Committee and that hearings on its provisions to tax interest on state and municipal bonds exempt under present law are scheduled to begin September 23, 1969.

We recognize the need for responsible tax reform and are, of course, aware that the tax exemption presently being asserted for industrial revenue bonds has stimulated broad controversy and demands for some form of corrective legislation.

We are writing, however, to urge the defeat of this bill since it is designed to eliminate or impair the essential and traditional tax exemption of state and municipal bonds issued for purely governmental purposes.

The primary objectionable features of this bill include the provision for an allocation of deductions requiring that deductions be made against both taxable and tax-free income in the same proportion if tax-free income exceeds $10,000, and a limit on tax preferences. The effect of these provisions is that investors will be penalized for purchasing tax-exempt securities by the prospect of higher taxes. They will insist on higher interest rates, thereby creating a tremendous new interest burden which will, in turn, fall on local taxpayers and users of local services.

An additional important consideration is the fallacy of the proposed subsidy program. We believe it will dangerously mislead state and municipal officials. We fear the amount of any such subsidy would be far less than they hope and it would probably be decreased and ultimately abandoned if the other attacks on tax exemption prove legally successful. Moreover, the principal point overlooked is that any such subsidy would have to come from taxes that would probably bear hardest on the very people who think they would profit from the elimination of tax exemption.

We respectfully submit that the elimination or the impairment of tax exemption of state and municipal bonds would precipitate catastrophic consequences for state and local governments throughout the United States.

State and local governments, staggering under the pressure of ever increasing budgets on the one hand and the urgent need for public improvements on the other, have found effective solutions to their dilemma through self-liquidating projects that respond to the public need without increasing their budgets or the tax rates. The keystone of these procedures, as you know, is the sale of tax exempt state and municipal bonds, such as were sold to construct the 559-mile Thruway across New York State.

Without the tax exempt status for its bonds, the Thruway could not have been constructed outside the State Budget. The debt service costs would have made it simply impossible to demonstrate that the project would be self-liquidating. With tax exempt status for its bonds, the Authority sold $972 million to private investors, constructed the expressway with dispatch, and now—fifteen years later—continues to operate it as a self-liquidating facility, without burdening the Legislature with requests for appropriations of tax funds.

Had it been necessary to construct the Thruway with tax monies, a large and probably unacceptable additional burden would have been placed on the taxpayers of the State and completion of the expressway would have been delayed for years while the Legislature debated annually the amount it could approve to advance the construction year by year.

The Thruway story and the methods used to finance it are not unique in New York State. The tax exemption on state and municipal bonds provides harassed governors, legislators, mayors and other municipal officers with feasible and frequently preferable alternatives to tax-financed public facilities and any legislation that would impair or eliminate this exemption would effectively slam the door on these alternatives and force state and local officials to add to the burdens of the taxpayers or defer the construction of urgently needed public facilities.

As highway administrators, we emphasize that one of the oldest and universally recognized governmental functions is the building of roads, bridges and tunnels and that state and municipal bonds issued for these purposes are issued in the performance of a traditional and an essential governmental responsibility. As such, we respectfully submit, they are entitled to the right of constitutional protection against federal taxation.

It has long been recognized that the federal government may not constitutionally tax the obligations of the sovereign states or their political subdivisions. If the Congress should impose a tax on these state and municipal bonds, it would indeed impair the sovereignty of the states themselves and stimulate costly and extended litigation that would add confusion, uncertainty and delays to the already frustrating problems of state and local officials.

It is an old adage, but nonetheless valid, that the power to tax is the power to destroy. The elimination or impairment of the traditional tax exemption of state and municipal bonds would effectively destroy, at least until the constitional issue is resolved in the courts, the right and the power of the states and their political subdivisions to finance essential governmental projects through the use of these obligations. Meanwhile, the public interest will suffer either through higher state and local taxes or from the absence of urgently needed public facilities.

For these reasons, Mr. Chairman, we respectfully urge that your Committee defeat this bill.

With kind regards and best wishes,

Sincerely,

R. Burdell Bixby.

Statement on Behalf of the Alaska Municipal League, by Don M. Berry, Executive Director

The Alaska Municipal League, in accord with municipal and state officials throughout the United States, wishes to take this opportunity to express its total opposition to the Senate Finance Committee of passage of HR 13270. While the League is sympathetic to need for a tax reform act, we do not find any justification for the imposition of new taxes on individuals receiving municipal bond interest in any such act.

In reality if the provisions to tax the income received from the interest on municipal bonds are enacted into law, the very citizens who allegedly started the tax revolt will be the most seriously hurt. The unavoidable result of such increased interest costs is higher state and local taxes. Inevitably the most obvious result would be higher real estate taxes. This is simply because most of the bonds to be taxed under HR 13270 are local government issues and local governments must rely mostly on real estate taxes to pay their costs. We are sure that the average taxpayer was not asking for reforms which would increase his costs for new schools or hospitals or which would increase his sales tax, his property tax or his income tax.

There is no denying that the impact of the House bill will be borne by the states and localities who will be faced with the very tangible higher borrowing costs and the potential inability to sell tax exempt bonds at all. It has been conservatively estimated that a one percentage point increase would result from the provisions of HR 13270. Even without action by the Senate as yet, the municipal bond market has already cracked wide open and it is difficult to forecast its disastrous reaction to final enactment of such legislation. With present economic conditions increasing pressure on all forms of municipal financing, including the upward trend on bond interest, the net effect of this added action would be to push the cost of capital financing for urgently needed public works beyond legal or economic limits.

The House of Representatives, in its hasty but ill-advised effort to establish so-called tax equity, included two different tax provisions in HR 13270. Individuals would no longer be allowed to charge personal income tax deductions against taxable income. Rather, they would have to charge their deductions against both taxable and tax free income in the same proportion that the one source of income bears to the other. However, an individual's tax free income must exceed $10,000.00 before the provision would apply. Several fallacies appear in this so-called reform. It extends to interest on outstanding state and local bonds as well as on future issues. State and local bond interest is not separately considered in this new tax. Under HR 13270, it is thrown into a common pot with four other disallowed tax preferences. Following this rule, it is very possible that an individual's tax free income could reach $10,000.00 without ever including the interest on municipal bonds. Thus governmental issues would be harmed by the total of entirely disconnected disallowed tax preferences even though the individual has very modest holdings in municipal bonds. The bill could result in the taxing of the municipal bond interest at top bracket rates, no matter how small the inte. est item.

There is no doubt that the attraction of municipal bonds on the open market would be impaired by the provisions. If enacted, a breach of faith to holders of municipal bonds would occur, and potential investors would lose confidence in the security of municipal bonds as investments. The psychological effects of the impairment would reach to corporate investors who, while not affected by HR 13270, would lose confidence in the future tax exempt quality of their investments. There is certainly nothing to prohibit Congress from eventually eliminating the tax exempt feature altogether. The net result is that all investors in municipal bonds would demand higher interest rates as hedges against tax losses if indeed they still found municipal bonds attractive investments at all.

This total situation is compounded by the Constitutional issue inherent in the provisions of HR 13270. State and municipal officials have long mantained that the exemption of municipal securities is derived from the foundations of our federal system of government. Since the federal government would be taxing a portion of the interest from tax exempt bonds through the limits on tax preference mechanism, it is a foregone conclusion that its Constitutionality will be challenged in the courts, resulting in lengthy litigation. During this time, the tax status of municipal bonds would be unknown and bond investors would be unlikely to invest until the issue is resolved. Thus, the market for bonds would be totally disrupted. It is interesting to note that the Attorney General of the United States has stated that grave constitutional problems are raised by including municipal bonds interest in a minimum tax base. Why this constitutional objection was completely ignored by the House is anyone's guess.

The House bill, having ended traditional tax exemption, then purports to give an option to state and local government issuers to receive a subsidy if they agreed to issue their bonds on a fully taxable basis. Under the specific subsidy provisions, a state or local government could choose, for a particular bond issue, a fixed percentage interest subsidy paid by the federal government. The subsidy would go directly to the issuer as a cash payment or, the state or local government could elect to have the federal government supply separate interest coupons which would be attached to the bond along with the issuers coupon. The state or locality would then issue its bonds as taxable securities. The subsidy would be paid by the federal government to the state or locality or its paying agent but not directly to the bond hoder. The subsidy would be considered an obligation of the United States and would be paid regardless of default by the issuer.

There are obvious flaws in both of these options.

HR 13270 may not provide much, if any, economic advantage or the qualities of total dependability that issuers would require. Much discretion is left to the Secretary of the Treasury in administering the program. The actual subsidy rate offered would have to be considerably greater than the 30% advantage now obtained in the tax exempt market if issuers are to be expected to elect this option. The subsidy is a percentage of the yield of the taxable municipal bond. The actual percentage is determined periodically by the Secretary. For the first five years there is a 30% floor and a 40% ceiling; then the floor drops to only 25%. The Secretary is supposed to select the percentage which is just enough to lead municipalities to elect to issue taxable bonds.

Thus, various proposals by one individual, such as proposing minimum tax treatment of banks or allocation of their interest deduction, could cause the market to push the interest rate on tax exempts, reduce the percentage gap between taxable and tax exempt bonds and justify lowering the subsidy percentage accordingly.

All subsidy payments proposed by HR 13270 are to be met by a permanent appropriation by Congress. However, nothing this Congress does in enacting this program commits a future Congress to maintain the program particularly if it proves costly to the federal government. And it is certainly not at all clear that, given a predictable change in the market for taxable municipal bonds as opposed to tax exempt bonds, the federal government could collect more money in tax revenues than it paid out in subsidies.

While the plan is supposed to involve no federal controls of the purpose of issuance or the details of the program financed, the Secretary of the Treasury is given the right to classify and disqualify certain bonds. Municipalities, by the elimination of tax exempt bonds, would be given the coercive choice between taxable bonds without subsidy or taxable bonds with whatever subsidy the Secretary and the Congress chose to bestow from time to time.

There is no doubt that the State of Alaska and its municipalities would be seriously and adversely affected by the enactment of HR 13270. Historically, we have experienced more than our share of trouble in the capital markets. The reasons for these problems have been variously blamed on small population remoteness, population shifts, lack of security in low population areas, and the amount of per capita debt incurred since Statehood.

Despite these handicaps, the people of Alaska have continued to demonstrate their faith by borrowing money in the open market to finance needed capital improvements. Now that this young and dynamic state is on the threshold of its greatest era of development, local governments must be given the tools to keep abreast of this development. Growing urbanization, improved services and the need for additional services are creating demands on municipalities far beyond the financing capabilities of property and sales taxes.

The ability to borrow money at reasonable and beneficial rates of interest must be maintained. If the chaos created in the municipal bond market by the mere threat of HR 13270 is allowed to continue, it will be impossible for Alaska's municipalities to meet the crushing need for financing schools, roads, hospitals, sewer and water systems, etc. Surveys conducted by the Conference on Intergovernmental Fiscal Relations indicate that the debt service cost to local governments in Alaska, on just existing debt, would increase one million dollars a year or twenty million dollars over the life of the bonds. Projected into 1970, this increased cost would amount to 22 million dollars. The presently overburdened local property taxpayer in Alaska neither could nor would bear these additional costs for providing merely the basic necessities of a good, healthy, progressive urban life.

The Alaska Municipal League wishes to thank you for this opportunity to present testimony in opposition to the municipal bond provisions contained in HR 13270. We urgently solicit your support of our position and request that you refuse to approve the dangerous proposals espoused by the House bill now before you.

Thank you very much.

Extract of Minutes of Meeting, Village of Little Canada, Minnesota, September 10, 1969

Pursuant to due call and notice thereof, a meeting of the Village Council of the Village of Little Canada, was held on the 10 day of Sept. 1969 at 7:30 P.M. at 440 Little Canada Rd. in said Village.

The following members were present: Mayor: Edward Loeffler; Clerk: Joseph Chlebeck; Trustees: Joseph Collova, Donald Valento, Gordon Nadeau.

Council member, Donald Valento, introduced the following resolution and moved its adoption.

Whereas the Congress of the United States is considering a bill which would remove tax exemption from municipal bonds issued to finance capital needs of local government, and

Whereas the only motivation for such a proposal which stands the test of any reasonable explanation, is an attempt to compel owners of large amounts of such securities to pay tax on their income; and

Whereas the vast amount of money needed for local improvements will certainly be curtailed by such legislation and will cost taxpayers much more than they can possibly gain out of taxes to be collected from the few owners of large amounts of such bonds; and

Whereas the whole concept will tend to further cripple the activities of local and place more power in the hands of central government when we should be working in an opposite directions: Now, therefore, be it

Resolved by the Council of the Village of Little Canada, That the respective Congressional representatives from this State, in both the House and Senate, are urged to put forth every effort and to take all necessary steps to preserve the tax exemption for municipal bond interest; and be it further

Resolved, That copies of this resolution be forwarded to all Senators and Representatives in Congress from the State of Minnesota and also to the Senate Committee before which this legislation is being considered.

Council member, Joseph Chlebeck, seconded the motion for the adoption of said resolution and upon a vote being taken thereof, the following voted in favor thereof.

Messrs. Valento, Chlebeck, Collova, Nadeau and Loeffler.

Whereupon said resolution was declared duly passed and adopted.

STATE OF MINNESOTA, *County of Ramsey, Village of Little Canada, ss:*

I, Joseph G. Chlebeck, clerk of the Village of Little Canada do hereby certify that the above is a true and correct copy of a resolution duly passed, adopted and approved by the Council of the Village of Little Canada, Minnesota on the 10th day of September 1969.

Witness my hand and seal of the Village of Little Canada on this the 22 day of Sept. 1969.

JOSEPH G. CHLEBECK,
Clerk, Village of Little Canada, Minn.

INTERNATIONAL MUNICIPAL PARKING CONGRESS,
September 26, 1969.

Hon. RUSSELL B. LONG,
Chairman of the Senate Finance Committee,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: The Executive Committee of International Municipal Parking Congress has taken a position on behalf of its Board of Directors and approximately 300 members in opposition to the proposed legislation to tax interest on municipal bonds.

IMPC is composed of Executive Directors of municipal parking authorities and parking divisions of some 150 cities throughout this country and Canada who administer municipal parking programs financed for the most part through the sale of municipal bonds. Its membership also includes manufacturers and suppliers who furnish equipment and materials to the parking industry as well as engineers and consultants.

The reasons for the opposition of this organization to Bill HR 13270 are as follows:

1. Taxing the interest on municipal bonds would result in higher parking charges to patrons of municipal parking facilities.
2. Development of municipal parking facilities is a necessary element in the revitalization of the central business districts throughout our country.
3. Passage of this bill would greatly impair the sale of municipal bonds and could result in an appreciable increase in real estate taxes to raise financial support so urgently needed in the development of municipal parking lots.
4. Many cities in this country have been forced to cancel bond offerings because of prevailing high interest rates. Purchasers of municipal bonds accept lower

interest rates because of their tax-free feature. Imposition of a tax on interest would completely destroy the market for municipal bonds.

5. A joint report in 1967 by the National League of Cities and IMPC indicated tl. local government estimates for the construction of municipal parking faciıtles for the ensuing five years would amount to over $400 million.

6. The report of the Joint Economic Committee of Congress entitled "State and Local Public Facility Needs and Financing" published in 1966 indicated the following sources of financing in descending order:

(a) General obligation bonds secured by both parki⌣g revenues and full faith and credit of the city government.

(b) Revenue bonds secured by revenues of the parking system (off- and on-street parking revenues).

(c) Revenue bonds secured only by the earnings of the offstreet facilities.

(d) Combination of revenue and general obligation bonds.

(e) General obligation bonds only.

(f) Capital reserve funds.

(g) Private capital and other methods.

It is respectfully requested that this letter be incorporated in the record of the hearing on this bill.

Thank you very much for your cooperation in this matter.

Sincerely,

THOMAS J. COYLE, *President.*

THE NEW ORLEANS BOARD OF TRADE, LTD.,
New Orleans, La., September 12, 1969.

Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Old Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: For as long as we can remember, our communities have been building schools, roads, hospitals, sewers, bridges, waterworks, and port improvements by issuing long-term, low interest municipal bonds. The interest on these bonds (and, therefore, the cost to the tax-payer) is lower than on other securities because historically, traditionally and *constitutionally* it is exempt from all Federal income taxes.

In the so-called tax reform bill passed by the House of Representatives, and now being considered by your Finance Committee, most important among the proposals, we understand, is taxation of municipal bonds. In our opinion and that of bond experts such a plan would be most inimical to our State, particularly with reference to Parish and City school bonds and the proposed bond issue for the Port of New Orleans which is a must if our port is to maintain its position as the second major port of the nation.

If the House Bill was enacted into law in its present form, it is our feeling that the market for tax-exempt securities would be significantly and lastingly damaged; municipal bond purchases by individuals would be substantially reduced; interest rates on municipal bonds would materially rise, the excess costs thereby resulting on the community at large for the sake of punishing the few who might buy large quantities of such bonds; the preferential position of municipal securities in the capital markets relative to taxable issues would be impaired.

Only several days ago the Parish of Jefferson proposed a school bond issue for $10,000,000. for the purpose of building much needed schools and not a single bid was received.

We strongly urge that you oppose any legislation that might jeopardize the long-standing, highly successful and economical system of tax-exempt municipal bond financing. Unfortunately and with much regret we will not be able to appear before your committee, however, we are sending you under separate cover twenty copies of this letter and kindly ask that it be made a part of the record of your Committee's hearing.

Sincerely yours,

KENT SATTERLEE, *President.*
ALEX C. COCKE, *Consultant.*

A MESSAGE TO THE U.S. CONGRESS—DO NOT TAX STATE AND LOCAL GOVERNMENT BONDS!!

SUBMITTED BY HERBERT J. BINGHAM, EXECUTIVE SECRETARY, TENNESSEE MUNICIPAL LEAGUE AND PREPARED BY: TENNESSEE COUNCIL OPPOSING FEDERAL TAXATION OF STATE-LOCAL BONDS

State of Tennessee
Office of the Governor
Office of the Lieutenant Governor
Fiscal Review Committee
Comptroller of the Treasury
Treasurer
Commissioner of Finance and Administration
Tennessee County Services Association
Tennessee Education Association
Tennessee Municipal League
Tennessee Valley Public Power Association
Tennessee Association of Utilities Services
Tennessee County Judges Association
Tennessee Counyt Highway Officials Association
Tennessee Municipal Finance Officers Association
Tennessee Municipal Electric Power Association

H.R. 13270 THREATENS BOND TAX EXEMPTION

Unless the U.S. Senate corrects certain aspects of the Tax Reform Bill recently approved by the House of Representatives, Tennessee state and local governments for the first time in American history will be subjected to damaging and costly Federal taxation.

The Senate Finance Committee, of which Tennessee Senator Albert Gore is a ranking member, has a grave responsibility to offer corrective amendments to the House bill.

In an effort to close tax loopholes, the House passed an act (HR 13270) imposing two new taxes on individuals receiving interest on state and local government bonds. One is a "minimum tax" plan which applies to outstanding bonds and those to be issued in the future. The other would deny the state-local bond holder his full personal deduction otherwise allowable.

A $70,000,000 TAX INCREASE IN TENNESSEE

When the full effect of these taxes on state and local government bond interest occurs over a 12 to 15 year period, Tennessee taxpayers will be faced with more than $70,000,000 yearly increase in their taxes to state, county, city, schools and district governments.

Reasons for this are very simple:

The present federal tax exemption for interest on state and local bonds means that they sell at an interest rate 30 to 40 per cent less than that paid by private issuers. Presently there is approximately a 2% interest differential in taxable and non-taxable bonds. Tennessee state and local governments are issuing new bonds for roads, schools, hospitals, sewers, water and electric utilities, etc., in an amount of more than $300,000,000 each year. Within 15 years over $3.5 billions of these new bonds will have been issued and the 30 to 40 percent higher interest rate resulting from this House bill would cost at least an additional $70,000,000 annually in state and local property, sales, and other taxes.

The potential impact on only one local government—Metropolitan Nashville and Davidson County—is sobering. Assume that this government's financing needs for the current year include approximately $30 millions of new money. If Metro issued 30-year bonds at the present taxable rate, the aggregate amount of increased borrowing costs would be as high as $10,664,000 over the life of the bond issue.

Well over $2.2 billions of Tennessee state and local government bonds are outstanding now. The interest cost would be some $45,000,000 higher each year if this proposed act had been in effect when these bonds were issued in past years.

TENNESSEE WOULD LOSE TAX SAVINGS

This legislation will transfer the previous tax savings of state and local governments and their taxpayers to the Federal Treasury in Washington. Whereas Tennessee state and local governments are now saving $45,000,000 annually on low interest rates due to the federal tax exemption, under the new tax measure any such possible state and local savings in the future would *all* be paid into the U.S. Treasury instead.

The so-called tax reform bill is truly a boomerang. It is hitting the pocketbooks of the homeowners and taxpayers who were told they would be benefited.

Even more strangely, under this act people in the top tax brackets (who now are liable for taxes of 60 to 70 per cent of their income) would pay only about one-half of these rates, or 30 to 35 per cent, on their income from municipal bonds.

By coincidence, 30 to 40 per cent is exactly the amount municipal bond holders traditionally have "paid" indirectly in state and local taxes by accepting lower interest rates on municipal bonds instead of buying equivalent private bonds. As a result, the municipal bond holder has already "paid" his "minimum tax" at the top bracket rates which the bill sets for other "sheltered" income. Under the proposed act, he would become the only class of taxpayer subjected to a *double levy* through this tax on the already-reduced bond income.

"TAX REFORM" TALK MISLEADING

The proposed new taxes have been represented as important elements in a "tax reform" program to insure that the rich pay at least some tax. There is talk of a "taxpayers revolt" and charges that some wealthy Americans who have invested heavily in municipal bonds are paying no federal income taxes at all. This is propaganda, unsupported by facts, according to the U.S. Municipal Finance Officers Association.

MFOA said it is true that some people with large incomes do not pay any income taxes (154 is the number reported by the Treasury); but in those tax returns that were presented to the House Ways and Means Committee by Treasury officials, tax-free municipal bond interest was not involved. However, the Ways and Means Committee report couples the recommendation for taxing municipal bond interest with a reference to 154 non-taxpaying millionaires. This no doubt helped generate support for HR 13270 among other House members and members of the general public who were unaware that this so-called tax reform will come back to haunt them and their state and local governments.

The two new taxes proposed in the House act represent only a partial tax on the interest income from state and local government bonds. But the purchasers of these bonds, which have interest and retirement scheduled over periods of from 20 to 35 years, already are raising the rates of interest demanded in order to take account of the possibility that the Congress in the future may further increase taxes on these new bond issues. After all, the House has voted to do just this on presently outstanding bond issues.

HIGHEST INTEREST IN HISTORY

The threat of taxing interest on state and local bonds has already increased interest rates by 1 to 1½ per cent. This has resulted in the highest interest rates in the history of the country. Furthermore, the unsettling effect on the desirability of these bonds to investors has made it impossible for a number of Tennessee counties and cities to sell their bonds and thus finance their urgent needs for school rooms and other purposes.

SUBSIDY PLAN HAS FLAWS

Having ended traditional "tax exemption," the tax bill approved by the House then promises to give an option to state and local governments to receive an interest "subsidy" if they agree to issue their bonds on a fully taxable basis. If the Federal Congress grabs over $70 millions a year eventually out of the treasuries of Tennessee state and local governments and the pocketbooks of their taxpayers, some grave questions arise as to whether this money will be replaced in interest subsidies.

One serious flaw in the bill is the discretion given the U.S. Secretary of the Treasury to set the floor for such subsidy as low as 25 per cent of the interest, when local bonds with tax-exempt features have been selling from 30 to 40 per cent lower than private taxable bonds.

In a recent letter to the two Tennessee members of the Congressional tax-writing committees—Senator Albert Gore of the Senate Finance Committee and Representative Richard Fulton of the House Ways and Means Committee—the presidents of the Tennessee County Services Association, the Tennessee Municipal League, and the Tennessee Municipal Finance Officers Association stated:

"We believe it is dangerous to lock the door on issuance of tax exempt bonds, because this would clearly place state and local government at the mercy of Congress in providing enough appropriations for interest subsidies. We regretfully bring to your attention numerous current and past instances when Congress has failed to provide appropriations to fund the programs promised to aid state and local governments in numerous acts adopted by the Congress".

THREAT TO UTILITIES

This tax act and the uncertainty of the interest subsidy seriously jeopardize the low-cost electric power and natural gas rates enjoyed by Tennessee homeowners, business and industry. These utilities in Tennessee are almost entirely publicly owned by local government and financed through tax-exempt bonds.

With 80 per cent of the entire country served by privately-owned electric and similar utilities, how long could Tennessee expect the majority of the Congress to support 25 to 40 per cent interest subsidies on our publicly issued electric and gas bonds when other areas of the country do not enjoy these benefits? The Congress can discriminate against these or other kinds of public facilities by refusing interest subsidy!

RAISES CONSTITUTIONAL QUESTION

The only safe and sound plan is to stand on the Constitutional principle that the sovereign states and their local subdivisions should not be subject to federal taxation. The Attorney General of the United States has stated that grave Constitutional problems are raised by including municipal bond interest in the "minimum tax" base; but the House has now overridden the Constitutional objection.

This will result in court litigation for at least two or three years and a possible threat, as mentioned above, of new and higher taxes on new bond issues resulting in much higher taxpayer payments through higher interest rates than the federal government will recover in income taxes.

Despite warnings of the consequences of this legislation, the House of Representatives did not give adequate consideration to this important bill.

Two Tennesseans were prominent among those publicly opposing precipitous and ill-advised action in the name of "tax reform." Governor Buford Ellington, as chairman of the National Governors Conference, and Mayor Beverly Briley of Nashville-Davidson County, as president of the National League of Cities, and others, warned Nashville Congressman Richard Fulton and other members of the House Ways and Means Committee of the potential effect on state and local financing. They pointed out that at the Committee hearings state and local officials had no opportunity to inform members of their views on these specific provisions of this bill.

The legislation as approved by the committee, a voluminous measure of more than 250 pages, came to the House floor under a rule prohibiting any amendments. It then was voted on within three days after it was printed and distributed to the House membership, without proper deliberation or the opportunity to modify any of its provisions.

SUMMARY

We declare the following objectives and principles which support action by the U.S. Senate and reconsideration by the House to preserve the tax immunity of state and local bonds:

1. We do not defend the special interest of wealthy individuals, but seek to avoid boomerang state and local tax burdens on the average citizen of Tennessee.
2. We do not seek to preserve a state and local government benefit conferred by Congress, but to preserve a right created by the U.S. Constitution almost 200 years ago to maintain a federal system which the Congress is not free to reconsider.
3. We do not favor income of individuals being excluded from a "minimum tax," but point out that public bond interest already pays such a "minimum tax"

to state and local governments in the form of lower interest charges. We further point out the inequity of bond interest alone paying *two* "minimum taxes" on income under the House-passed act.

4. We speak for state and local governments which are an equal part of the federal system in protesting a hasty act by the U.S. House, adopted without adequate consultation with the states and their subdivisions. This act will seriously cripple the capabilities of state and local governments to serve their citizens, will drastically increase governmental costs, and will subject state and local government decisions to federal domination and control.

We strongly urge that every public official who has responsibility for state and local government operation and every citizen and taxpayer of Tennessee will promptly express opposition to this pernicious tax act (H.R. 13270) to the Tennessee members of the tax-writing committees as follows:

Senator Albert Gore, Senate Finance Committee, U.S. Capitol, Washington, D.C.

Representative Richard Fulton, House Ways and Means Committee, U.S. Capitol, Washington, D.C.

and also to the other United States Senator from Tennessee:

Senator Howard Baker, Jr., U.S. Capitol, Washington, D.C.

and to your own Congressman in the House of Representatives, U.S. Capitol, Washington, DC.:

Representative James H. Quillen, First District.
Representative John J. Duncan, Second District.
Representative William E. Brock, III, Third District
Representative Joe L. Evins, Fourth District.
Representative William R. Anderson, Sixth District.
Representative Ray Blanton, Seventh District.
Representative Ed Jones, Eighth District
Representative Dan Kuykendall, Ninth District.

CITY OF OGALLALA,
Ogallala, Nebr., September 27, 1969.

STATEMENT BY PAUL L. CASSEL

Mr. Chairman and Members of the Committee: As President of the City Council and representing the people of the City of Ogallala, Nebraska, I would like to express our view in opposing the proposed Federal taxation of the now tax free municipal bonds.

It has become increasingly evident that through the actions of the House of Representatives, the present market for bonds has become very unstable. It is our opinion that if the sections of the bill which pertain to taxation of these bonds were to pass, the market for bonds as we know it today, would be non existant.

I am in agreement with the fact that all people should pay their fair share to our local, state, and national tax burden, which also includes the 154 cases as cited by the Treasury Department. I do not feel it is fair, however, to impose a tax that might corral the few, when in reality it will cause additional taxation on the already heavy taxed middle and low income brackets through additional interest rates.

It is also noted that the government has proposed the Interest Subsidy Program in connection with the taxation of bonds. This repayment to the local municipalities in part is fair, but as has happened in the past, I feel this would again tend to tighten the controls over local government. It would in fact be in direct contradiction to President Nixons policies as he has previously stated to lessen the controls of Federal Government.

I would like to finalize by saying that I do not feel the inclusion of the taxation of the income of municipal bonds in H.R. 13270 is of a tax reform nature, but rather a political and constitutional reform. I feel that it is unconstitutional and I also feel that it is politically and fiscally unwise in that its consequences, in addition to being a more costly method of financing municipal improvements, involved a threat to the whole concept of the separation of the powers between federal, state and local governments.

Because of the reasons stated above, I would ask you to strike out all provisions of H.R. 13270 relating to the taxation of municipal bonds and subsidy.

Sincerely,

PAUL L. CASSEL, *President.*

SACRAMENTO, CALIF., *September 25, 1969.*

Senate Finance Committee,
Washington, D.C.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE: I appreciate the reason for your telegram advising that the short amount of time available for hearings on the vital matter of impairment of the federal income tax exemption on municipal bonds does not allow for a personal presentation by the undersigned on behalf of the more than 400 cities who are members of the League of California Cities in the nation's largest state. Every public agency in the country wants to appear and protest. The implications of the proposals, direct and indirect, have so alarmed the market that state and local taxpayers are already paying the penalty of Congressional tampering. We appreciate the opportunity you gave Mrs. Priest to be heard and we fully support her excellent statement. Because the matter is of such major and fundamental importance, it is imperative that your consideration be given to our written statement concerning H.R. 13270.

I will not repeat the many arguments you have heard and read concerning the very doubtful constitutionality of the proposed change. I know that you have before you the results of staff research as well as prior hearings which deal with this aspect of the matter in detail. I simply wish to state that these constitutional doubts are grave, else the bill which is before you would not be as complicated as it is in its attempt to sidestep this basic issue through the imposition of a tremendously complicated "substitute system."

Baldly and succinctly stated, it is my opinion that removal of the tax exemption feature, even in the devious form of the present bill, is, in fact, both unconstitutional and a subversion of the federal form of government which this nation alone enjoy. The power to tax is indeed the power to destroy and there are many who view the present proposal as yet another step toward a unitary form of government for these United States which can have *only* a negative effect on the viability of the federal system and eventually a displacement of local self government.

Traditionally cities, counties, districts and many states have financed their long range capital requirements through the issuance of bonds. Local governments throughout the country have required unprecedented amounts of capital to finance the $15,000 of public works facilities required for each new family. This includes streets, sewers, waste disposal systems, recreation facilities, fire stations, etc. Our free enterprise system has provided funds for these public borrowers in a manner unparalleled in other countries. The competition for funds is great and if the profit is removed from this market public agencies will be hard pressed to find funds with which to finance major improvements. The primary, and in some cases the only investment lure, is tax exemption.

As practical and immediate as are the consequences of H.R. 13270 on the bond market, our major concern is and must be the violation of fundamental principles represented by the provisions of the bill before you. Removal of tax exemption can have only one result: The increasing threat of federal control over state and local governments. Since the founding of our nation, state and local bond issues have—under established and recognized principles of comity grounded in our Constitution—been exempt from federal taxation. As one also concerned with the practicalities of federal program operations, I will illustrate in later portions of this testimony why the extraordinarily complicated U.S. Treasury subsidy proposal as a substitute will not work.

H.R. 13270 comes before you as a tax reform measure. The report of the Committee on Ways and Means of the House of Representatives as well as the remarks on the floor of the House by the distinguished Chairman of the Committee indicate that the proposal is aimed at eliminating a so-called "tax haven" supposedly taken advantage of by not more than a couple of hundred individuals. You have the responsibility of weighing that alleged goal against the absolute fact that tens of millions of local government taxpayers will have to pay literally billions of dollars in higher local property taxes to accomplish this "reform."

The proposal before you has already driven local government interest costs to their highest point in our history! Not even during the worst depressions have local governments had to pay as high an interest as they now do. The cost of borrowing money at these rates for public purposes can come from only one place—your pockets and mine along with millions of other local property taxpayers.

Three weeks ago, for the first time in our history, more than $170 million of temporary housing notes issued on behalf of local government projects to meet the nation's tremendous need for low-income housing could not be sold because the statutory limit of 6% precluded receipt of any bids. A fortnight ago more than two dozen local housing agencies received a startling setback and intolerable delay in their low-income housing programs when nearly $200 tax-exempt housing bonds issued by the Housing Assistance Administration failed to find a satisfactory market. Soaring interest rates directly attributable to H.R. 13270 created there "first time in history" experiences.

On Wednesday, July 30, the Wall Street Journal carried the following quote from a senior official experienced in the tax-exempt bond market:

"This is the worst single day in our market's history, and its significance is that it was the beginning of the realization that the tax-exemption feature is in jeopardy."

Nineteenth month U.S. Treasury Notes sold at an interest rate of 8% in September. Fifteen year U.S. Government insured merchant marine bonds sold during the same month at 8.05%. It simply is not realistic to assume that 20–40 year local government bonds which are not tax-exempt will sell for any less than these costs.

This being so, the only inevitable result will be an interest cost for local government bonds that will be at least double the averages for the past four or five years. In California, where our studies indicate an average annual amount of $1.5 billion in state and local government bonds coming to market during the immediate future, this equates to more than a billion dollars in higher interest costs which will have to be borne by local government taxpayers in California between now and the end of the century! This is money which can come only from local government taxpayers to the detriment of local government programs for the construction of the physical facilities, public works and other improvements so desperately needed and so pointedly noted in the many federally-sponsored reports in recent years pointing to alleged shortcomings in local government performances. It is ironic to say the least, for local governments to be so castigated and characterized by federally-sponsored studies and, simultaneously, to note your consideration of a fundamental change which will only add to the monumental difficulties and problems spoken to in those documents—several of which are, in fact, published by various committees of your own branch of the Congress.

Removal of the tax-exemption on local bonds will further hamstring, handcuff and strait-jacket local governments as they go about their business in trying to solve core city problems which are universally agreed as being the nation's number one domestic priority. Inability to borrow for long range needs will result in pay-as-you-go higher taxes competing with taxes vital to current urban requirements.

While it may be extraneous to my remarks to note the extraordinary haste which accompanied this provision of H.R. 13270, since the bill is now before your Committee, I would be remiss in my responsibility if I did not note (at least for the record) that the bill came before the House of Representatives under a rule which prohibited amendment. As Congressman Utt of California noted on the floor of that House, massive changes were made pertinent to the provision to which I address my remarks two days before the bill was reported and, indeed, one day *after* it was reported. Mr. Utt, a member of the Ways and Means Committee, in commenting on the removal of the tax-exemption provision bemoaned these procedures and the tenor of his remarks closely parallels my testimony to this point with the added notation that the proposal results in increased costs which he correctly stated must be paid for by "The people in my community in increased local taxes." In echo of his remarks I would say, as he did, "If you want to do something for the local communities, stay away from interfering with tax-free-bonds."

Finally, let us examine the practicality of the so-called U.S. Treasury subsidy to make up for what is universally acknowledged and confirmed by the Ways and Means Committee report accompanying H.R. 13270 to be higher costs for desperately needed public improvements. There is, of course, no "trust fund" concept for the proposed subsidy. This means that Congress has two choices. To act in good faith it must provide an open-ended appropriation to cover all bond issues which might possibly come to market during every fiscal year from here to eternity under the normal due processes of law preceding such marketings OR, it will set a limit on the amount it annually appropriates for that purpose. There is nothing in the history of federal programmatic grants to urban areas to indicate that the first choice will be the one that Congress would follow. Logically, then, Congress will set a finite amount in each annual appropriation act for the "subsidy." It follows as the night must follow day, that the appropriation will not provide enough funds for all local government issues seeking a market under the subsidy program. And, just as surely, this means that a federal agency under some formula still not devised will decide which local bond issues they think are "good" and consequently subsidize; and, which they think are "bad" and consequently will not.

Undoubtedly, a large federal bureaucracy will have to be created somewhere to make these decisions. This was publicly stated in mid-August by Alan K. Browne, Senior Vice President of the Bank of America and widely acknowledged as the Dean of the nation's tax-exempt bond business:

"Unless something is done, the tax-exempt bond as a major debt tool of local government will soon be a curiosity. In its place . . . will be a taxable municipal bond. . . . That would be bad on several counts including the need for a costly bureaucracy and a danger of federal intervention in local affairs."

Undoubtedly, the making of such decisions will tremendously twist and distort our normal governmental processes.

Undoubtedly, given the normal time-consuming delays usually encountered in such administrative processes, added costs will be piled on local governments as they are inevitably inordinately delayed pending decisions from a federal agency.

Undoubtedly, this process will result in the replacement of decisions made by those duly elected to fulfill those responsibilities at the local level by anonymous federal employees. In our local communities, general obligation bonds cannot be issued except by a ⅔rds vote of approval from the people. Even after authorization for issues by state legislatures and constitutions, approva' by city councils and approvals by a vote of the people, federal bureaucratic processes may as a matter of practicality, result in non-issuance of such bonds. The Congress of the United States will be doing a disservice to their fellow elected officials at the local level by subjecting them to public criticism or "failures'" to issue and market bonds at reasonable rates when those failures are caused by a lack of "subsidy" funds and approvals from the bureaucracy. Surely you cannot expect local officials to stand before the electorate in answer to those charges with the feeble response that some Budget Analyst somewhere in the Treasury maze or elsewhere has turned down a request for the subsidy, and, consequently, the bond issue approved by the city council and the electorate is now in a state of suspended animation or limbo.

Undoubtedly, passage of H.R. 13270 in its present form will result in at least two or three years of litigation during which time local bond issues for urgently needed public programs would, for all practical purposes, come to a halt. Given the present costs added to public works projects by inflation each year, the agglomerated costs of such a multi-year delay will eat up at least $250 million with no useful purposed served whatsoever.

Undoubtedly, if the tax-exemption is removed from local bonds, their attractiveness would seriously deteriorate, causing us to fall further behind in our race to attack the nation's major domestic problems in our cities. Already Dillon Reed Municipals, Inc., a major buyer of municipal bonds, has announced that it has decided "for the moment" that it will not bid on new tax exempt issues until their status is clarified. Other major brokerage houses are currently advising their clients not to buy municipals because their attractiveness would be seriously dampened by making them at least partially taxable.

In conclusion, I reiterate the grave possibility of the demise of our federal system of government inherent in any decision to tamper with, destroy or weaken the tax-immunity of local government bonds. The matter is no less important than that. Local governments in the United States exist as a matter of right, not as a matter of administrative or revenue-producing convenience for central authority. Our activities within the area of our competence and responsibility should not be overlapped with the heavy hand of federal bureaucracy. Even partial taxation of municipal bonds will strike a mortal blow at local self government and home rule. During the past twenty years, Congress has on many occasions considered the question of tax-exemption of municipal bonds. In every case it has wisely concluded that nothing should be done to interfere with it because it was not in the best interests of the United States, for whatever reason put forth, to make local government simply an administrative functionary within a unitary system of government. On behalf of the cities of the nation's largest state, I urge the 91st Congress to come to the same conclusion.

RICHARD CARPENTER,
Executive Director and General Counsel, League of California Cities.

RESOLUTION NO. 1074, OF THE CITY OF MIAMI SPRINGS, FLA.

A RESOLUTION OPPOSING THE ELIMINATION OF EXEMPTION FROM INCOME TAX LAWS APPLICABLE TO INTEREST ON MUNICIPAL BONDS.

Whereas, the United States Senate is considering a number of reforms in Income Tax legislation, the purpose and intent thereof being to eliminate certain inequities now existent therein; and

Whereas, it has been represented by the United States House of Representatives in House Bill No. 13270 that it is necessary to remove the existing exemption from taxation on interest on municipal bonds; and

Whereas, such proposal, if adopted, would have the following adverse consequences for the City of Miami Springs:

1. Preclude the City from selling bonds since the Charter limitation on interest rates that can be paid is 6⅞%.

2. Prevent the City from undertaking construction of a Sanitary Sewer System which is needed to eliminate existing health hazards.

3. Make it impossible for the City to provide needed capital improvements to serve a growing population.

Now, therefore, be it resolved by the City Council of Miami Springs, Florida:

1. That it is opposed to the elimination of said exemption from income tax laws applicable to interest on municipal bonds.

Be it further resolved that each of the Congressman and the two Senators representing the State of Florida be, and they are hereby formally requested to vigorously oppose the elimination of said exemption of interest on Municipal Bonds and to exert all possible effort to maintain the said existing exemption.

Passed and adopted by the City Council of the City of Miami Springs, Florida, this 15th day of September, A.D., 1969.

JOHN A. CAVALIER, *Mayor.*

Attest:

MARGARET H. SANDERS, *City Clerk.*

CITY OF DALLAS, TEX., *September 19, 1969.*

Mr. TOM VAIL,
Chief Counsel, Committee on Finance,
2227 New Senate Office Building, Washington, D.C.

DEAR MR. VAIL: I shall appreciate it if you will convey the following statement to the Senate Committee on Finance concerning the provisions of H.R. 13270 which affect the tax exempt status of municipal bonds.

This matter has been a source of constant concern for all of the cities and other governmental units of the United States for many years. It has been especially difficult during this year. This has been brought about by the passage of this bill and for all practical purposes has brought the progress of necessary capital improvements in local communities to a standstill.

Each day we receive news of bonds that were offered for sale and no bids received. We also hear of numerous cities withdrawing their bonds from the market even if bonds can be sold at especially high interest rates. This is an intolerable strain on local government budgets for debt service, many having limitations on how much can be spent for this purpose.

The provisions referred to as "tax reforms" or "closing tax loopholes", if passed, will in fact pass the burden on to the local taxpayer in the form of additional ad valorem, sales and other types of local taxation.

All of the points concerning the constitutionality of the federal taxation of local governments, the separation of governmental powers, and local determination of what projects are necessary have no doubt been brought to the attention of the Committee by many other people. The fact that one provision of this bill would tax the interest on bonds now outstanding appears to be a clear breach of contract, inasmuch as they were sold with the explicit provision that they were not subject to federal income tax. The Attorney General of the United States has stated that grave constitutional problems are raised by including municipal bond interest in a minimum tax base.

An illustration of the disruption of the municipal bond market can be made by the situation in the City of Dallas. A $175,000,000.00 capital improvement program in the City of Dallas is less than one-half completed. This was planned when the average interest on municipal bonds was 4%. If we are to complete this program, it will cause a drastic increase in the local ad valorem taxes. Another local illustration is the Dallas Independent School District which was unable to sell its bonds a few weeks ago and will have to discontinue the construction of schools in a very short time.

The Attorney General of the State of Texas has stated that if this portion of the tax reform bill is finally passed no bonds can be issued in the State of Texas until litigation, which would certainly occur, concerning the taxation of municipal bond interest is finally determined. This would mean a complete cessation of necessary public improvements in our local communities.

We urge that any portion of the bill which would tax municipal bond interest, either directly or indirectly, be deleted.

Respectfully,

E. LYNN CROSSLEY,
Past President, Municipal Finance Officers Association of the United States and Canada; City Auditor, City of Dallas, Dallas, Texas.

RESOLUTION OF THE CITY OF ROYAL OAK, MICH.

At a regular meeting of the Commission of the City of Royal Oak, Michigan, held at the City Hall in said City, on the eighth day of September, 1969, at 7:30 o'clock p.m., Eastern Standard Time:

Present, Commissioners Austin, Cline, Johnson, Kramer, Schoenholtz, Zuidema; Mayor Potter.

Absent, none.

The following action was taken:

"Whereas, the City of Royal Oak requires financing in the amount of $875,000.00 for the construction of various street and alley improvements and will be unable to finance these necessary improvements unless investors are assured that the tax exempt status of these bonds will be continued.

Now, therefore be it resolved that the City of Royal Oak respectfully urges the Senate of the United States to reject any proposals which change in any manner whatsoever the tax exempt status of bonds issued by The City of Royal Oak, and

Be it further resolved, that the members of the City Commission of the City of Royal Oak consider the taxing of these bonds a serious invasion of the rights guaranteed by the Constitution of the United States and, therefore, urge that immediate action be taken by the Senate of the United States to defeat any proposal for taxing obligations of the separate states and municipalities."

I hereby certify that the foregoing is a true and correct copy of a resolution adopted by the City Commission of the City of Royal Oak at a regular meeting held Monday, September 8, 1969.

EVELYN DEMSKE,
Deputy City Clerk.

STATEMENT OF C. CAREY DONWORTH, CHAIRMAN OF THE COUNCIL OF THE MUNICIPALITY OF METROPOLITAN SEATTLE, WASHINGTON

The Municipality of Metropolitan Seattle is a special purpose municipal corporation of the State of Washington, authorized to develop and operate a metropolitan sewage disposal system for the Seattle Metropolitan Area and to plan for the development of a metropolitan public transportation system for the area. The Municipality is completing a basic $145,000,000 sewage disposal system which has been financed by the issuance of sewer revenue bonds. It faces the need to issue an additional $80,000,000 of revenue bonds to extend this system. The development of a public transportation system for the area will require the issuance of approximately $400,000,000 of general obligation bonds of the Municipality.

The Municipality wishes to strongly protest against the minimum tax and allocation of deductions provision of H.R. 13270 as they apply to the interest on state and local bonds. We believe that these provisions in their net effect will substantially increase the cost of state and local financing and will result in a heavy increase in the tax burdens upon local taxpayers.

The option purportedly offered by H.R. 13270 to issue either fully taxable bonds with an interest subsidy payment from the Federal government (two coupon bonds) or to continue to issue conventional "tax-exempt" bonds without receiving a subsidy is partially illusory. The "tax-exempt" bonds which would be issued under H.R. 13270 will no longer actually be tax-exempt because the interest on them will, in effect, be increasingly taxable under the minimum tax and allocation of deductions provisions of the bill. The effect of these provisions is by gradual stages to make state and local "tax-exempt" bonds less attractive in the market. When this fact is coupled with action by the Secretary of the Treasury each quarter to set the interest subsidy for fully taxable bonds on the basis of the difference between the interest yield on such bonds and the yield on "tax-exempt" bonds as determined by the market at that time, it becomes apparent that the difference between fully taxable bond yields and "tax-exempt" bond yields would gradually decline and the cost of borrowing to state and local governments would substantially increase even under the subsidy option.

These provisions are urged on the basis that they will prevent wealthy people from escaping the payment of income taxes. This is seriously misleading. The purchaser of tax-exempt bonds may choose in a free market place to buy a relatively low-yielding municipal bond. He may, on the other hand, choose to buy a higher yielding corporate bond and pay a tax. In effect, by choosing the lower yielding bond, he pays a subsidy or tax to local government at the time he decides to buy that bond.

The wealthy can always protect themselves in the market place. The market will return to them the value it places on the use of their money and will soon reflect in increased interest costs what the wealthy require as compensation for the use of their money. Furthermore, the impact of estate taxes and death taxes upon the estates of wealthy persons is such that well-advised persons find much more attractive those equity investments which make possible large capital gains.

The net effect of the enactment of these provisions of H.R. 13270 which affect local and state bonds will be to slightly increase the annual tax yield to the Federal government at the expense of substantially increasing the annual cost of borrowing by state and local governments. It will increase the Federal income tax yield at the expense of higher property taxes and higher utility charged for the local residents who pay the cost of municipal and state borrowing. *The provisions of H.R. 13270 affecting state and local bonds are not progressive tax reform but enforced local tax regression. They accomplish a shift of the tax burden to the advantage of the Federal Treasury, but the disadvantage of renters, home-owners and utility users who must pay these costs regardless of their ability to pay.*

Finally and importantly, these provisions place in the hands of the Congress and indirectly in the hands of the Treasury Department and the Bureau of the Budget the power each year to determine whether and at what cost state and local governments may borrow to meet their local and state needs. No matter how this bill is analyzed, the provisions relating to taxation of state and local securities amount to annual Federal control, changeable at the wish of the Federal Congress. This represents a substantial shift in the balance of power under our Federal system.

A block grant tax-sharing program is a poor trade for so automatic and effective a tax-sharing plan as tax-exemption now provides.

The mere consideration of this bill by the Congress has turned the municipal market into chaos, has already cost local taxpayers hundreds of millions of dollars in additional interest costs and has prevented many urgently needed sewer, water and school projects from being built. It is most important that the Senate *unequivocally* affirm the immunity of state and local bonds from Federal taxation and that this declaration be so clear as to prevent any misunderstanding by the market. Only such action will restore the ability of local governments to raise the capital funds required to meet urban needs.

TOWN OF HARRISON,
Harrison, N.Y., October 1, 1969.

Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: On behalf of the Town Board and the people of the Town of Harrison, I hereinafter set forth our considered views with respect to so much of HR 13270—"Tax Reform Act of 1969", as deals with the taxation of "State and Municipal" bond issues. We believe that the proposed legislation in this regard contains within it the seeds of destruction of local capital improvement plans by increasing the cost of local improvements to a point where no improvement will be made. Because of the serious and far-reaching impact of this provision, I respectfully request that this letter be made *part of the record* of the deliberations of the Senate Finance Committee.

The Town of Harrison is an economically balanced suburban community about 25 miles North of New York City. Our population numbers approximately 22,000 people who live in homes or apartment houses situate on parcels of land measuring all the way from large estates of many acres to one-family and two-family dwellings on plots of 50 feet x 100 feet. As is true with other suburban communities all over the U.S., Harrison is faced today with the enormous problem of providing funds needed for capital improvements, such as, new schools, recreational facilities and new and expanded town service facilities which must be constructed in order to provide the entire spectrum of town services from fire and police protection to the undramatic but yet necessary garbage collection and disposal. Every facet of town and municipal services is affected by the cost of the facility or improvement and Harrison, like countless other communities, can only raise the needed funds by borrowing and then repayment by imposition of a real property tax. The burden of the real property tax, of course, falls on all residents of the town, who, by far, consist mostly of middle-income wage earners.

In an effort to face the problems of the future and establish the capital improvement and facilities needs in the foreseeable future, Harrison has embarked upon the development of a master plan. Specific separate emphasis is being given to development of a program for providing educational and recreational facilities in addition to vital master planning for roads, sewers and general town improvements. Obviously, capital expenditures of the kind that will be scheduled by the master plan will require the assembly of capital in order to complete the improvement by borrowing. The taxpayers must then pay for the improvement over the period of use of the facility—in most cases, a period of 20 to 40 years, by repayment of the borrowing and *interest* through the real property tax.

All of the foregoing seems elementary but must be repeated and emphasized because the proposed Congressional action which would subject interest on municipal and local bonds to Federal income taxation has cast severe doubt on Harrison's ability to fullfil its plans to provide for the future of its residents.

It has been reported in the public press, and it is obvious even to the unsophisticated observer, that the market for state and local bonds is near collapse. Such are the results merely from proposed action in Congress. Complete collapse and the utter destruction of local governments' ability to raise funds for local improvements will result if municipal bond interest is subjected to *any* form of Federal income taxation. Municipal bonds have been saleable in the past only because of the tax-exempt feature. The individuals and financial institutions who tend to buy tax-exempt municipals are sophisticated enough financially to consider making an investment of this kind on the basis of an after-tax return. Whether administration officials know it or not, it is a fact of current-day life that investment decisions in all aspects of business are made after considering the net return *after taxes*. Accordingly, it seems clear that the lower interest rates which a municipality formerly enjoyed would nearly double if the interest is subjected to Federal income taxation. Doubling the interest rate would be severe enough a result, but, unfortunately, there will be much more in store for municipalities. The added interest cost will make current debt service much more expensive, drive local real property taxes up in order to satisfy this increased cost, with the ultimate disastrous result that municipal bonds generally will be undesirable as investments. The Administration's proposal to share revenues or compensate for added interest cost in some yet undefined way will not forestall this obvious result. The pure and simple fact of the matter is that those individuals and persons who have the resources will just not be willing to tie up their capital for a long period of time in municipal bonds where a market for such bonds will be non-existent, and the chances of not being able to sell the bonds at par or at cost after purchase are reasonably great. An investor will be willing to trust the credit of a small town if the debt service which must be carried by the real property tax is low. However, should current debt service increase by close to 100%, then the town's credit might no longer be acceptable.

I will not deal with the constitutional arguments against the adoption of the proposed measure, since these arguments are well known to all members of the Committee. I wish to emphasize on behalf of the people of the Town of Harrison that the proposed action will make proper development of our town impossible because such action will eliminate the pool of capital which formerly was available for development. Local officials will be incapable of performing their governmental functions since the cost of funds will rise beyond manageable proportions.

Recently the public press reported that Mr. Stanley S. Surrey, former Assistant Secretary of the Treasury, (and a long-time proponent of taxation of municipal bond interest) said with respect to the measure now before you that "there is no one so pessimistic about the future of his country or his industry as a taxpayer who is about to lose a tax preference . . ." The forecasters of disaster, he said, have come from those "who stand to gain if their pessimistic predictions are believed." (New York Times, September 26, 1969)

For once, I find myself able to agree with Mr. Surrey. The people who are about to lose a tax preference *are* pessimistic about the future of the country. Mr. Surrey, however, loses sight of the fact that the outcry against any form of Federal taxation of municipal bond interest has not come from wealthy individuals and institutions but rather from local officials on behalf of the real property taxpayer—the grass roots of America. On behalf of the people of Harrison, very few of whom are in the 50% or higher tax brackets, I respectfully request that you continue this tax preference which enables local governments to keep real property taxes at a minimum while, at the same time, enabling local officials to provide capital improvements. This tax preference is enjoyed by the small and middle-class taxpayer, and already amounts to revenue sharing by the Federal government. Let it continue.

If the Administration's desire is to forestall local development as a way of slowing down the economy, the proposal to tax municipal bond interest will definitely result in the elimination of local development projects. However, if *tax reform* is truly the object of the Tax Reform Act of 1969, then the bill misses the mark by far in this regard since it eliminates just about the only tax preference that exists for the *small* and *middle-class* taxpayer. The wealthy individual or institution will still enjoy the numerous other tax preferences which still exist and will make investments based on an after-tax dollar return. The loser will be the small and middle-class taxpayer.

Respectfully submitted.

E. A. Dominianni,
Town Board Member.

Statement of the State Association of County Commissioners of Florida

The State Association of County Commissioners of the State of Florida is grateful for the opportunity to present its views to the Senate Finance Committee with respect to the provisions of HR 13270 that change the current status of tax exempt bonds. The State Association of County Commissioners is unalterably opposed to any change in the law with respect to tax exempt bonds. In support of this position, the following should be noted:

In growth states, such as Florida, the competition for investment capital for public purposes is extremely keen. The monies required to build schools, water and sewage systems, roads, dormitories for higher education and plants to attract industry are dependent upon the issuance of governmental bonds that offer attractiveness in addition to the interest rate.

The State has only recently taken advantage of some of the provisions for tax exempt bonds to meet the needs of our local government. In 1968, a new Florida Constitution was adopted, which permits the issuance of industrial revenue bonds. Many counties in Florida are preparing to take advantage of this to obtain a necessary capital to attract desirable industry and thereby reduce unemployment. During the 1969 Legislature, a bill was enacted to permit counties to establish authorities and issue revenue bonds for the construction of much needed private dormitories and educational facilities. Also during 1969, provisions were adopted for counties to issue short term bonds to build needed secondary roads, pledging as security therefor the county's portion of the state gasoline tax. Prior to these important changes being made, public needs were largely met through the issuance by state, municipal and other local government entities of tax exempt securities.

The public purposes served by obtaining these critical needs far outweigh any benefit which might accrue in the form of tax shelter to the investor. The only feasible alternative to the issuance of tax exempt obligations is to raise interest rates to exorbitant levels, thereby increasing the threat of inflation and penalizing the public, not only in the reduction in construction of needed public facilities, but in reduced buying power of the dollar.

The experience of those states which have utilized tax exempt securities to a greater extent than Florida, has proven its wisdom. It was for this reason that Florida's new Constitution contains a provision for pledging the credit of the state and for issuing additional types of these securities. Continuation of the tax exempt feature of these securities is deemed essential to every segment of local government in the State of Florida.

It is respectfully urged that no change in the present tax exempt bond law be effected.

Statement of School District No. 1, City and County of Denver, State of Colorado, Submitted by William G. Berge, President, Board of Education, and Robert D. Gilberts, Superintendent

Removing the tax exempt feature from Municipal Bonds, as proposed in H. R. 13270, will greatly increase problems in meeting the capital construction needs in School District No. 1, City and County of Denver.

There is ample evidence being presented by others which shows beyond a doubt that the proposed action will be detrimental to the sale of bonds by our district.

Our Municipal Bond dealers, financial advisors, and bond attorneys inform us that the proposed action will have adverse effects on sale of school bonds by our district not only now but for several years to come. Recent experiences of our neighboring school districts furnish direct evidence to support this probability and the non-tax exempt status of such bonds has not yet become a fact.

We do not feel that the tax subsidy plan can adequately compensate for the increased cost to the local taxpayers. The uncertainties connected with this proposal as well as the complex system of controls and administration make it undesirable.

We believe that the total tax exempt status of school bonds should be retained and that in order to insure marketability and lower cost to the local taxpayer they should not be subject to the tax preference and allocation of personal deductions provisions in the bill.

Because of constitutional questions raised by this proposal and the expected litigation to ensue, the municipal bond market will be doomed to chaos for several years with a resultant cost to local taxpayers of additional millions of dollars.

Capital construction in our school district has experienced severe delay because of serious problems arising out of plans for integration. We now need to begin a capital construction program to meet the following needs: (a) replace 26 old buildings located in the core city, 18 of which were built prior to 1900; (b) build 14 new schools in recently annexed areas of the city where there are now no schools; (c) building and conversion of buildings to meet requirements for vocational and other present day educational needs of 96,000 children. At present day costs, this program would amount to more than $130,000,000.

In view of the foregoing conditions, it seems almost a certainty that a tax on interest received from school building bonds will create serious disruption and uncertainty, if not practically insurmountable obstacles, in carrying out future planning for capital improvement programs in our school district. We believe the provisions in this bill relating to the tax on income from municipal bonds will have a boomerang effect on local tax burdens for the average taxpayer.

Finally, if our school district were authorized to sell bonds today, our statutory limit of 6% interest cost prohibits the sale of such bonds in today's market where the municipal bond index is 6.33%.

Statement of the City of Hastings, Nebr.

Re H.R. 13270—Proposed taxation of interest on municipal bonds before the Committee on Finance, United States Senate.

Mr. Chairman and Members of the Committee: On behalf of the City of Hastings and also representing the school district at the hearing before the Senate

Finance Committee on September 23, 1969 the following resolution is the firm opposition to the tax reform bill effecting taxation of interest on municipal bonds.

"Be it resolved that the City of Hastings, Nebraska has considered the provisions of the tax reform bill now pending before the Congress of the United States which would impose taxation of interest on municipal bonds. The elimination of tax exempt status will have a serious impact upon the outstanding and future bond issues, with additional interest rates increasing from two to three percent. The City of Hastings urges your committee to recommend the elimination of subject provision within the bill."

Respectfully submitted,

W. F. GETTMANN,
Mayor, Hastings, Nebr., and
The Board of Education of
the School District of the City of Hastings.
County of Adams, Nebr.

STATEMENT OF ERIK JONSSON ON BEHALF OF THE CITY OF DALLAS, TEX.

Mr. Chairman and Members of the Committee: On behalf of the City of Dallas, I am making this statement in regard to H.R. 13270 as relates to the proposed taxation of interest on municipal bonds. I am also acting in my capacity as Chairman of the Dallas-Fort Worth Regional Airport Board and President of the Texas Municipal League.

The long-standing exemption provided under the law for interest on municipal bonds would be substantially eroded under this Bill. I am gravely concerned about the hardships that will befall the urgent building programs of all cities in this country if the tax-exempt nature of such bonds is in any way impaired.

In 1967 the citizens of the City of Dallas approved a $175 million Capital Improvement Program which is now only partially completed. At the time of the election approving the comprehensive improvement program of projects necessary to the health and welfare of all of the citizens, the average interest rate on the securities of the City of Dallas approximated 4 percent. It is now estimated that the average rate of interest on bonds issued for these purposes would be 6.5 percent. No small part of this increase can be attributed to the consideration in Congress of the tax proposals contained in H.R. 13270. Pure and simple, this means that the cost of this additional amount will ultimately have to be paid by the very people the tax reform law is designed to assist. The cost of financing the remainder of the improvement program will far exceed the original projected cost, with the result that some improvements that are critically needed will be deferred indefinitely, if not permanently.

All of the civic improvements that Dallas has authorized are desperately needed, and any action that causes delay in carrying out the program of improvements will be harmful to every member of the community. Our present method of financing through the issuance of municipal bonds is well established and relatively expedient. I feel certain that the proposed changes, even where the city might receive an interest subsidy on new securities, would be slower and would result in substantial delays in projects that are essential. The offering of a subsidy in lieu of tax exemption intended to equalize the cost to the cities will be time-consuming and inevitably will result in destroying our schedule of improvements. It will also interfere with local self-determination of programs. This proposal represents the strongest move toward centralizing government that I have encountered in my lifetime. Our improvement program has been designed for local needs and approved by our taxpayers and should be completed by them without experimenting with a financial scheme that would shift control of major decisions from the local level to Washington.

The crisis of the cities has been further aggravated as a result of a by-product flowing from the mere consideration of a change in the long-established tax exemption. This effect is demonstrated by the recent behavior of tax-exempt yields in the municipal bond market. Cities today are in a position where they can scarcely market their bonds.

The interest on municipal bonds has been exempt from the Federal Income Tax since it was adopted in 1913. Any disturbance of this status now can only compound the difficulties that all cities face today.

I urge that this Committee delete any reference in H.B. 13270 that will in any way affect, directly or indirectly, the tax-exempt status of municipal bonds.

Respectfully submitted,

ERIK JONSSON.

STATEMENT IN BEHALF OF THE

DALLAS-FORT WORTH REGIONAL AIRPORT BOARD

Submitted by E. Ray Hutchinson of
McCall, Parkhurst & Horton
Dallas, Texas

INTRODUCTION

H. R. 13270 contains essentially 4 provisions which directly affect the tax exemption on municipal bonds: (1) the provisions placing a "Limit on Tax Preferences" ("LTP"); (2) the provisions requiring an "Allocation of Deductions" ("AOD"); (3) The provisions declaring taxable the interest paid on so-called "Arbitrage Bonds"; and (4) the so-called alternative to tax exemption, the "Federal Municipal Interest Subsidy."[1]

Comment regarding the direct attempted elimination of the municipal tax exemption is probably by this time running into the hundreds of thousands of words. Comment on the indirect method of obtaining the same result through LTP and AOD is doubtless running into the tens of thousands. Most arguments against them have been stated and will be repeated and duplicated before this Committee, probably by many witnesses and in many written Statements, and some will be footnoted again herein. But, hopefully, most repetitious arguments will be avoided.

This Statement is not intended, in any sense, as a legal memorandum on the law of the subject, though a few cases will

[1] While great damage can be done by vesting in the Department of the Treasury unlimited jurisdiction to determine rules relating to municipal Arbitrage through the issuance of bonds, those provisions of H.R. 13270 will not be discussed herein except to urge that this Committee provide proper standards so as to assure the ability of local governments to invest public funds in Federal Securities. Additionally, the merits and demerits of the interest subsidy plan will not be discussed, except to suggest (a) that it really furnishes no alternative at all, and (b) that in any event the plan is not even legal under the laws of most States.

be cited. As will be repeated herein, however, it is surely true that any Federal tax law calculated to increase taxes on account of the holding of municipal bonds will be the subject of years of litigation. Nevertheless, as a public agency and a party to the Constitutionally created partnership between the States and the Federal Government, the Dallas-Fort Worth Regional Airport Board proposes to speak, not in legal terms but in terms of the crisis to fall upon us all if these proposals or any akin to them become at least temporarily the law of the land.

The planned Dallas-Fort Worth Regional Airport is not typical, nor will it be just another airport. It represents an attempt to recognize that technology and usage in aviation and air transportation and commerce have overrun us – to the extent that airports throughout the Country are obsolete and many were so on opening day. The same is true also of the federally owned and financed airways system which connects airports throughout the Country. It is overcrowded and in many areas unsafe. The airports could barely be used, if at all, without the airways. The airways would be useless entirely without the airports. A true example of the mutuality of the need between two governments.

The only proven, feasible means by which a local government can finance its part of the cost of airport facilities is through the issuance of municipal bonds. Throughout the history of our governmental system, no other more workable means has been

[2] Two excellent legal presentations were filed with the Committee on Ways and Means on the Subject of the "Tax Treatment of State and Local Bonds": One, by the Honorable Francis O. Burch, Attorney General of the State of Maryland; and another by Mr. Northcutt Ely, Attorney at Law, Washington, D.C. Undoubtedly, both will be filed with your Committee.

devised. Indeed, none has even been proposed, and certainly none is contained in H.R. 13270.

The Dallas-Fort Worth Regional Airport will be owned jointly by the cities of Dallas and Fort Worth, Texas, and will become the regional center for domestic and international air commerce serving many parts of the world. Its planning spans over ten years and its first phase construction cost is estimated at $250,000,000. Its second phase, another like amount. That is, unless it is stopped, or becomes "typical or just another airport" through lack of funds. Yes, this facility faces a stoppage, a shut-down. It cannot foreseeably afford a 9% or 10% interest rate on its bonds through the sources of revenue it has available with which to pay them.[3]

By some standards, this project is small; by others, it is gigantic. By all standards, it is needed, in the interest of public safety, convenience and necessity. But in this reality, this project stands in no different shoes than the mass of other State and local projects throughout the Country which have aborted because of one simple fact of life – their financing is under attack in Congress. Their projects are of another nature, but equally as important.

Therefore, this Statement cannot properly be limited to the personal experiences of one airport in one area. Indeed, all States and local governments suffer. In this, then, the Dallas-Fort Worth Regional Airport is only representative and this Statement is submitted accordingly.

[3] By calculation, each 1% interest rate increase on Dallas-Fort Worth Regional Airport Revenue Bonds increases the cost of the airport by $86,723,000. Its last issue, December 1968, carried interest at 4.9%. It is now estimated that a 7½% coupon would be required. Thus, in 9 months, the interest cost increase alone virtually equals the debt needed to pay construction costs.

A Classic Miss of the Mark - *The Result: A Tax on Local Projects and Initiative*

> "Your Committee believes that no one should be permitted to avoid his fair share of the tax burden-*to shift his tax load to the backs of other taxpayers.*" Ways and Means Committee Report accompanying H.R. 13270, pg. 78. (emphasis added).

With this pronouncement, the Committee on Ways and Means proceeded to describe and recommend that the House of Representatives adopt a tax policy which calls for the levy of an indirect and sometimes direct tax (through LTP and AOD) on the interest paid on municipal bonds. The statement in its context is a classic example of missing the mark, of misleading, short-sighted and careless generality and incongruity. Surely a tax on municipal bond interest must represent the most obvious "pass-on" tax one could possibly describe or recommend. Without even so much as a ceremonial hearing on these provisions, sealed without substantive debate under the so-called "Closed Rule" of the House, the House of Representatives and its Committee on Ways and Means have succeeded in-

> tragically increasing the cost of State and local borrowing[4] to the point of shut-down in many instances and beyond the legal limits of many States;[5]

[4] According to the *Weekly Bond Buyer*, September 2, 1969, since July, 1969, when the Ways and Means Committee started serious consideration of these proposals, investment yields on new issues of local government "AA"-rated bonds had through September 2 risen by about 70 basis points (from about 5.50% to 6.20%), while yields on similarly rated corporate taxable bonds had risen during the same period by only 5 basis points (from about 7.95% to about 8%).

[5] For example, the Texas Legislature in March, 1969, enacted a law increasing permissible interest rates on local borrowing to 6-1/2%. On September 8, 1969, it became necessary that it pass a law removing all interest rate limitations. Else, except for a few, all local projects in Texas faced an involuntary moratorium at least until the Regular Legislative Session of 1971.

> wreaking havoc with the capital improvement planning and programs of State and local governments, including projects in process;
>
> displaying a calloused breach of faith through retroactive taxation of outstanding municipal bonds;[6] and
>
> challenging the very essence of our National, State and local governmental system, namely the constitutionally recognized principle of reciprocal tax immunity;

all without the benefit of logic and positive legal authority, and as a method of accomplishing the objective quoted above.

In this simple stroke of uninformed generality, under the guise of closing "loopholes" in the tax law, and in the ill conceived rush to burden one celebrated cause in the State of Michigan and 154 taxpayers (who did not utilize the municipal exemption to reduce taxes) with "their fair share of the taxes," the House and its Committee has inadvertently confirmed the genius and wisdom of Chief Justice Marshall when he said, in the often quoted statement-

> ". . . the power to tax involves the power to destroy."[7]

The municipal bond market has virtually ceased to exist, State and local projects and planning throughout the Country being left in the wake. Thus, unbelievably, at a time when State and local governmental units need so much in the way of funds in order-

> at least to abate, if not to solve, the crises in the Cities through improved public housing and other public facilities;

[6] Of all actions to date, this feature of LTP and the Administration's recently recommended treatment of AOD is perhaps the most unspeakable. Surely, a discussion of the point is not required.

[7] M'Culloch v. Maryland, 4 Wheat (U.S.) 316,431(1819)

to avoid the pollution of the air and of the Country's rivers, waterways and harbors and to develop its water resources;

to repair the streets and road systems throughout the States;

to provide school buildings and facilities in order to avoid the present and continuing crisis in primary and secondary education;

to make an effort toward solving the problems of higher education in part through the construction and equipment of adequate buildings and facilities, including college housing;

to assist in the alleviation of the present and continuing crisis in air transportation and aviation by the attempted construction of adequate ground facilities at airports, in the interest of the public safety and commerce;

to provide for adequate recreation facilities, parks and park systems;

to provide hospital and care facilities for the sick, injured, infirm and aged; and

to provide at least the minimal, basic facility needs of citizens through adequate water, sewerage, storm, fire, police, public transportation and other facilities,

the States and their local governments are now, somehow, in this year of 1969, called upon to make a Statement in defense of their Constitutionally recognized power, right and duty to proceed with the job at hand, and to plead with the Congress of the United States not to destroy their ability to do so, or even to take the first step in that direction.[8]

It is unbelievable that the planners of State and local governmental projects throughout the Country, such as the

[8] "...It is obvious that taxation on the interest (on municipal bonds) would operate on the power to borrow before it is exercised..." *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. (1895), affirmed on rehearing, 158 U.S. 601 (1895).

18,000 acre Dallas-Fort Worth Regional Airport, could be praised for their vision in planning on the one hand by one or more agencies of the Federal Government, and be condemned by another agency of the same government (the Department of the Treasury) to the fate of paying a pass-on tax on those facilities if constructed according to those plans.

It is inconceivable that the Congress on the one hand would be considering proposals this very day to fund Federal and to assist in funding State programs to alleviate the problems of the Federal Government and of States, cities and schools,[9] and on the other hand, at the same time, be seriously considering a pass-on tax proposal under the name of "Tax Reform" which adversely affects and ultimately will destroy[10] the only successfully proven method of financing State and local self-help. If LTP and AOD or any law akin to them remain in H. R. 13270, then all Federal programs which depend on degrees of local self-help will be rendered meaningless, wiped-out, useless. Congress will have fallen victim to its own illusion.

It is inconceivable that the Department of the Treasury of the United States, an important arm of Federal Administration, could join favorably in this advocacy at a time when, under concepts of "New Federalism" and others, decentralization, local initiative and self-help are being advocated.

[9] To name only two: At least a $5 billion Five-year airport facilities program, and a $10 billion highway program, not to mention programs for HUD, HEW, FHA and others.

[10] In a legal context, this Statement is speaking in terms of the Congressional "right" to tax, as distinguished from the "rate" of any tax on municipal bond interest. If a discussion on this subject ever degenerates simply to a question of "how much a tax will be," then the cause is lost. The Federal Government will be in complete control. Reference need only be made to the familiar argument that prevailed at the time of the initial proposal of the income tax in which some argued that a Constitutional limit of 10% should be imposed. This was considered absurd by others.

Many other things are inconceivable about the position in which we find ourselves. But such are the facts, unbelievable and inconceivable though they may be. The last chance lies in the Senate, with your Committee and the Conference that will follow, for, while unfairness and bad taste are not in order or intended, nevertheless, it does appear that the House of Representatives will adopt anything bearing the title "Tax Reform," and there are no present indications that the President would not sign it.

The unfortunate term "loophole" as used so frequently in connection with H. R. 13270 implies that the municipal tax exemption is a tax haven for the rich, or for those who are almost so. The above quoted objective of the Committee on Ways and Means, being sought in the removal or impairment of the tax exemption, must be tested by looking at the result to an investor in municipal bonds if the exemption is removed: Would he become less rich? In absolute and positive contradiction of the Ways and Means Committee, it is patently obvious that the answer is "No." He would serve simply as the conduit through which the tax would be levied and collected – from the very people the tax reform law was designed to assist.

Is there a difference because the tax may be discriminatorily indirect, such as through a requirement that ordinary deductions be allocated against the exempt income, as is provided in H. R. 13270? In this situation, it seems also patently obvious that this is a change in form only and that the results of a tax cannot be avoided by an attempt to hide it. Since the application of the tax depends upon the particular financial

[11] In the first place, this exemption finds its source, not in the Congress as a matter of Congressional grace, but rather in the Constitution as a matter of inherent right. *Pollock v. Farmers' Loan & Trust Co.*, supra.

circumstances of each individual purchaser of municipal bonds, it seems perfectly clear that the interest rates will increase across the board on all municipal bonds in order to protect the initial purchaser's prerogatives of resale and transferability, unencumbered by adverse tax rules as applied to various individuals as potential buyers.

The insidious characteristic, therefore, in both a direct and an indirect tax on municipal bonds is that the result to and the impact on States and local governments is the same: The change in the tax law relating to municipal bonds results directly and consequentially in an increase in the cost of State and local borrowing undertaken in the public interest in response to critical public needs, and in pursuit, at least until now, of recognized national goals and objectives. The House of Representatives and the Department of the Treasury are thus saying to States and local governments:

> "Proceed with your school buildings, your airports, your public housing projects, your water development plans, your pollution control programs, your colleges, your streets, your highways and your hospitals – but if you do you must pay (through local ad valorem taxation and charges) not only the normal cost of furnishing these facilities, but also you must additionally provide an amount to the Federal Government for doing so."

We submit that this additional amount,[12] pure and simple, is a direct tax imposed by the Federal Government upon State and local projects and upon State and local initiative, to avoid which

[12] How much the Federal treasury actually receives from this additional amount under an indirect tax is another question. Under the Treasury Department's recent proposal regarding AOD, the Federal Treasury will receive only $45,000,000 annually, according to Secretary Kennedy. It is suggested to the Committee that the personal deductions of increased ad valorem and sales taxes alone by reason of the across-the-board increase in interest rates will very likely produce a net loss to the Federal Treasury both under H. R. 13270 or the alternative proposed by the Treasury Department.

the State and local Governments simply do not build, grow and thrive of their own free will.[13]

The Question-
The unthinkable tax on a Partner

As stated earlier, it is not the purpose of this Statement to present the Committee with a legal memorandum or brief of the law on this subject. Obviously, it is a matter about which there is some difference of legal opinion. The Administration apparently is of the view that LTP is unconstitutional but that AOD is not. The Committee on Ways and Means apparently feels that both are legal. But one thing is for sure, the Constitutional question will be determined by the Courts if H. R. 13270 is passed in its approximate form.

What we hope to accomplish is simply to raise to the Committee what we consider to be the telling questions regarding this issue and the positions of the parties:

(1) Is it not just as unthinkable for the Federal Government to levy a tax (or adopt a tax policy having that effect) on an airport owned and operated by a State or local government, as it is unthinkable for a State or local body to levy a tax on a federal control tower at that airport or the federal airways system?

(2) Is it not just as unthinkable for the Federal Government to levy a tax on a State highway as it is

[13] The same thing can be stated in many different ways: The tax simply increases local ad valorem and other taxes and charges to the people who are supposed to benefit from "tax reform." Also, for those projects which simply are not feasible at higher costs, the obvious result is unemployment, further deteriorating public facilities, bankruptcy and the like. For the first time in recalled history, Congress will have been directly and solely responsible for a substantial, identifiable increase in local ad valorem taxes.

[14] As has been stated many times, this period of interminable litigation which perpetuates the doubt in investors as to their tax status, can have no effect other than the adverse continuance of the present financial crisis in States and their municipalities.

unthinkable for the State to levy a tax on the Federal highways running through it?

(3) Is it not just as unthinkable for the Federal Government to levy a tax on a State or local government hospital as it is unthinkable for a State or local governmental unit to levy a tax on a Federal hospital for the health care of veterans or others?

(4) Is it not just as unthinkable for the Federal Government to levy a tax on a State or local police building, a city hall or courts building as it is unthinkable for States and local governments to levy a tax on Federal government centers, post offices of courthouses?

Has the partnership between the Federal and State Governments, both joined together for the common good and for the benefit of the same people,[15] proceeded to the point of desperation where one of the partners seeks to increase the cost to the other of doing the public's business?[16] If so, is it not to be expected that the other partner will retaliate in kind and to the same degree? If it is Constitutionally permissible for the Congress of the United States to levy taxes (either directly or indirectly) on the interest paid on State and local bonds to the great and obvious detriment of those governments, is it not also true that State and local governments will be permitted Constitutionally to tax in the same manner the interest paid on the notes and bonds of the Federal Government, to its great

[15] While this is not an earth-shattering observation, we all deserve an occasional reminder that the same people constitute the citizenry of both governments, and it is their interest which we all seek to protect.

[16] "We are relieved, as we ought to be, from clashing sovereignty; from interfering powers; from a repugnancy between a right in one government to pull down what there is an acknowledged right in another to build up; from the incompatibility of a right in one government to destroy what there is a right in another to preserve." *M'Culloch v. Maryland*, supra.

detriment and cost?[17] Is this not a classic case where neither government wins? Will it not, in the final analysis, lead ultimately to the dissolution of the partnership?

Won't the public be surprised when they hear it said, "All we were trying to do was close a loophole."

[17] "It is admitted that there is no express provision in the Constitution that prohibits the General Government from taxing the means and instrumentalities of the States, nor is there any prohibiting the States from taxing the means and instrumentalities of that government. In both cases the exemption rests upon necessary implication, and is upheld by the great law of self-preservation; as any government, whose means employed in conducting its operations, if subject to the control of another and distinct government, can exist only at the mercy of that government. Of what avail are these means if another power may tax them at discretion?" *Buffington v. Day,* 78 U.S. 113 (1871)

STATEMENT OF THE METROPOLITAN WATER DISTRICT OF SOUTHERN CALIFORNIA, SUBMITTED BY JOSEPH JENSEN, CHAIRMAN, BOARD OF DIRECTORS

The Metropolitan Water District of Southern California is a public corporation organized under the laws of the state of California to furnish supplemental water at wholesale for municipal and industrial use to cities and other public agencies. The District now serves most of the coastal plain of Southern California. It has a population of more than 10 million living in 121 cities and in various unincorporated areas including the metropolitan areas of Los Angeles, Orange County and San Diego.

Southern California, a semi-desert area, has experienced the greatest influx of people in the world's history during the past three decades in which it has become one of the great urban complexes in the world. This amazing and unprecedented growth placed tremendous pressure on public officials to continue furnishing the most basic commodity for this dynamic and expanding economy, namely, water. The natural distribution of waters in California has never coincided with population and industrial demands, a problem characteristic of most of the southwestern United States. The difficulties of meeting this growth and attempting to plan for the future involved enormous costs and from a practical standpoint could only be accomplished by spending vast amounts of funds requiring long term financing.

In addition to the major water resource works already constructed in Southern California with municipal bonds, the voters of the Metropolitan Water District authorized the sale of $850,000,000 in general obligation bonds in 1966 as part of a financing package for the construction of $1,250,000,000 in new works for the distribution of additional water within our service area. These bonds are in addition to the $1,750,000,000 in bonds authorized for the California State Water Project, the world's largest water project which will meet Southern California's needs until close to the turn of the century. As of this time, Metropolitan has yet to sell $665,000,000 worth of its bond authorization, while the state has $600,000,000, which are unsold.

These figures quite accurately reflect the enormous costs to state and local governments of financing just one of their essential services in the west under the unprecedented growth pressures experienced since World War II. Today in California, public agencies have over $2 billion in bonds awaiting sale for the construction or betterment of water supply systems. In most instances, the added flexibility of long-term financing has permitted public agencies to do a more comprehensive and more efficient planning and construction job in the development of their water resources. Piecemeal planning and construction, quite frequently caused by practical financial restrictions, has usually resulted in a poorly balanced use of available resources and in the long run more expensive development.

Sections 301 and 302 of the House Tax Reform bill, H.R. 13270, will clearly have an immediate impact on the costs of long-term municipal financing. The far-reaching effect of the minimum income tax and allocation of deductions proposals is unquestioned. Investors, of course, handle their portfolios in large part based on the tax consequences of their decisions and the question is not whether this will increase the cost of issuing municipal bonds but rather how much. The other distinct possibility is that investors will seek other more profitable investments, thus limiting the supply of funds for municipals and so in effect driving up interest costs as competition between municipal agencies increases in a narrower market.

The other effect of these proposed changes is to undermine the confidence of investors who will not be specifically affected by these amendments but who are afraid that they represent a trend which will eventually include them. They can only view municipals as an investment with much less certainty of return than that upon which they have come to rely. Their reaction may well be the same, i.e., either they will look elsewhere for investment potential or reflect their concern in the bids they make for these securities. Also, until the constitutional issues raised by some of the proposed amendments are resolved by the courts, investors will be reluctant to consider municipals.

From the standpoint of Metropolitan and other public agencies, these reactions will cost money—a great deal of money—which must be passed on to taxpayers or water users. Metropolitan must sell the $665,000,000 balance of its current bond authorization to complete its construction program and an increase of one percent in the interest rate of these bonds will result in an added cost of somewhere around $275,000,000. An increase of 2¼ percent will result in an increase equivalent to the principal amount.

This added cost to Metropolitan will not be for the investor's benefit. The investor is demanding a higher interest rate to maintain his rate of return in the face of changes in the tax law and the added interest cost to state and local agencies which investors will demand will equal what investors expect they would face in additional federal income tax.

Obviously, we are opposed to the inclusion of interest on municipal bonds in these two provisions. We do not feel the Federal government's need for additional revenue needs to be at the expense of local taxpayers. The almost miniscule number of individuals who escape a portion of income tax because of ownership of municipal bonds is not adequate reason to impose much higher costs on local government, the most greatly troubled level in our entire government structure today.

The alternatives to the tax-exempt bond which have been proposed in connection with tax reform so far fall into three general groups. The House bill provides for a no-strings-attached subsidy for those public agencies willing to issue fully taxable bonds. The other two have been generally lumped into the "urban bank" approach and some type of guarantee system.

These latter two involve Federal surveillance and regulation of local capital projects in order to obtain the financing offered. We do not agree with this. We do not feel that having to accept Federal approval of our construction programs is an alternative to our reluctance to go into a more costly bond market. Some areas of state and local government need Federal assistance to develop needed programs in accordance with national policy but we feel this should be a conscious decision by Congress to aid in a particular field with established standards and a recognition of need rather than as an only alternative for paying higher interest rates. We do not feel that the Federal government's need for additional funds as stated by the Treasury Department is adequate justification for making local public projects into a Federally supervised program.

The no-strings-attached subsidy provided in the House bill has more merit from the standpoint of local agencies and is more consistent with Treasury's arguments that its objection to tax-exempt bonds is in large part based on loss of revenue. However, we cannot agree with such an approach when it must go hand in hand with a major deterioration of our traditional financing market, leaving as an alternative one which is untried and subject to constant change by future Administrations and Congresses. If the direct subsidy approach, which we believe will prove far more costly than current estimates indicate, proves unacceptable or is altered by Congress at some future time, then state and local agencies are left without recourse as their traditional market will have already been substantially altered or eliminated.

The Metropolitan Water District is opposed to any legislative proposals which will eliminate or curtail the tax-exempt status of municipal bonds, reduce or impair their marketability, increase interest costs or otherwise adversely affect the municipal bond market.

THE CITY OF COUNCIL BLUFFS, IOWA,
September 15, 1969.

Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
New Senate Office Building,
Washington, D.C.

DEAR SENATOR: Availing ourselves of the opportunity offered in Mr. Vail's telegram of September 10, 1969, we wish to make the following statement on behalf of the City of Council Bluffs, Iowa:

The City Council, August 4, 1969, unanimously adopted a resolution opposing any legislation which would tax income on State and Local government securities.

The municipal bond market is presently demoralized, partly as a result of the proposed legislation. Passage of this legislation will result in continued demoralization of this market pending anticipated litigation.

Increased interest rates will result in higher property taxes, as property taxes still represent the largest share of municipal income. Every home owner or renter will be penalized. The people have not asked for reforms which raise property taxes.

The Attorney General has grave doubts as to the constitutionality of the Federal Government taxing States and their governmental subdivisions.

Taxing existing municipal bonds penalizes the holder, unfairly, who in effect has already paid a tax when accepting interest rates amounting to 65% to 70% of rates on private securities.

No showing has been made that municipal bond interest entered into the 154 cases cited by the TreasuryDepartment of taxpayers who paid no income tax, even though their adjusted gross income was at least $200,000.00.

The tax subsidy proposed will not equal existing benefits to states and their governmental subdivisions. The City of Council Bluffs, Iowa in 1968 paid $239,961.55 interest. H.R. 13270 could increase this cost one-third or $80,000.00 annually. Should funds appropriated for the Federal Subsidy fall short, the Secretary of the Treasury would in effect be the judge of which governmental subdivision would receive a subsidy and for which purposes debt might be issued.

The City of Council Bluffs, Iowa does not oppose correcting inequities in the present federal income tax laws, but does oppose the creation of new inequities in planning to tax interest on local government securities.

The government of the City of Council Bluffs, Iowa wishes to preserve a benefit created by the Constitution and to retain its ability to serve its people without federal domination and control.

M. DON HARMON, *City Manager.*
CHAS. L. CAMPBELL, *Director of Finance.*

MISSISSIPPI ASSOCIATION OF SUPERVISORS,
Pascagoula, Miss., September 19, 1969.

Hon. Senator RUSSELL LONG,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR LONG: Thank you for the opportunity of presenting testimony in opposition to H.R. 13270.

The attached information is considered highly reliable and should be of great help in helping you and your committee to decide to oppose that feature of H.R. 13270 that takes away the opportunity of securing tax free interest on Municipal Bonds held by individuals, etc.

In addition to the attached information I would like to respectfully call to your attention the fact that millions of dollars issued by the State of Mississippi, city and county governments have built industries which cause the employment of several thousand people. We emphatically state that these buildings and equipment and this employment have created for the Federal Government a *new broad tax base.* Yet, at the same time counties and cities grant tax exemptions to industry on the assumption that other tax benefits come from these industries. In order to serve the people who are employed at these new industries the counties and cities are called on to construct new schools, water and sewer systems, road and bridge facilities and recreational facilities. We, therefore, feel that we are sharing a burden with the Federal Government and at the same time the government is a direct recipient of tax income 10 years prior to any income which may come to the state, county and city. For example, the Standard Oil Company of California has built a 125 million dollar refinery in our county. One of the main reasons why they located here was the fact that we had a deep water channel and an industrial park adjacent to the channel. This channel and park were constructed from funds derived from a County-wide Bond Issue of 2 million dollars. We were able to sell the bonds at low interest rate because of the "tax free interest" feature.

The important point here is that Standard Oil did not close its operations in Richmond, California. Therefore, I contend that the building of this refinery has caused for the Federal Government a new source of taxation at the employee and company levels. In addition, the State of Mississippi is building a 130 million dollar modern automated shipyard which will cause the employment of 12,000 people. They will build ships for the Federal Government and private industries. Here again, the bonds issued by the State of Mississippi plus another one million dollars issued by Jackson County for dredging a channel to serve this industry were sold at a favorable rate of interest because of the tax free feature The Federal Government will be a direct beneficiary of this new industrial unit. This evidence can be produced in every state in the union due to the fact that all of us are seeking new industry which contributes to the national economy, as well as our own.

On behalf of thousands of Mississippians, I want to extend our heartfelt thanks for the great passion exhibit by the Congress, the President and Vice-President of the United States of America in our present dilemma caused by Hurricane Camille. The Senate and House bills which you have passed favorably and are now awaiting the President's signature will be of tremendous help in rebuilding homes, business and industry for the citizens of Mississippi, Louisiana, and Alabama as well as for the nation. This Camille Bill provides for federal matching funds to restore public works installations. I must emphatically state here that the only way we can raise money to match this federal grant is through the bond route. We are positive that we will not be able to sell these bonds, or if we do, we will be forced to pay a high rate of interest which our people cannot afford.

I must include in this testimony the fact that most of the 3,000 counties of the nation secure most of their funds from ad valorem taxes and state refunds of revenue taxes collected. These two areas of taxation have reached the maximum. A serious problem exists for all counties in the fact that the burden of local government capital improvements demand the issuance of full faith and credit bonds to meet the advancing and critical needs of the people.

The fifty states in the union, 3,000 counties, and thousands of small towns and municipalities are meeting the challenge of a growing America. I contend that H.R. 13270 sets up a distinct and dangerous deterrent to the economy of the nation and its forward march of progress if that part of H.R. 13270 which removes tax free interest from the municipal bonds becomes law.

We respectfully solicit your total opposition to this part of the bill and urge a floor fight to defeat it.

Respectfully submitted,

EDWARD A. KHAYAT,
Executive Secretary.

ANALYSIS OF ADDITIONAL FINANCIAL BURDEN TO STATE AND LOCAL GOVERNMENT

H.R. 13270

The attached schedules represent an estimate of the potential financial impact on state and local government should the provisions of H.R. 13270 affetcing tax exempt bonds be enacted into law.

Columns 1-4 of Schedule II reflect the issuances of tax exempt municipal securities for years 1965-1968 on a state by state basis as reported in the *IBA Statistical Bulletin*. The figure shown for each state includes not only issuances by the state government but also the issuances by local governmental units within the state.

The amounts shown in Columns 5 and 6 of Schedules II represent estimates of tax exempt bond sales for 1969 and 1970. As will be noted, these projections represent a 10% year-to-year increase over 1969. This 10% includes provision for a 5% increase in costs due to inflation and construction cost escalation and a 5% provision for real growth in governmental outlays. While the projection for these two years is based on a rudimentary measure, they should be without question, extremely conservative. Inherent in the 1969 and 1970 forecast is the assumption that the present tax situation would have no disruptive effect on the issuance of municipal securities. In other words, the figures for 1969 and 1970 indicate the needs for local government financing and the amount of municipal sales that *would have occurred* had not the threat of taxation turned the municipal bond market into chaos. In actuality, what will probably take place is a substantial forced reduction in 1969 (and probably 1970 as well) bond issuances and then *some* catch-up in succeeding years as real property taxes are adjusted to meet higher borrowing costs so that the crushing need for financing of schools, roads, sewers, etc. may be fulfilled despite the additional financial burden on the local taxpayer. As a matter of fact, due to the inability of state and local governments to finance projects at reasonable interest levels or at interest rates within legal limits, tax exempt municipal bond issuances for 1969 are running at an annual rate of less than $11 billion based on first-quarter statistics. In other words, the ominous tax situation with respect to municipal securities and the attendant high interest rates is causing state and local government financing to be cut to a level 40% below that which would reasonably have been expected this year.

On Schedule *I* there are estimates of the cost in terms of the additional interest that would be incurred by state and local governments should the provision of H.R. 13270 affecting municipal bonds be enacted into law. Two such estimates are made on Schedule I—the first based on the *actual* volume of municipal bond sales in 1968, the second based on the *projected* volume for year 1970. Although 1968 bond sales are, of course, past history, they were included inasmuch as they represent a year unaffected by the uncertainties in the present market generated by the threat of taxation and, therefore, represent an indisputable measure of the actual need for state and local financing. As discussed above, the volume of municipal bond issuances for 1969 have been adversely influenced by the threat of taxation.

Column 2 of Schedule I represents a calculation of the annual debt service on the bonds issued in each state during 1968. Inasmuch as it would be impossible to calculate the actual debt service on each of the over 5400 separate issuances for that year, a 20 year bond with equal annual payments of principal and interest was assumed for this computation. The interest rate used (4½%) was the approximate average of the *Bond Buyer's Index* for 1968. This well-known Index consists of 20 municipal bonds picked for their representativeness of the overall market. As shown on Schedule I, debt service in 1968 was $1.24 billion on an aggregate basis for the entire 50 states.

Bond analysis are of the opinion that the provisions of H.R. 13270 would cost the issuer up to two additional percentage points of interest. Comparison of the *Bond Buyer Index* (20) and the average of composite yields on industrial bonds as published by *Moody's* tends to support 2% increase, assuming municipal yields approach those of industrials should the provisions of H.R. 13270 become fully effective.

For purposes of the computations of Schedule I, two percentage points have been assumed. The figures in Column 3 represent a computation which reflects debt service costs had the provisions of H.R. 13270 been in effect during 1968. As can be seen, this results in annual debt service of $1.46 billion for the 50 states and as shown in Column 4; this is an increase of some $222 million over the tax exempt cost. The figures in Column 5 show that for debt issued during 1968 the additional interest cost resulting from the effect of H.R. 13270 would have amounted to the staggering sum of $4.45 *billion* over the assumed 20 year life of the bonds issued in that year. As appalling as this amount may be, it relates, of course, only to a single year's bond issuances.

Columns 6–10 of Schedule I contain information similar to that in Columns 1–5 but is based on the projected municipal issuances for year 1970. As can be noted, even the modest growth assumed to occur between 1968 and 1970 results in a significant increase in interest cost as compared to 1968. (Column 4 Vs. 9 and Column Vs. 10).

As time goes on, the increase in debt service costs for local and state government caused by the impairment of municipal bond tax exemption under H.R. 13270 is multiplied. For example, Column 9 of Schedule I indicates that the additional interest cost for the first full year that bonds issued during 1970 are outstanding would be $270 million. Assuming the same amount of debt were issued in 1971, the increase in cost would then be $540 million after only two years. By the 10th year, making the unrealistic assumption that state and local financing would *not* grow from year to year, $2.7 billion would have to be paid that year in additional interest cost out of the budgets of state and local governments.

SCHEDULE I.—ANALYSIS OF POTENTIAL COST TO STATE AND LOCAL GOVERNMENT, H.R. 13270

MUNICIPAL BOND ISSUANCES BY STATE AND ESTIMATED DEBT SERVICE THEREON—TAX EXEMPT VERSUS TAXABLE

[In millions of dollars]

State	Issuances, 1968 (actual)	Dedt service, tax-exempt basis	Debt service, taxable basis	Additional interest cost due to tax		Issuances, 1970 (projected)	Debt service, tax-exempt basis	Debt service, taxable basis	Additional interest cost due to tax	
				Each year	Life of bond				Each year	Life of bond
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Alabama	299	23.0	27.1	4.1	82	363	27.9	32.9	5.0	100
Alaska	69	5.3	6.3	1.0	20	84	6.5	7.6	1.1	22
Arizona	90	6.9	8.2	1.3	26	109	8.4	9.9	1.5	30
Arkansas	36	2.8	3.3	.5	10	44	3.4	4.0	.6	18
California	1,976	151.9	179.3	27.4	548	2,391	183.8	217.0	33.2	662
Colorado	72	5.5	6.5	1.0	20	87	5.7	7.9	1.2	24
Connecticut	266	20.4	24.1	3.7	74	322	24.8	29.2	4.4	80
Delaware	61	4.7	5.5	.8	16	74	5.7	6.7	1.0	88
Florida	585	45.0	53.0	8.0	160	708	54.4	64.3	9.9	194
Georgia	221	17.0	20.0	3.0	60	267	20.5	24.2	3.7	74
Hawaii	90	6.9	8.2	1.3	26	109	8.4	9.9	1.5	30
Idaho	15	1.2	1.4	.2	4	19	1.5	1.7	.2	4
Illinois	553	42.5	50.1	7.6	152	669	51.4	60.7	9.3	186
Indiana	216	16.6	19.6	3.0	60	262	20.1	23.8	3.7	76
Iowa	165	12.9	14.9	2.0	40	200	15.4	18.2	2.8	54
Kansas	108	8.3	9.8	1.5	30	131	10.1	11.9	1.8	34
Kentucky	367	28.2	33.3	5.1	102	444	34.1	40.3	6.2	126
Louisiana	531	40.8	48.2	7.4	148	642	49.4	58.3	8.9	172
Maine	64	4.9	5.8	.9	18	77	5.9	7.0	1.1	28
Maryland	512	39.4	46.4	7.0	140	619	47.6	56.2	8.6	172
Massachusetts	369	28.4	33.4	5.0	100	447	34.4	40.6	6.2	124
Michigan	694	53.3	62.3	9.0	180	839	64.5	76.1	11.6	232
Minnesota	299	23.0	27.1	4.1	82	362	27.8	32.3	4.5	90
Mississippi	141	10.8	12.8	2.0	40	171	13.1	15.5	2.4	48
Missouri	452	34.7	41.0	6.3	126	547	42.1	49.6	7.5	150
Montana	12	.9	1.1	.2	4	14	1.1	1.3	.2	4

SCHEDULE I.—ANALYSIS OF POTENTIAL COST TO STATE AND LOCAL GOVERNMENT, H.R. 13270—Continued

MUNICIPAL BOND ISSUANCES BY STATE AND ESTIMATED DEBT SERVICE THEREON—TAX EXEMPT VERSUS TAXABLE—Continued

[In millions of dollars]

State	Issuances, 1968 (actual)	Dedt service, tax-exempt basis	Debt service, taxable basis	Additional interest cost due to tax		Issuances, 1970 (projected)	Debt service, tax-exempt basis	Debt service, taxable basis	Additional interest cost due to tax	
				Each year	Life of bond				Each year	Life of bond
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Nebraska	372	28.6	33.8	5.2	104	450	34.6	40.8	6.2	124
Nevada	22	1.7	2.0	.3	6	26	2.0	2.4	.4	8
New Hampshire	34	2.6	3.1	.5	10	41	3.2	3.7	.5	10
New Jersey	472	36.3	42.8	6.5	130	571	43.9	51.8	7.9	158
New Mexico	50	3.8	4.5	.7	14	61	4.7	5.5	.8	16
New York	2,197	168.9	199.3	30.4	608	2,659	204.4	241.3	36.9	738
North Carolina	223	17.1	20.2	3.1	62	270	20.8	24.5	3.7	74
North Dakota	9	.7	.8	.1	2	11	.8	1.0	.2	4
Ohio	700	53.8	63.5	9.7	194	847	65.1	76.9	11.8	236
Oklahoma	212	16.3	19.2	2.9	58	256	19.7	23.2	3.5	70
Oregon	219	16.8	19.9	3.1	62	265	20.4	24.0	3.6	72
Pennsylvania	1,187	91.2	107.7	16.5	330	1,437	110.5	130.4	19.9	398
Rhode Island	95	7.3	8.6	1.3	26	116	8.9	10.5	1.6	32
South Carolina	146	11.2	13.3	2.1	42	177	13.6	16.1	2.5	50
South Dakota	13	1.0	1.2	.2	4	15	1.2	1.4	.2	4
Tennessee	212	16.3	19.2	2.9	58	256	19.7	23.2	3.5	70
Texas	775	59.6	70.3	10.7	214	938	72.1	85.1	13.0	260
Utah	22	1.7	2.0	.3	6	26	2.0	2.4	.4	8
Vermont	54	4.2	4.9	.7	14	65	5.0	5.9	.9	18
Virginia	202	15.5	18.3	2.8	56	244	18.8	22.1	3.3	66
Washington	320	24.6	29.0	4.4	88	387	29.8	35.1	5.3	106
West Virginia	52	4.0	4.7	.7	14	63	4.8	5.7	.9	18
Wisconsin	237	18.2	21.5	3.3	66	287	22.1	26.0	3.9	78
Wyoming	37	2.8	3.4	.6	12	45	3.5	4.1	.6	12
Total	16,125	1,239.5	1,461.9	222.4	4,448	19,514	1,500.6	1,770.2	269.6	5,392

ANALYSIS OF POTENTIAL COST TO STATE AND LOCAL GOVERNMENT H.R. 13270 MUNICIPAL BOND ISSUANCES BY STATE

[In millions of dollars]

State	Amount of issuances				1969 (projected)	1970 (projected)
	1965	1966	1967	1968		
	(1)	(2)	(3)	(4)	(5)	(6)
Alabama	362	261	390	299	330	363
Alaska	12	11	78	69	76	84
Arizona	103	93	49	90	99	109
Arkansas	49	79	147	36	40	44
California	1,642	1,584	1,719	1,976	2,174	2,391
Colorado	131	104	85	72	79	87
Connecticut	189	117	314	266	293	322
Delaware	59	96	68	61	67	74
Florida	364	274	219	585	644	708
Georgia	204	272	346	221	243	267
Hawaii	58	24	89	90	99	109
Idaho	11	11	7	15	17	19
Illinois	353	422	606	553	608	662
Indiana	186	209	193	216	238	260
Iowa	53	144	175	165	182	209
Kansas	103	70	113	108	119	131
Kentucky	153	414	351	367	404	444
Louisiana	299	246	442	531	584	642
Maine	16	22	40	64	70	77
Maryland	227	270	386	512	563	619
Massachusetts	250	262	446	369	406	447
Michigan	379	466	586	694	763	839
Minnesota	282	203	296	299	329	362
Mississippi	120	99	217	141	155	171
Missouri	136	146	270	452	497	547
Montana	22	24	21	12	13	14
Nebraska	45	100	55	372	409	450
Nevada	47	51	50	22	24	26
New Hampshire	55	22	52	34	37	41
New Jersey	265	343	348	472	519	571
New Mexico	81	73	36	50	55	61
New York	1,416	1,457	1,554	2,197	2,417	2,659
North Carolina	143	130	294	223	245	270
North Dakota	17	19	7	9	10	11
Ohio	414	332	608	700	770	847
Oklahoma	149	309	86	212	233	256
Oregon	56	141	122	219	241	265
Pennsylvania	673	639	998	1,187	1,306	1,437
Rhode Island	84	40	106	95	105	116
South Carolina	63	44	165	146	161	177
South Dakota	12	15	8	13	14	15
Tennessee	149	207	396	212	233	256
Texas	657	543	662	775	853	938
Utah	102	15	23	22	24	26
Vermont	22	39	5	54	59	65
Virginia	166	105	243	202	222	244
Washington	267	85	301	320	352	387
West Virginia	84	80	71	52	57	63
Wisconsin	222	202	225	237	261	287
Wyoming	16	10	51	37	41	45
Total	10,968	10,924	14,119	16,125	17,740	19,514

GRAPHS AND TABLES

The attached Graphs* and Tables demonstrate visually the deterioration that the municipal bond market has suffered since the specter of elimination of tax exemption arose.

Historically, comparable municipal and corporate bonds have been considered to have had a relationship as to yield in the vicinity of 70%; that is to say, municipal yields have been generally running at about 70% of those on comparable corporates (e.g., if a corporate bond were selling at 8%, a comparable municipal bond would be expected to have a yield of about 5.60%). Graphs No. 1 and No. 2 indicate that this approximate 70% relationship has now increased to about 80%. In other words, if one were to compare a corporate bond selling at a yield of 8%, one would find a comparable municipal yield of about 6.40% rather than 5.6% which would normally have been expected based on the historical relationships of tax exempt and taxable yields. This, of course, has resulted from a *threat* to the tax exempt status of municipal securities. Should that threat be enacted into law, a substantial further narrowing, or even complete disappearance, of this differential could be expected.

Graphs No. 3 and No. 4 show that the yields to tax exempt and taxable bonds over the past two years as indicated by representative indices. Here again can be seen the closing of the gap between yields of taxable and tax exempt securities. As shown on Table No. 3, during 1967 and 1968 this yield differential generally averaged in the range of 2%. The difference is now 1.39%.

COMPARISON OF YIELDS, MUNICIPAL (BOND BUYER 20) AND INDUSTRIAL (MOODY'S AVERAGE)

[In percent]

	Bond buyer's index of 20 municipal bonds	Average of yields on industrial bonds (Moody's)	Differential
1967:			
August	4.06	5.84	69.5
September	4.19	5.93	70.6
October	4.27	6.05	70.5
November	4.45	6.28	70.8
December	4.44	6.39	69.4
1968:			
January	4.16	6.34	65.6
February	4.44	6.31	70.3
March	4.54	6.33	71.7
Arpil	4.43	6.42	69.0
May	4.64	6.52	71.7
June	4.48	6.55	68.3
July	4.11	6.42	64.0
August	4.38	6.23	60.3
September	4.30	6.26	68.6
October	4.56	6.40	71.2
November	4.76	6.60	72.1
December	4.85	6.79	71.4
1969:			
Janua.y	4.97	6.74	73.7
February	5.04	6.87	73.3
March	5.30	7.16	74.0
April	5.09	7.02	72.5
May	5.60	7.08	79.0
June	5.68	7.20	7[illegible].8
July	5.93	7.32	81.0

*Graphs were made a part of the official files of the committee. Prepared by Conference on Intergovernmental Fiscal Relations.

COMPARISON OF YIELDS—MUNICIPAL (BOND BUYER 11) AND INDUSTRIAL (MOODY'S Aaa)

[In percent]

	Bond Buyer's Index, 11 bonds	Moody's average of yields on Aaa corporate bonds	Differential
1967:			
August	3.82	5.62	67.9
September	3.99	5.65	70.6
October	4.15	5.82	71.3
November	4.16	6.07	68.5
December	4.37	6.19	70.5
1968:			
January	4.27	6.17	69.2
February	4.04	6.10	66.2
March	4.38	6.11	71.6
April	4.19	6.21	67.4
May	4.32	6.27	68.8
June	4.40	6.28	70.0
July	4.36	6.24	69.8
August	4.00	6.02	66.4
September	4.32	5.97	72.3
October	4.25	6.09	69.7
November	4.44	6.19	71.7
December	4.65	6.45	72.0
1969:			
January	4.72	6.59	71.6
February	4.84	6.66	72.6
March	5.05	6.85	73.7
April	5.12	6.89	74.3
May	4.99	6.79	73.4
June	5.61	6.98	80.3
July	5.57	7.08	78.6

COMPARISON OF YIELDS—MUNICIPAL (BOND BUYER 20) INDUSTRIAL (MOODY'S AVERAGE) AND U.S. GOVERNMENTS (20 YEARS)

[In percent]

	Bond Buyer's Index of 20 municipal bonds	Average yields on industrial bonds (Moody's)	Yields of U.S. Government's 20
1967:			
August	4.06	5.84	4.99
September	4.19	5.93	5.12
October	4.27	6.05	5.18
November	4.45	6.28	5.46
December	4.44	6.39	5.60
1968:			
January	4.16	6.34	5.57
February	4.44	6.31	5.37
March	4.54	6.33	5.39
April	4.43	6.42	5.59
May	4.64	6.52	5.47
June	4.48	6.55	5.47
July	4.11	6.42	5.31
August	4.38	6.23	5.12
September	4.30	6.26	5.20
October	4.56	6.40	5.29
November	4.76	6.60	5.40
December	4.85	6.79	5.55
1969:			
January	4.97	6.74	5.92
February	5.04	6.87	6.00
March	5.30	7.16	6.08
April	5.09	7.02	6.20
May	5.60	7.08	5.92
June	5.68	7.20	6.29
July	5.93	7.32	6.12

OFFICE OF THE COMPTROLLER,
Milwaukee, Wis., September 29, 1969.

To the Honorable SENATE FINANCE COMMITTEE,
U.S. Senate,
2227 New Senate Office Building,
Washington, D.C.

GENTLEMEN: The City of Milwaukee, acting through its Mayor and Common Council, wishes to go on record as being strongly opposed to the provisions of H.R. 13270 which alter the tax exempt status of currently outstanding and future municipal general purpose obligations, and provides an undesirable option for the issuance of taxable municipal obligations in the future. Attached is a certified copy of Common Council Resolution File No. 69–1360 which states Milwaukee's position.

The provision for a 25 to 40% federal reimbursement on taxable municipal bonds to be administered uniformly would require an annual appropriation by Congress, and no one can predict whether a future Congress would set an appropriation at a sufficient level to fully cover the added interest cost on taxable municipal bonds. Thus, indirectly, by underfunding the subsidy appropriation the federal government could be instrumental in setting the level of capital improvements undertaken by municipal governments, since many municipalities would be forced to forgo the issuance of bonds on which the interest differential would not be fully covered by federal payment.

Moreover, municipal bonds historically have sold at an interest cost of approximately 70% of corporate issues, or, put in another manner, municipal interest rates would rise 43% to meet the level of taxable corporate bond rates. Thus, the maximum subsidy allowed under this legislation does not appear to fully cover the additional costs, when viewed from an historical perspective.

It is our conviction, also, that even with the optional feature contained in the legislation, which allows the continued issuance of tax-exempt bonds, the overall impact of the legislation would be to raise to a new plateau the interest rates of all municipal borrowing, whether it be of the tax exempt or taxable type, for two reasons.

First, the provision requiring a minimum federal income tax would affect the judgment of an investor in submitting a quote on a municipal tax exempt bond. Secondly, there are indications that part of the fixed supply of money presently going into the bond market would be diverted to other investments, and as the supply diminished, the interest cost on all borrowing, including federal borrowing, would increase.

With respect to any increase in the level of municipal interest cost, the taxpayer does not enjoy the substantial credit realized by corporate bond issuers via the corporate income tax deductions.

At a time when Milwaukee and other cities are straining under overworked property taxes, we feel that the provisions of H.R. 13270 applicable to municipal borrowing would only add to the present fiscal problems.

We respectfully urge that the provisions of H.R. 13270 which alter in any way the present tax-exempt status of municipal bonds be stricken from the legislation.

Respectfully submitted.

JOHN E. KALUPA,
City Comptroller.

CERTIFIED COPY OF RESOLUTION

FILE NUMBER 69–1360

Resolution relative to the tax exempt status of municipal bonds.

Whereas, The United States House of Representatives has passed H.R. 13270, and such legislation is now pending before the Senate Finance Committee; and

Whereas, Included in the legislation are provisions that considerably alter the present tax exempt status of municipal bonds; and

Whereas, Under these provisions, municipalities would be allowed to continue to either issue tax exempt bonds or to issue taxable bonds, and if taxable bonds are issued, the Federal government ultimately would reimburse the municipalities in an amount equal to 25% to 40% of the interest cost of such bonds; and

Whereas, The actual percentage of reimbursement would be determined quarterly by the Secretary of the Treasury and would be applied on a uniform basis against all taxable bonds issued in the ensuing quarter, thus rendering a municipality incapable of accurately projecting its local debt service requirements for the following year; and

Whereas, Of paramount significance, however, is the initial erosion of the tax exempt status of municipal bonds which erosion could be completed by subsequent acts of the Congress; and

Whereas, From all indications, the impact of H.R. 13270 on local government would be to raise the interest cost on all bonds, whether tax exempt or taxable, thus placing additional strains on already overworked local budgets; and

Whereas, The Common Council steadfastly has opposed the principle of taxation of municipal general purpose bonds as distinguished from bonds issued for the acquisition of construction of industrial plants or factories, recognizing that the taxation of general purpose bonds would doubtless curtail Milwaukee's needed capital improvements programs; and

Whereas, In a related matter of about one year ago, various City officials were directed by Resolution File No. 68–670 to study the impact of the removal of the tax exempt status for certain municipal bonds, and the Comptroller's Office has reported that the removal of the tax exempt feature will raise local debt service costs; now, therefore, be it

Resolved, By the Common Council of the City of Milwaukee, that it hereby declares its opposition to the provisions of H.R. 13270 which alter the tax exempt status for municipal bonds of a general purpose nature; and, be it

Further Resolved, That nothing contained in this resolution shall be interpreted to alter the position which the City of Milwaukee has heretofore stated in opposition to the tax exemption for bonds issued for the construction of industrial plants and factories; and, be it

Further Resolved, That the Mayor and the President of the Common Council jointly shall select a representative of the City of Milwaukee to appear before the Senate Finance Committee in Washington, D.C. to present the City position on the subject matter of this resolution.

Upon motion the rules were suspended and the resolution adopted.

OFFICE OF THE CITY CLERK, MILWAUKEE, WIS.

I hereby certify that the foregoing is a copy of a resolution adopted by the Common Council of the City of Milwaukee on September 9, 1969.

RAY MARKEY, *City Clerk.*

HASTINGS PUBLIC SCHOOLS,
Hastings, Neb.

Re: Hearing Before Senate Finance Committee
HR 13270
Date: September 23, 1969

The Board of Education of the School District of the City of Hastings opposes provisions of the omnibus tax reform bill presently before the United States Congress which would eliminate the tax exempt status of municipal and school district bonds. The Honorable William F. Gettmann, Mayor of the City of Hastings, represented the school district at a hearing before the Senate Finance Committee on September 23, 1969. He was authorized to present the following resolution passed by the Hastings School Board at its regular meeting September 8, 1969.

"BE IT RESOLVED that the Board of Education of the School District of the City of Hastings, Nebraska has considered the provisions of the omnibus tax reform bill now pending before the Congress of the United States. The Board considers a provision of that tax reform bill to eliminate the tax exempt status of municipal bonds to have a deleterious effect on the Hastings School District. The Board urges the Nebraska Congressional Delegation to seek whatever means possible to eliminate the provision of the tax reform bill which would affect the tax exempt status of school district."

THOMAS N. KEATING,
Superintendent of Schools.

OFFICE OF THE CITY CLERK,
RECORDS BUILDING,
Dallas, Tex., September 30, 1969.

HON. RALPH YARBOROUGH,
U.S. Senator,
142A Old Senate Office Building,
Washington, D.C.

DEAR SENATOR YARBOROUGH: So nice to see you in Dallas last week and I know we both were pleased with the crowd in attendance at your appreciation dinner.

Inclosed please find copy of resolution by the Dallas County Commissioner's Court voicing opposition to approval of H.R. 13270.

Please call on us anytime we can be of service to you.

Very truly yours,

TOM E. ELLIS,
County Clerk.

SEPTEMBER 25, 1969.

STATE OF TEXAS, COUNTY OF DALLAS

BE IT REMEMBERED, at a regular meeting of the Commissioner's Court of Dallas, Texas, held on the 25th day of September, 1969, on motion by M. G. Price, Commissioner of Dist. No. 2 and Seconded by Jim Tyson, Commissioner of Dis. No. 3 the following resolution was adopted.

WHEREAS, the United States House of Representatives has adopted H.R. 13270, entitled the Tax Reform Act of 1969, and Senate Committee hearings on the proposed legislation's section relating to municipal bonds are scheduled to begin September 23, 1969; and

WHEREAS, this Act would make the interest received upon bonds issued by states, counties, municipalities and other local governmental units subject to Federal income tax, thereby completely reversing a principle which has been recognized from the very inception of the Federal income tax, and one which was implicit in the constitutional authorization of that; and,

WHEREAS, the separation of governmental powers is a basic principle in the Federal constitution, and H.R. 13270 encroaches upon the powers of other governmental units for local determination with regard to the financing of local needs; and,

WHEREAS, the House action and the threat of Senate concurrence in this action have created chaos in the municipal bond markets and have generated critical and complex problems for all local governmental units in the sale of bonds for capital improvements; and,

WHEREAS, the constructive goals in tax reform can be accomplished without removing the tax exempt status of local governments' bonds and without doing injury to the abilities of local governments to finance urgently-needed capital improvements; and,

WHEREAS, prolonged chaos in the municipal bond market over the threatened application of Federal income tax to interest derived from municipal bonds will delay or make totally impossible the construction of schools, hospitals, trafficways, and other local capital improvements required in communities throughout America:

NOW, THEREFORE, BE IT RESOLVED, that the Commissioner's Court of Dallas County, Texas, in behalf of its One Million Three Hundred Thousand residents of Dallas County, Texas, respectfully urge Senators Ralph Yarborough and John Tower to steadfastly oppose Senate approval of H.R. 13270 unless it is amended to approve the tax-exempt status of local governmental units' bonds; and,

BE IT RESOLVED: That the Commissioners' Court of Dallas County, Texas respectfully urge Senators Yarborough and Tower to seek early and definite action in the Senate to end the chaotic conditions which the House action hes created in the municipal bond markets, seriously delaying vital public improvements in Dallas and other communities; and, BE IT FURTHER RESOLVED: That copies of this resolution be transmitted also to members of the House of Representatives from Texas, urging that, in the event Senate action requires Conference Committee consideration of H.R. 13270, the Texas members of the House exert their utmost influence to preserve the tax-exempt status of local governmental units' bonds.

DONE IN OPEN COURT, this the 25th day of September, 1969, A.D., all members present and voting.

W. L. "Lew" Sterrett, *Judge.*
John Whittington, *Commissioner, District No. 1.*
M. G. Price, *Commissioner, District No. 2.*
Jim Tyson, *Commissioner, District No. 3.*
Denver Seale, *Commissioner, District No. 4.*

Brown County,
Newulm, Minn., September 16, 1969.

Tom Vail,
Chief Counsel, Senate Finance Committee,
2227 New Senate Office Building,
Washington, D.C.

RE: Tax Exempt Status of Municipal Bond Interest

Dear Sir: Brown County, Minnesota, is located in the South Central part of the state about 100 miles Southwest of the Twin Cities. The population is approximately 30,000 and the county seat is New Ulm.

There is an excellent balance between agriculture and business in the County which provides a very stable and growing economy. About 95.7% of the county's 392,320 acres is in farm land. There are about 1,733 farms in the County averaging about 216 acres in size. The average price for farm land is about $270 per acre.

New Ulm, the county seat, has the greatest part of the commercial activity in the county, employing about 5,000 people. Some of the largest employers are Minnesota Mining and Manufacturing, Kraft Foods, B. F. Goodrich and International Milling.

A substantial growth in industrial development is somewhat indicated by the 476 homes built during the last 7 years. A Sales Management Survey listed the 1966 effective buying income per household at $7,322.

The balance of bonded indebtedness in Brown County, Minnesota, on January 1, 1969, is summarized as follows:

4 major school districts	$5,354,000
Local improvements (3 cities and 2 villages)	2,790,392
Farm Drainage Systems	1,798,000
Total	9,942,392

The original total of this bonded indebtedness was:

4 major school districts	$6,454,000
Local improvements	3,621,227
Farm Drainage Systems	2,241,000
Total	12,316,227

The net interest rates on these issues range from 2.3% for December, 1962, issues to 4.33% for June, 1968, issues with repayment schedules from 10 to 25 years.

The August Bond Buyers Index soared to 6.25% as an interest rate on high quality tax exempt bond issues. Using this guide line, we have conservatively estimated that a 2.5% higher interest rate on the Brown County bonds now in force, would have cost our local taxpayers and drainage system owners an additional $4,292,000 in interest.

The Board of Brown County Commissioners has directed me to inform the United States Senate Finance Committee that they are in opposition to the proposed removal of the present tax exempt status of the interest income on municipal bonds.

Sincerely yours,

Otis A. Loose,
Brown Couny Auditor.

STATEMENT OF ROBERT B. MCLEAISH, JR., COUNTY AUDITOR, HIDALGO COUNTY, TEXAS

My name is Rober B. McLeaish, Jr., and I am the County Auditor of Hidalgo County, Texas. Professionally, I am an attorney-at-law, licensed to practice law in the State of Texas, also before the United States District Court, and before the Tax Court of the United States, and I am also a Certified Public Accountant. Hidalgo County is primarily a rural county, located in South Texas and having a population, according to the last federal census, of 180,904.

I requested of Chief Counsel, Tom Vail, the opportunity to offer testimony to this Honorable Committee since I am deeply concerned with what I consider to be the adverse economic impact that will be felt by my county and others in similar circumstance if that portion of House Bill 13270, which deals with the tax exempt status of municipal and local governmental bonds should be passed into law.

May I briefly give some background on Hidalgo County and the economic status of its citizens. According to *Sales Management Survey of Buying Power*, published June 10, 1968, and reflecting 1967 figures and estimates, our population of slightly more than a hundred and eighty thousand persons live in approximately 43,400 households and had an effective buying power of $236,629,000. We are further informed by this same source that the per household income is $5,452, on the average. Many of the problems of this County are similar to those of other counties, as well as cities, across these United States. As an example, we find ourselves constantly in the position of having to market our governmental bonds for the purposes of constructing needed capital improvements. In years past, this County has marketed many bonds for the purposes of acquiring rights-of-way and constructing roads and bridges.

As a result of the fierce blow that this County suffered in September of 1967, when Hurricane Beulah descended with such devastating force, our citizens have become increasingly aware of the need for more adequate drainage facilities. Our engineers have made preliminary surveys indicating that the total cost of additional drainage structures for the local government alone should be slightly in excess of ten million dollars. With an overall tax valuation of only a little over two hundred million dollars in the County, the issuance of an additional $10,000,000 in bonds would indeed place a heavy burden on the local taxpayers. However, should we be forced to pay in the neighborhood of eight per cent instead of the four and a half or five per cent that we could logically have expected to pay only a few short months ago, the burden then becomes insupportable for our typical family with an annual income of $5,452. The difficulties that we are commencing to face are two-fold; not only does the interest rate appear to esculate with each new release of congressional intentions but it becomes increasingly necessary to pay off our securities over a shorter period of time, thus further esculating the annual requirements on an issue and thus increasing, perhaps to the breaking point, the tax rate on a group of low income individual property owners.

Perhaps this plight would not be so great were it only limited to the citizens of Hidalgo County; however, conversation with fellow county officials across the State of Texas leads me to believe that most others face essentially the same problem. It is quite apparent that since individual investors have been notified of the congressional wish, or at least the wish of some Congressmen, to do away with the tax exempt market altogether, buyers of new local government taxable bonds are extremely hesitant to invest in bonds of more than a year or two, preferring to place their investment money in equities securities or in investments with tax shelters that may still be around in other fields, such as real estate or minerals.

As evidence of the effect that legislation in this field would have on the market, the *Weekly Bond Buyer*, a very reputable publication in the securities field, has estimated that since early July when the Ways and Means Committee opened hearings on its final proposals, investment yields on new issues of local government AA-rated bonds have risen by about seventy-five basis points (from about 5.50 per cent to 6.25 per cent) while yields on similarly rated corporate bonds have risen by only about ten basis points (from 7.95 per cent to 8.05 per cent). In other words, the rise in interest rate on municipal securities cannot be attributed to inflation alone.

Before the recent activities on the part of the House Ways and Means Committee we had an orderly market for municipal and local government bonds in this country. Now we do not. Furthermore, hard experience has taught those of us at the local level that creation of a new bureau is not the answer to our problems. We have learned that programs can and will be seriously delayed by payment delays resulting from excessive "red tape," differing versions of ground rules on the part of various officials within the same department and apparently sometimes a simple failure to perform the work necessary to expedite payment. It is a sad fact that many of the best intentioned and apparently worthwhile programs authorized by a generous and benevolent Congress are frequently thwarted by the combination of operational inefficiency and disorganization of a lethargic group of bureaucrats.

Let me assure you that in speaking on behalf of the individual property owners of my own county I feel that I am seeking to preserve a benefit conferred on the people and created by the Constitution and that should not be tampered with. I do not believe that immediate rejection of any proposal seeking to do away with tax immunity on local government bonds would impede tax equity. Those persons who purchase municipal bonds for the most part pay a price in the form of lower interest for the tax immunity received. I wish to assure you that I am not a representative of private special interests but that I speak only on behalf of my local government and its many thousands of lower income taxpayers and speak against the formulation of policies which strike at the financial stability of my level of government and its ability to serve the people without undue federal controls and domination.

I further wish to express my appreciation for this opportunity to present this testimony to this Honorable Committee.

ROBERT B. MCLEAISH, JR.

COMMONWEALTH OF VIRGINIA,
COUNTY OF FAIRFAX,
Fairfax, Va., September 19, 1969.

CHAIRMAN,
Committee on Finance,
U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: This is in reference to Mr. Vail's telegram of September 9, 1969, in which the County of Fairfax was advised to submit its views relative to tax reform in written form. We appreciate this opportunity to outline the problems encountered by a rapidly-growing urban county in meeting its capital funds needs—and to provide our views as to the impact of the tax reform proposals on our financing of required improvements.

Our presentation is in three parts: A short discussion of Fairfax County's recent and projected near-term growth, the capital funds needs generated by that growth, and finally, our views and recommendations relative to the tax reform proposals and their effect on our principal form of long-term financing—municipal bonds.

The following table illustrates the growth that has taken place in Fairfax County within the past 19 years:

	1950	1960	1969 estimate
Population	98,557	262,482	432,482
Public school membership	13,278	59,983	[1] 130,300
Households	26,558	62,743	116,501
Assessed property valuation	123,353,798	470,849,300	1,454,742,832
Long-term bonded debt (general obligation)	0	42,450,310	208,765,000

[1] 27 percent of total population.

It is expected that, by 1975, population will exceed 580,000, there will be an additional 30,000 public school students, and that long-term debt will exceed $350 million.

Thus, Fairfax County is an excellent example of a community which has been confronted with a requirement to provide, within a very short period, the necessary governmental services infrastructure. This could only be done by incurring long-term debt—for, otherwise, tax rates would have had to be prohibitive.

Were it not for the ability to sell its bonds in an established market the County, today, would not have:

119 elementary, 18 intermediate, and 19 secondary schools.

Appropriate governmental facilities including courts space, a jail, and offices for the administrative staff.

1,278.61 miles of sanitary sewers plus 8 treatment plants.

6 public library buildings, including one headquarters facility and 5 branches.

4,433 acres of parks.

A 770 bed hospital and two modern public health centers.

It is proposed that, during the 1970–1975 period, Fairfax County will be required to sell $195.1 million in bonds—just to keep up with the schools and other facility needs. If the market does not exist, the County will be faced with:

An inability to meet Potomac River water purity standards.

A classroom space shortage of massive proportions.

Delay, if not default, in its ability to share in the cost of the planned Washington Area rapid transit system.

Failure to meet health facility needs.

Termination of the parks program.

Serious reductions in the planned public library program.

It is for the above reasons that the existence of a municipal bond market—one which charges minimal interest rates—is essential to the health and well-being of the citizens of Fairfax County. This is not to say that the County is committed to any specific type of market; but, rather, that continuation of the present disrupted conditions and excessive interest rates makes it extremely difficult, if not impossible, for local government to meet its valid needs.

We understand that the major points of concern with the present municipal bond market, on the part of the Federal Government, are:

The fact that the interest on municipal bonds is not subject to the Federal income tax provides a tax shelter for certain wealthy individuals.

The stated loss of income to the Federal Government, as a result of the interest non-taxability feature—and the statement that the benefits of tax-free interest to State and local governments are less than the losses incurred by the Federal Treasury.

We are not qualified, nor do we think it appropriate to make recommendations relative to Federal tax policy. However, we would cite the following as disadvantages inherent in the House-passed bill:

The municipal bond market, today, is established with well-channelled avenues of marketing, specialized agencies to do the marketing, and defined markets. The House-passed bill has already disrupted these marketing approaches; will obviously throw the present mechanism completely out of kilter, provides for no new mechanism, and leaves local governments in a "limboesque" position until such time as economic forces create a new mechanism.

The creation of dual markets (i.e., local choice as to retention of the tax-free advantage or receipt of a Federal subsidy) requires the issuing jurisdiction to make a decision as to whether to enter into competition with corporate and Treasury sales; or to say within a severely contracted tax-free market. Neither has the advantages of the current protected market-place.

The concept of creating an urban development bank has the severe disadvantage of requiring State and local governing bodies to submit each and every project to Federal review; with the probable loss in time and the possibility of loss of local autonomy.

We should add that we recognize both the concerns expressed by Federal authorities rê the tax advantages—and would cite our belief that the present municipal bond rating system tends to penalize localities such as Fairfax—where rapid growth causes a consonant increase in debt—but where debt is controlled to maintain a relatively low ratio with wealth (about 10 percent in our case).

In conclusion, we would recommend retention of the present tax-free interest procedure; recognizing its deficiencies; but accepting it as a working means of providing funds for those needs which are properly the concern of local government.

It has been a pleasure to provide these views. We would be happy to provide any amplification the Committee desires.

Sincerely,

CARLTON C. MASSEY,
County Executive.

STATEMENT OF THE EXECUTIVE COMMITTEE OF THE LEAGUE OF MINNESOTA MUNICIPALITIES

The Executive Committee of the League of Minnesota Municipalities would like to express its opposition to those provisions of the Tax Reform Act of 1969 (H.R. 13270) which would result in the direct or indirect taxation of the interest on municipal bonds. Specifically, we are opposed to the provision of this bill which includes the interest from municipal bonds in the proposed allocation of deductions rule and the provision which includes the interest from municipal bonds in the proposed limit on tax preferences.

Our opposition to these specific provisions of H.R. 13270 should not be construed as opposition to the general objective of introducing a greater degree of fairness and equity into the federal income tax. We are fully aware that the sentiment both in the Congress and among the public at large is strongly in favor of tax reform and we are in sympathy with these views. However, with the interest rates on municipal bonds at the highest level in one hundred years, we must oppose the inclusion of the interest on municipal bonds in these two provisions of the bill because enactment in their present form would almost certainly have the effect of increasing the interest rates on municipal bonds even further.

If, despite the opposition of municipal officials, the Congress in its wisdom determines that the interest on municipal bonds should be included in the allocation of deductions rule and/or the limit on tax preferences, then we strongly urge that the proposed bond interest subsidy program for bond issuers who waive their tax exemption be retained in the bill, including the provision permitting the issuance of dual coupon bonds. This latter provision would be absolutely necessary in Minnesota in order to avoid violation of the state statute which limits the interest which can be paid on obligations issued by its subdivisions to 7% per annum.

CITY OF NEW ORLEANS,
CLERK'S OFFICE,
New Orleans, La., September 18, 1969.

HON. RUSSELL B. LONG,
Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: We are enclosing for your information, and that of the members of the Senate Finance Committee, copies of a Resolution adopted by the Council of the City of New Orleans at its regular session held today, Thursday, September 18, 1969.

Very truly yours,

MARY LOUISE MOON,
Assistant Clerk of Council.

RESOLUTION

CITY HALL, SEPTEMBER 18, 1969

By: Councilmen Landrieu, Ciaccio, Curtis, Dupuy, Moreau, Petre, and Sapir.

Whereas, the present Congress is considering major changes in the Income Tax laws, and

Whereas, one of the measures being discussed deals with the taxation of interest on State and Local Government Bonds, and

Whereas, any change made by Congress resulting in the taxing of State and Local obligations would, because of Constitutional questions involved, provoke long lasting litigation thereby making present investors in these securities dispose of their holdings and would also discourage the sale of new offerings, and

Whereas, a substantial increase in interest rates would push the cost of money to intolerable economic limits, possibly beyond the legal maximum rate established by State law, and

Whereas, the burden for carrying the cost of the higher interest rate would be shifted to the local taxpayer, who would be unwilling to accept this burden, and

Whereas, it follows that with taxpayer resistance the likelihood of new bond proposals being approved by the electorate would be remote, and

Whereas, any impairment of long term financing would necessitate a reduction in essential services,

Now, Therefore Be It Resolved, by the Council of the City of New Orleans, that the Council hereby petitions the United States Senate to reject any attempt to tax, directly or indirectly, State and Local Government Bonds, and

Be It Further Resolved, That a copy of this resolution be forwarded to the following:

1. The Clerk of the United States Senate for forwarding to all members of the Senate Finance Committee
2. Both senators from the State of Louisiana
3. For special attention, to the Chairman of the Senate Finance Committee, Senator Long.

The above resolution was read in full, the roll was called of the adoption of same and resulted as follows:

Yeas: Ciaccio, Curtis, Dupuy, Lanrieu, Moreau, Petre, Sapir—7

Nays: 0

Absent: 0

And the resolution was adopted.

Statement of Stephen J. Matthews, Executive Director, Texas Municipal League, Austin, Texas

The publicity which has attended studies by Congressional committees of the subject matter of this bill, and its final passage by the House of Representatives, has exerted a pressure on the market for state and local government bonds which has virtually crippled Texas cities in financing capital improvements.

The volumes of new bond issues by Texas cities at the end of the first eight months of this year is 27% behind that established by August 31, 1968, and the downward curve is precipitous. At the same time the demand for new improvements and expansion and enlargement of existing public facilities can be charted on a curve which accelerates sharply upward. The disparity between the two is reaching the proportions of a crisis.

Texas cities are particularly vulnerable to the sort of decline in the bond market which has been brought on by Congressional action. In this State practically all revenue producing facilities provided by city government, such as waterworks, sewage disposal plants, and sometimes other utilities, are financed through issuance of revenue bonds. Tax bonds, normally used for such nonrevenue producing facilities as streets, hospitals, public buildings and the like, are payable from ad valorem taxes, the rates for which are rigidly limited by provision of the State Constitution. In each instance the income which can be pledged to payment of bond interest and principal has an inflexible ceiling.

It is axiomatic that when there is a limit on the amount of funds available for debt service, the higher the rate of interest, the fewer the amount of dollars left available for payment of principal and the smaller the amount of the loan which it is possible to secure. This is the bind in which Texas cities now find themselves.

The situation is further aggravated by yet another disparity; that between the declining curve describing the volume of borrowing legally possible within the limits just mentioned and the curve describing the escalation in construction costs.

Immediate and complete excision of Sections 301 and 302 is necessary to avert crisis of major proportions in providing those facilities essential to the preservation of life and property in the urban areas of Texas. Aside from the hardship which has already resulted (and which will grow progressively worse) from excessive interest rates on new city bond issues, there looms ahead the more serious threat of a virtual stalemate, a paralysis, in public financing in Texas due to prolonged litigation which will be the inescapable result of any attack on the right of local government to issue tax-exempt bonds.

Even if these legal impediments could be removed, there remains the handicap of the impossibly high cost of borrowing. A sewage disposal plant costing $5 million can be financed with a total annual payment of $316,000 if 30-year serial bonds can be sold at a rate of interest of 4¾%. But the prospect of the loss of the tax exempt status of city bonds threatens to boost interest rates to 8% or higher, and under such conditions, the $316,000 used in this example will finance a sewage disposal plant costing no more than $3,558,000. There is no project in the planning stage by a city in Texas at the present time which can stand this drastic paring in size or scope; on the contrary, city planners are hard pressed to revise the plans upward at a rate in keeping with the increasing demand.

Texas Municipal League urges the removal of Sections 301 and 302 from the bill on the grounds that they will, for all practical purposes, completely destroy the market for bonds of Texas cities. Sections 601 and 602 are believed to be impracticable from a legal standpoint in that cities are without legal authority to waive their right to issue tax-exempt bonds and, even though they had such a right, would be unwilling to accept subsidies under the conditions which would be imposed.

STATE BOARD OF EDUCATION,
REGENTS OF THE MONTANA UNIVERSITY SYSTEM,
Helena, Mont., September 11, 1969.

SENATOR MICHAEL J. MANSFIELD,
Senate Office Building,
Washington, D.C.

DEAR SENATOR MANSFIELD: The State Board of Education, ex officio Regents of the Montana University System, has requested that I express their concern over tax questions raised in H.R. 13270, "The Income Tax Reform Act of 1969." This concern specifically relates to those parts of the Act regarding the taxing of State and Municipal bonds. It is their conviction that this Act, as it now stands, would be injurious to all public higher education in this Nation and, in your State of Montana, would seriously hamper efforts to establish a meaningful building program for the Montana University System.

We ask that your efforts be exerted to assure that any tax proposal adopted by Congress will not destroy the State's ability to meet its responsibility for adequate facilities. We also ask that no change in the tax exempt status of State and Municipal bonding be made until the sates are assured they can, without a Federally forced inflationary rise in bond cost, meet their obligations for funding these vital programs.

Sincerely,

EDWARD W. NELSON,
Secretary.

RESOLUTION OF THE CITY OF FREMONT, NEBRASKA

Councilman Arthur Gifford offers the following resolution and moves its adoption, seconded by Councilman Gerald E. Roder.

Whereas, H.R. 13270 entitled "A Bill to reform income tax laws" is under consideration by the Senate Finance Committee; and

Whereas, H.R. 13270 contains provisions which affect the tax-exempt status of municipal bonds; and

Whereas, a large number of major municipal capital community improvements are financed through the issuance of municipal bonds and the tax-exempt status of said bonds is in many instances a property tax savings as a result of lower annual interest costs; and

Whereas, it is contemplated that the Federal Government will have to provide an interest subsidy appropriation to reimburse local units of government for the additional interest expense on their bonds if the tax-exempt status is abolished; and

Whereas, the abovementioned provision of interest subsidy would make the payment of municipal bonds dependent on Federal appropriations; and

Whereas, interest subsidy dependency upon the Federal Government could only lead to Federal review of state and local projects and bond issues which would diminish whatever local autonomy still remains in our Federal System of Government,

Now therefore be it resolved by the Fremont City Council that it go on record in opposition to those provisions in H.R. 13270 which would (1) tax directly or indirectly the interest from municipal bonds, (2) substantially increase state and local government borrowing costs, (3) adversely affect the marketability of state and local government bonds, (4) create a Federal interest subsidy or state and local bond marketing system which would make the payment of municipal bonds dependent on Federal appropriations, (5) provide for Federal review of state and local projects and bond issues, and (6) alter the constitutionally protected right of state and local governments to issue tax exempt bonds.

Passed and approved this 9th day of September, 1969.

EUGENE W. BUCH,
Mayor.
EARL HEURING,
City Clerk.

Milwaukee County

Milwaukee, Wis. 53233

RUDOLPH P. POHL
Supervisor, 20th District
1841 N. 73rd Street
Wauwatosa, Wis., 53213

TELEPHONES
Residence: 258-7531
Courthouse: 276-5800
Extension 407

CHAIRMAN – COMMITTEE ON FINANCE

MEMBER
Metropolitan Problems Committee
Institutions Committee
Program Evaluation Committee
Fiscal Liaison Committee
Committee of Committees

September 19, 1969.

Senate Finance Committee,
2227 New Senate Office Building,
Washington, D. C.

Gentlemen:

We should like at this time to express our total opposition to any plan whereby the Federal Government infringes on the right of localities to issue tax exempt securities. This tax-exempt market provides us with an effective and advantageous vehicle for the financing of public capital projects and regard this financial independence as a significantly important feature of our federal system of government.

Investors in tax-exempt securities bought them in the belief that the income would never be taxed by the federal government. Once this principle is breached, there is theoretically no limit to the extent to which succeeding congresses could go. More than any other sector of the security markets, these bonds are based on the good faith of government at all levels. Any change in the tax status would not only result in higher initial interest cost, but irreparably damage investor confidence with far reaching effects on the cost of future local financing.

Federal tax exemption is not a gift to certain investors but really a concession made to the investor who accepts a lower rate of return than he could get in alternative investments. In a very real sense, the investor in tax exempt securities has already paid his income tax and done so in advance.

Presently, Milwaukee County is at the statutory limit for interest payments. Additionally, our property taxes are well beyond the reasonable limit of public endurance. We are now at the point of curtailing such things as parks, welfare and hospital programs. An additional burden of increased financing costs would force an even greater sacrifice in a time of impending urban crisis.

The County Board, by resolution and other actions, has fully endorsed this position.

Very truly yours,

Rudolph P. Pohl

Rudolph P. Pohl,
Chairman,
Finance Committee.

SUMMARY OF STATEMENT BY JOHN RICE, CORPORATE COUNSEL ON BEHALF OF THE CITY OF BELLEVUE, NEBRASKA AND THE SCHOOL DISTRICT OF THE CITY OF BELLEVUE, NEBRASKA

The City of Bellevue is in opposition to the taxation by the Federal Government of the income on municipal bonds, and to any such provision which is contained in HR 13270 under Title III Section 301 and 302 and Title IV Section 601 and 602 relating to this subject, as well as any provision which would restrict the right of a municipality to invest in Government Bonds funds of the city received from the sale of bonds for legitimate purposes including advance refunding where required by the circumstances in revenue financing.

The City is opposed to the taxation on the basis of constitutional grounds. They also think that the exemption is logical, creates economies, develops initiative and cooperation from the local levels. They feel that taxation of the bonds will be so costly as to stop municipal financing without aid from the Federal Government, and that this would result in undesirable controls and loss of freedom, and that there is no reasonable substitute for local financing and local self-determination.

STATEMENT MADE ON BEHALF OF THE CITY OF BELLEVUE, NEBRASKA AND THE SCHOOL DISTRICT OF THE CITY OF BELLEVUE, NEBRASKA

PROPOSED TAXATION OF INTEREST ON MUNICIPAL BONDS, WAIVER OF IMMUNITY AND ARBITRAGE

(By the Corporate Counsel John Rice)

Mr. Chairman & Members of the Committee:

I have been authorized by the Mayor and Council of the City of Bellevue, Nebraska to present this statement as the official view of the governing body. We are opposed to all Sections of HR 13270 which make indirect or direct income tax on the income from municipal bonds, including Title III Section 301 and 302 and Title IV Section 601 and 602, and any provision of the bill relating to the so-called arbitrage transactions.

The existance at the state and local level of the right of self-government is threatened by any provision which in any way would indicate that the Federal Government is involved with and will restrict or can tax obligations of the states of their subdivisions. The ability of the municipal communities to issue bonds on a competitive basis is really the only basis of their ability to govern themselves, to make their own decisions and fulfill the function that they have so long fulfilled; that is, the economy of local government and local control and one of the principal guards of our freedom in the United States.

This constitutional immunity and fundamental tradition of the sovereign states or their subdivisions create a unique situation. Every purchaser of a municipal bond, by agreeing to purchase the bond at a return to him which is from a third to one-half less than he could obtain on similar credits or other ventures which are taxable, does pay directly to the City a tax equivalent to the difference. The amount of the difference may vary, depending upon the city's credit, its willingness to exercise reasonable restraint and expenditures and to fulfill its obligations, but the opportunities are there. It is becoming more apparent that in order to get the job done on the local level that it may be necessary for the Federal Government to return tax dollars to the states or municipalities. Under the system we presently enjoy, this return of dollars is indirectly being done, and if removed would require even more return dollars from the Federal Government. We do not think this is wise; we do not think it is intended; and request that you strike all provisions from the bill.

Bellevue, adjoining Offutt Air Force Base, has grown from a few hundred inhabitants following World War II to a City approaching 25,000 people. All levels of services, facilities have been made possible by financing through municipal bonds. The state has wisely outlined our powers under our constitution and made the exercise permissive. Our powers are restricted only where public health and policy require. We are free to decide what improvements we want, the type and construction, all in accordance with our own priorities and our ability to pay. In the same sense, the State is able to make such decisions on a State level. A recent constitutional amendment allows the state to issue revenue bonds for highway construction, but otherwise the electors refuse to allow a debt of the state in excess of $100,000.00.

There is no reasonable substitute for local financing of improvements where local determination and local ability to pay are involved. The Federal Government in areas of national concern can construct necessary improvements or facilities themselves or in cooperation with states and their municipalities as they do sewer disposal facilities, for water pollution control, recreational facilities, water facilities in rural areas, as they do for urban renewal and public housing and mass transportation. Where grants are allowed, direction and control are expected and needed, since they affect all and are of national concern. But in the vast area of municipal growth and improvements payable from tax and assessments against benefited property where the construction is permissive either by election or the right to object to the improvements, there is an urgent need for funds to be available at a reasonable cost to construct the facility as decided locally at the time they are needed.

The taxation of municipal bonds would effectively stop all such improvements under local financing and require the states and cities and schools to look to the Federal Government as the only logical source of capital, whether by grant, subsidy or loan. The concept of the right of states to govern themselves would be violated and independence would no longer exist. This is why our Supreme Court has long protected the states from their encroachment, the power to tax being the power to destroy.

What we have is worthwhile saving, not destroying. Let's develop programs of joint cooperation, not control. Allow this freedom to flourish and enjoy the fruits of local enthusiasm, cooperation and production, the principal of which is economy.

Please make public at an early time a strong statement in opposition to the provisions of the bill mentioned above to correct the rupture in the present market so that municipalities can get on with the job of building better cities. Please stop it once and for all.

Thank you for allowing our appearance on September 23 with the Nebraska delegation where North Platte was graciously allowed to testify two days early to accommodate those of us from Nebraska present that day at the Hearing.

Statement Presented by Ross H. Rasmussen, Executive Secretary, Nebraska State School Board Association

Gentlemen: We made timely application for oral appearance and have received your telegram advising that we would not be able to appear for oral presentation. The date set out in the telegram for the filing of written statements was different than that established for the other cities of the state. I assume that this date is in error and that this statement is timely filed.

The School Board Association represents over 80% of the Assessed Valuation of the State of Nebraska. By resolution duly adopted, the Association is on record and does hereby convey to you their opposition to all provisions of HR 13270 which in any way directly or indirectly provide for the taxation of bonds of the states or their governmental subdivisions, including strong opposition to any plan or scheme for the Federal Government to be involved in subsidizing this financing under any arrangement of voluntary waiver of tax immunity.

The School Board Association feels that this is a violation of the constitutional guarantee of the separate powers of the State and Federal Governments. We feel that the system of independent local government, such as state, municipalities, or school districts, has been a major factor in our maintaining our freedom and in the growth of our nation to leadership in the world, and that any attack on the taxable status of the securities of the states and their subdivisions is a step backward which will radically effect the cost of financing as well as the cost of construction of school buildings because of the involvement of federal bureaucracy.

Grants and aid in cooperation with school districts across the nation and their resultant ideas and controls where grants are involved have helped level the school burden and raise the standards of education. The power to construct our capital improvements and finance them, however, based on local determination, must not be violated, since we feel this would bring in entirely different kinds of controls and influences, and destroy the existing impetus for good. On behalf of the Association, I ask that you come out strongly opposed to the theory and strike all provisions in the bill relating to the taxation of municipal bonds.

On authority of the officers and board of the Association, we had special counsel present in Washington, D.C. at the Nebraska Congressional Breakfast on September 23 to attend the Committee hearings on said date. We appreciated the courtesy of being included by your committee in the Nebraska delegation presented at the time North Platte gave their oral presentation, and further appreciated your rescheduling North Platte's oral presentation to accommodate the Nebraskans.

Statement By Edward F. Renshaw and Donald J. Reeb, Graduate School of Public Affairs and Department of Economics, State University of New York at Albany

SUMMARY

1. The debt of state and local government is now in excess of $140 billion and has been projected to grow at a faster rate than the aggregate economy through 1975. The market for tax exempt bonds is largely limited to commercial banks and a few wealthy individuals whose assets are not likely to grow as rapidly as the economy. Many states are now paying over six percent interest on new issues of municipal securities and at these historic rates are unable to find buyers for about half of the normal volume of new issues.

2. The current crisis is likely to continue owing to:

(a) a much slower growth in the money supply which will force banks to ration credit more carefully,

(b) a preference on the part of banks for business loans as opposed to investment in municipal bonds,

(c) possible changes in our tax laws which will reduce the cash flow of corporations and financial institutions, and

(d) a tremendous pent-up demand for credit to provide housing, automobiles and consumer durables for a maturing baby boom and the returning G.I.'s from Vietnam.

3. Recognizing that state and local governments will face a continuing problem in finding financing for needed public construction, the members of the House of Representatives have included in their tax reform bill a provision which would permit the Treasury to provide state and local governments with a direct interest subsidy if they elect to issue taxable bonds. This provision would:

(a) provide the Treasury with a clear mandate to gradually eliminate one of the most glaring inequities in our federal tax system, and

(b) make it reasonable for the financial officers and managers of the trust funds of state and local governments, who now administer over $100 billion in financial assets, to help solve the current crisis.

4. No Urban development bank would be large enough or possess enough local appeal to accomplish these ends. Congress and the Treasury can afford to be generous in encouraging state and local governments to abandon tax exempt securities in favor of a more equitable system of public finance. The increase in taxes which would accrue to the U.S. Treasury can be expected to offset even the maximum subsidy of 40 percent which would be permitted in the House bill.

5. The lack of basic data on which to assess the effects on the market of other provisions in the House bill which might tax some of the interest on tax exempt bonds is unfortunate. It and problems related to credit ratings and other ways state and local governments can reduce the cost of borrowing high light a need for a major study of the municipal bond market.

1. TAX EXEMPT BONDS

The debt of state and local governments—now in excess of $140 billions—has grown at about eight percent per year since the end of World War II and has been projected to grow an average rate of about seven percent per year through 1975.[1] The market for this debt has been constrained by the implicit form of the subsidy and its dependence on the federal personal and corporate income tax rates. That is, the size of the subsidy varies directly with the marginal tax bracket of the holder of the bond. The result has been that nearly seventy-five percent of the state and local debt is owned by commercial banks and high income individuals.

Household demand for municipal securities grew at a fairly steady rate in the early post war period and then reached a state of near saturation in 1955 when

[1] The Joint Economic Committee, *State and Local Public Facility Needs and Financing*, December 1966, Volume 2, p. 35.

additions to total holdings amounted to more than three billion dollars. Between 1955 and 1966 household demand declined to an average increase of less than two billion dollars. In 1967 and 1968 demand for new issues was not sufficient to replace retirements. It became increasingly clear from the periods of monetary restraint such as 1966 and 1969 that a very high interest premium must be paid to induce a significant number of new individual investors to enter the market for municipal securities.

Commercial banks absorbed about 75 percent of the net increase in municipal securities in the seven year period from 1962–68. Dominance in this market appears to have been related to a high marginal tax rate and an unusual growth in the money supply (8 percent).

See columns (3) and (4) of Table 1. In the preceding fifteen year period (1947–1961) when the money supply, was growing at a much slower rate (3 percent), commercial banks were willing to absorb only 27 percent of the increase in municipal debt.

In the second half of 1966 and in the first eight months of 1969 commercial banks sold more municipals than they purchased. While one would expect bank demand to improve somewhat as inflationary pressures begin to ease, there are several reasons for supposing that *the total volume of municipals held by commercial banks might not grow at all in the next few years.* If this rather pessimistic view is warranted, state and local governments will either have to find new sources of financing for from eight to ten billion of public improvements each year or cut back on their capital accumulation drastically.

2. THE FUTURE MARKET

Five reasons can be advanced in support of a pessimistic view of *bank* demand for municipals. The first reason is the monetary outlook. The percentage growth in the money supply including time deposits has already declined sharply from the eleven percent growth rate which prevailed in 1967 and 1968 and will probably not be permitted to grow at an average rate of more than five percent per year in the next few years. If past relationships were to hold, this would mean that bank demand should fall to less than half of all net new issues of municipal debt.

TABLE 1.—THE COMPOSITION OF COMMERCIAL BANK ASSETS IN RELATION TO INTEREST INCENTIVES AND CHANGES IN THE MONEY SUPPLY, INCLUDING TIME DEPOSITS, THE UNITED STATES, 1947–68

Year	Other securities (which are mainly municipals) as a percent of bank loans	S. & P.'s high-grade municipal rate as a percent of the average short-term bank rate	Percentage growth in the money supply including time deposits	Increase in bank holdings of municipals as a percent of the total increase in municipals
	(1)	(2)	(3)	(4)
1947	23.6	95.7		64.3
1948	22.2	96.0	−.7	20.0
1949	24.5	82.5	.0	29.6
1950	24.3	73.6	3.7	53.3
1951	23.7	64.3	5.3	44.0
1952	22.6	62.8	4.8	37.0
1953	22.2	73.7	2.7	14.0
1954	23.7	65.6	4.1	32.7
1955	20.8	68.4	2.5	2.0
1956	18.5	69.8	1.9	4.3
1957	19.6	77.9	2.2	22.2
1958	21.4	82.0	6.8	53.1
1959	19.1	79.0	1.4	10.2
1960	18.3	72.3	2.2	12.0
1961	19.8	69.6	6.6	39.7
1962	21.8	63.6	7.4	64.3
1963	23.4	64.5	8.0	94.5
1964	23.1	64.5	7.8	59.3
1965	23.3	64.6	9.7	82.0
1966	23.4	63.7	4.8	40.0
1967	27.0	68.0	11.0	89.1
1968	28.1	67.5	10.9	[1] 81.4

[1] Estimated by the Investment Bankers Association.

Source: Economic Report of the President and Flow of Funds Statistics of the Federal Reserve.

Secondly, the unprecedented demand for credit that is likely to result when the baby boom reaches maturity and the economy strives to provide more consumer durables could cause bank demand for state-local bonds to fall even lower than would be indicated by past history. In addition, it should be remembered that commercial banks have always tended to give first priority to the needs of business and to only invest their "excess funds" in other securities such as municipal bonds. In his book on the *Management Policies for Commercial Banks*, Howard Grosse, Vice-President of the Federal Reserve Bank of New York, has stated this preference in the following way:

> The policy approach advanced in this book has stressed the primary obligation of a commercial bank to serve the credit needs of the community. It has emphasized, also, the need for protective liquidity and has advocated the provision of sufficient additional liquid assets to meet any foreseeable local demand for loans. Banks in some areas, however, or at some times, will have provided adequate liquidity, granted all the sound loans they can, and still have excess funds to invest. Funds so employed represent the bank's "investment portfolio" as distinguished from its liquidity position and its loan account.[2]

State and local bonds are generally considered to be part of a bank's investment portfolio.

Corporate demand for bank loans surged from a net increase of less than 3 billion dollars in the early 1960's to over nine billion in 1965 and has since held at about twice the average level of the earlier period. The impact of this demand on the portfolios of commercial banks has been especially marked in the case of the large New York City Banks. The five largest NYC banks had about 10.3 percent of their assets invested in municipal bonds at the end of 1964; by the end of 1968 this figure had dropped to 7.3 percent—a decline of three percentage points.[3] While other banks did tend to increase the share of municipals in their portfolio during this period of time, none of larger NYC banks were inclined to do so.

As large corporations turn increasingly to banks in other cities and force unincorporated businesses to pay for goods received more quickly, it is likely that many more banks will feel compelled to make a permanent reduction in the share of assets invested in municipal securities.

A third factor to consider is the House of Representatives tax reform bill.[4] Section 703 proposes the repeal of the seven per cent investment credit and the extension of the corporate surcharge tax (Section 701). The amount of funds that are available to businesses will be reduced by nearly 4.0 billions by 1971 if these two provisions are enacted.[5] This would force large corporations to rely more heavily on the credit obtained from large banks and be less generous in supplying credit to retail establishments, in turn forcing the latter to be more dependent on loans from local banks.

Fourthly, the market for municipal bonds will be decreased if Congress adopts the Treasury's proposal to grant banks a special tax deduction when they invest in residential construction, make loans to college students and accept SBA guaranteed loans.' The Treasury proposal not only provides a direct incentive for banks to discriminate against municipal bonds in favor of other kinds of investments but also contains an "allocation of deductions" feature which would include tax exempt interest. Since over 50 percent of the net income of many commercial banks is from tax bonds, it seems likely that some banks would have to sell municipal obligations to take advantage of the new subsidy. Most individuals, on the other hand, do not invest a very high proportion of their assets in municipal bonds.[6] It stands to reason, therefore, that an allocation of deductions

[2] Howard Grosse, *Management Policies for Commercial Banks*, Englewood Cliffs, New Jersey: Prentice-Hall, 1962, p. 231.

[3] These percentages are based on simple averages that were not weighted for differences in total assets. A weighted average decline in the proportion of municipals would be smaller since the two largest banks only decreased the share of assets invested in municipals by a little over one and one-half percentage points.

[4] U.S. Congress, H.R. 13270, "*An Act to Reform the Income Tax Laws.*" August 8, 1969.

[5] U.S. Congress, *Tax Reform Act of 1969, Report of the Committee on Ways and Means*, August 2, 1969, p. 19.

[6] Benjamin A. Okner, *Income Distribution and the Federal Income Tax*, (Ann Arbor: Institute of Public Administration, the University of Michigan, 1966), Table A-1, p. 83. It is estimated that only 1.1 percent of all investors in municipal bonds invest more than 25 percent of their assets in municipals.

principle applied to financial institutions could have a decidedly more negative impact on the municipal bond market than the allocation of deductions formula applied to individuals which the Treasury would like to see retained in the House bill.

Another important consideration, from the point of view of these hearings, is that an effective housing program is almost certain to divert thrift deposits from commercial banks to savings and loan associations which do not provide a significant market for municipal bonds.

Since 1947 commercial banks have maintained a remarkedly constant proportion of their total loan portfolio in mortgages. The average ratio for the period 1947–68 was about 26 percent and has actually trended down slightly since 1963. The comparable proportion for savings and loan associations is nearly 100 percent. New deposits in savings and loan associations increased from a little over one billion in 1947 to more than eleven billion in 1963. Large portions of this flow of potential mortgage money have been diverted to commercial banks in recent years, however, as a consequence of changes in regulation which permit banks to pay higher rates on some time deposits and restrictions which have been placed on the rates that savings and loan associations may pay on their deposits. The result, of course, is that housing starts are now significantly lower than in 1963 when family formation was considerably less than it is today. The most effective way to increase the flow of savings going into residential construction would be to permit savings and loan associations to *again* pay somewhat higher rates of interest on time deposits than commercial banks. This has been the traditional way of diverting savings into housing and is almost certain to be resorted to again if a proper balance is to be struck between residential and business investment. Thus would result in a relative decline in commercial banks time deposits—and a lesser demand for municipal bonds.

In our testimony before the Committee on Ways and Means on March 11, 1969 we estimated that there now exists a permanent shortage of municipal financing amounting to at least five billion dollars per year and that the shortage this year could be even greater if commercial banks abandon the municipal bond market as was the case in the second half of 1966.

More than twice as many new issues of municipal bonds have been withdrawn from the market this year than in 1966. The slowness of the economy to respond to monetary and fiscal policy, the tremendous pent up demand for housing and other types of consumer credit, and the prospect that Congress will enact major tax reforms makes us even more convinced that the present market for municipal securities cannot be relied upon to provide adequate financing for public facilities.

3. A NEW MARKET

Recognizing that state and local governments will face a continuing problem in finding financing for needed public facilities, the members of the House of Representatives have included in their tax reform bill a provision which would permit the Treasury to provide state and local governments with a direct interest subsidy if they elect to issue taxable bonds rather than tax exempt obligations. This provision has several advantages over other proposals which would broaden the market for municipal securities.

The most significant advantage of the House bill is that it would provide the U.S. Treasury with a clear mandate to gradually eliminate one of the most glaring inequities in our Federal tax system without reducing the amount of capital available to finance state and local facilities.[64] No Urbank would be large enough to accomplish this objective.

A Federal Urban Development Bank could not be considered a financial success unless its securities sold at a rate of interest almost equal to Treasury obligations. This would make U.S. government bonds and the Urbank debt very close substitutes. Since the Treasury is responsible for keeping interest on the U.S. debt as low as possible, it would tend to oppose large increases in the amount

[64] The law reads . . . "The Secretary of the Treasury . . . shall pay a fixed percentage of the interest yield . . . in order to encourage the states and political subdivisions . . . to make elections [to issue taxable bonds]. U.S. Congress, H.R. 13270, *An Act to Reform the Income Tax Laws*, August 8, 1969, p. 320–1.

of Urbank debt for fear that these obligations will drive up the rates of U.S. government bonds and destroy much of the yield advantage that the Federal government has traditionally had in competing for funds in the private market. A small Urbank operation would mean added delays to state and local borrowing, an onerous rationing mechanism, and an extra layer of administrative costs in the financing of public facilities.

A direct interest subsidy to taxable local bonds would permit these obligations to compete more directly with high grade corporate bonds, which are now the most preferred investment in the cash and security holdings of state and local governments. These holdings amount to over $100 billion dollars. In 1956 when interest rates were lower and the yield differences between municipals and high grade corporate bonds were fairly negligible, state and local governments held about 12 percent of their assets in municipal bonds. This figure has declined to less than three percent of total assets in 1969. Corporate bonds during the same period of time increased from 10.4 to about 40 percent of total assets.

While state and local governments would not have a very compelling reason to support a market for securities of a Federal Urbank—U.S. government securities in state and local retirement funds declined from 50 to 20 percent of total assets between 1954–68—there is reason to believe that the managers of these funds would feel a very strong obligation to support a *fair* and *orderly* market for the *taxable* securities of their respective governments. It seems likely, therefore, that a system of direct interest subsidies to state and local governments that issue taxable bonds would provide a broader and more competitive market for municipal securities than an urban development bank.

The severe fiscal problems of state and local governments make it both proper and desirable that Congress adopt a tax reform bill which persuades, rather than coerces states and local governments into issuing taxable bonds.

Since the increased taxes which would accrue to the US Treasury can be expected to offset even the maximum subsidy of 40 percent which would be permitted in the House bill,[7] it is clear that Congress and the Treasury can afford to be generous in encouraging state and local governments to abandon tax exempt securities in favor of a more equitable system of public finance.

Those attacking the exemption feature have generally recognized that state and local governments benefit from tax exemption but have argued that exemption is an inefficient subsidy. If income taxes are progressive and if the volume of bonds is too large to be absorbed by persons in the highest tax bracket, tax exempt rates must be raised enough to attract capital from persons in lower brackets, giving bond holders with higher incomes a windfall gain. Estimates suggest that the interest saving to state and local governments in the postwar period has ranged from about one-third to less than two-thirds of the revenue loss to the federal government.

There is one feature in the present bill which we feel should be deleted. That is the provision which would lower the minimum subsidy that the Treasury is permitted to pay state and local governments from 30 to 25 percent in 1975. No rationale is provided for this reduction. It might be considered a breach of faith which increases the uncertainty as to whether Congress really intends to phase out tax exempt bonds by offering a more attractive substitute.

If the intention is to gradually eliminate the supply of outstanding tax exempt bonds, the subsidy to state and local bonds will have to be increased over time instead of lowered. This follows from the fact that fewer tax exempt issues will create a scarcity condition that will enable the outstanding issues to be absorbed almost entirely by persons and institutions in the very highest tax brackets. Its these groups which now obtain the largest amount of windfall gain from the excess supply of municipals that is now depressing bond prices and raising yields to historical highs.

The most important point to note in connection with other features of the House bill which might tax some of the interest on municipal bonds is that we

[7] David J. Ott and Allan H. Meltzer, *Federal Tax Treatment of Local Securities* (Washington, D.C.: The Brookings Institution, 1963), p. 1. Lucille Derrick, "Exemption of Security Interests from Income Taxes in the United States," *Journal of Business*, Vol. 19 (Oct. 1946), Part 1, App., listed 114 resolutions introduced between 1920–1943 to reduce the subsidy. Cited in Ott and Meltzer.

really have little or no information on the possible effect of these measures on the market for municipal bonds. Individual tax payers are not required to report interest on municipal securities. This lack of basic data on which frame an important public policy highlights a need for major study of the municipal bond market. In the remainder of this paper we will cite some additional reasons for undertaking such a study.

4. SOME NOTES ON THE NEED FOR A MAJOR STUDY OF THE MUNICIPAL BOND MARKET

That portion of the Federal debt which was not held by the Federal Reserve or agencies of the U.S. government was about 18 times as large as the debt of state and local governments at the end of World War II and has actually declined somewhat since 1945. The debt of state and local governments, on the other hand, has grown at about 8 percent per year and is now more than half as large as the net Federal debt. If past trends continue, it will be only about five years before state and local governments will place in the hands of private investors more debt than is (now) obtained from the Federal Government.[8]

While many volumes have been written on the "burden of the national debt," comparatively little attention has been paid to the management of state and local debt.[9] Two of the most prestigious college texts devote only one paragraph to problems connected with the municipal bond market.[10]

It has become increasingly clear in the last 2 years that the present market for municipal securities is too narrow to provide the facilities that will be needed by state and local governments in the decade ahead.[11] Rising concern on the part of public officials has inspired a large number of alternative arrangements which are now being given serious consideration within the broader context of tax reform. Is it to be hoped that a method will soon be worked out to provide state and local governments with an *attractive* direct interest subsidy that will not only broaden the market for municipal securities but also end the stigma of an inequitable tax system.

If Congress does enact something along the lines of the "dual coupon" proposal which has recently suggested by the National Governors' Conference [12] there will still be a need for a follow-up study to determine whether the yields on taxable municipal securities compare favorably with other interest rates and to consider the benefits and costs that might be associated with various arrangements to improve financial information [13] and further reduce the cost of state and local borrowing.

Options such as permitting the Federal trust funds to hold state and local bonds and the creation of a Federal system of state urbanks are particularly worthy of study. It would also be interesting to know whether the same objectives

[8] This projection subtracts U.S. Government securities that are owned by state and local governments from the net Federal debt. About seven years would be required for the debt of state and local governments to exceed the total net Federal debt, if past trends continue. Data are from the *Economic Report of the President*, p. 303 and the Joint Committee Print on *State and Local Public Facility Needs and Financing*, Dec. 1966, Vol. 2, p. 40.

[9] The new SEC investigation which was presumed to imply a broad based study of the security markets will not devote much effort, as near as we can determine, to problems connected with the municipal bond market.

[10] Richard A. Musgrave, *The Theory of Public Finance* (New York: McGraw-Hill Book Company, 1959), p. 575. Less than half a page is devoted to borrowing by local governments. John F. Due, *Government Finance* (Homewood, Illinois: Richard Irwin, Fourth Edition, 1968), p. 400. One paragraph is used to summarize the conclusions of Ott and Meltzer in their monograph, *Federal Tax Treatment of State and Local Securities* (Washington, D.C.: Brookings Institution, 1963). The only other major work in this area by an academic economist is the now out-of-date book by Roland I. Robinson, *Postwar Market for State and Local Government Securities* (New York: National Bureau of Economic Research, 1960).

[11] In the seven year period from 1962–68 commercial banks absorbed about 75 percent of the net increase in municipal bonds. This was made possible by an unusual growth in bank deposits. In the preceding 15 year period when the money supply, including time deposits, was growing at a more normal rate, commercial banks were willing to absorb only 27 percent of the increase in municipal debt.

[12] *The Wall Street Journal*, May 5, 1969, p. 3.

[13] Some states such as North Carolina have actively supervised the information and procedures used to issue local bonds. It would be interesting to study whether this effort has been successful at improving the bids received by localities.

could be obtained by simply creating a new type of Federal Deposit Insurance Corporation to insure the interest to some public officials is the fairness of the existing municipal security rating system.

Are Bond Rating Meaningful?

In July, 1965, Moody's Investors Service lowered New York City's credit rating from A to Baa. The reaction of finance administrator Roy M. Goodman "touched off a national debate on bond ratings" which eventually resulted in two hearings on the subject before the subcommittee on Economic Progress of the Joint Economic Committee in December 1967, and July 1968.

In March, 1968, Senator Proxmire and Representative Patman introduced identical bills to establish a government corporation patterned on the Federal Deposit Insurance Corporation to guarantee the payment of interest and principal on state and local bonds. The preamble to this bill contends that states and local governments are being forced to pay excessive interest owing in part to "the failings of the existent municipal securities rating system." [14]

One of the best ways to indicate a need for an independent study of the municipal bond rating system is to observe the pattern of ratings which emerges when states are ranked on the basis of total personal income divided by the amount of debt outstanding which pledges the state's full faith and credit to guarantee both interest and principal. Total personal income is surely the best single measure of the taxable revenue base that is available to most states. One would expect such coverage to be an important determinant of credit ratings. It is clear from Table II, however, that Moody's ratings give little weight to income coverage. Twenty-one states, with lower credit ratings, have higher personal income coverage than either Vermont or Connecticut, both of which enjoy a triple-A rating.

The lack of relation between income coverage and credit ratings raises a serious question as to whether Moody's ratings are sufficiently objective to provide a fair and reasonable standard of investment quality. An indepth study of available information and factors that might be used to establish a more objective rating system is not only in order but would seem necessary if states are to be encouraged to make maximum use of their general borrowing power in support of needed state and local facilities.

STATE ASSISTANCE TO LOCAL GOVERNMENTS

In 1966, 17 states had credit assistance programs to aid local governments in financing public facilities.[15] The majority of these programs use the state's borrowing power to make direct loans to local governments for such purposes as educational facilities, public housing, road construction, sewage and airport facilities. The trend toward greater use of state borrowing power to finance local facilities would be greatly accelerated if Congress and/or the several states develop a system of state urbanks.[16]

This modification to the concept of a single urban development bank would seem to imply that states and local governments might be able to reduce their borrowing costs significantly without resort to Federal intervention.[17] It would seem desirable, however, to determine how successful existing programs have been before plunging into a national system of 50 different urbanks.

[14] The two bills were re-introduced into the 91st Congress as *Senate Bill S. 398 and H.R. 2115*.

[15] Carol Krotski and George A. Bell, "State Credit Aid for Public Facilities," *State and Local Public Facility and Financing* (Washington, D.C.: Government Printing Office, December, 1966) Vol. 2, pp. 92–101.

[16] In the revised statement of the National Governors' Conference at the Hearings of the Committee on Ways and Means on the tax treatment of state and municipal bonds, March 11, 1969, it was suggested that serious consideration be given to a Federal System of 50 State Urbanks which would purchase local bond and re-issue taxable obligations which would be subsidised by the U.S. Treasury through the Federal Urbank. The Federal Urbank might also act as a secondary market for state urbank obligations and as an insuring agent for state and local bonds in return for a premium to be paid on each issue.

[17] Other alternatives that should be considered in this context include the possibility of creating either a *state savings* bond program or the sponsorship of a state municipal mutual bond fund that would be sold to individuals that lack the $5,000 of savings that is usually required to purchase just one municipal bond.

AN ANTEQUATED SYSTEM OF DEBT LIMITATIONS

Movement in the direction of a more rational pattern of state-local borrowing has been impeded in many instances by an out-dated system of debt limitations. A number of states have constitutional provisions which either prohibit the use of general obligation bonds or limit the amount that may be issued to a small proportion of the tax revenues that are now available to meet interest and repay principal. The recent rise in interest rates has forced some of these states to raise interest ceilings and also consider other changes which would make debt limits more realistic and avoid the necessity of elaborate subterfuges which increase the cost of state and local borrowing.[19] An up-to-date report on the progress which has been made in the last few years would be quite helpful to those public officials who are still laboring to modernize debt limitation practices which sometimes date back to the Civil War period.

TABLE II.—STATES WITH GENERAL OBLIGATION BONDS RANKED IN ORDER OF PERSONAL INCOME COVERAGE AND COMPARED WITH MOODY'S CREDIT RATINGS

	General obligation bonds [1] (millions of dollars)	State personal income divided by general obligations bonds [2]	Moody's rating [3]
	(1)	(2)	(3)
1. Idaho	0.8	2,130.0	Aa
2. North Dakota	1.8	851.7	Aa
3. Michigan	44.8	618.0	Aa
4. Iowa	16.5	500.5	Aaa
5. Missouri	45.4	283.2	Aaa
6. Pennsylvania	130.3	264.3	Aa
7. Washington	48.0	204.1	Aa
8 Alabama	51.8	140.0	A
9. Arkansas	31.2	126.0	Aa
10. Nevada	12.5	120.6	A
11. Illinois	344.6	110.5	Aaa
12. Texas	315.5	86.6	Aaa
13. Montana	22.5	81.9	Aa
14. New Jersey	292.7	81.2	Aaa
15. Ohio	575.6	55.0	Aaa
16. Oklahoma	114.0	53.5	Aa
17. New Mexico	48.8	49.0	Aa
18. New York	1,323.2	48.1	Aa
19. Minnesota	256.1	40.5	Aa
20. Louisiana	207.3	39.7	A
21. Tennessee	226.8	38.0	Aa
22. West Virginia	104.7	37.6	A
23. Utah	67.0	37.3	Aaa
24. South Carolina	160.3	33.1	Aaa
25. North Carolina	377.3	30.0	Aaa
26. Maine	89.5	27.1	Aaa
27. Maryland	442.2	26.2	Aaa
28. Kentucky	362.1	19.7	Aa
29. Massachusetts	1,085.7	16.3	Aa
30. California	4,265.2	15.2	Aa
31. Mississippi	279.5	14.9	Aa
32. New Hampshire	131.6	14.4	Aaa
33. Rhode Island	202.7	13.5	A
34. Vermont	82.0	13.0	Aaa
35. Connecticut	839.9	12.9	Aaa
36. Oregon	482.9	11.9	Aa
37. Alaska	76.4	11.9	Baa
38. Hawaii	217.4	10.3	A
39. Delaware	270.2	6.7	Aa

[1] The figures are for mid-1967. An effort was made to deduct sinking funds and to include all issues where both the interest and the principal were backed by the full faith and credit of the State.

[2] The personal income figures are for 1966.

[3] The credit ratings were obtained from Moody's 1968 Manual on Municipal Securities. A few of the ratings refer to the most typical issue that was rated in Moody's Manual.

[19] Paul Heffernan, "The Changing Notions of Debt Limit Borrowings," *The Bond Buyer*, Special Conference Issue No. 1, May 26, 1969, pp. 41–61.

STATEMENT SUBMITTED BY PATRICK H. RENSCH, SPECIAL COUNSEL, CITY OF NORTH PLATTE, AND LANFORD L. JORGENSEN, ADMINISTRATIVE ASSISTANT TO THE MAYOR OF NORTH PLATTE, NEBRASKA

Mr. Chairman and Members of the Committee:

The Mayor and Council of the City of North Platte, Nebraska, have gone on record as strongly opposed in principal to any language in H.R. 13270 or any other Bill which would in any way directly or indirectly tax the income of any bonds or obligations of any State, or any governmental subdivision of any State. They also have gone on record opposing any language in H.R. 13270 or other legislation which would in any way establish voluntary relinquishment by a State or subdivision thereof of the tax exemption for any reason, whether it be subsidy, aid grant or control. They have also gone on record as being opposed to any language in H.R. 13270 which might relate to the subject called arbitrage which in any way would give the federal government a right to question legitimate financing plans or programs, whether required to be in the form of advance refunding or other programs where the only logical investments, or the only legal investment, might be an interim investment in United States government bonds. This written statement is a brief summary of these objections and some of the reasons for the objections.

This statement is made not only on behalf of the City of North Platte, but is authorized to be and is presented as the official expression of the School District of North Platte and of the Mid-Plains Area Vocational Technical School, a multi-county vocationaltechnical school district is Western Nebraska, and that reference hereafter to the official body of North Platte, we refer also to the other political subdivisions above mentioned.

First let us say that we do not believe that the inclusion of the taxation of the income of municipal bonds in H.R. 13270 is tax reform. We consider it to be more in the nature of the political or constitutional reform under the guise of tax legislation. We feel it is unconstitutional and we feel that it is politically and fiscally unwise in that its consequences, in addition to being a more costly method of financing municipal improvements, involves a threat to the whole concept of the separation of the powers of the federal government and the States and their subdivisions.

We believe in the principal of the separation of the powers between the Federal Government and the States as provided for in our constitution and as they have developed under the laws of the United States Government and the decisions of the United States Supreme Court. We recognize that the present ability of States to sell bonds at a rate which is competitive with the cost of financing of the federal government is probably the biggest single factor today in retaining the principal of the separation of the powers of the federal government for those of the state local government. We feel that any change in the nature of this relationship will only lead to more and stronger centralized federal control over matters which are rightly within the prerogative and the concern of the State and local governments. We feel that the right of taxation of municipals is politically and financially unsound and will ultimately lead to chaos in the municipal bond market, will lead to higher financing cost and ultimately to the assumption by the Federal Government of the function of financing of the local improvements resulting in the loss of local control and decision making.

We feel that the passage by the House of Representatives of H.R. 13270 shows a lack of understanding of this concept not an intent to change our constitutional birthright which is subject to ultimate termination by the logical extension of this legislation. We know that the impression which has been given by publicity in the national news media from statements made by those espousing the taxation of municipals are misleading and that the true picture of the problems involved has not been recognized, possibly because of this. You should recognize that our bonds are purchased by those in an income tax bracket which makes the purchase of our bonds advantageous to them - the margin is thin. To say that the purchaser of a municipal bond does not pay a tax is grossly in error. When an investor buys a North Platte bond with a tax free rate of 4%, whereas he could buy a taxable bond of similar quality for 6%, he pays directly to the city whose bond he purchases a tax of 33% since his return is one-third less. The treasury department in their proposals acknowledge that this difference may be between 30% and 40%.

We have here an ingenious system for the return of tax dollars to municipalities which preceeds and complements anhounced plans for returning tax dollars to cities and states. In one sense the city whose bond is purchased receives a tax from the purchaser in the form of reduced interest. Without developing a bureaucracy or creating other problems we have one solution, the return to the local government of federal income taxes, which should be expanded, not curtailed. The publicity concerning about 150 to 200 millionaires who do not pay taxes was unfortunate and inaccurate as it relates to municipal income.

Title III, Section 301 of H.R. 13270 makes possible a direct income tax on the income from municipal bonds owned by individuals, estates and trusts in that tax preference income will not be permitted to exceed one half of the total income and the taxpayer will be required to pay tax on the remaining half (in case of taxpayers with total tax preferences in excess of $10,000). This applies equally to outstanding bonds as well as new bonds and is hereafter referred to as "limited tax preference".

Tit! III, Section 302 H.R. 13270 would in certain instances deprive taxpayers of their present ability to deduct fully the amount of personal income tax deductible against their taxable income. This does not apply to bonds issued prior to the specified date. This will hereafter be referred to as "allocations of deductions".

Title VI, Sections 601 and 602 H.R. 13270 - There is provision for a State or political subdivision to elect to issue bonds the interest from which will be taxable, and the United States will pay an interest subsidy so as to reduce the interest payments made by the State or a local subdivision. This will be referred to as the "interest subsidy provision".

Ample testimony will be presented to show the fiscal impact on municipal financing and to support our feelings as set out above; that no need for a federal subsidy will be shown by those involved and objections come from all levels of government of the States and subdivisions as well as citizens (other than those attempting to justify their political, social and constitutional reform program); to show the wiseness in our present system; to show that the actual result of such a tax will be an increase in the tax of those with lower incomes; to show the legislation will complicate unduly the income tax provisions relating to bonds; to show the extent to which such legislation will be resisted in court causing additional continued market uncertainty and therefore higher costs to municipalities; that feasible projects will not be financeable thus increasing the demand for grants and aids and federal expenditures and be an impetus to further inflationary trends.

We feel the Federal Government is physically unable to fill the void. Consider the multi-agencies involved with grants and attempts to aid smaller communities in financing improvements for water, sewer and recreation. The lack of success of the loan program is indicative of the general lack of needs of governmental involvement in financing. Where costs exceed ability to repay, grant in aid programs have been useful to obtain desired results.

Public housing financed by municipal corporations has been successful because the United States Government is willing to guarantee payment of bonds and pay all deficiencies of rentals set low for income groups. This would not work where bonds are payable from taxes or from assessments on a local level. Tax legislation will take municipalities out of federal housing or raise financing costs. For the United States Government to have all States and local municipalities as a partner in this program independently financing, planning and executing is one of our Federal Government's major assets and this is one sane approach not to be tampered with.

We feel the Subsidy Provision is absolutely unnecessary and is as conducive to higher costs and uncertainty as is taxation of the bonds themselves. We do not agree that a compromise enactment of these provisions is possible. The confusion created by conflicting interpretations and controls which would develop together with governmental promotion of their program would be costly, cause delay and increase costs.

Our Governor, before the Ways & Means Committee proposed a detailed study of the problems. In this we concur. We do not concur in any inference in his other testimony or any testimony before this committee, that a subsidy system for higher interest on bonds incurred where taxation imm ity is waived by States would be useful in any way—but rather harmful as outlined above.

SUMMARY

All provisions of H.R. 13270 relating to taxation, direct or indirect, or under subsidy and tax waiver agreement are opposed. Results will be increased financing costs, loss of local governmental interest and economical operation; local taxes and the costs of utilities paid by most tax-payers will be increased; confusion caused by threat of taxation; lack of confidence due to taxation of outstanding bonds and anticipation of court litigation pose long-term uncertainties compounding the results of anticipated tax; and taxation of bonds is not tax reform but political, social and Constitutional reform. The subsidy provision is part of this reform, and unwise and costly.

We believe in the principal of the sovereign state as a partner with the Federal Government, not its tool, and the taxation of municipal bonds is the key to this independent action. We ask you to strike all references to tax and subsidy.

OFFICE OF THE
BOARD OF WAYNE COUNTY AUDITORS,
Detroit, Mich., September 18, 1969.

Mr. TOM VAIL, *Chief Counsel,*
Senate Finance Committee,
New Senate Office Building,
Washington, D.C.

GENTLEMEN: Sections 601 and 602 in Title VI of the Tax Reform Act of 1969 (H.R. 13270), by means of a direct interest subsidy from the Federal Treasury, propose to alter the traditional and time-tested method of financing state and local governments by means of tax-exempt bonds.

Local units of government should not be hampered by more Federal red tape in raising the funds required to finance their capital improvement programs and meet their daily problems effectively and in timely fashion. It is well known that the financial resources available to local governments are at best limited, due to the fact that prime sources of tax revenues are preempted by the Federal and state governments. Local units and school districts have traditionally relied heavily on tax-exempt bond issues to fund costs of needed streets, sewers, parks, schools, and other necessary improvements.

For example, Wayne County government, through its several agencies, has issued or assisted in the issuance of approximately $300 million in public improvement bonds; and proposes, within the next three years, to issue an additional $300 million necessary to the construction and expansion of public facilities, including sanitary drains, sewer interceptor systems, waste disposal plant projects, airport facilities, water mains, hospital and other construction, and many diverse improvements.

It is the firm belief of the members of the Board of Wayne County Auditors that without the aid of tax-exempt bonds the citizens of Wayne County would have been, and will be, denied the beneficial use of many millions of dollars worth of facilities, and that the County's ability to construct further improvements will be substantially impaired. If local units cannot economically market their issues, or can only do so at very high interest rates due to the shrinkage in demand for municipal bonds, it can only have the effect of hampering expansion and discouraging local development.

In view of the foregoing, the members of the Board of Wayne County Auditors strongly urge that the tax exemption on municipal bonds be continued as at present.

Very truly yours,

ARTHUR A. SUMERAOKI, *Chairman*
RICHARD H. AUSTIN, *Vice-Chairman*
JOHN F. WILLIAMS, *Secretary*

COUNTY OFFICERS ASSOCIATION
OF THE STATE OF NEW YORK,
Albany, N.Y.

HONORABLE SENATE FINANCE COMMITTEE,
2227 New Senate Office Building,
Washington, D.C.

Attn: Tom Vail, Chief Counsel

Statement of County Officers Association of the State of New York, representing fifty-six counties outside New York City, to be included in report of public hearings held before Senate Finance Committee September 23, 1969.

RE: H.R. 13270 INCOME TAX REFORM BILL

This Association opposes that part of the above bill which would tax interest on state and municipal bonds and notes as part of the income of the individual holders of such obligations.

1. The threat to tax this formerly exempt income has already increased the interest rate by almost 2% when a purchaser for the obligations is found.

2. Such increase has to be borne by local property owners already overburdened with taxes to maintain local governments.

3. Removing the exemption of interest on state and local obligations will not accomplish the purpose of the bill, i.e. to tax the income of wealthy people and plug loopholes in the income tax law.

4. Desirability of municipal bonds and notes has been destroyed and will not be made desirable by the proposed flexible subsidy which places control over the activities of municipalities in the federal bureaus.

5. Such a tax has been declared unconstitutional by the United States Supreme Court.

This Association wholeheartedly supports the position of the National Association of Counties to which organization and its speakers before your Committee on September 24, 1969 reference is hereby made for amplification of this statement.

Respectfully submitted,

HERBERT H. SMITH, *Executive Director.*

CITY OF BRIDGEPORT, CONNECTICUT,
OFFICE OF THE TREASURER,
Bridgeport, Conn., October 1, 1969.

SENATE FINANCE COMMITTEE
Washington, D.C.

The City of Bridgeport is one of only three cities in the State of Connecticut that enjoys a AAA credit rating, earned by many years of careful financial planning and conservative management of municipal funds. Bonds issued by Bridgeport for needed capital programs have traditionally evoked spirited bidding and resulted in the lowest interest cost of any city in the state. Resulting savings have meant available tax dollars could be channeled into other needed services and modernization of this most important industrial city. The tax dollars deposited to the City Treasury go further because our interest costs are low. Any interference with the existing system by removing the tax exempt privilege of interest paid on municipal bonds must necessarily result in increased cost to the people of Bridgeport which can only come from increased city taxes. A Tax Reform Bill that results in higher costs to taxpayers is not good tax legislation. The mere threat of removing this tax exempt privilege has already disrupted the bond market to the extent that those municipalities unfortunate enough to have planned their bond offerings for the present time have been forced to pay unheard of interest on their bonds and in many cases have cancelled or postponed the financing of needed municipal improvements.

The plight of the urban community is serious. The need for modern facilities and creative social programs can only be met with sound financial planning. Any action of the Federal Government that will even remotely increase the already oppressive financial burden of our cities is a disservice to the people of urban America.

The evidence is clear and convincing. Responsible government cannot impose a tax that will impede the progress of our cities. I urge the Senate Finance Committee to omit from the pending Tax Reform Bill any change in the present tax exempt status of interest paid on municipal bonds.

Very truly yours,

VINCENT M. SIMKO,
Treasurer, City of Bridgeport.

THE NEW ORLEANS BOARD OF TRADE,
New Orleans, La., September 12, 1969.

Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
217 Old Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: For as long as we can remember, our communities have been building schools, roads, hospitals, sewers, bridges, waterworks, and port improvements by issuing long-term, low interest municipal bonds. The interest on these bonds (and, therefore, the cost to the tax-payer) is lower than on other securities because historically, traditionally and *constitutionally* it is exempt from all Federal income taxes.

In the so-called tax reform bill passed by the House of Representatives, and now being considered by your Finance Committee, most important among the proposals, we understand, is taxation of municipal bonds. In our opinion and that of bond experts such a plan would be most inimical to our State, particularly with reference to Parish and City school bonds and the proposed bond issue for the Port of New Orleans which is a must if our port is to maintain its position as the second major port of the nation.

If the House Bill was enacted into law in its present form, it is our feeling that the market for tax-exempt securities would be significantly and lastingly damaged; municipal bond purchases by individuals would be substantially reduced; interest rates on municipal bonds would materially rise, the excess costs thereby resulting on the community at large for the sake of punishing the few who might buy large quantities of such bonds; the preferential position of municipal securities in the capital markets relative to taxable issues would be impaired.

Only several days ago the Parish of Jefferson proposed a school bond issue for $10,000,000 for the purpose of building much needed schools and not a single bid was received.

We strongly urge that you oppose any legislation that might jeopardize the long-standing, highly successful and economical system of tax-exempt municipal bond financing. Unfortunately and with much regret we will not be able to appear before your committee, however, we are sending you under separate cover twenty copies of this letter and kindly ask that it be made a part of the record of your Committee's hearing.

Sincerely yours,

KENT SATTERLEE, *President*,
ALEX C. COOKE, *Consultant*.

COUNTY OF GREENE,
STATE OF MISSOURI,
Springfield, Mo., September 18, 1969.

Hon. RUSSELL B. LONG,
Chairman, Members of the Senate Finance Committee

Due to the large number of witnesses requesting time to testify on tax reform measures in your current hearings, Tom Vail, Chief Counsel for your Committee has advised me to submit a written statement. We appreciate the consideration that is being granted us.

My name is W. Fred Schaeffer. I am Presiding Judge of the Greene County Court, Greene County, Missouri. I am also President of the Association of County Judges of Missouri.

I strongly oppose the action of the House of Representatives in H.R. 13270, the "tax reform" legislation which includes the interest local governments pay to individual investors in their bonds. Under both the Limit on Tax Preference formula and the Allocation of Deductions Rule, local government will suffer. We in local government are continually faced with a shortage of funds, the resistance to an ever increasing tax on Real Property, and now with the adverse pressure of the House action, the Tax Exempt market continues to deteriorate rapidly.

Our county has a great number of elderly and retired citizens, the most of whom are on fixed incomes. We are also in a fast growing area which is continually faced with the need for capital improvements of governmental facilities. The most practical means of financing is by bond issue and without tax exempt bonds we are in serious trouble.

We recognize that the intent of this legislation is to reduce inequities among taxpayers. We do not believe that it is the intent of this legislation to jeopardize the preferential character of local government bonds. Indications are that our cost of local bonds as of this date would exceed 6.25% which is above the legal limit in Missouri.

We realize that there is no easy solution to the problem of alleviating the financial burdens of the states and their local governments. It is also important that the market for state and local government securities is not destroyed by well meaning attempts to equalize taxes.

It is our earnest hope that your Committee will in its deliberations find a way to avoid taxing local bonds.

As stated, I am also President of the Association of County Judges of Missouri. This Association held its 49th annual meeting on September 11 and 12, 1969 in Jefferson City. The matter of tax exempt bonds was discussed with this group by our State Treasurer, the Honorable William E. Robinson. The Association passed the following Resolution and asked that it be made a part of my statement to your Committee:

Whereas, it is essential that any government have the power to tax and to borrow to support necessary services; and

Whereas, the freedom of the Federal Government and the States from taxation by the other is part of the genius of our federal system; and

Whereas, this freedom necessarily encompasses the immunity of State and local government obligations from Federal taxation and a similar immunity of Federal obligations from State and local taxation; and

Whereas, as measures for tax reform or the raising of additional revenue, proposals have been made to amend the Federal tax laws to close certain "loopholes", or to bring about a greater measure of equity among taxpayers; and

Whereas, these proposals include one to enact a minimum income tax and another to set a maximum amount of income that could be exempted from tax enactment of either of which, if they include interest paid on local government obligations, would pose a serious problem; and

Now, Therefore, Be It Resolved by the Association of County Judges of Missouri at their annual meeting September 11, 1969, that it reaffirm its support for the reciprocal freedom of the States and the Federal Government from taxation by the other; and

Be it further resolved that it petition the Finance Committee of the Senate of the United States to refrain from enacting legislation which would make more difficult and more costly the performance of their responsibility by local governments, and endanger the market for local securities; and

Be It Further Resolved that copy of this resolution be sent to the Finance Committee of the Senate and to all members of Congress from this State.

Respectfully submitted,

W. Fred Schaeffer.

Board of Education,
Houston Independent School District,
Houston, Tex., September 19, 1969.

Hon. Russell B. Long,
Chairman, Committee on Finance,
U.S. Senate,
Washington, D.C.

Dear Senator Long: We in the Houston Independent School District appreciate the opportunity of having these remarks considered as direct testimony before the Senate Finance Committee as concerns certain provisions of H.R. 13270, Tax Reform Act of 1969, which opposes removal of tax exemptions from the local government bonds.

I am sure that you have been provided with a wealth of satistical information which will convince the United States Senate that this proposal for "tax reform" would be more accurately described as "tax disaster."

I would like to offer the following comments as to what I think all these statistics mean in everyday language.

As you may know, school revenues across the nation are in desperately short supply. Demands on the school budget are increasing at a rapid rate. Inflation and teacher salary schedules are rising at a far more rapid rate than revenue. The public schools are in the middle of an emergency situation in financial support and the prospects are that the situation is going to worsen before improvements can be brought about.

As you know, public schools in Houston, in Texas and in most parts of the nation rely upon bond issuances for the long-term financing needed to build the new schools necessary to care for our increasing population of school children. These bonds are saleable primarily because of the tax advantages offered to those who risk the capital necessary to provide construction financing. At the same time, financial support of local schools by local taxpayers is made more palatable because the retirement of tax exempt bonds means, simply, a lower local school tax.

If these damaging proposals for removing exemptions on school and other local government bonds are allowed the U.S. Senate to become law, a travesty will have taken place. It is evident that for many school districts construction funds will simply dry up under the influence of inflated interest rates that would result from the removal of exemptions on these bonds.

For those school districts that might be able to sell construction bonds at higher rates, it will mean no less than a near doubling of expenses for local schools and a sizeable increase in local tax rates in order to pay off the bonds. If the Senate enacts this idea, we can forget about new school construction and be left with the children suffering the consequences of overcrowded schools and the resulting havoc that accompanies overcrowding, such as double sessions, a decline in school cleanliness and a rapid deterioration of teaching effectiveness and learning accomplished.

The alternative posed by the writers of this doctrine of "reform" purposes some kind of federal bank that would buy local government bonds so as to keep interest rates low. This is an inane idea that, whether intended or not, smacks of raw Marxism and which would surely bring the ultimate full control of local education into the hands of the federal government, not to mention the sure prospect of a gross, unnecessary increase in the federal bureaucracy.

It is inconceivable that these proposals should ever be brought before the United States Congress. In tax-exempt bonds we have a wise system of federally-supported assistance to local schools. At a time when the United States Government is increasing subsidies to education it would appear that the proposals for removing exemptions on local government bonds with be tantamount to giving to the schools with one hand and taking away from the schools with the other hand, leaving the schools far poorer in the end than they would have been had this sort of financial relationship never existed.

I am sure that every United States Senator believes in the strongest possible local effort so that local responsibilities can be met to the fullest extent without the control and interference by a bureaucracy.

I am enclosing two documents. Exhibit A is a Dun & Bradstreet report entitled "The Coming Crisis in Intergovernmental Relations," dated August 4, 1969. I would appreciate having the essence of this report's arguments against exemption removal considered by the committee as it conducts its examinations.

Exhibit B is a letter from the Financial advisor to the Houston Independent School District showing a comparison of the effective rate of interest being paid by the Houston Independent School District on bond issuances since April 10, 1953 and the corporate equivalent interest rates that the school district would have had to pay had local government bonds not enjoyed tax exempt privileges during this time.

In closing, I say to you that this proposal for removing exemptions on local government bonds must be exposed as a threat to the continued progress and effective existence of American public school education and therefore must be defeated and destroyed with all the force that can be summoned against it.

Sincerely yours,

ROBERT Y. ECKELS.

EXHIBIT A

DUN & BRADSTREET, MUNICIPAL CREDIT REPORT, OCCASIONAL PAPER NO. 5

August 4, 1969.

THE COMING CRISIS IN INTERGOVERNMENTAL RELATIONS

"And if the means and instrumentalities employed by the (general) government to carry into operation the powers granted it are, necessarily, and, for the sake of self-preservation, exempt from taxation by the states, why are not those of the states depending upon their reserved powers, for like reasons, equally exempt from federal taxation?"

(Nelson, J., in The Collector v. Day)

Certain "tax reform" proposals before the Congress relating to state and local bond taxation, promise, if adopted, to effect a more far-reaching alteration in Federal-State-Local relations than any single piece of legislation heretofore enacted. The proposals, moreover, are apparently to be rushed to the floor of the House of Representatives as part of a "take it or leave it" tax package which the sponsors have successfully tied to the surtax extension. There is a real risk that argument on the merits of the proposals will not occur until the bill reaches the Senate.

So hasty has been the action of the Ways and Means Committee in bringing out its bill that the utmost confusion exists at this writing as to its actual provisions. Accounts of the tax reduction features seem complete enough, in truth, but on the treatment of tax exempt bonds no two press accounts are in full agreement. A "minimum income tax" provision would by all accounts include interest on state and local government bonds, as would an "income allocation" procedure (similar to that applicable to life insurance companies upheld in the so-called Atlas case), but it is not clear that the "preference" feature often discussed is included. At least one account describes as part of the bill a Federal banking intermediary to subsidize fully taxable state and local bonds. But whatever the exact provisions of the Committee bill, their intended effect will be to impair, and ultimately eliminate, the tax exemption of municipal bonds.

Opposition to the proposals has not been lacking, but it has not always been in the most pertinent terms. Taxation of municipal bond interest would increase state-local borrowing costs, but that is by no means the whole story. It would be a breach of faith with holders of outstanding bonds, it would impair a (normally) thriving industry, it would dislocate the habits of investors, and so on—all perhaps relevant, but not necessarily overriding. Most of the disadvantages generally cited, in fact, are private, whereas the benefits claimed by the sponsors of the legislation are public—gains in tax equity. On the contrary, one must be bound to argue from the facts that the disadvantages are public, and will extend to every citizen and taxpayer of the nation. It is these public disadvantages that are the subject of this paper.

The essential argument against impairment of the existing exemption from Federal income taxes of the interest on state and local government obligations is that such impairment would wreak havoc with the capital improvement programs of the state and local governments. In the process it may be expected to produce dislocations, perhaps chaotic, in the entire capital markets, and ultimately it may be expected to alter fundamentally the preexisting balances in our Federal system. Since such pernicious results were hardly anticipated by sponsors of "reforms" intended to correct inequities respecting a few wealthy taxpayers, explanation is obviously in order:

1. Impairment or elimination of tax exemption of municipal bonds would wreak havoc with the capital improvement programs of state and local governments.

Successful execution of capital facilities construction programs requires advance planning, careful scheduling of work, and a flow of funds adequate to meet cash requirements as construction progresses. The task is quite demanding even for small projects, and for the projects of large state and local governments, extending over many years or even over decades, it is intricate and complex. Order and continuity are essential, and abrupt changes or interruptions can be quite costly in increased expenditures or deferral of benefits or both.

Foresight and competence at the state and local level can minimize the risks associated with threats to order and continuity that are controllable at the state and local level. Changes and interruptions that are not so controllable are another matter, and have not been lacking. The Great Depression of the 1930s was such an interruption, as was World War II. The combined impact of these two events, which were beyond state-local control, are at the root of some of the problems with which state and local units are coping today. Since early 1966, inflation and a strained money market have been equally upsetting to the execution of state-local capital programs. Further, individual programs initiated at the Federal level have dislocated state-local programs or created or exacerbated state-local problems. Thus, federally-guaranteed mortgages facilitated the flight of city-dwellers to the suburbs, not only creating a demand for additional public facilities in the suburbs but also destabilizing older central-city neighborhoods. The interstate (i.e., national) highway system took vast land areas through and around the central cities and their suburbs, often drastically altering land-use patterns and necessitating costly construction and reconstruction of public facilities to adjust to the new patterns. Federal-aid programs offering debt-service reimbursement rather than capital-cost contributions have required state-local borrowing not originally contemplated, with replanning, reprogramming, and delays. In some instances, Federal programs have been changed in mid-stream, with additional state-local work, cost, and deferral of benefits. These are cited not to pass judgment on the merits of the programs involved, but to exemplify the dislocations resulting from factors not controllable at the state-local level.

Presently, financial continuity at the state-local level is facilitated by the fact that the state and local governments have as full control as is practical through possession of the initiative in the issuance of their bonds, which are used to finance a high proportion of the improvements. Such outside control as is exerted stems from the operation of the market in which they sell their bonds, and they are no more vulnerable than other borrowers to the factors which affect that market. Moreover, it is a competitive market.

Competitively, in the money market, state and local governments occupy a unique position, in that their obligations are exempt from Federal income taxes, and generally from state and local taxes in the state of issuance at least. Because of tax exemption, the state and local units do not compete directly for funds with the U.S. Treasury, Federal agencies, corporate bonds, savings banks, mortgages, and so on. This lack of competition is fortunate, for municipal bonds are in truth exotic fare. The merchandise is completely unstandardized. Not only are no two communities identical, but the laws of the respective states differ, and within individual states differing provisions for government, powers, taxation, are made for the several types of local subdivisions and often for distinct classes of like types—cities, counties, and so on. Moreover, continuity of management appears uncertain, the governing body (board of directors, so to speak) being elective.

If the real attraction of municipals to investors is their tax exemption—and technical studies so suggest—it follows that impairment of that exemption will adversely affect the ability of the state and local governments to borrow.[1] It cannot be doubted that the smaller borrowers would with few exceptions be unable to sell taxable obligations, and that only the very largest, best managed, and financially and economically strongest units would, in competition with taxable securities, find a sustained and stable market comparable to that now existing for their tax exempt bonds. The number of state-local obligors who might be expected to be able to compete with the debt securities of the larger corporations and the public utilities is absurdly small—probably less than 500 and certainly no more than 1,000.[2]

This is of course not intended to suggest that inability to sell their bonds directly in the market place would make it impossible for state and local governments to borrow. The Congress appears to have spent some years in the development of alternative means of financing, prior to the introduction of specific suggestions to modify or eliminate the tax exemption. The alternative proposals typically provide (1) that a Federal agency or Federal agency-created corporation will issue its taxable bonds to raise money to loan to state and local borrowers at rates approximating rates on tax exempt bonds, the Federal government absorbing the difference, or (2) that the state and local borrowers issue fully taxable bonds in return for an interest subsidy estimated to represent the difference between the cost of taxable and tax exempt loans. There are numerous variants; the so-called urban development bank is an example of the first type of arrangement, the so-called Patman-Proxmire guarantee corporation the latter.

Much is made by the Congressional sponsors of these various alternatives of the assertion that their use by state-local borrowers would be voluntary. But, to just the extent that impairment or elimination of tax exemption makes it difficult or impossible for state-local borrowers to sell taxable obligations in the market place, the alternative becomes compulsory, not voluntary. The alternative to using the Federally-sponsored financing device would be to forego capital construction.

Bills introduced to implement the proposals establish various eligibility criteria for the making of the loans or extension of the guarantee and reimbursement. Under the Patman-Proxmire proposal, projects must be "needed", bonds shall contain "satisfactory amorization provisions," the public facility to be financed must be "economically sound," and the borrowers' debt payment record over the preceding 25 years must be taken into consideration, among other things. The Urban Development Bank bill requires that loans be "in accordance with sound and prudent banking principles," for public works and community facilities "serving public needs," "not inconsistent with comprehensive planning for the development of the community" or "disruptive of Federal programs which authorize Federal assistance for the development of like or similar . . . projects." It is, moreover, inconceivable that *any* Federal assistance program can or should be drawn that does not impose eligibility criteria and define the what, when, where, and how of the activity.

This brings us inevitably to the nub of the matter: control is at the center of *any* system of subventions. He who pays the piper calls the tune. With the

[1] Cf. Personal Trusts as Sources of Funds, Chapter 28 in *State and Local Public Facility Needs and Financing*. Subcommittee on Economic Progress of the Joint Economic Committee, December 1966, Volume 2, p. 434.

[2] About 500 is the estimated number of state-local borrowers each having at least $50,000,000 of bonds outstanding, about 1,000 those with at least $25 000.000. Not many more than 200 of these have a supply of debt securities exceeding $100,000,000.

market for tax exempt bonds badly impaired (probably, for the great mass of small and medium-sized communities, destroyed) some state and most local governments will be in the position of having to turn to the only banker available, the Federal government, and they will have to meet its terms to borrow at all. A Federal agency, not the state or local governing body and the market place, will determine what constitutes a public need, what is acceptable planning, whether the master plan is "economically sound", what building standards should be, when the project should be built, etc., etc.

This prospect will please some who believe that increased centralization and standardization are desirable, but it is sending waves of apprehension through state and local administrators, planners, and finance officers, who are aware of the diversity of needs and programs involved, the intricate planning years ahead of time that is required, and the myriad of ways in which third parties can intrude to defeat the best laid plans.[3] They are aware that every major new Federal-aid program involves readjustments that result in costly interruptions to projects already under way and delays and often added expenses for projects in the planning stage. Heretofore, these delays and added costs have been isolated, applicable to one individual program at a time. The vast readjustment in borrowing practices and the changes resulting from the degradation of control by state-local governments and the market place and substitution of control by the Federal government, will apply to *all* programs. It will not only affect projects under construction and those scheduled for initiation in the current budget year or next year; it will also affect projects approaching the drawing-board stage, those only in preliminary form, and those blocked out on the agendas for study in future decades. Moreover, not the market but the Congress will determine just how much in total is to be loaned each year, and state and local construction will fluctuate with the Federal budget.

The dual nature of the proposals involved is particularly to be noted: on the one hand, impair or eliminate the tax immunity of the debt obligations of the state and local governments, and on the other, make continued financing feasible by extending Federal loans on terms prescribed by the Congress. State and local governments were delivered a similar one-two punch a generation ago. In the 1930s, "tax reformers" concerned with shifting support of local government from income-producing property to the great mass of the population devised the strategy of rigorously limiting real estate taxes by state constitutional amendment and, after the limits wrecked local budgets, stepping forward with general sales taxes as the needed "replacement" revenue.[4] Today, these tax limitations are properly decried as a major contributor to serious local problems, and they have certainly proved in the long run to be a costly "reform". There is no reason to believe that the present tax reform proposals will be less serious in their impact on state-local government capital facilities programs.

2. Disruption of the capital markets

State and local government loans are an important component of the capital market structure. In many recent years the net demand for state-local long-term funds has exceeded the change in publicly-held Federal and Federal-agency securities, and municipal bonds sometimes dwarf bonds in net demand on capital funds.[5] Evidently, significant alternations respecting so sizeable a component may be expected to have significant effects on the whole market.

Under present arrangements, the importance of state-local bond financing is obscured by the fact that the tax exemption feature of these loans isolates them

[3] Capital improvement programs are like icebergs—only the top shows. The most prevalent capital budget format presents appropriations for one year and planned outlays for the ensuing five years, with some documents including an estimate of cost to completion for any projects running beyond the six-year term. Studies, however, are based on a "foreseeable future" time span, with progressive refinement and added detail as needs become more specific and the timetable becomes determinable. Most individual bond authorizations cover construction periods of two to five years, and many contemplate construction, and piecemeal bond issuance, over a decade or longer.

[4] Cf. "Bitter Fight Promised Over Tax Rate Laws," in Taxation and Government, *National Municipal Review*, Vol. XXIII, No. 12, December, 1934, pp. 700–702, for an account of the strategies employed in the sales tax-tax rate limit campaigns, with consequences which the last 35 years experience have demonstrated to have been accurately foreseen.

[5] Over the ten years 1959–68, the median annual change in outstanding municipal bonds was roundly $6.5 billion, in corporate bonds $5.8 billion, and in publicly held Federal and Federal-Agency securities, $5 billion. The net demand on the capital markets for municipal bonds exceeded that for publicly-held Federal and Federal-Agency securities in six of the ten years.

from the remainder of taxable securities. Municipal bonds do not compete with Governments, or corporates, or utilities, or mortgages, and other taxable investments. They of course experience the handicap of a segmented market restricted in the main to taxable savings, but in return they receive preference among the owners of such savings.

At this point, it is desirable to comment on what are often termed inequities in taxation between the owners of taxable securities and the owners of tax exempt securities. Actually, the variations are more meaningfully described as disparities resulting from a system of graduated tax rates. The effective interest rates received by holders of state and local obligations *discount the tax exemption*, while the effective interest rates received by investors in taxable securities *capitalizes the tax*. That is, the municipal bond holder accepts less interest than he would otherwise demand, because his interest will not be subject to tax, while the corporate or government bond holder demands more interest to compensate him for the tax he will pay. The discounting and capitalizing process is of course approximate and imperfect, and imputes an identical value of the tax to all holders. In fact, however, holders taxed at an effective rate lower than that implied by the market's determination as to the value (or cost) of the tax will derive a benefit (or suffer a penalty) opposite to that experienced by holders in a tax bracket higher than that implied by the market determination. In other words, inequities between holders in different tax brackets extend to taxable as well as to tax exempt securities.

Another factor to be noted is that impairment of tax exemption has the same implications for market changes as has the complete elimination of tax exemption. A taxable security that is a little bit taxable is like the young bride who was a little bit pregnant—the ultimate outcome is not in doubt. Any invitation to doubt should be dispelled by the experience of the legal reserve life insurance companies under the Life Insurance Tax Act of 1959; after the courts affirmed the validity of income allocation with respect to interest on municipal bonds, their municipal bond holdings fell from more than 6% of their investments to less than 1%.[6]

Two types of market changes can be anticipated to occur if the taxation of state and local debt securities is impaired. In the long run (but perhaps in a relatively short span of time) the added volume of taxable securities will bring about a new equilibrium in the sources and allocations of savings and in the interest rate structure. That is, a new "model" of the capital markets will be created. It is beyond the scope of this memorandum to explore the possibilities, but several probabilities appear: one is that interest rates on taxable securities generally may be expected to come to rest at a level somewhat higher than they would otherwise occupy, another is that if state-local borrowing is financed with Federal or Federal-agency taxable securities, interest rates on Federal securities will rise relatively more than will interest rates on other securities.[7]

In the short run, the changes are likely to be dramatic, even chaotic. As investors begin to believe that bonds offered as tax exempt *may* become taxable, they will hesitate to buy more bonds, and some will attempt to start selling off their holdings; prices will drop, and interest rates rise. This has already happened. Then, as investors in numbers begin to believe that bonds offered as tax exempt *will* become taxable, they will either stop buying altogther or will buy only if the interest rate is comparable to that obtainable on other taxable securities. At this point, state and local borrowing will halt and remain moribund until the

[6] This occurred despite the fact that a tax exempt bond has *some* advantage in yield over a taxable bond for *any* life insurance company, although the relative advantages depend on a number of variables. It appears that the life companies tend to concentrate their investment management resources on those investment outlets which as a class promise to be most productive, and to ignore the least productive. It seems likely that other institutional investors follow a like policy. The behavior of individual investors is less clear, but the absence of tax exempt municipal bond interest as a factor in the tax avoidance of 154 individuals on whom data has been summarised by the U.S. Treasury suggests that wealthy individuals already concentrate on other investment outlets more remunerative than debt securities.

[7] Municipal bonds are almost entirely serial (i.e., mature in annual principal installments) and have an average term of not much over ten years. The Federal debt is highly concentrated in the shorter maturities. Corporates, on the other hand, are typically "term" bonds, due in 20 to 30 years. With municipals tax exempt, they offer no competition with short Governments; taxable the situation may be expected to differ, particularly if the expected response to tax immunity impairment materialised—Federal taxable bonds are used to make the loans to the state and local units, increasing the supply of Federal short term paper.

situation is clarified.[8] Even if the proposals presently before the Congress come to nothing, confidence will have been eroded and it is not likely to be restored quickly.[9]

In considering interest rate levels, it would be pertinent to distinguish between the increases since 1966 resulting from strong inflationary pressures and the extraordinary monetary restraints imposed as counter-inflationary measures, and that portion of the increases which may or will be attributable to expectations (or the realities) respecting tax exemption of municipal bond interest. Unfortunately, the two influences are not likely to prove separable; not later than July 1968 a considerable number of state and local officials and persons in the municipal bond industry became apprehensive that tax exemption might come under concerted attack, and since early 1969 these apprehensions have spread and become increasingly prevalent. Thus, historic high rate levels resulting from inflationary and counter-inflationary pressures coincide with the undermining of confidence respecting the future status of state and local loans. Nor can it be said categorically that corporate and Government rates also have not been affected already by the municipal bond situation.

3. Alteration of the Federal system.

The proposals to impair or even eliminate the immunity of interest on state and local securities to the Federal income tax are made in the name of tax reform. The tax exemption enjoyed by municipal bonds is stated to be a "loophole" in the tax laws. In realty, the exemption is a necessary and proper consequence of an intergovernmental immunity basic to the functioning of our Federal system of government. To characterize it as a "loophole" is as absurd as it would be to characterize as a "loophole" in the criminal law the immunity of the President of the United States from arrest.

It is not necessary here to argue the legal basis of the doctrine of intergovernmental immunity. It need only be observed that the doctrine is necessary for the functioning of our Federal system as it has evolved, and if and to the extent necessary must be inferred, just as the doctrine of implied powers must be inferred; the one is as necessary to the effective functioning within the Federal system of state-local government as is the other to the functioning of the Federal government.[10] Alter either, and the Federal system as it now stands will be fundamentally altered.

Of course, it might be argued that the system has already been altered out of all recognition by the Founding Fathers, or even by the grandfathers of those presently living. Certainly, state-local borrowing is already encumbered with sizeable loans for essentially *Federal* programs, and it seems likely to become increasingly so. In fact, there appears to be growing emphasis at the Federal level for eliminating direct grants for aided programs and substituting "debt service reimbursement", a device clearly contrived to reduce Federal appropriations for the programs, or eliminate Federal borrowing by shifting it to the State and local units, or both. These developments, however, are not justification for the proposals now pending, nor does their existence prove their wisdom. Further, there appears to be a clear distinction between present arrangements, in which the *majority* of capital improvement programs remain within the initiative and control of the states and their local subdivisions, and the control of *all* programs at the Federal level as is likely under the pending proposals.

It might also be argued that it is absurd to postulate fundamental changes in intergovernmental relationships in powers and function from sc isolated an act as making taxable the interest, or part of the interest, on municipal bonds. But we have already seen that the impairment of tax exemption will hinder all state-local governmental units in borrowing directly, and may be expected to

[8] Some of the municipal units, anticipating the hiatus, have already accelerated their borrowing programs to sell (at abnormally high rates) bonds sufficient to keep construction progressing in the event the market grinds to a halt.

[9] Faith is a fickle thing. Retroactive taxation is regarded by investors as probably illegal, certainly a breach of faith. At the same time, they find it difficult to discover how retroactivity is to be avoided in minimum income tax, tax preference, and income allocation schemes. As to the constitutional question, *caveat emptor* is an adequate legal defense, but not likely to inspire the confidence of the investor who ignorantly assumed his exemption was constitutionally based.

[10] The doctrine of reserve powers, however, is explicitly constitutional It is deemed by some jurists to *contain* the doctrine of intergovernmental immunity.

deny some of them access to the market; that this will necessitate the creation of a Federal banking intermediary to raise the funds needed for state and local improvements and lend those funds to the state and local governments; and that the Federal government in the process will inevitably and necessarily exercise controls over the use of the funds it lends. This will shift the decisions as to what should be constructed, and when, and how, from the state-local level to the Federal level. It will also shift to the Federal level the decisions as to how much should be borrowed.

That such far-reaching consequences should inhere in proposals for a minor tax reform may appear remarkable. More remarkable is that the proposals have been heretofore threshed out before the Congress, so that their pernicious nature is not unknown. And yet more remarkable is that measures whose consequence will be to place under Federal control even the most insignificant of physical improvements, should be advanced at a time when all the evidence at our disposal suggests that community participation in the decisions affecting matters of community importance should be increased, not decreased; that highly standardized programs should be made more flexibly responsive to meet diverse needs, and that decentralization, not increased centralization, is desirable.

The proposals, both for the impairment of tax exemption and for the "voluntary" substitution of taxable bonds under Federal loan arrangements, should be defeated, and defeated so decisively that they will not again appear before the Congress. The damage they are capable of inflicting is massive, the improvements from the desired "reforms" paltry by comparison.

WADE S. SMITH.

EXHIBIT B

RAUSCHER PIERCE & CO., INC.,
Houston, Tex., August 27, 1969.

DR. H. S. BRANNEN,
Superintendent of Business, and Business Manager,
Houston Independent School District,
3830 Richmond Avenue,
Houston, Tex.

DEAR DOCTOR BRANNEN: In reference to your letter of August 22 requesting various corporate bond rates, we have made a few assumptions, namely the comparative corporate rate is the Moody's weekly average of corporate bonds with a Moody's rating of "A". Of course, this is a similar rating that Moody's has given the Houston Independent School District.

Date of bonds	Amount	Effective rate (percent)	Corporate equivalent (percent)
Feb. 10, 1969	$12,000,000	4.78553	6.97
May 1, 1968	14,000,000	4.54089	6.62
Sept. 10, 1967	39,800,000	4.3687	6.06
Feb. 10, 1967	20,000,000	3.3763025	5.38
Mar. 10, 1965	6,500,000	3.21139	4.56
Aug. 10, 1964	10,000,000	3.251	4.57
Oct. 10, 1963	10,000,000	3.2162	4.52
July 10, 1962	12,500,000	3.1912	4.65
Feb. 10, 1961	14,000,000	3.3015	4.63
Dec. 10, 1959	18,000,000	3.9162	4.45
Apr. 10, 1958	15,000,000	3.30379	4.01
Apr. 10, 1957	15,000,000	3.4989	3.95
Do	1,750,000	3.5032	3.95
Apr. 10, 1955	15,000,000	2.5952	3.19
Mar. 10, 1954	10,000,000	2.3424	3.16
Apr. 10, 1953	10,000,000	2.99	3.44

Please let us know if you need additional information.

Sincerely yours,

EUGENE B. SHEPHERD,
Vice President.

BELLEVUE PUBLIC SCHOOLS,
Bellevue, Nebr. September 15, 1969.

HON. SENATOR RUSSELL B. LONG,
Chairman, Senate Finance Committee,
New Senate Office Building,
Washington, D.C.

MR. CHAIRMAN: The Bellevue School District of Bellevue, Nebraska wishes to file testimony in opposition to section 301 of H.R. 13270.

We oppose this section of the bill for the following reasons: (1) We believe that those individuals who are buying municipal bonds are already indirectly taxed by accepting a lower return on their money. (2) We are of the opinion that if this section of the bill becomes law the inevitable litigation to follow will make the municipal bond market an uncertainty for many years. (3) Any attempt to eliminate or curtail the issuance of tax-free municipal bonds can only weaken local self-government and place greater power in the federal bureaucracy in Washington. The citizens of our community are qualified to determine the needs of our school and the ability of this community to meet those needs.

As a federally impacted school district we have experienced a government program for building. The conclusion we have reached based on this experience is that the time lapse in appropriation does not allow this district to meet its immediate needs.

Our district is attempting to sell bonds at the present time. We have been unable to sell the bonds because of this proposal under consideration by the Congress. Because of rapid growth our district must sell bonds to meet the need for additional facilities. We urge this Committee to reject the proposal to tax municipal bonds.

Sincerely,

RICHARD L. TRIPLETT,
Superintendent.

METROPOLITAN GOVERNMENT OF NASHVILLE
AND DAVIDSON COUNTY,
Nashville, Tenn., September 18, 1969.

FINANCE COMMITTEE OF THE UNITED STATES SENATE,
2227 New Senate Office Building,
Washington, D.C.

GENTLEMEN: There will be few times in the history of our country when a legislative effort on the part of our national government will be as adverse to local and state government as certain provisions of H.R. 13270 the measure now before your committee for consideration. It is not so much the exact extent to which this bill removes the tax-exempt status of state and municipal bonds as it is the irreparable harm that would be done to our traditional governmental system and balance. The inference of bad faith that would be established by such action could literally wreck all the current programs which aim at the promotion of intergovernmental relations. Efforts thereafter to establish strong local and state government credit ratings would be an exercise in futility, and further control of the Federal Government over local and state affairs would be assured.

Everyone knowledgeable about public finance knows that to remove the tax exempt status of our bonds means one of two things. We will either have to abandon our capital outlay programs, which are dependent upon our ability to market our obligations at reasonable debt service costs, or be put in a position of subservience in this area of our operations. Surely, for the sake of the democratic process, you will not want to see the Federal bureaucracy take over control of our local functions to this extent.

Let's look at the present system. What is so wrong with us having our tax exempt bonds? It affords a better approach to financial relief for us than anything suggested in the way of a Federal program in fifty years of ever-increasing growth of power by the central government. Our bond purchasers by our obligations and in so doing they forego an opportunity to get a higher interest rate in the taxable market. We know they have an incentive for doing this and that's fine with us, because we are getting a better concession in the transaction than the buyer. It saves us from thirty-five to forty percent on our debt service costs annually. Keep in mind, all this advantage coming our way without any element of the Federal Government having to be involved to any degree. It would be a major mistake to have the municipal bond market abolished.

Submitted herewith and attached hereto are several statements from state and local government officials relative to their views on H.R. 13270 as it pertains to tax-exempt bonds. Please include these in my testimony.

Yours truly,

JOE E. TORRENCE,
Director of Finance.

STATEMENT OF LINWOOD E. TOOMBS, CHAIRMAN OF THE BOARD OF SUPERVISORS, HENRICO COUNTY, VA.

Mr. Chairman and honorable members of the Senate Finance Committee, I am Linwood E. Toombs, Chairman of the Board of Supervisors of the County of Henrico, Virginia. I am here to present our views relating to certain provision in House Bill No. 13270.

Henrico County is an urban county adjacent to the City of Richmond and has a population of approximately one hundred and sixty five thousand citizens. Our County maintains its own system of schools, highways, utilities, recreation, welfare and the countless other services required to meet the needs of an expanding population.

Our current debt, represented by long-term bonds, is $43,020,500. In addition we have an additional $15 million authorized, but as yet unissued, to provide required new schools and classrooms, and $5 million to complete the firm financing of water and sewer programs now almost completed. The $20 million represents a current need and does not include the many unscheduled future capital improvements, such as highways, parks and library facilities and office space to adequately serve our citizens. For many months we have delayed issuing our authorized bonds in the hope that the interest rates on municipal bonds would decline as a result of measures taken by the Federal Government to combat the inflationary trend which has so adversely affected the cost of borrowing.

During this period a further deterrent to the improvement of our borrowing costs has risen as a result of proposals in the House of Representatives Bill No. 13270 which is now before this Committee for study and recommendation. This Bill, a "Tax Reform Bill", contains provisions which would both directly and indirectly tax the interest earned on obligations of State and local Governments. As a result, rather than seeing bond interest rates decline, we have seen higher and higher rates—to such an extent, that under our legal interest ceiling of six percent—it may now not ever be possible to sell our securities on todays' market.

Gentlemen, we, like until hundreds of other local governments, are in a very real dilemma. How do we raise the funds required to provide educational facilities—facilities which are needed in the immediate future? How do we secure permanent financing for utility improvements which have, or are now being installed through temporary financing arrangements? These are questions for which we do not now have answers but which must soon be solved.

The Minimum Income Provision or, Limit on Tax Preferences, included in H.R. Bill No. 13270, would result in a direct tax on interest earned on State and local obligations whenever the aggregate of certain preferred income excluded a specified tax formula. This, Gentlemen, is a complete change in the traditional treatment of such income, and is to say the least, on questionable legal grounds. In this respect, we are advised that the Attorney General has expressed doubt as to its legality. The Court tests which would be inevitable if this becomes law would place a cloud over the municipal bond market, with a further increase in the already burdensome interest rates.

In addition, because of the retroactive feature by which the interest on approximately 120 billion in outstanding municipal and State bonds would become taxable to some extent, the holders of these obligations would suddenly find the value of their holdings materially decreased. Since these bonds were purchased at a price to yield a specified return on a non-taxable basis, the purchasers of these bonds were willing to accept a lesser yield. Now, however, the holder will find that the return has decreased, and may decide that further retention of the investment would be unprofitable.

In such event, we could very well see the market flooded with existing issues which would provide competition to the new issues which must be marketed to provide the capital to construct new State and local public institutions, schools, utilities, highways and the magnitude of other public improvements required by our expanding populations. No one can possibly foresee the harm and confusion which will result if this Bill is passed with its provisions to tax the income of State and local bonds. As I indicated earlier, there is in our minds serious doubt concerning the Constitutional authority for this proposed legislation. The fact that, this time, the law would apply only to individuals is of small comfort. For if the Congress has the right to impose this tax at all—then the next move would lead to the taxing of commercial banks and the other financial institutions holding the bulk of State and local tax exempt obligations. Herein lies the real danger—and here is where the harm has already been done as now reflected in bids on our obligations.

Henrico County is not a depressed economic area. Rather, we have a healthy economy, little unemployment, and a "double A" credit rating by Moody's Investors Service. Our bonds have been eagerly sought by purchasers who have generally recognized our stability by competitively pricing our obligations at interest rates below normal market conditions. But not today! Today, with the very real threat of direct and indirect Federal taxation of the interest on bonds such as ours, the bond purchaser is now unwilling to accept the normally lower interest return historically accorded State and local bonds inasmuch as he may now also be required to pay Federal tax on this income. Consequently, he can no longer afford to accept a lower yield municipal obligation and is now offering to buy only at much higher interest rates. As we understand House Bill No. 13270, Title III includes provisions which would impose a direct tax on interest earnings from State and local obligations through a "Minimum Income Provisions" known as the "Limit on Tax Preferences", and provisions to indirectly tax these earnings through the "Allocation of Deduction Provision."

It is not our intention to go into the details of these provisions. However, it is clear that the net result of these would be to impose a Federal tax on the obligations of both State and local obligations.

We are told that this is a "Tax Reform Bill", that loopholes of many kinds have been closed. We are first to commend the Congress for this action and we quarrel not with the intent of this Bill. We oppose only one thing—the proposal—the very right of the Federal Government to impose taxes—either directly or indirectly on the income of our State and local obligations.

Gentlemen, why have the purchasers of our obligations been willing to buy our securities at low interest yields? The answer is obvious—they are tax free! Because of this they will accept a lower return. Who has benefited? Again the answer is obvious—the average taxpayer and property owner in our communities. They have benefited in the lower property taxes required to pay the interest on these obligations.

Now, if our obligations became taxable, with the inevitable higher interest rates which State and local governments will be required to pay—who will be the ultimate loser? Not the future bond purchaser—he will price his bid to reflect the taxable feature. No, it will be the average taxpayer and property owner who will suffer through the increased local tax levies required to pay the higher interest rate. The burden has merely shifted to the already over-taxed average citizen. In view of this inescapable conclusion, we request that you strike from this bill all measures in Title III which would in any way, directly or indirectly, place a Federal tax on the interest of State and local obligations.

Title VI of the Bill contains a provision whereby the Secretary of the Treasury is given authority to pay a subsidy to those State and local governments who elect to give up their tax exemption status and issue fully taxable bonds. This subsidy in the beginning would be from 30 to 40 percent of the interest charges, but in five years, would be reduced to as low as 25 percent.

We are told that the normal relationship of municipal bonds to corporate bonds, on the average, runs from 30 to 45 percent lower for municipals. If this be true, in a very short time the subsidy would be below the lowest ratio. In addition, in our own case in the County of Henrico, one favorable credit and the respect for our bonds in the market, has in most instances, resulted in rates below the averages for similar bonds. Consequently, even if an equitable formula can be devised to compensate local government for higher interest costs on taxable bonds, we doubt that we would receive a payment equal to the advantage previously enjoyed.

I would like, with minor changes and additions, to echo the recent comments made by the Executive Director of the Municipal Finance Officers Association.

1. We are not here to defend the special interests of wealthy individuals; instead, we are here to defend interests of the average citizen and taxpayer from the increased local taxes required to meet the higher interest costs on State and local obligations which will result from taxing the interest earnings on such obligations.

2. We are not seeking to preserve a benefit conferred by Congress; rather we are here to seek a continuance of benefits stemming from the Constitution of the United States by preserving the right of State and local governments to issue tax-free obligations.

3. We are not attempting to oppose provisions of this Bill whereby individuals would be subject to a minimum tax, nor a system of allocating deductions; but we are here to oppose the inclusion of interest on State and local obligations from being included in any of these Sections.

4. We are not here to impede "tax equity"; on the other hand, we are here to *oppose tax inequity* which we firmly believe would result since the purchaser of such obligations has already made tax payment "in kind" through the acceptance of lower interest earnings.

5. We are not here to represent any special interests; we speak for Government—State and local—and the millions of average citizens who make up these governments—who will be adversely affected through the higher taxes each will be required to pay to State and local governments to meet the vastly increased interest costs which will result if this Bill is approved as now proposed.

6. We implore you to remove all provisions in this Bill which would, in any way, directly or indirectly, result in a Federal tax on the interest earned on State and local obligations, both existing obligations, or those which may be issued in the near future.

And finally, it seems to us that a proposal which would say to the many purchasers of our bonds, that even though they purchased a tax exempt obligation at a low interest yield in good faith, and even though these bonds bear legal opinions attesting to the fact that they were tax exempt under all existing legislation, now through retroactive Federal legislation these investments are now taxable, that somehow this cannot but undermine the public's very faith in the integrity of Government.

I thank you for this opportunity to present our views on this most vital issue.

City of Norfolk,
Norfolk, Nebr., October 1, 1969.

Mr. Chairman, Members of the Committee:

Availing ourselves of the opportunity extended by telegram dated September 2, 1969, the City of Norfolk would like to present the following testimony in opposition to those portions of H.R. 13270 that relate to any form of taxation of the income from municipal bonds.

Norfolk is a city of 16,000 persons located in northeast Nebraska. Our economy is basically agricultural.

Our City and School District has a bonded indebtedness of approximately $5,000,000.00 with an average interest rate of about 3 and ¾ per cent. The annual interest cost is $175,000.00 or a little more than $10.00 per person. Like all other governmental subdivisions, we are having difficulty meeting current operating costs without the added burden of doubling the cost of capital impovements. The Federal Government has on the one hand reqüired large expenditures for anti-pollution of streams, schools, sanitary sewer systems, etc., and has on the other hand taken away the means of the City to finance such improvements.

The confusion and chaos that has already occurred in the bond market has made many municipal and school projects impossible to start or complete.

The Statutes of the State of Nebraska in many instances require that the maximum interest rate on bonds be 6 per cent and it is presently not possible to secure buyers for bonds that carry an interest rate within the statutory maximum.

The proponents of H.R. 13270 talk of a Federal subsidy to put the cities back into their former position. This is untenable. There can be no subsidy program without a Federal agency to determine what projects qualify for the subsidy and which do not. Given this, the Federal agency has the power to determine What, Where, When and How Much. Local governments and their local taxpayers have provided for their own capital improvements and hope to be able to continue to do so—they require, however, that they be the ones to determine What, Where, When and How Much.

We feel, as do all of the other opponents of H.R. 13270, that the Act is unconstitutional and that any amendment proposing a waiver of immunity would likewise be unconstitutional.

Only by allowing municipal bonds to remain tax exempt can the integrity and independence of the municipality be maintained.

We respectfully urge not only that the Committee delete those portions of the Bill that relate to the taxability of income from Municipal Bonds but further urge that this Committee immediately go on record as being opposed to such provisions. We feel that such a response by the Committee will at least tend to stabilize the present chaotic condition of the bond market.

EDWARD I. VRZAL, *Mayor.*

STATEMENT OF THE JEFFERSON COUNTY BOARD OF EDUCATION, BY RICHARD VANHOOSE, SUPERINTENDENT, JEFFERSON COUNTY PUBLIC SCHOOLS, JEFFERSON COUNTY, KENTUCKY

Mr. Chairman and Members of the Senate Finance Committee: As superintendent of the Jefferson County Public Schools, Louisville, Kentucky, I am in a position to evaluate the need for tax-exempt municipal bonds. Our school district has grown from 47,000 to 89,000 students during the past ten years. Our building program has been financed almost entirely through school construction revenue bonds. Jefferson County bond sales during the past five years:

1965	$ 3,250,000
1966	10,570,000
1967	13,975,000
1968	12,815,000
1969	16,950,000

At the present time we have a total of $69,000,000 in bonds to be paid over the next twenty-five years. Even this accelerated construction program financed through bonds has left us with unmet needs for our student population.

Our last $3,150,000 bond issue sold in August for 6.6 percent. We feel that the interest rate reflected anxiety caused by the threat to the tax-exempt status of municipal bonds. We have another $1 million issue scheduled for sale later this month, and we are concerned by the severe deterioration of the bond market. The State of Kentucky has a 7 percent interest rate ceiling.

We have difficulty in marketing our bonds because of the large number issued in recent years. While school construction revenue bonds are acceptable in local areas, our sources of marketing have reached the limit which they may hold of Jefferson County School Revenue Bonds. This makes it necessary for us to go outside the State of Kentucky to sell our bonds. It is difficult enough to sell to "home folks." You can imagine our problem when we try to place these bonds elsewhere, especially without a tax exemption feature. There does not seem to be any broad public support for taxing municipal securities. The appeal is primarily an emotional one to tax a few of the millionaire income class.

One of the few current advantages enjoyed by local governments is the tax-exempt status of municipal bonds. Destruction of this financial resource would constitute a serious problem for schools and other institutions for which local and state governments are responsible. I respectfully ask the Finance Committee to give thoughtful consideration to preserving the present tax-exempt status of municipal bonds to allow local governments to seek minimum cost financing of long-term projects.

STATEMENT BY FRANK M. WHISTON, PRESIDENT, CHICAGO BOARD OF EDUCATION

Mr. Chairman and Members of the Senate Committee on Finance: I am Frank M. Whiston, President of the Chicago Board of Education. It is a pleasure to have this opportunity to present my views on certain sections of HR–13270, the Tax Reform Act of 1969.

The sections of HR–13270 with which I am primarily concerned are those which would affect the tax-exempt interest on certain governmental obligations. The Chicago Board of Education annually markets over $148,000,000 in tax anticipation warrants and we expect the Public Building Commission of Chicago to sell $140,000,000 in bonds over the next two or three years to finance construction of our school buildings. Hence our vital concern as to the marketability of these instruments and the interest rate that will be required.

It is my conviction that Section 301, dealing with the limit on tax preferences, and Section 302 on the allocation of deductions, would seriously impair the marketability of our tax warrants and bonds and require much higher interest rates. The added cost of borrowing would be a severe burden on the already strained finances of the Board of Education and of course would result eventually in higher taxes for property owners.

It is also my belief that these proposed changes will result in lengthy litigation. During the several years the matter would be in court the tax status of municipal obligations would be unknown and the market for our tax warrants and bonds would be totally disrupted. This would leave the Chicago Board of Education in financial chaos.

The provision in Section 601 for the issuance of taxable bonds and the interest subsidy provided in Section 602 are considered impractical and costly ways of overcoming the difficulties created by Section 301 and 302.

In conclusion I wish to indicate my complete opposition to Sections 301, 302, 601, and 602 of HR 13270 and request that they be eliminated from the Senate version of the Tax Reform Act of 1969.

Thank you for the opportunity to present this statement.

September 19, 1969.

TEXAS WATER CONSERVATION,
ASSOCIATION,
Austin, Tex., September 20, 1969.

STATEMENT OF JOSIAH WHEAT, PRESIDENT, TEXAS WATER CONSERVATION ASSOCIATION, AUSTIN, TEXAS

TO: SENATE COMMITTEE ON FINANCE IN OPPOSITION TO H.R. 13270

It is with the utmost urgency that the Texas Water Conservation Association pleads the catastrophic effects that certain sections of the Tax Reform Act of 1969 (H.R. 13270) has placed on the municipal bond market. The minimum income tax provisions and the income allocation procedures of the bill seek to circumvent the United States Constitution which exempts the interest on municipal bonds from all federal taxation. The United States House of Representatives has chosen to ignore the educated pleadings from all segments of local and state leadership to pass H.R. 13270 on August 7th. Since, deterioration of the tax-exempt bond market has been predictable. The evaporation of new monies into this market culminated when the City of Houston, our State's largest city, recently failed to attract bids for its bonds. The city resorted to a negotiated sale to provide funds so desperately required to eliminate the need for water rationing in the city. We urge the United States Senate to oppose any legislation that directly or indirectly places a federal tax on interest of municipal bonds.

STATEMENT OF THE CITY OF WATERBURY

Subject bill will have a hearing before the U.S. Senate Committee on Finance on or about September 23, 1969. The contents of the bill should frighten every local and state government in the country. It may very well be the final blow to all municipal solvency.

As Budget Director of this City for the past twenty-five years, I have watched the demands on the municipal government grow in intensity, scope and cost. Each requited demand had a natural resultant reflection in the local tax rate. There was no relief given to the City in broadened tax structures or grants. Each grant given by the higher levels of government carried strings attached that resulted in municipal operating costs.

At this moment, Waterbury is considering an investment of 50 million dollars in its school plant. It has a capital improvement program grossing 218 million dollars. Other municipalities are in the same situation proportionately. The City's share of such expenditures will be financed by bond issues. Our execution of the capital improvement plan is also certain to increase the City's operating costs.

To add to such costs by arbitrarily increasing the interest expense to the municipalities seems almost a wanton and hostile act against the municipalities.

The attack which the proposed bill levels is not, as described, against non-tax paying millionaires but rather a direct attack on the local taxpayers throughout the country. As a result of this legislation, the local taxpayer will receive a diminished quality and scope of service and a higher tax rate.

Many of the local taxpayers throughout the country are living on fixed and meagre incomes. Their distress is evident when one considers that in this community there are over 2,200 families who have proven their inability to cope with the local tax burden and by statute have been granted relief.

I charge that the contents of this bill are unconstitutional, inconsistent, immoral and unethical. If the bill is passed in its present form, then I foresee the demise of integrity and responsibility in our federal government.

UNCONSTITUTIONALITY

For years, it has been my contention that taxing the interest on municipal bonds constitutes the levying of an ad valorem tax on the property within the several communities of the country. Because it further becomes a tax on such several municipalities and the Federal government has no constitutional authority to do so. It now appears that the U.S. Attorney General admits that there are grave constitutional questions involved, making me feel more secure in my original approach to this matter.

If the proposed tax is levied, its constitutionality will undoubtedly be challenged in court. This action may consume several years before a final decision is reached. In this interval, the bidders on bonds will be offering a high interest rate reflecting the statutory taxable status of the bond income. The courts, I believe, will ultimately find the provisions of this bill unconstitutional. This means that the holders of the municipal bonds will have an unwarranted windfall income.

A decision on the constitutionality of the taxable status of interest on municipal bonds may very well have an effect on the taxable status of municipal salaries under the Public Salary Act of 1938. There may very well ensue income tax refunds to all municipal employees for a period of over thirty years.

INCONSISTENT

The holders of bonds issued by private corporations are taxed on the income derived therefrom. Offsetting this taxation is the ability of the issuing corporation to treat such item as a tax deduction. The interest on municipal issues is not in the same category.

IMMORALITY

The bill, I am informed, was sold to the House of Representatives as part of a tax reform measure. Supposedly, there exists 154 millionaires with an income in excess of $200,000.00 per year who pay no income taxes. I am advised that not one of these persons owned a municipal bond.

UNETHICAL

The bill proposes that bonds now outstanding will be included in the taxable status. These bonds were sold with the understanding that the income derived therefrom would be excludable from the gross income of the recipient. This is a firm legal contractual relationship. I challenge the constitutionality of any action by Congress which interferes or sets aside a contract. The persons who have purchased these securities accepted a reduced interest rate because the income from the investments was non-taxable. This is a proposed unethical act, not worthy of the American government.

Respectfully submitted,

THE CITY OF WATERBURY
(*S*) Arnold E. Furlong
(*City Auditor and Director of Budget*).

STATEMENT TO THE SENATE COMMITTEE ON FINANCE BY PAUL A. AMUNDSEN EXECUTIVE DIRECTOR, AMERICAN ASSOCIATION OF PORT AUTHORITIES ON H.R. 13270

Public marine terminals have never been attractive to private capital. With a few exceptions they have been developed by city or state governments or agencies thereof.

Local government has been able to provide such facilities at low investment rates because of the marketability of fully tax exempt general obligation or revenue bonds.

Historically, the total local public investment in marine terminals had reached $861,000,000 by 1941.

As attachments show, investment by city and state port agencies for 1946–65 has been $2,127,464,000. An additional $692,789,000 is being spent in the 1966–70 period, bringing all-time expenditures to almost $3.7 billion.

While minor portions of this total investment stem from direct appropriations by state and city governments, and from direct reinvestment of operating revenues, almost the entire dependency of the U.S. public port system is upon the fully tax exempt revenue bond or the general obligation bond for investment capital.

For this reason the member ports of The American Association of Port Authorities are opposed to any direct or indirect Federal taxation of interest on State and Municipal bonds. The effect of any such taxation on the bond market, already brought out by other witnesses, is, on the nation's seaport system, total and direct. Consider that system.

State port agencies apply in Maine, Massachusetts, New York and New Jersey (bi-state), Philadelphia, Pa.-Camden, N.J. (bi-state), Maryland, Virginia, North and South Carolina and Georgia as well as in Alabama. New York, Philadelphia, Norfolk, Savannah and others also have City agencies. Wilmington, Delaware is a city Port Commission. The Louisiana ports of New Orleans, Lake Charles and Baton Rouge are administered by agencies deriving their powers from the State. The Port Commissions of Mississippi are agencies of the State's Board of Agriculture and Industry. In Florida, a system of county port agencies applies (not unlike Navagation Districts). Well defined and more autonomous port authorities exist in Jacksonville and Tampa.

As the United States developed westward, from the Mississippi River, it is notable that port development began in local public hands and then remained so, there being very little private operation of commercial waterfront facilities in the West Gulf, and almost none in the states of California, Oregon, Washington. Texas ports are governed by Navigation Districts deriving their powers from the State. The port cities of California were given "commerce and navigation" responsibilities by the State and hence the California pattern has been one of City development primarily. San Diego has within the last several years changed from a City agency to a regional Port Authority. San Francisco, long the lone State agency, within recent months has become a City agency.

Oregon has City agencies generally and a State agency identified with the Columbia River and airport structure. Washington has a system much like that of Florida, involving districts and elected commissioners, emanating from State powers.

Turning to the Great Lakes, the City harbor departments there in many cases have been replaced by port authorities including Duluth, Toledo, Cleveland and Buffalo. In Chicago there is both a City port department and a Chicago Regional Port District under State auspices. Milwaukee remains a City department whereas Detroit is a port commission under County auspices.

Every one of the port agencies has developed in an atmosphere of local self-determination. As each port area evolved, protection of the public interest of that area, from the standpoint of waterborne commerce and harbor development has resulted in a port agency particularly tailored to that area's needs. As a result, no two of the agencies are alike as political structures. Nor are they alike as business entities.

Competing for a fair share of the nation's export-import tonnage is a large part of the job of protecting the local public interest, and this competition is very keen among ports in the cargo producing centers here and abroad.

Competing for industrial locations is likewise very keen, for this is "captive cargo" which is built into the port physical plant.

Seaport competition for cargo, given equal freight rates and frequency of sailings, really boils down to the provision of port facilities which offer efficiencies to the shipper and steamship line. This competition has resulted in the finest natonal port system on the globe.

It consists of 2,121 deepwater cargo terminals of all types (bulk as well as general cargo) of which 1254 were constructed since 1940. The average age of the total plant is 24.6 years, well under the typical amortization period of 35 years.

In general cargo terminals, where the competittion is very keen, 720 of the above terminals were built since 1946, their average age being 11 years.

Of these, 49 are container terminals built since 1965, average age 4 years. Another 24 container terminals are under construction and another 45 are in the planning stage.

Almost the total investment in this system has been by local public agencies through fully tax exempt bond issues.

The Federal investment in ports has been mainly in the form of deepwater channels, the U.S. Engineers being responsible for navigable waterways.

The all-time Federal investment in channels since 1824 totals almost $1.5 billion, including maintenance. Comparing this to the historic local public investment in marine terminals ($3.7 billion) means that port authorities have invested more than $2.00 for every Federal dollar.

Customs collections at marine terminals for fiscal 1969 totalled $3 billion (excluding air cargo). The Federal deep channel appropriation for fiscal 1970 will probably be $35.5 million.

Thus on ports alone, the Federal Government has a very advantageous arrangement here. A 10.000% annual cash flow return on its dollar of annual investment as the minor partner in the joint venture.

The technology of world shipping is undergoing rapid change. Thanks to the competitive public port system of the United States, the nation's world gateways are keeping pace and indeed assumed an early leadership position in urging new technology.

The Senate Finance Committee should very carefully consider that a major national asset, totally dependent upon local tax exempt issues for its progress, is being destructively dealt with by those provisions of H.R. 13270 which directly or indirectly hamper marketability through taxation.

Exhibit C

NORTH AMERICAN PORT DEVELOPMENT CUMULATIVE EXPENDITURES GENERAL CARGO FACILITIES (millions of dollars)

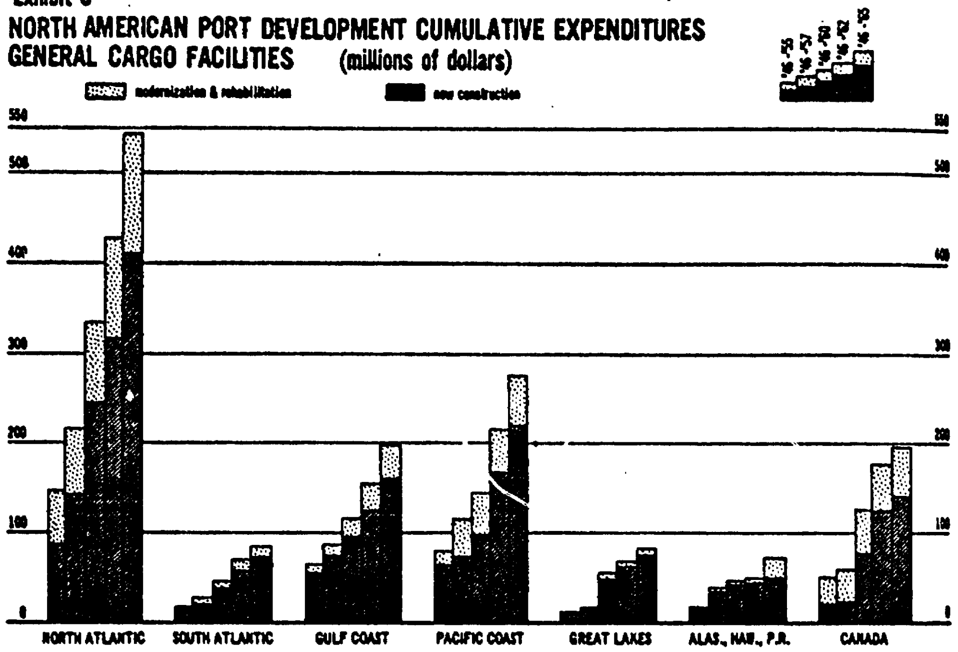


Exhibit D

NORTH AMERICAN PORT DEVELOPMENT CUMULATIVE EXPENDITURES SPECIALIZED CARGO FACILITIES (millions of dollars)

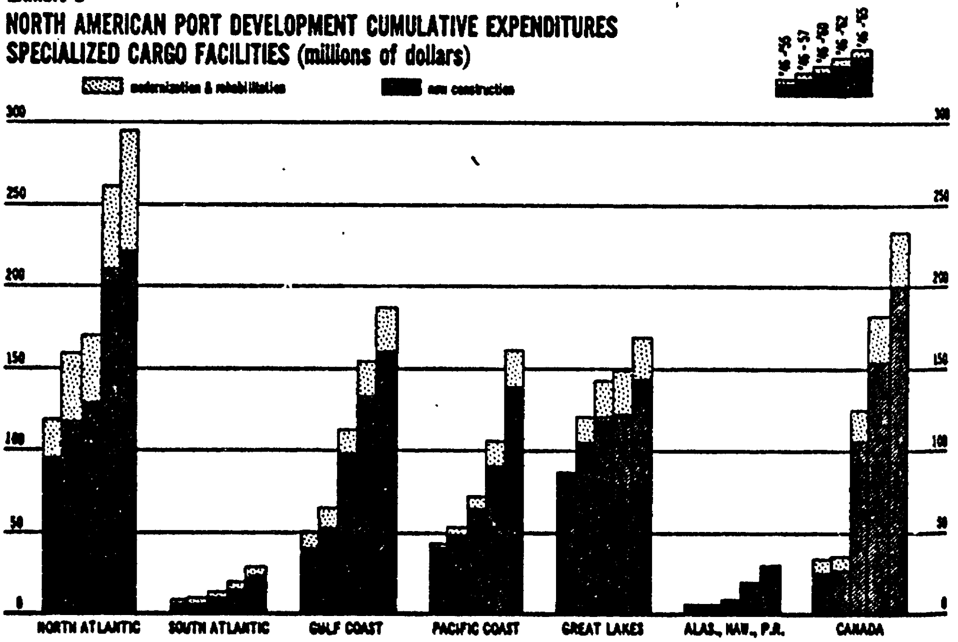


TABLE XI.—PORT DEVELOPMENT EXPENDITURES, JAN. 1, 1961, TO DEC. 31, 1965; JAN. 1, 1966, TO DEC. 31, 1970

[In thousands]

Area	1966-70			1961-65		
	New	M-R	Total	New	M-R	Total
North Atlantic:						
Authorized	$94,131	$27,466	$121,597			
Planned	74,000	2,278	76,278			
Total	168,131	29,744	197,875	$258,130	$76,332	$334,462
South Atlantic:						
Authorized	43,031	15,906	58,937			
Planned	25,450	675	26,125			
Total	68,481	16,581	85,062	47,867	5,384	53,251
Gulf Coast:						
Authorized	62,061	14,573	76,634			
Planned	24,321	1,439	25,760			
Total	86,382	16,012	102,394	126,453	30,647	157,100
Pacific Coast:						
Authorized	269,933	41,560	311,493			
Planned	58,833	5,013	63,846			
Total	328,766	46,573	375,339	194,947	25,389	220,336
Great Lakes:						
Authorized	10,000		10,000			
Planned	500	1,000	1,500			
Total	10,500	1,000	11,500	48,554	5,049	53,603
Alaska, Hawaii, Puerto Rico:						
Authorized	13,366	250	13,616			
Planned	17,163	3,130	20,293			
Total	30,529	3,380	33,909	26,099	20,800	46,899
Canada:						
Authorized	63,873	15,555	79,428			
Planned	43,160	9,512	52,672			
Total	107,033	25,067	132,100	155,950	21,711	177,661
Total:						
Authorized	556,395	115,310	671,705			
Planned	243,427	23,047	266,474			
Total	799,822	138,357	938,179	858,000	185,312	1,043,312

STATEMENT OF JACK S. BURK, PRESIDENT, BARNARD AND BURK, INC., CONSULTING ENGINEERS, BATON ROUGE, LA.

Our firm's consulting engineering practice includes a large volume of municipal and other public works. We represent a substantial number of municipalities, school boards, special service districts (waterworks, sewerage, drainage, road, etc.) and other political subdivisions and local units of government in the Southern and Southeastern States in connection with the above. Our clients are directly affected by the proposed tax legislation, which strikes at the heart of their method of raising money to construct essential governmentaı facilities to meet the needs of their constituents. Traditionally, these local entities have financed capital improvements through the issuance and sale of bonds or other debt obligations carrying an exemption under existing law from federal income taxation. Because the proposed legislation (insofar as it relates to the treatment of municipal bonds) will adversely affect and virtually cripple their financing power, they have requested that we vigorously oppose, on their behalf, such legislation.

We will address ourselves to the matter of specific objections to the proposed tax reform bill. We object to (1) the allocation of deductions and (2) the federal subsidy plan on the grounds that (a) they raise serious questions involving the immunity of states and their political subdivisions from taxation by the federal government which cannot be resolved except through lengthy and costly litigation, the effect of which will be to paralyze local finance until a final judicial determination of the issue; (b) they would prevent the orderly financing of public improvements in an established capital market in the private sector of the economy at a time when such improvements are needed to help overcome the tremendous socio-economic problems facing urban areas; and (c) they would result in a deterioration and destruction of the historic federal-state relationship in the field of public finance and centralize the control of local finance in the federal government at great cost to the citizens and taxpayers of the nation. The combined effect of the foregoing could be to fuel an economic recession of major proportions.

The successful imposition of the proposed taxes would require that the Supreme Court overrule certain long-standing constitutional law. This will make litigation inevitable and will doom the municipal bond market to several years of confusion and disorder, which will seriously delay the financing of and thereby the realization of important health and community services. In addition, but of secondary importance, it will cost the public taxpayers hundreds of millions of dollars in additional interest costs.

The inescapable fact is that even the *threat* of removal of the tax exempt feature from municipal bonds has resulted in a drastic increase in interest rates on such bonds in recent months, to the point where nearly two billion dollars of such bonds have not been sold. This results in the delay or postponement of a corresponding amount of construction of vitally needed public improvements. The taxation of interest on such bonds would permanently impair the ability of local governments to finance such construction, just at a time when the need for public facilities is at its peak. Then the so-called "taxpayer revolt" would become the "peoples' revolution" because the working man would be required to pay *higher* taxes to finance *fewer* improvements. Nor is the answer at this point a federal subsidy to "cover the difference" in the cost of issuing tax-free and taxable bonds. We already *have* a unique and time-tested subsidy program in the tax-free privilege accorded municipal bonds. This system has worked effectively for many years and should not be changed unless there is clear evidence of a better system, which is not provided for in the proposed legislation.

At a time when state-federal "revenue sharing" is being recognized as one solution to the many economic ills at the local level, a tax on bonds is proposed which would, in effect, shift revenue from the state to the federal level, resulting in a net loss to the states and local subdivisions. Inevitably this shift would bring federal control and weaken our entire system of federal-state relationships.

In conclusion, the retention of our entire state-federal government structure and the preservation of a sound economy demands that any attempts to levy a tax on interest or municipal bonds be defeated.

LAW OFFICES,
DODRILL & DODRILL,
Huntington, W. Va., September 23, 1969.

Hon. ROBERT BYRD,
U.S. Senate,
Washington, D.C.

DEAR SENATOR BYRD: Because of my interest in the financing capabilities of the Tri-State Airport Authority, I am writing you this personal letter concerning provisions of the Tax Reform Act of 1969, presently pending before the Senate.

In my opinion, an immediate and substantial rise in the cost of borrowing by state and local governments operating public airports would certainly result if the provisions of the Tax Reform Act of 1969, which would change the current tax exemption of state and local government bond interest, are enacted into law.

As passed by the House, this legislation provides for indirectly taxing the interest on tax-exempt municipal bonds through the minimum income tax and allocation of deductions mechanisms. Interest would be included in the base of a minimum income tax to apply to individuals. In addition, individuals receiving income from tax free bonds and financial institutions and other corporations having deposits and policyholder accounts would be required to allocate itemized deductions between taxable and tax free income.

The bill also contains an alternative capital financing mechanism to "encourage" states and local governments to relinquish "voluntarily" the right to issue tax-exempt bonds and, by issuing *taxable* bonds, to become eligible to receive a fixed percentage interest subsidy from the Federal Government.

This subsidy percentage would range between 30 and 40 percent from date of enactment of the Tax Reform Act of 1969, and January 1, 1975. Thereafter, it could range between 25 and 40 percent. Determination of interest yield on any issue of obligations would be made immediately after their issuance. The Secretary of the Treasury would administer the interest subsidy program and would establish the ground rules under which the municipalities could elect to utilize the program.

The attraction of municipal bonds on the open market would certainly be impaired by the provisions of the Tax Reform Act. If enacted into law, a breach of faith to holders of municipal bonds would occur (because the bill's language would apply to outstanding bonds) and potential investors would lose confidence in the security of new municipal bonds as an investment. It would also mean that new buyers would have to be found for $10 billion to $20 billion annually of new debt securities for the local public sector of the economy.

The impact of this legislation and the resulting increased interest rates on municipal bonds (estimated from one to two percent) would be borne in great measure by the local taxpayer. With present economic conditions increasing pressure on all forms of municipal financing, including the upward push on bond interest, the cost of capital financing for urgently needed public works would go beyond legal and economic limits.

Too little is known about the salability of a *taxable* municipal bond. Such a bond would have to compete with corporate debentures, utility bonds and Federal securities for available capital and would normally sell at the interest rate above those of other taxable securities and cost the public taxpayer hundreds of millions of dollars in additional interest cost.

The required reliance on the Federal Government for an interest subsidy would seriously impair the local resource allocation responsibility which is inherent in our system of government. In reality, the interest subsidy provision would provide the Secretary of the Treasury with a tool for minimizing any competition from taxable municipal securities at a time the Federal Government attempts to float its own debt securities. It would also enable the Secretary to minimize the cost of the program to the Federal Government.

The situation is compounded by the constitutional issue inherent in the provision for taxing municipal bonds. State and local officials have long maintained that the exemption of municipal securities is derived from the foundations of our Federal system of government. This exemption stems from the *McCulloch vs. Maryland* decision in 1819. There is no doubt that if this Tax Reform Act is enacted into law, as written, litigation will result and will doom the municipal bond market to several years of chaos. *With the market for tax-exempt bonds badly impaired, some state and most local governments will have to turn to the only banker available, the Federal Government, and they will have to meet its terms to borrow money.* A Federal agency, not the state or local government, will determine what constitutes a public need, what planning is "economically sound" and what and when projects may be built. As stated by Marshall, Chief Justice of the Supreme Court, in *McCulloch vs. Maryland*, "the power to tax is the power to destroy."

Your commitment to press for deletion of municipal bond interest from the minimum income tax and allocation of deductions provisions of the Tax Reform Act of 1969, during Senate deliberation is urgently requested. I am aware of your strong interest in constitutional law and the preservation of the integrity of state and local governments in our system of dual sovereignties. I sincerely urge you to contest this effort to use the Federal taxing power to subordinate local governmental prerogatives to the desires, opinions and plans of Federal agencies. Further, the interim damage to local financing capabilities while the constitutionality of the proposed legislation is being tested will be incalculable.

Very truly yours,

CHARLES F. DODRILL.

EHLERS AND ASSOCIATES, INC.,
FINANCIAL CONSULTANTS,
Minneapolis, Minn., September 15, 1969.

THE SENATE FINANCE COMMITTEE,
2227 New Senate Office Building,
Washington, D.C.:

This communication is in lieu of an oral presentation to the committee on provisions of HR 13270 affecting taxation of interest on state and local bonds. In general this will be in opposition to these provisions in the proposed legislation.

By way of background, the writer is the principal of Ehlers and Associates, Inc., a government finance consulting firm which has been commissioned to assist the financing of some 500 capital improvement projects for over 300 local governments in mostly, Minnesota, North Dakota, South Dakota and Wisconsin. The firm is not a bond dealer or broker.

Without going into constitutional questions of which members of Congress must be fully aware, this will discuss only some very serious and very practical objections to proposals to tax interest on these bonds and substitute federal financing either through a dual coupon arrangement or through a so-called "Urbank" or "Metro Bank".

1. EVASION OF TAXES—THE FALLACY

It is charged by Mortimer Caplin that while municipalities save $1 billion per year the federal government losses $2 billion per year. The House Committee estimates were $1.3 billion and $1.8 billion respectively and it has been admitted that, allowing for estimating errors and the cost of a new, massive federal agency, the saving and loss could just about wash.

It is charged by Caplin and others that municipal bond investors pay no taxes. For example a midwest widow allegedly invested $57 million which has earned $1.5 million per year tax free (a yield of 2.8%) as though she made *no* social contribution. What is not recognized is that she could have elected to *not* invest in public works and, instead, invest in (taxable) securities which would have grossed some $1 million more annually. To be sure the federal government might have extracted more than $1 million higher yield (if her investment had yielded ordinary income), but it is simply not true that this investor gave up *nothing.* She did forgo some $1 million *in lieu of federal taxes.*

2. MARGINALITY OF BOND SALES: MINIMUM TAX, ALLOCATION OF DEDUCTIONS

Under Paragraph 1 above the possibility of the federal government collecting $1.8 million added taxes was cited. However, it is *not* proposed to tax all interest on bonds and so this federal yield *would not result* under this bill proposed. However, because of the marginal nature of the tax exempt bond market only a minor inpairment of the most prominent feature of such bonds would cause their interest rates to approach those of taxable securities for the following reasons.

As we learned in Econ. 1 the price of a commodity (wheat for example) will fall (interest rates rise in the case of bonds) to the level at which the entire supply can be sold. If, by taxing state and local government bonds, Congress destroys even a minor part of demand then the price of bonds must fall (interest rates rise) to the point where lower tax bracket investors can be induced to buy them. If some of the bond supply must be sold to someone already tax exempt (such as pension funds, retirement funds, etc.) then the *whole* price/yield structure of tax exempt securities will move to that level. Thus, though the proposals seem only directed at the very rich, the practical effect to local governments would be to raise their interest rates to the taxable yield level.

3. SUBSIDY, THE FEDERAL TEAT, FEDERAL CONTROL

In recognition of the above result it is proposed to provide a subsidy of 25% to 40% of municipalities' interest cost through a dual coupon arrangement or through a federally sponsored "Urbank" or "Metro Bank". And, it is said, there shall be no federal review of the advisability of a projec' or the community's ability to repay the bonds.

This is incredible. Congress has often deplored open end, back door, massive financing programs over which it has no control. Notwithstanding the language of the Bill, almost certainly some controls will be and should be imposed. For example, would Congress stand for federal financing of segregated schools, municipal liquor stores, ill advised medical facilities, a municipal or state *owned and operated* commercial enterprise? Would local government be able to finance projects not otherwise subject to the Davis-Bacon Act?

Ultimately there would have to be some federal control. This would mean the destiny of local government would fall to a federal dependency, that local initiative, which has accomplished so much, will degenerate into a begging for federal handouts.

4. Halt of Public Works Construction

The most immediate result of impairing the market for state and local government bonds and providing a federal pacifier would be the virtual *halt* of local public works construction. Even now, because of this tax threat, many communities are pressing their statutory interest rate limitations. Should the Bill pass, we expect that few if any bonds will be sold on the market thereafter.

If our experience with federal programs says anything, it says there will be something like a two year delay in effectively implementing a federal interest substitute. A whole new federal agency must be set up to process upwards of $15 billion of financing each year. An experienced staff must be recruited and educated. Rules and regulations must be formed and adopted after hearings. The investing public and public officials must be educated to a whole new concept of lending and borrowing, applications must be prepared, gotten into the hands of local officials, prepared, returned and processed and probably litigation must be resolved. It is impossible to see anything less than a 24 month time period for implementation of the federal subsidy. The questions then are: Can we afford to idle a large segment of the productive capacity of the heavy construction industry and its employees for two years? Can we afford a tax "reform" that will derive little or no net revenues to the federal government? Can we afford to delay needed sewers, water systems, schools, hospitals, highways, and other needed local improvements for 24 months?

5. Litigation

There is a real constitutional question as to the taxation of interest on municipal bonds, especially the retroactive features of HR 13270. Even though the Bill talks about "allocation of deductions" holders of large blocks of bonds can hardly be expected to let a large value of their holdings be confiscated by a measure which, in effect, tax that interest.

6. Other Solutions

Without question the spread between taxable and tax exempt yields has narrowed. One of the most serious reasons for this is the current congressional threat to tax, directly or indirectly, and retroactively, the interest on tax exempt bonds. At the moment the most appropriate remedy to restore the full value of tax exemption to state and local governments would be to decisively strike this proposal in HR 13270.

Beyond that, the most effective remedy to assure full value of the tax exemption would be to reduce the supply of tax exempt bonds.

As we noted, marketability of municipal bonds is marginal. That is, prices of all bonds will move down to the level required to market the last bond. As the supply of bonds grows the yields must increase (prices must fall) until buyers are found—probably buyers in lower income tax brackets.

One source of a large tax exempt bond supply has been federally sponsored housing and urban development issues which, if financed entirely by the federal government (non-tax exempt), would relieve much of the pressure on the market for other tax exempt bonds. Though these housing issues constitute only about $2 billion of a $16 billion tax annual exempt market, elimination of such bonds would greatly improve the remaining market for other types of tax exempt bonds. Because of the marginal nature of the market, the resulting interest rates would then drop to more truly reflect the full value of the tax exemption as a saving to local governments. The spread between taxable and tax exempt bonds would widen considerably.

From our side, the local government side, we must recognize that, since almost all states and municipalities can offer tax exempt industrial revenue bond financing, and since the location of industrial plants is again determined by old economic factors, this type of financing should be done away with in all of the 50 states. No community can gain any special advantage over any other community by using this financing but its use has contributed substantially to the oversupply of tax exempt bonds, higher tax exempt interest rates, and probably, to the inclusion of this provision in HR 13270. We in municipal governments must recognize this and support congressional efforts to eliminate this abuse of tax exempt financing.

We must also recognize that so-called arbitrage or advance refunding bonds can only sour the tax exempt bond market as a source of fresh money for actual, new public improvements. These two provisions, reducing the amounts of industrial revenue bonds and advance refunding, bonds would be supported by us and by most state and local officials.

IN SUMMARY

Removal or impairment of tax exemption of interest on state and local bonds will raise little if any net revenues. It will, however, effectively and substantially increase interest rates on local borrowing. It is not just a tax "reform", it will result in a major restructuring of government. Those who own such bonds *do* make a substantial contribution "in lieu of" federal taxes

If passed, this provision would cause about a two year halt in most local improvement construction.

Notwithstanding language in HR 13270, there would, ultimately, be federal control of local financing. In fact it would be unwise to not have control of a $15 billion per year program.

There are some less drastic measures that can be taken without setting up the new, massive and costly federal program provided in HR 13270.

Thank you for your attention.

Respectfully submitted,

Ehlers and Associates, Inc.,
By: Robert Ehlers.

Statement of Cornelius W. Grafton, Grafton, Ferguson, Fleischer & Harper

MAY IT PLEASE THE COMMITTEE:

As a Municipal Bond Lawyer with more than 30 years' experience, largely in working with the smaller communities of Kentucky, I wish to be heard on the point that these smaller communities simply cannot survive this legislation in its present form.

Sections 601 and 602, with an appearance of innocence which assumes naivete and downright stupidity, *seem* to offer a harmless and deceptive new choice on a voluntary basis, while leaving undisturbed the privilege of issuing tax-exempt bonds as in the past.

But quite obviously, the provisions in Section 301 and 302, providing for such euphonius "reforms" as Limited Tax Preference and Allocation of Deductions, will, so destroy the marketability of tax-exempt bonds as clearly to indicate that there is really no choice at all.

The smaller communities, for which I am undertaking to speak, will be unable to market tax-exempt bonds; and when effectively forced by this legislation to seek the federal interest subsidy which is supposed to be just as good, they will learn that this is not an acceptable or workable substitute. Then it will be too late.

The essential and tragic fallacy lies in the assumption, which is false, that an interest subsidy, even in the maximum amount of 40% which is permitted, will make taxable bonds as marketable and effective as tax-exempt bonds, at the same cost to the small community, and with the federal government making up the difference.

Somebody is engaging in spinning out a self-pleasing but very foolish daydream. I have a mental picture of so-called experts in the Treasury Department who entertain a theory that there is no difference between a taxable bond and a tax-exempt bond that cannot be made up, in any and all events, by a 40% interest subsidy. And I have no doubt that they prove their case by producing the published averages of Dow Jones, The Daily Bond Buyer, and others. These averages have little or no significance in the cases of bonds offered for sale by little communities—they are openly published as being averages of bonds offered and sold by the biggest issuers, the household names, and the credits which have long and reassuring histories.

The same averages and theories are wholly without any realistic relation to bonds offered by little issuers, names unfamliar to the investing public, and credits which venture into the market-place for the first time. If these are effectively deprived of the historic tax-exemption which gives them the only break they have ever had; then, subsidy or no subsidy, they will be obliged to go out in open competition with the gold-plated names of the great corporations which are listed on the Exchanges and deal in terms of millions and billions of dollars.

This can be called "competition," if you like, but only in the cynical sense in which it might be suggested that the local high school football team may fairly "compete" with the New York Jets, the Baltimore Colts, or the Green Bay Packers; the argument apparently being that the hospital and surgical bills will be paid by the government, so everything will be equal.

In high school football in Kentucky, as I believe to be the case in many other states, schools are put in different classes according to size; so that the big ones play the big ones, the mediums play the mediums, and the little ones play the other little ones. Each has a chance to become a champion—but among equals, and not with the odds rigged against them. So also in boxing, where featherweights are not put in the ring with heavyweights.

I carry no torch, nor shed tears of sympathy, for certain persons of great wealth who are shown to have avoided payment of federal income taxes, in whole or in part, by investing substantially in state and local tax-exempt bonds Nor am I qualified by education or experience to weigh the right and the wrong of avoiding taxes by making charitable contributions. These practices are held up as deplorable "loopholes" which make people very angry and are said to threaten a "taxpayers' revolt."

But it seems to me there is a certain amount of blindness or at least myopia about all this, in terms of perspective. Out of perhaps 200 million people in the United States, it appears from statements by proponents of this "Tax Reform Bill," as found in the Congressional Record (August 7, 1969, page H7075) that there are 155 persons worthy of being held up to the rest of us in horror on this account.

The idea of curing 155 cases of this sort at the cost of destroying what little ability small communities may have to finance essential local improvements (if they can do it at all), seems to me to be like drowning the faithful family dog in order to drown his fleas at the same time. No doubt the fleas will be drowned, and then we will adjourn to the back yard and bury Old Rover. This makes sense only if you hate dogs; not just because you hate fleas.

I assume that if I were testifying before this Committee in person, instead of submitting this written statement,—I would be interrupted at this point (if not considerably earlier), with a suggestion that I justify my essential premise by explaining just why it is that an interest subsidy of up to 40% will not, in fact, serve as the equivalent of exemption of interest from federal income taxation in the first place.

There is no trouble at all in making such an explanation—and to the experts who may still be doubters, I can only suggest that they come down to Kentucky, prepare bond issues for little communities, and see what happens to them. They have a hard time getting noticed. Even with the benefits of tax exemption, the best of engineering service, and competent and vigorous sponsorship and financial assistance from licensed underwriters, they sometimes fail to receive a purchase bid. In many instances they can obtain no encouragement from dealers and investors, and have no choice but to look for grants and low-interest loans from the federal government, which virtually monopolizes the readiest sources of tax revenues and therefore has all the money. If government grant and loan resources have been exhausted (which is as often the case as not), they wait in line for the next fiscal year's appropriations—or give up and do without.

The principal bond-purchasing officer of one of the big New York banks told me one day that he could give consideration to bonds of the Commonwealth of Kentucky, the City of Louisville, and perhaps seven other cities and the counties in which they are situated. The other cities, counties and public bodies of Kentucky could not be considered because they were not covered in published, official source material, generally could not obtain ratings from the standard rating agencies, had no credit history, and were offering bond issues too small to warrant the expense of an independent study of his own.

A high-ranking officer in a nationally-known underwriting firm explained to me that during the average week his staff has opportunities to participate in 50 to 100 bond syndicates—that it was impossible to give thoughtful consideration to more than 20, and that the rest simply had to be passed up, regardless of the fact that they might very well have merit. The ones that are passed up are naturally the little ones that need help the most. I am not complaining. These are the facts of life.

Our small communities, having no impact in the national markets, owe their successful financial ventures, when they happen, to a combination of two factors—the tax-exempt status of the bonds they can offer, and the loyal and vigorous support they get, in meritorious cases, from investment banking firms operating out of Louisville and Lexington, Kentucky, Cincinnati, Ohio, and Nashville, Tennessee. These fine firms, well acquainted as they are with local conditions and neighborhood customers for bonds in small lots, constitute the only available market for those bond issues that cannot survive in the national market, yet have merit enough to warrant distribution, with help. Otherwise there is no place to go, except to governmental agencies for grants and what amount to sub-marginal loans.

But all of these nearby dealers will tell you, I believe, that without the feature of tax exemption working in their favor, the small bond issues they can otherwise maange to distribute with persistent effort might as well be forgotten in the face of the Tax Reform Bill of 1969. The little communities will be reformed out of existence. If a purchase bid cannot be obtained—a subsidy of 40% of nothing is nothing. Letcher County, Kentucky, cannot compete with General Motors.

Even the small local investors are already alarmed and their faith in their national government has been shaken. The doctrine that the sovereign governments of the States may not tax the sovereign government or agencies of the United States was originally enunciated by the Supreme Court in a case where it was the United States that was the party seeking protection, and which obtained it. It is scarcely imaginable that the doctrine does not apply in the converse, when the idea is advanced that it is somehow permissible for the United States to tax the governments, agencies, and subdivisions of the several States. The Supreme Court has so held.

Exemption of interest received on bonds of the States, their municipalities, agencies and subdivisions has been in the income tax laws, and in the regulations implementing the income tax laws, as long as such laws and regulations have been in existence. The basis has always been Justice John Marshall's truism that "the power to tax is the power to destroy."

It has been upon the faith of these long-standing laws, regulations, and repeated interpretations of them, that investors large and small have purchased state and local bonds upon terms favorable to public issuing bodies—terms which could not otherwise have been justified. Now these investors are confronted by legislative proposals that seek to obtain by indirection and circuity what the Congress obviously knows it cannot achieve by a direct and frontal constitutional attack.

It is disconcerting to be confronted with a rather sly and pleased suggestion of one's own government that a way may have been discovered to accomplish what cannot be done forthrightly, by simply wiggling around the end and back of it. The States, their governments, and large public bodies such as the New York Port Authority appear to be big enough, and possessed of sufficient means, to be heard—and we are confident that they will speak up—hopefully on behalf of small investors as well as in their own defense.

The small investor, and the small public issuing bodies, can only sit still and be bewildered. A course of action in the direction now suggested may be constitutional, while at the same time constituting a crashing breach of faith. The present administration even suggests publicly that the underground erosion of the historic and traditional tax-exempt status of state and local bonds be applied in retrospect to bonds which were issued when the law was clearly otherwise. It would be bad enough to be given warning of the future so that one might avoid getting into a trap. It is not in accord with ordinary standards of good faith and morality to have the trap sprung on what has already been done under different ground rules.

It is a cause for legitimate wonder when government acts toward its citizens in a manner which, if used by citizens against their government, would doubtless cause speeches to be made in high places, and perhaps investigations to be ordered and indictments to be sought.

And all this seems stranger still, when one observes that although the government long ago abandoned exemption of interest on its own bonds from its own income taxation—yet when it felt the necessity to obtain from private sources the most inexpensive possible money for its vast housing program, it (a) by law made the bonds incontestable, (b) by law pledged the full faith and credit of the United States to their payment, and (c) by law exempted interest thereon from "*all taxation now or hereafter imposed by the United States.*" (The United States Housing Act of 1937, as amended.)

H.R. 12370 is some 368 pages in length, and I cannot pretend to have read and understood all of it, or indeed any very substantial part of it. But I have read published summaries and analyses, and I have yet to find any suggestion that the government proposes to subject the housing bonds which it has thus guaranteed and exempted from "all taxation now or hereafter imposed by the United States" to the destructive proposals which are directed toward state and local municipal bonds by the legislation here under consideration.

I am reminded of the long-protracted litigation between the Dollar Steamship Line and the United States; wherein the United States, shamefully but obviously without any sense of shame, refused to obey a final judgment of its own Supreme Court, and our Supreme Court. After the case was decided against it, the United States persisted in attempts to litigate, in the District Court for the Northern District of California, issues which had already been litigated to final conclusion.

In *United States* v. *Dollar et al* (1951), 100 F.Supp. 881, there is to be found a long and indignant discourse by Judge Murphy on the subject of the government's behavior. It is, we think, appropriately brought to a climax in this passage (see p. 889):

> "The government should not be permitted to avoid liability by tactics that would never be countenanced between private parties. The government should be an example to its citizens, *and by that is meant a good example and not a bad one.*" (Emphasis supplied.)

Someone has said what somebody ought to have had the courage to say.

I agree.

THE HEFNER COMPANY,
Oklahoma City, Okla., July 11, 1969.

Re: Proposed Tax Reform Legislation

HON. RUSSELL B. LONG,
U.S. Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: I note from a recent press release that the Senate Finance Committee is holding hearings with reference to Tax Reform Legislation and that you have stated that any individual who believes that he would be affected by the proposals to be considered by the Committee might be heard. I feel that I would be unable to appear and testify but would appreciate it if my letter to you and the copy of my letter to Senator Fred Harris could be made available to and considered by the Committee.

It is my understanding that, among other things, it is proposed that the income from state and municipal bonds already issued and purchased by the taxpayer be made taxable, either directly or indirectly, through the medium of a "minimum income tax" bill, an "allocation of deductions," or a "limited tax preference." It would seem to me that any such tax would be unconstitutional under the decisions of the Supreme Court of the United States. Aside from any constitutional consideration, however, a retroactive tax on transactions already completed is unjust, inequitable and unfair in all respects.

For more than 20 years I have been an independent oil and gas producer in the State of Oklahoma. During this period, I have plowed back into my properties practically all of the proceeds from the sale of production, reserving only a very modest amount for personal expenses. On January 1, 1968, I sold all of my producing wells to Sun Oil Company and invested the proceeds in state and municipal bonds of the State of Oklahoma yielding approximately 4% tax-free interest. Near mid-1968 Congress passed the 10% Surtax Bill and made the same retroactive supposedly to January 1, 1968. Actually the retroactive effect of this legislation went back more than 20 years in my case and resulted in a change of the capital gains tax from 25%, as the law existed at the time the transaction was made, to 27½%. This certainly constituted the changing of rules after the game was over and the imposition of an unfair and unjust tax on a transaction already completed.

As I stated to Senator Harris, the unfair and unjust *retroactive* effect of the 1968 Surtax Bill is certainly mild as compared with the impact which the proposals presently being considered would have on the tax-free securities which I so recently purchased. Their market value has already declined more than 20% and my investment is irretrievable. I think everyone would concede that the market value of the securities which I purchased will decline approximately another 50% if the income from them be made taxable.

If I understand the purpose of the proposed tax reform legislation, it is to reach a few citizens who over the years have had very large incomes and have paid very small or no taxes at all. I should like to point out that I have paid substantial taxes throughout the time of my business career. I have reviewed my federal income tax records for the past 20 years and find that the taxes I have paid to the Federal Government are equivalent to 48% of my total taxable income and 37% of my adjusted gross income. These federal income taxes are in excess of the total proceeds received by me from the sale of my producing properties to Sun Oil Company on January 1, 1968.

The unjust, inequitable and unfair effect of the ex post facto legislation being considered is, I think, quite clear in its application to my situation. I do not see how an individual can go on if he cannot transact business in a fair and honest manner, relying on the law of the land as it exists at the time the transaction is made. The Supreme Court has held, I think, that the power to tax is the power to destroy. I think that I have shown that retroactive taxation of transactions already completed can destroy the results of an individual's lifetime effort and that it amounts to the taking of one's property without due process of law.

Sincerely,

ROBERT A. HEFNER, JR.

JUNE 12, 1969.

Re: Proposed Tax Reform Legislation

Hon. FRED R. HARRIS,
U.S. Senate,
Washington, D.C.

DEAR SENATOR HARRIS: Thank you very much for your letter of June 8, including the excerpt from the Congressional Record reviewing your bill providing for the "minimum income tax." Inasmuch as the income from tax free state and local securities are made a factor in determining this "minimum tax", the effect, of course, is to make the income from these securities taxable. It is my understanding that similar proposals to tax the income from such securities have been made to the House Ways and Means Committee through the medium of a minimum income tax, tax allocation of deductions or a limited tax preference.

The first question, of course, is one of constitutionality. The Supreme Court of the United States has, I think, specifically held that income from state and municipal bonds is not subject to taxation by the federal government and that Congress has no power to enact legislation making the same taxable. Even aside from the constitutional consideration, however, justice, fairness and equity would dictate that any tax imposed must of necessity be limited to bonds issued *subsequent* to the enactment of the legislation. It seems unthinkable to me that a man in our free and democratic country in making a decision involving the sale of his property (representing the accumulation of a lifetime of effort) and the investment of the proceeds from such sale, could not rely, in making his decision, on the laws of our country as they exist at the time the decision is made. Again, aside from any constitutional consideration, the *harmful* and *wrongful* ex post facto effect of legislation recently passed by Congress and of the legislation now being considered can, I think, be clearly illustrated by its effect on me and my entire business career. I beg your indulgence in my detailing this as briefly as possible.

For more than twenty years I have been independent oil and gas operator engaged in the drilling and development of oil and gas properties. My investment in this project has been entirely with my own fully tax paid dollars. With the exception of one shallow dry hole drilled in 1966, I have at no time "promoted" the drilling of any well, as many other operators do, where other investors pay some part of the cost of drilling, development and operation of the well. As a result of these many years of diligent effort I accumulated an interest in a number of producing oil and gas wells. This interest represented practically the entire accumulation of my business career. On January 1, 1968, this interest was sold to The Sun Oil Company. During the year 1968, proceeds of this sale, less the taxes paid thereon, were invested in tax free state and municipal bonds in the State of Oklahoma. Near mid 1968 the Congress passed the 10% surtax bill and made the same retroactive supposedly only to January 1, 1968. Actually, in my case, this tax related back for a period of more than twenty years and certainly constituted changing the rules after the game was over and the imposition of an unfair and unjust tax on a transaction already completed.

The unfair and unjust retroactive effect of the 1968 surtax bill is certainly mild as compared to the impact which your proposed income tax bill would have on the tax free securities which I purchased during 1968 with the proceeds from the sale to The Sun Oil Company. During the short time I have held these securities the decline in the market value has been substantial and my investment there is irretrievable. These bonds were purchased to yield 4% tax free income. It is now questionable whether bonds could be sold on a basis to yield even 6% tax free income. When proposals are being considered for making these bonds taxable I certainly would not purchase them at any price and it would not surprise me if all other investors felt the same way about the matter. If the income from bonds already purchased should be made taxable, it would certainly seem they would have to sell on a depreciated basis to effect a yield comparable to that of other taxable bonds. No one knows how high this yield will go, but at this time it would seem to be 8% or even higher. The retroactive effect of any such legislation would result in the depreciation of the compensation for my life's work by some 50% or more. Surely no one would contend that any such legislation could be fair or just.

Even though the legislation be limited to state and municipal bonds issued in the future, it seems clear that the result would be disastrous to the states and municipalities of this nation. You are aware, I am sure, that Triple "A" corporate bonds are selling on a basis to yield 8% or more and it is questionable whether issues at this rate of interest will sell. I should think it would be impossible for states and municipalities to issue and sell taxable bonds at a lesser rate of interest. It has been suggested that the federal government could subsidize state and local government to compensate them for the added cost, but this would, of course, bring on federal control of state and local government and would certainly signal the end of our dual system of government, which has proven so important to the progress of this nation and the independence of its citizenry. In the end the tax-payers generally would have to meet this added financial burden through increased taxation and the effort to place an additional tax on a very few tax-payers paying less than they should would certainly result in the unjust and inequitable treatment of many thousands, if not millions, of taxpayers.

Surely any action taken by the Congress changing the depletion allowance or the right of the oil operator to deduct intangible drilling cost would apply only to *future* operations, and would not be retroactive. In such event the oil operator would, at least, have the option to continue in business or to "close up shop." I am sure you are aware that the independent operator has, since the beginning of the oil and gas industry, discovered well over 50% of the reserves found in this nation and that estimates of future demand indicate that reserves of oil and gas are in short supply. It is my opinion that if the Congress adopts legislation adversely affecting depletion or the right to deduct intangible drilling costs the independent operator will be forced to "close up shop."

If I understand the purpose of the proposed tax reform legislation, it is to reach a few citizens who, over the years, have had very large incomes and have paid very small or no taxes at all. I have paid substantial taxes throughout the entire time since my graduation from the University of Oklahoma in 1930. I have reviewed my federal income tax records for the past twenty years and find that the taxes which I have paid to the federal government are equivalent to 43% of my total taxable income and 37% of my adjusted gross income. The federal income taxes which I have paid in the past twenty years are in excess of the total proceeds received by me from the sale of my producing properties to The Sun Oil Company on January 1, 1968. You are, of course, aware that many additional taxes are paid to state, municipal and local governments. After a lifetime of effort, and modest expenditures for personal matters, I felt that with my investment in tax free securities I would be in a position to retire with sufficient tax free income to meet all living costs. It seems unthinkable to me that Congress could, or would, impose a retroactive tax in a situation of this kind. I feel sure there are many thousands of tax-payers in the United States in this same situation. Surely, if it is the intent of the Congress to reach a few persons with very large incomes, who over the years have failed to pay their fair share of taxes, some other means may be found. I sincerely hope that careful further consideration will be given before the proposed tax reforms are adopted into law.

Inasmuch as other proposals are before the Congress which might result in legislation having an ex post facto effect, I have taken the liberty of making copies of my letter available to the Oklahoma delegation to Congress and others who might be interested.

Yours very truly,

ROBERT A. HEFNER, Jr.

JULY 31, 1969.

Re proposed tax reform legislation.

Hon. RUSSELL B. LONG,
Room 217, Old Senate Office Building,
Washington, D.C.

DEAR SENATOR LONG: The mere fact that Congress is *considering* legislation which would have the effect of making the income from state and municipal bonds taxable has already had a disastrous effect on the market for such bonds. This, I think, is clearly shown by the enclosed article from The Wall Street Journal of Wednesday, July 30, 1969.

As I have said in previous letters, if legislation is adopted, the effect will be the same whether the tax is direct or indirect through a "minimum income tax," an "allocation of deductions," or a "limited tax preference."

Yours very truly.

ROBERT A. HEFNER, Jr.

[From the Wall Street Journal, July 30, 1969]

THREE ISSUES DRAW NO BIDS, TWO OTHERS STYMIED IN CHAOTIC REACTION TO LEVY PLANS

A WALL STREET JOURNAL NEWS ROUNDUP

Municipal bond market conditions turned chaotic yesterday in the wake of tentative Congressional plans for curtailing the tax-exempt privileges of all state and city issues, investment dealers said.

Five separate competitive sales totaling $60,545,000 of bonds were stymied, with three of the day's scheduled issues failing to attract any bids. At the two other unsuccessful auctions, all bids were rejected as too costly for $20,495,000 of Newark, N.J., bonds and $25.5 million of Chicago bonds.

Newark officials characterized as "entirely out of line" a 7.4395% annual net interest cost proposed by a lone bidder at yesterday's sale. They noted the city had sold $18 million of similar bonds slightly more than a year ago, on June 18, 1968, at a cost of only 5.28%.

Several other local governments, strapped for funds to finance public projects, reluctantly accepted the steepest interest rates in history. For example, Seattle incurred a 6.4577% cost in awarding $25 million of sewer bonds and, thereby, agreed to pay about $12.1 million more in interest alone than under a 4.726% rate obtained at the city's previous sale last Oct. 1.

Seattle had "no choice"

A spokesman for Seattle Comptroller C. G. Erlandson said a lack of any alternative funds with which to meet engineering contracts already awarded in connection with the sewer projects meant the city "had no choice but to accept" the high interest cost. "We got advance word to the effect that many of the major New York bond houses wouldn't even make us a proposal, so we were afraid to take a chance on waiting for a possible later improvement to market rates," he added.

Seattle had anticipated about a 6.20% net yearly rate for its latest bond issue, and each 0.01 percentage point of interest charge between that level and the actual rate of 6.4577% results in an additional $69,534 for debt service, the spokesman disclosed. "It's simply unbelievable how badly the municipal bonds market has been hurt by this legislation pending before the House Ways and Means Committee," he said.

The powerful House tax-writing committee is considering a proposal that would employ Federal subsidies to induce states and cities to issue taxable rather than tax-exempt bonds. As part of a tax-reform package to be sent for approval by Congress, it also might decide to recommend various methods of trimming, or even halting altogether, the tax-free benefits of both new and old municipal bonds.

The crux of the worry among dealers and investors is the huge current float of about $130 billion of tax-exempt securities outstanding, which presumably would undergo a precipitous price decline in order to raise yields to a range competitive with fully taxable bonds of corporations and the Federal Government. "This is the worst single day in our market's history, and its significance is that it was the beginning of a realization that the tax-exemption feature is truly in jeopardy," one senior official said.

Another mark falls

Another landmark record set yesterday was the 5.94% annual net interest cost accepted by Ohio in awarding $65 million of development bonds. It was judged by financial officials to be the highest rate on record for a public financing by a state with a triple-A credit rating, far surpassing the previous known peak of 5.71% set just last week at a $60 million sale by Connecticut.

Ohio awarded its offering to underwriters managed by Morgan Guaranty Trust Co. of New York on their bid of 100.045 with various coupons. A Bankers Trust Co. team—the only other bidder—was a distant runner-up with a proposal that would have resulted in a 6.24% cost.

Moreover, Bankers Trust and associates submitted a "conditional" bid, which meant the offer was to be canceled in the event Congress alters the tax-exempt status prior to delivery of the bonds. Despite such an escape hatch, many member firms belonging to the Bankers Trust withdraw from the syndicate in advance of the sale deadline, it was learned.

"There was substantial differences of opinion as to pricing terms among our group, but those of us that remained in the team decided to go ahead on a conditional basis as a means of formally registering our protest against the proposed Congressional tax changes," a Bankers Trust official said.

STATEMENT OF HAWKINS, DELAFIELD & WOOD

New York, New York

Re: PROPOSED TAX REFORM ACT OF 1969 (H. R. 13270)

Preliminary Statement

This statement is submitted in accordance with press release of the Senate Committee on Finance and a telegram from the Chief Counsel of the Committee received on September 10, 1969.

The principal points presented in the statement are summarized as follows:

(1) The minimum tax on income including state and municipal bond interest levied by the House Bill is unconstitutional. The *Pollock* case holds that a tax on the interest from state and municipal bonds is unconstitutional. The Sixteenth Amendment did not change the decision in the *Pollock* case. The Congress has construed the Sixteenth Amendment consistently with the decision in the *Pollock* case. The history of the adoption of the Sixteenth Amendment confirms the Congressional and Supreme Court construction of its intent and meaning. To the extent that the minimum tax applies to interest on local housing authority obligations it also impairs the obligation of contract.

(2) The withdrawal from state and municipal bondholders of deductions allowed other taxpayers discriminates against individuals owning tax-exempt securities and by raising the cost of borrowing interferes with the borrowing power of states and municipalities. Although Congress may in some circumstances disallow deductions directly related to interest on state and municipal bonds or properly allocable to such interest, by disallowing deductions not reasonably related to the receipt of tax-exempt income, the House Bill violates the doctrine enunciated in the *National Life Insurance Company* case and is not supported by the *Atlas Life Insurance Company* case.

(3) The municipal bond subsidy provisions and the provisions relating to arbitrage obligations of state and local governments provide for unnecessary and undesirable federal control of state and local financing. Neither industrial development bonds as defined in Section 107 of the Revenue and Expenditure Control Act of 1968 or arbitrage obligations would be eligible for the subsidy program. Thus many bonds which would be issued to finance facilities for many acknowledged and traditional state and local functions would be ineligible. In addition the subsidy program is unworkable in certain respects. No political subdivision of any state has the power at the present to issue taxable bonds notwithstanding the possible passage of the Tax Reform Act of 1969. The payment of a percentage of interest yield on taxable state and local obligations is of no value. The dual coupon concept will not accomplish its intended purpose because state interest limitations will nonetheless apply. The administration of the subsidy program will involve substantial and undesirable federal involvement in state and local financing.

I

The minimum tax on income including State and Municipal bond interest levied by the House Bill is unconstitutional.

Section 301(a) of the House Bill adds a new Section 84 to the Internal Revenue Code of 1954. The new section includes in the gross income of a taxpayer other than a corporation the amount of so-called "disallowed tax preferences" and defines the so-called "items of tax preference." Among the items is any excess of interest on obligations which is excludible from gross income under section 103 of the Code, namely, the interest on "the obligations of a State, a Territory, or a possession of the United States, or any political subdivision of any of the foregoing, or of the District of Columbia."

The proposed section provides a transitional rule for including interest exempt under section 103 as an item of tax preference which is 10% multiplied by the number of taxable years beginning after December 31, 1969. When the new section is fully effective the limit on tax preferences will be an amount equal to (1) one-half of the sum of the items of tax preference and the taxpayer's adjusted gross income or (2) $10,000, whichever is greater.

The Report of the Committee on Ways and Means illustrates the application of the limit on tax preferences by the case of a taxpayer with a salary of $50,000 and tax preference items amounting to $150,000 and states that:

> "Under present law, such an individual is taxed only on his $50,000 of salary. Under the limit on tax preferences, he is to be required to pay tax on $100,000 of income (one-half of his total income of $200,000)." H. Rep. No. 91-413 (Pt. 1) (91st Cong., 1st Sess.) p. 79.

Thus, if the tax preference item comprises only interest on hitherto tax-exempt securities and 100% of the interest is taken into account at the end of the transitional period, the individual who receives a $50,000 salary and $150,000 in interest on tax-exempt securities will pay a tax on $100,000 of income. Obviously, since his salary amounts to $50,000 the remaining income of $50,000 on which he pays a tax can not consist of any income other than the interest received on his state and municipal bonds.

Law, as Mr. Justice Holmes has told us, is a "prophecy of what courts do in fact." In our opinion, the Supreme Court would hold that such a tax on the interest on state and municipal bonds is unconstitutional for the reasons stated below. From the time the income tax was imposed in 1913 until now both Congress and the Supreme Court have adhered steadfastly to the constitutional doctrine that state and municipal bond interest is exempt from federal income tax. It would be strange for Congress to abdicate its obligation to respect constitutional limitations upon its power by levying a tax on such interest without awaiting new constitutional authorization.

The doctrine of federal immunity from state interference, including interference by taxation, is a general principle of constitutional law with which this Committee is undoubtedly familiar. The converse immunity of the states from federal interference is equally well established. The doctrine was specifically applied to interest on bonds of states and municipalities and of state and municipal instrumentalities by the Supreme Court of the United States in the landmark case of *Pollock* v. *Farmers' Loan & Trust Company,* 157 U. S. 429 (1895) and on rehearing, 158 U. S. 601 (1895).

The cases decided by the Supreme Court under the Sixteenth Amendment as well as the legislative history of the amendment in Congress during the period it was being ratified by the state legislatures demonstrate that any claim that the amendment repudiated the rule of the *Pollock* case is unsupported by any judicial precedent, is unfounded in fact, and altogether spurious.

For the purpose of this statement it is not necessary or desirable to delve into the much repeated history of the constitutional doctrine of reciprocal immunity before August 15, 1894 when Congress enacted a statute which levied a tax upon net income, including income from all real property and from all personal property, both tangible and intangible, including the interest on state and municipal bonds.

At that time and until the Sixteenth Amendment became effective on February 25, 1913, Article I, Section 2, of the federal Constitution required the apportionment of "direct taxes" among the states according to population, as follows:

> "Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective numbers, which shall be determined by adding to the whole Number of free Persons, including those bound for Service for a Term of Years, and excluding Indians not taxed, three-fifths of all other Persons."

Article I Section 8, of the Constitution also requires that "Duties, Imposts and Excises" shall be uniform, as follows:

> "The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defense and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States; . . . "

A. *The Pollock Case holds that a tax on the interest from State and municipal bonds is unconstitutional.*

In the *Pollock* decision which considered the validity of the income tax law of 1894, the Supreme Court pointed out that the federal government had an unlimited power of taxation with a single exception and subject to two qualifications. The one exception was that "Congress cannot tax exports . . . " The two qualifications were that Congress "must impose direct taxes by the rule of apportionment, and indirect taxes by the rule of uniformity." 157 U. S. at 557.

In the first *Pollock* case the Supreme Court held that a tax on the rents and other income from real estate was a direct tax and consequently violated the Constitution because the tax was not "apportioned among the several States . . . according to their respective numbers." The Court also unanimously held that the taxing power, like any and all other powers of the federal government, was impliedly subject to the constitutional limitation that it could not be so exercised that the instrumentalities of the states were taxed. 157 U. S. at 584.

Thus, the first decision in the *Pollock* case held the income tax act of 1894 invalid in respect of (1) the tax on rents and other income from real estate and (2) the tax on the interest from state and municipal bonds. The justices divided equally on the constitutionality of the income tax pertaining to personal property other than state and municipal bonds and on whether the 1894 act as a whole was unconstitutional.

On rehearing the Supreme Court decided (four of the justices dissenting) first, that the tax on income from personal property was a direct tax and hence was invalid because not apportioned and, second, that the 1894 Act was unconstitutional in its entirety.

The *Pollock* decision was unanimous as to municipal bond interest because in the words of Mr. Justice Fuller to tax the interest on municipal bonds "would operate on the power to borrow before it is exercised, and would have a sensible influence on the contract,"* and would be a "tax on the power of the States and their instrumentalities to borrow money and consequently repugnant to the Constitution." 157 U. S. at 586.

To the same effect was the separate opinion of Mr. Justice Field:

> "These bonds and securities are as important to the performance of the duties of the State as like bonds and securities of the United States are important to the performance of their duties, and are as exempt from the taxation of the United States as the former are exempt from the taxation of the States." 157 U. S. at 601

And Mr. Justice Brown who had concluded that "a tax upon rents or income of real estate is a tax upon the land itself" nevertheless said in the second *Pollock* decision:

> "The tax upon the income of municipal bonds falls obviously within the other category, of an indirect tax upon something which Congress has no right to tax at all, and hence is invalid. Here is a question, not of the method of taxation, but of the power to subject the property to taxation in any form." 158 U. S. 692-693

* This is a prophecy found to be all too accurate and greatly understated by those state and municipal officials who have tried to borrow money since the introduction of the bill. The Monthly Economic Letter of the First National City Bank of New York says "the damage done by the proposals in the bill in terms of raising the cost of borrowing by States and municipalities this year cannot be underestimated. Those governments which have been penalized this year have no recourse to a Treasury subsidy."

Thus, all the justices in both *Pollock* decisions, whether they subscribed to the theory that a tax on income was a tax on the source of the income or considered that theory untenable, came to the identical conclusion that the interest on state and municipal bonds could not be included in federally taxable income. It is clear, therefore, that the decision in *Pollock* concerning the unconstitutionality of taxing state and municipal bond interest rests not on the economic premise that a tax on income is a tax on the source of the income but on the inviolability of the borrowing power of the states and their political subdivisions.[*]

B. *The Sixteenth Amendment did not change the decision in the Pollock Case.*

This, then, was the law when the Sixteenth Amendment was declared in full force and effect by the Secretary of State on February 25, 1913. The Amendment reads:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

1. *The Congress has construed the Sixteenth Amendment consistently with the decision in the Pollock Case.*

Even before the Supreme Court decided that the phrase "from whatever source" in the Amendment relates not to the power to tax but to the requirement that certain federal taxes must be apportioned among the states according to their respective populations, Congress had also concluded that the object of the Amendment was to eliminate the necessity of *apportionment* irrespective of source in order that the income derived from the source of real and personal property could be taxed. Briefly stated, the Amendment means that a tax on income "from whatever source" is immune from the constitutional requirement of apportionment. 38 Stat. L. 168 (1913); 39 Stat. L. 758-59 (1916); 40 Stat. L. 329-30 (1917) and 1065-66 (1918).

When during World War I, a revenue act was drafted with a provision to include the interest on municipal bonds in gross income, the lack of power to tax such interest was expressed both in committee reports and congressional debate. It was recognized that lack of apportionment was not the objection to federal taxation of state and municipal bond interest but that the lack of power to tax such interest was absolute. The provision was omitted. H. Rep. No. 767, (65th Cong. 2nd Sess.) p. 9; Sen. R. No. 617, (65th Cong. 3rd Sess.) p. 6; 56 Cong. Rec. p. 10933-41, 10628-33, 11181-87.

Such a contemporaneous construction of the Sixteenth Amendment by Congress from the time it became effective through World War I is certainly an influential if not a controlling consideration in determining the meaning of the Amendment.

[*] The reluctance of the four justices in both *Pollock* cases to accept the theory that a tax on income is a tax on the source of the income was later shared by the Supreme Court in *New York ex rel Cohn* v. *Graves,* 300 U. S. 308 (1937) in which the New York State income tax on rents from real estate in New Jersey was upheld. Obviously, however, this was not the *ratio decidendi* of the *Pollock* case, because four of the justices who did not agree that a tax on income from personal property was a tax on the property itself joined with the other justices in invalidating the tax on municipal bond interest.

Later, in 1923, after the decision of the Supreme Court in *Evans* v. *Gore,* 253 U. S. 245 (1920), to bc discussed below, Congress considered and the House of Representatives passed a constitutional amendment[*] to authorize the taxation of income derived from future issues of state and municipal bonds and to authorize states to tax the income of future issues of federal bonds. H. J. Res. 314, (67th Cong. 4th Sess.); H. Rep. No. 969, (67th Cong. 2d Sess.) The proposal failed to pass the Senate.

2. *The Supreme Court has construed the Sixteenth Amendment consistently with the decision in the Pollock Case.*

In *Evans* v. *Gore,* 253 U. S. 245 (1920), the Supreme Court held (Justice Holmes and Brandeis dissenting) that the Sixteenth Amendment did not authorize an income tax on the salary of a federal judge in view of the fact that the Constitution provided that the compensation of judges "shall not be diminished during their continuance in office." Const. Art. III Sec. 1.

The Court then considered whether the constitutional inhibition against such diminution was modified by the Sixteenth Amendment. After an elaborate analysis of the Sixteenth Amendment the Court concluded that:

> "the genesis and words of the Amendment unite in showing that it does not extend the taxing power to new or excepted subjects, but merely removes all occasion otherwise existing for an apportionment among the States of taxes laid on income, whether derived from one source or another." 253 U. S. at 261-2.

Although *Evans* v. *Gore* was overruled in *O'Malley* v. *Woodrough,* 307 U. S. 277 (1939), it is clear from the opinion of Mr. Justice Frankfurter in the latter case that the decision that federal judges could be taxed on their salaries was based on the premise that, as Justices Holmes and Brandeis had said in their dissenting opinion in *Evans* v. *Gore,* a tax on salaries was not a diminution of compensation. Only that portion of the majority opinion in *Evans* v. *Gore* was repudiated and not one word in the opinion in *O'Malley* v. *Woodrough* questions the above-quoted conclusion of the Court in *Evans* v. *Gore* concerning the Sixteenth Amendment.

[*] The proposed amendment read as follows:

"[H. J. Res. 314, Sixty-seventh Congress, fourth session.]

JOINT RESOLUTION Proposing an amendment to the Constitution of the United States.

Resolved by the Senate and House of Representatives of the United States of America in Congress assembled (two-thirds of each House concurring therein), That the following article is proposed as an amendment to the Constitution of the United States, which shall be valid to all intents and purposes as part of the Constitution when ratified by the legislatures of three-fourths of the several States:

'ARTICLE .

'SECTION 1. The United States shall have power to lay and collect taxes on income derived from securities issued, after the ratification of this article, by or under the authority of any State, but without discrimination against income derived from such securities and in favor of income derived from securities issued, after the ratification of this article, by or under the authority of the United States or any other State.

'SEC. 2. Each State shall have power to lay and collect taxes on income derived by its residents from securities issued, after the ratification of this article, by or under the authority of the United States, but without discrimination against income derived from such securities and in favor of income derived from securities issued after the ratification of this article, by or under the authority of such State.'"

In *Evans* v. *Gore* the Supreme Court had referred to previous cases in which the Court had considered the Sixteenth Amendment, beginning with the opinion of Chief Justice White in *Brushaber* v. *Union Pacific R. R. Co.*, 240 U. S. 1 (1916) which was the first case involving the scope and meaning of the Sixteenth Amendment. In that case, referring to the text of the Amendment the Chief Justice had declared (240 U. S. at 17-18):

> ". . . It is clear on the face of this text that it does not purport to confer power to levy income taxes in a generic sense—an authority already possessed and never questioned—or to limit and distinguish between one kind of income taxes and another, but that the whole purpose of the Amendment was to relieve all income taxes when imposed from apportionment from a consideration of the source whence the income was derived. Indeed, in the light of the history which we have given and of the decision in the *Pollock Case* and the ground upon which the ruling in that case was based, there is no escape from the conclusion that the Amendment was drawn for the purpose of doing away for the future with the principle upon which the *Pollock Case* was decided, that is, of determining whether a tax on income was direct not by a consideration of the burden placed on the taxed income upon which it directly operated, but by taking into view the burden which resulted on the property from which the income was derived, since in express terms the Amendment provides that income taxes, from whatever source the income may be derived, shall not be subject to the regulation of apportionment."

The *Brushaber* case was decided on January 24, 1916. On Feberuary 21, 1916, the Supreme Court handed down the decision in *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103 (1916). The decision was unanimous and again the Court reiterated the rule

> ". . . that the provisions of the Sixteenth Amendment conferred no new power of taxation . . ." 240 U. S. at 112

In *Peck & Co.* v. *Lowe*, 247 U. S. 165 (1918), the Supreme Court decided that the net income of a corporation derived from exporting goods was not a tax on exports prohibited by the Constitution, the unanimous opinion of the Court stating:

> "The sixteenth amendment, although referred to in argument, has no real bearing and may be put out of view. As pointed out in recent decisions, it does not extend the taxing power to new or excepted subjects, but merely removes all occasion, which otherwise might exist, for an apportionment among the States of taxes laid on income, whether it be derived from one source or another." 247 U. S. at 172-3

Two years later, in *Eisner* v. *Macomber*, 252 U. S. 189, 206 (1920), the Court said:

> "As repeatedly held, this did not extend the taxing power to new subjects, but merely removed the necessity which might otherwise exist for an apportionment among the States of taxes laid on income."

In 1926 in *Metcalf & Eddy* v. *Mitchell,* 269 U. S. 514, 521, Mr. Justice Stone flatly declared:

> ". . . the sixteenth amendment did not extend the taxing power to any new class of subjects."

Five years later, in *Willcuts* v. *Bunn,* Chief Justice Hughes, 282 U. S. 216, 226 (1931), speaking for a unanimous Court which held capital gains on the sale of public securities to be taxable, reiterated the rationale of the rule as follows:

> "In the case of the obligations of a State or of its political subdivisions, the subject held to be exempt from Federal taxation is the principal and interest of the obligations. *Pollock* v. *Fcrmers' Loan & Trust Company, supra.* These obligations constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the exercise of the borrowing power of the Government."

Again in *James* v. *Dravo Contracting Co.,* 302 U. S. 134, 153 (1937) Chief Justice Hughes restated the reason for income tax immunity of state and municipal bond interest as follows:

> "There is no ineluctable logic which makes the doctrine of immunity with respect to government bonds applicable to the earnings of an independent contractor rendering services to the Government. That doctrine recognizes the direct effect of a tax which 'would operate on the power to borrow before it is exercised' *(Pollock* v. *Farmers Loan & Trust Co., supra)* and which would directly affect the Government's obligations as a continuing security. *Vital considerations are there involved respecting the permanent relations of the Government to investors in its securities and its ability to maintain its credit,—considerations which are not found in connection with contracts made from time to time for the services of independent contractors."* (italics supplied)

And again, in *Helvering* v. *Mountain Producers Corporation,* 303 U. S. 376, 386 (1938) the Chief Justice repeated that:

> "a tax on the interest payable on state and municipal bonds has been held to be invalid as a tax bearing directly upon the exercise of the borrowing power of the Government (*Weston* v. *Charleston* * * *, *Pollock* v. *Farmers' Loan & Trust Co.* * * *)."

In the previous year Mr. Justice Cardozo had also pointed out in *Hale* v. *Iowa State Board,* 302 U. S. 95, 107 (1937):

> "By the teaching of the same *(Pollock)* case an income tax, if made to cover the interest on Government bonds, is a clog upon the borrowing power such as was condemned in *McCulloch* v. *Maryland* * * * and *Collector* v. *Day* * * *."

And in *Helvering* v. *Gerhardt*, 304 U. S. 405 (1938), in upholding a federal income tax as applied to salaries of the employees of the Port Authority, Chief Justice Stone also referred to the hazard of impairing the borrowing power, stating that the immunity doctrine had been sustained

> "where * * * the function involved was one thought to be essential to the maintenance of a state government: as where the attempt was * * * to tax income received by a private investor from state bonds, and thus threaten impairment of the borrowing power of the state, *Pollock* v. *Farmers' Loan & Trust Company*, 157 U. S. 429; cf. *Weston* v. *Charleston, supra*, 465-466."

The rationale of the *Helvering* v. *Gerhardt* case was followed in *Graves* v. *New York ex rel O'Keefe*, 306 U. S. 466 (1939) in which the Court held that the salary of an employee of the Home Owners Loan Corporation was not immune from state income tax. Both these cases relate to the same question whether intergovernmental immunities extend to the salaries of employees: *Gerhardt* to a federal income tax applicable to state employees and *O'Keefe* to a state income tax applicable to federal employees.

It is noteworthy that in the *Gerhardt* case Mr. Justice Stone pointed out that the *Pollock* case had no application because, as distinguished from the income taxation of public salaries, the income taxation of public securities would "threaten impairment of the borrowing power of the state." The *O'Keefe* case does not refer to the *Pollock* case, probably because of the Government's position that the income taxation of public securities was essentially different.

In his argument in *Graves* v. *O'Keefe* before the Supreme Court, Solicitor General Robert Jackson, later Justice of the Supreme Court, had explained that the Government accepted the distinction drawn by Chief Justice Stone in the *Gerhardt* case and had emphasized that where one deals with a debtor-creditor relationship, the borrower is the one who is burdened. The Solicitor General said that it was *the presence of an actual burden upon the public instrumentality which issues public securities which distinguished the taxation of the interest on public securities from the taxation of the salaries of public employees.*

The evidence is overwhelming that the views of Congress and the Supreme Court on the scope of the Sixteenth Amendment correctly express the purpose and meaning of the Amendment. That purpose was to permit Congress to levy and assess taxes on income without complying with the impracticable rule of apportionment according to population. Before the Amendment Congress had the power to lay income taxes but not without apportionment. After the Amendment Congress need not apportion. The history of the Amendment proves that it was never intended to repeal the constitutional doctrine of reciprocal immunity from taxation of state and federal instrumentalities and obligations.

3. *The history of the adoption of the Sixteenth Amendment confirms the Congressional and Supreme Court construction of its intent and meaning.*

Sixty years ago President Taft sent a special message to Congress in which he urged a constitutional amendment which would confer upon the national government

> "the power to levy an income tax * * * without apportionment among the states in proportion to population."

The President urged Congress not to reenact the 1894 income tax law which had been declared unconstitutional, saying:

> "For the Congress to assume that the court will reverse itself, and to enact legislation on such an assumption, will not strengthen popular confidence in the stability of judicial construction of the Constitution." 44 Cong. Rec. (June 16, 1909) p. 3344

Previous to President Taft's special message, Senator Brown of Nebraska had offered a resolution for a constitutional amendment to the effect that "The Congress shall have power to lay and collect taxes on incomes and inheritances." Upon being informed in debate that Congress already had both of the powers in question and that only the rule of apportionment stood in the way of federal income taxation, Senator Brown offered, a few days later, a second resolution which read that "The Congress shall have power to lay and collect direct taxes on incomes without apportionment among the several states according to population." 44 Cong. Rec. pp. 1548, 1568-9, 3377. The Senate Finance Committee soon reported a resolution for a constitutional amendment in which the words "direct taxes" were changed to "taxes" and after "income" the words "from whatever source derived" were inserted. The proposed amendment then read:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration." 44 Cong. Rec. p. 3900

The Committee gave no explanation of the reason for these changes.* However, the reason for the two changes is clear. The words "direct taxes" in Senator Brown's proposal would require explanation because it was not obvious why the amendment should only provide that direct taxes need not be apportioned. Hence, to eliminate the ambiguity of "direct taxes" the committee provided that taxes on income "from whatever source derived" need not be apportioned. Senator Brown's proposed amendment as clarified by the Senate Finance Committee did not grant power to Congress to lay and collect a tax on incomes; Congress already had plenary power to levy income taxes under Article I, Section 8 of the Constitution (quoted *supra* at p. 3). The phrase "from whatever source derived" was simply another way of saying that Congress need no longer apportion any tax on incomes, irrespective of the source of the income; that was the sole purpose of the Amendment proposed by President Taft and introduced by Senator Brown.

* The only colloquy which took place when the revised resolution was reported to the Senate is found in 44 Cong. Rec. 3900.

The debate in Congress took one day in the Senate and one day in the House. The joint resolution proposing the amendment as redrafted by the Committee passed both houses and was immediately submitted to the states. No consideration was given at all to the question of the taxation of income from state and muncipal bonds. The matter simply was not discussed. There was no indication that anyone sought to overturn the doctrine that state and municipal bond interest was immune from federal taxation which had been unanimously established in the *Pollock* case.

On January 5, 1910, Governor Hughes of New York submitted the amendment to the Legislature with a message calling attention to the words "from whatever source derived," suggesting that this might permit the taxation of income from state and municipal bonds, and questioning whether the amendment should be ratified.

On February 10, 1910, Senator Borah spoke in the Senate in answer to Governor Hughes' objection, stating in substance that no such meaning could be attached to the amendment. 45 Cong. Rec. 1694-9. He was followed by Senator Brown who concurred with Senator Borah's interpretation. Later, Senator Brown pointedly suggested that Governor Hughes stood alone in his fear:

> "It is a very significant fact that this amendment which was pending in Congress for days and was the subject of discussion by Congress and the press, should never have met this criticism while it was pending. In its present form it had the support of a unanimous Senate and a practically unanimous House of Representatives, who were all, judged by their votes, in favor of conferring this power on Congress, and yet no one in Congress ever suggested any change in the language of the resolution or proposed an amendment thereto to cover the objection now made.
>
> "Nor did any distinguished Governor from any of the 46 States, all of whom are now very loud in their protestations that the Government should have the power to tax incomes without apportionment, ever suggest that the amendment should have been modified in form in any respect. In this body the State of New York enjoys representation of the very highest character and most eminent ability, and yet New York on the roll call, as shown in the Congressional Record, was in favor of this amendment as it passed Congress, and was silent as to any suggestion that the language was faulty.
>
> * * *
>
> "The amendment does not alter or modify the relation today existing between the States and the Federal Government. That relation will remain the same under the amendment as it is today without the amendment. It is conceded by all that the Government cannot under the present Constitution tax state securities or state instrumentalities." 45 Cong. Rec. 2245-6 (Feb. 23, 1910)

On February 17, 1910, Senator Elihu Root of New York, a strong advocate for the amendment, wrote to New York State Senator Davenport giving his reasoned opinion that the amendment did not affect the immunity of state and municipal bonds. Senator Root wrote:

> "Much as I respect the opinion of the Governor of the State, I cannot agree with the view expressed in his special message on January 5, and as I advocated in the Senate the resolution to submit the proposed amendment, it seems appropriate that I should state my view of its effect.
>
> * * *
>
> "The proposal followed the suggestion of the Supreme Court in the *Pollock case.*
>
> "The evil to be remedied was avowedly and manifestly the incapacity of the National Government resulting from the decision that income practically could not be taxed when derived either from real estate or from personal property, although it could be taxed when derived from business or occupation.
>
> "The terms of the amendment are apt to cure that evil and to take away from the different classes of income considered by the court a practical immunity from taxation based upon the source from which they were derived." 45 Cong. Rec. p. 2539-40 (Mar. 1, 1910)

Thus, three United States Senators sought to allay any doubt held by Governor Hughes. No other member of Congress or any Governor* expressed any other view. That Governor Hughes' doubts were set at rest is shown by his opinions after he became Chief Justice, in *Willcuts* v. *Bunn* (*supra*, p. 8), *James* v. *Dravo Contracting Co.* (*supra*, p. 8) and *Helvering* v. *Mountain Producers Corporation* (*supra*, p. 8).

No one would doubt that if the states and their municipalities were to attempt to impose state or local taxes upon interest received by their residents from obligations of the Federal government, such a levy would be unconstitutional in the absence of consent by Congress to such taxation. *Weston* v. *City of Charleston*, 2 Pet. (U. S.) 449 (1829). And this is so even though it is universally accepted that the state legislatures possess plenary power to tax, subject only to the limitations of their state constitutions.

It is our opinion that the unanimous holding in the *Pollock* case, reaffirmed so many times after the Sixteenth Amendment, that interest on state and municipal securities is free from Federal income taxation under the Constitution would be again reaffirmed by the Supreme Court and that therefore the House Bill insofar as it seeks to lay a minimum tax applicable to such interest is unconstitutional.

*In a message to the New Jersey Legislature, dated February 7, 1910, John Franklin Fort, Governor of New Jersey, said:

"* * * Nor am I inclined to accept the statement that the Supreme Court of the United States might construe the words 'from whatever source derived' as found in the pending amendment as justifying the taxing of the securities of any other taxing power."

On February 23, Senator Brown, referring to the message of Governor Fort, of New Jersey, said:

"It cheers our hearts to read in the press that President Taft agrees with the Governor of New Jersey, who, in a message to his legislature February 7 and since the New York message was transmitted, took immediate and direct issue with the governor of New York." [45 Cong. Rec., p. 2245]

C. *To the extent the minimum tax applies to interest on local housing authority and agency obligations it is also unconstitutional under the Fifth Amendment.*

It is also our opinion that if the minimum tax in the House Bill applies to the interest on bonds of local public housing authorities issued to finance low rent housing, slum clearance and urban renewal projects, the bill violates the Fifth Amendment to the Constitution.

The United States Housing Act of 1937 [50 Stat. L. 888] provides in section 5(e) as follows:

> "Obligations, including interest thereon, issued by public housing agencies in connection with low-rent housing or slum-clearance projects, and the income derived by such agencies from such projects, shall be exempt from all taxation now or hereafter imposed by the United States."

The Housing Act of 1949 [63 Stat. L. 413] provides in section 102(g) as follows:

> "Obligations, including interest thereon, issued by local public agencies for projects assisted pursuant to this title, and income derived by such agencies from such projects, shall be exempt from all taxation now or hereafter imposed by the United States."

Since the interest on obligations issued by a local public housing authority or agency constitutes interest upon obligations of a political subdivision of a state, such interest is excluded from gross income under section 103 of the Internal Revenue Code. When interest is excluded from gross income under the Code, the provisions of the House Bill imposing the minimum tax become operative and apply to such exempt interest in excess of the $10,000 floor.

Each of the above-quoted provisions of the United States Housing Act of 1937 and the Housing Act of 1949 that the obligations of local housing authorities and agencies "including interest thereon" * * * shall be exempt from all taxation now or hereafter imposed by the United States constitutes a statutory contract between the federal government and the holders of such obligations. In our opinion, to deprive such holders to any extent of their immunity from federal taxation on the interest which they receive from such obligations impairs the obligation of the contract in violation of the Fifth Amendment which "protects rights against the United States arising out of a contract." *Lynch* v. *United States,* 292 U. S. 571 (1933). See also *Farmers and Mechanics Savings Bank* v. *Minnesota,* 232 U. S. 516, 528 (1913).

II

ADR by arbitrarily disallowing deductions unrelated to tax-exempt interest discriminates against state and municipal bondholders.

Section 302(a) of the House Bill which adds a new section 277 to the Code is inconsistent with established principles of judicial decisions concerning income tax deductions. The new section provides in effect that if a taxpayer other than a corporation has so-called "allocable expenses" for a taxable year, the deductions otherwise allowable for such expenses are disallowed to the extent of an amount equal to (1) the aggregate of such expenses multiplied by a fraction, the numerator of which is the "allowable tax preferences" and the denominator of which is such preferences plus "modified adjusted" gross income, or (2) the "allowable tax preferences," whichever is lesser.

The deductions which the bill requires to be allocated are payments or losses not related to a business or to a transaction entered into for profit, including interest, state and local taxes, and personal theft and casualty losses, as well as charitable contributions, cooperative housing expenses, medical and dental expenses, and net operating losses attributable to nonbusiness casualty losses.

Among the "allowable tax preferences" which would cause the partial disallowance of allocable deductions is interest in excess of $10,000 received from state and municipal bonds issued on and after July 12, 1969.

The Secretary of the Treasury when he appeared before this Committee advocated the adoption of an even more stringent provision limiting deductions for individuals so far as interest on state and municipal obligations is concerned. Although the House Bill contains transitional provisions under which the interest on state and municipal bonds would be taken into account gradually over a ten-year transitional period, the Secretary of the Treasury proposed that 100% of the interest should be taken into account immediately. The respected Secretary referred to the section disallowing deductions as the "ADR" provision of the bill, meaning "Allocation of Deductions Rule."

The House Ways and Means Committee Report, which accompanied the bill, tries to give a simple example of the operation of sections 301 and 302 in a footnote which reads as follows:

> "For example, suppose the individual has as taxable income of $30,000, a tax-exempt income of $70,000, and $30,000 of personal deductions. Applying the limit on tax preference first results in adding $20,000 to the individual's taxable income increasing the latter to $50,000 and decreasing tax-free income to $50,000. Deductions are then allocated on the basis of a 50-50 split between taxable and nontaxable income, resulting in disallowing $15,000 of the total of $30,000 of deductions. For simplicity, this example omits the effect of the $10,000 floor." H. Rep. No. 91-413 (Part I), *supra*, p. 83, n. 3.

If, for example, the $30,000 of personal deductions consisted of contributions to charitable organizations (irrespective of whether the contributions consisted of cash or securities appreciated in value), the result would be that a substantial portion of the charitable contributions would be lost as a deduction.

First of all, the percentage limitation of 50% under the bill in the case of a cash contribution and 30% under the bill in case the contribution consisted of appreciated securities, would apply. Then the amount allowable as a deduction would be cut by 50% regardless of the nature of the charitable contribution. Presumably under the House Bill the amount in excess of the percentage limitation (either $5,000 if the contribution were in cash or $15,000 if the contribution were in appreciated securities) could be carried over for the following five years and deducted as a charitable contribution. Nevertheless the 50% disallowed as a result of the application of the proposed allocation of deductions rule could not be carried forward and the donor would have no tax benefit from having given this amount.

Omitting "for simplicity" the $10,000 floor, if the $30,000 of personal deductions consisted of state and local taxes, or casualty losses, instead of charitable contributions, one-half of the deductions would be disallowed.

A. *There is no doubt Congress may disallow deductions directly related to interest on state and municipal bonds or properly allocable to such interest.*

In order to clarify an issue already beclouded by a fundamental discrepancy between the bill and the Committee Report, we wish to emphasize that in our view, Congress has plenary power to disallow any deduction directly related to tax-exempt interest on state and municipal bonds. This principle is illustrated by the provision of the Reverue Act of 1921 [now Code § 265(2)] which forbids the deduction of interest paid on loans used to carry tax-exempt securities. In *Denman* v. *Slayton*, 282 U. S. 514 (1931) the constitutionality of this disallowance was upheld by a unanimous Supreme Court. The Court distinguished *National Insurance Company* v. *United States*, 277 U. S. 508 (1928) on the ground that Slayton, a municipal bond dealer, was not required to pay more taxes because he owned exempt securities.

Nor do we have any doubt regarding the constitutionality of section 265(1) of the Code which provides that no deduction shall be allowed for any

> "amount otherwise allowable as a deduction under section 212 (relating to expenses for production of income) which is allocable to interest * * * wholly exempt from taxes * * *."

For exampie, if an individual taxpayer receives one-half of his income from tax-exempt securities and one-half his income from taxable securities, all such securities being in a custody account of a bank, the custodian fees paid to the bank can constitutionally be allocated between the income from the tax-exempt securities and from the taxable securities. The statutory inhibition against the deduction of one-half of those fees and expenses is in our opinion constitutional because there is a meaningful basis for the allocation.

B. *By disallowing deductions not reasonably related to the receipt of tax-exempt income, ADR violates the rule of law in the National Life Insurance Company case.*

The House Ways and Means Committee Report gives lip service to the principle that allocation should be required "only for those expenses which can reasonably be assumed to be met in part out of tax-free income." H. Rep. 91-413 (Part 1), p. 82.

However, this assertion in the Committee Report finds no counterpart or expression in the House Bill which contains no clause confining the ADR to deductions having a reasonable relationship to the tax-exempt income.

Any attempt to include such a limitation on ADR would indeed be contradictory of the other provisions of the bill which apply ADR even when the deductions are wholly unrelated to the receipt of interest on state and municipal securities, such as, for example, the inclusion in so-called "allocable deductions" of casualty losses, charitable contributions, or state and local taxes.

Under ADR an individual with tax-exempt securities who also has deductions for casualty losses, charitable contributions or state and local taxes will be forced to pay a higher federal income tax simply by reason of the ownership of such securities. A simple example omitting the $10,000 floor should suffice to show that the ADR requires this result. Assume two taxpayers, each married and under 65 but with no dependents. Taxpayer A receives $50,000 in income from municipal bonds and has an adjusted gross income of $50,000 and deductions of $25,000. Taxpayer B has the same adjusted gross income and deductions but receives no tax-exempt interest. Taxpayer A will pay a federal income tax, disregarding the 10% surcharge, of $10,475, in contrast to Taxpayer B, who will pay a tax of $5,596, as follows:

	Taxpayer A		*Taxpayer B*	
Adjusted Gross Income ...		$50,000		$50,000
Tax-exempt municipal bond interest		50,000		none
Allocable Expenses	$25,000		$25,000	
Less:				
Amount Disallowed by ADR	12,500	$12,500	none	$25,000
Taxable Income		$37,500		$25,000
Tax		$10,475		$ 5,596

When prospective purchasers of tax-exempt securities realize that their right to deductions will be substantially eroded if either the House Bill or the Treasury proposal becomes law they may well curtail their purchases and even be forced to sell securities acquired since the cutoff date of July 11, 1969 in the House Bill. The incongruity of an individual who owns no tax-exempt securities paying less taxes than a taxpayer with the identical taxable income who accepts the lower interest rate borne by municipal bonds can have a serious impact upon the municipal bond market. The adverse effect of this potential interference with the borrowing power of states and municipalities stems primarily from the discriminatory disallowance of charitable contributions, state and local taxes, theft and casualty losses, and medical and dental expenses, none of which are even remotely connected with the receipt of tax-exempt interest.

In *National Life Insurance Company* v. *United States,* 277 U. S. 508, 522 (1928), the Supreme Court held that "Congress has no power purposely and directly to tax State obligations by refusing to their owners deductions allowed to others."

And yet this is precisely what happens under ADR as the foregoing example demonstrates. It is submitted that ADR plainly discriminates against those taxpayers (other than banks and other corporations) who receive state and municipal bond interest by compelling them to pay a higher tax than other taxpayers receiving the same amount of taxable income who do not own tax-exempt public securities.

C. The Atlas Life Insurance Company case does not support ADR.

United States v. *Atlas Life Insurance Company,* 381 U. S. 233 (1965), which considered the constitutionality of The Life Insurance Company Income Tax Act of 1959 does not support the ADR. That Act imposed a tax upon the taxable investment income of life insurance companies and upon one-half the amount by which total gain from operations exceeds taxable investment income. 73 Stat. 112, Code §§ 801-820. In arriving at taxable investment income, the Act recognized that life insurance companies are required by law to maintain policyholder reserves to meet future claims, that they normally add to these reserves a large portion of their investment income, and that these increments should not be subjected to tax. The Act defines life insurance reserves, provides a method for establishing the amount which for tax purposes is deemed to be added each year to those reserves, and prescribes a division of the investment income of an insurance company into two parts, the policyholder's share and the company's share.

Under section 804 the total amount to be added to the reserve is divided by the total investment yield and the resulting percentage is used to allocate each item of investment income, including tax-exempt interest, partly to policyholders and partly to the company. The effect of apportioning the annual addition to the reserve to nontaxable and taxable income *pro rata* is to limit the deductions allowed against taxable income to its proportionate part of the addition to the reserve. The remainder of each item is considered to be the company's share of investment income. In computing taxable investment income, the Act then allows a deduction of the company's share of tax-exempt interest from the total amount of investment income allocated to the Company.

Atlas claimed it was entitled to deduct from total investment income both the full amount of the annual additions to the reserves and the full amount of tax-exempt interest received. The company argued that by assigning part of the exempt income to the reserve account rather than assigning only taxable income, the Act places more taxable income on the company's share of investment return, with the result that it paid more tax because it had received tax-exempt interest.

The Supreme Court speaking unanimously stated that:

"... the policyholder's claim against investment income is sufficiently direct and immediate to justify the Congress in treating a major part of investment income not as income to the company but as income to the policyholders. 381 U. S. at 247-8

* * *

"Under the 1959 Act this portion is arrived at by subjecting each dollar of investment income, whatever its source, to a pro rata share of the obligation owed by the company to the policyholders, from whom the invested funds are chiefly obtained. In our view, there is nothing inherently arbitrary or irrational in such a formula for setting aside that share of investment income which must be committed to the reserves." 381 U. S. at 249

The Court pointed out that:

"The formula does pre-empt a share of tax-exempt interest for policyholders and the company will pay more than it would if it had full benefit of the inclusion for reserve additions *and at the same time could reduce taxable income by the full amount of exempt interest.* But this result necessarily follows from the application of the principle of charging exempt income with a fair share of the burdens *properly allocable* to it." 321 U. S. at 251 (italics supplied)

This treatment of tax-exempt income prevents, as it was intended to do, a double deduction. If life insurance companies could not only deduct *in full* the annual additions to reserves which were assigned to the policyholders but also *exclude* from their income the tax-exempt interest assigned to the policyholders, they would be in effect deducting tax-exempt interest which had already been excluded from their taxable income. Thus, life insurance companies would have an exemption and also a deduction for the same amount of tax-exempt interest.

The Court declined to consider any comparison of two life insurance companies which received the same amount of taxable income but one of which companies received tax-exempt municipal interest, pointing out that life insurance companies do not have a choice of investing or not investing but must invest either in one kind of security or another to accumulate funds for their policyholders and that the items of income and expense which entered into any computation of taxable income of a life insurance company were so interrelated that it was unrealistic to compare life insurance companies with different earning capacities in determining whether expenses were properly allocable to tax-exempt income. 381 U. S. at 250-1.

In so doing the Court accepted the distinction between an individual taxpayer and a life insurance company which had been urged upon it by the Department of Justice in its brief in the case. In the brief the Department had emphasized this distinction as follows:

"If we were dealing with a simple tax upon gross income received by a taxpayer *exclusively for his own benefit* without deductible costs, then it might be true to say that a tax liability which is increased because of the additions of an increment of State bond interest is, to some extent, a tax on the income from the bonds. But that is not this case; here we deal with the net income after sundry subtractions from the received income coming into the company's possession.

"... but the arithmetic is meaningless unless we also consider *whether the State-bond interest has such a relation to other items entering into the determination of taxable net income that the receipt or non-receipt of the State bond justifies a change in the corresponding elements of the arithmetical computation.*" Pet. Br., pp. 22-3 (italics supplied)

It is this very distinction which is so blurred by the self-contradictory language in the Report of the Ways and Means Committee that the draftsmen of the House Bill could not find words to insert in the bill which would limit the ADR to an allocation of deductions involving expenses reasonably attributable to the production and collection of the interest received by an individual (or an estate or trust) from state and municipal securities.

The Supreme Court in the *Atlas* case was not "dealing with a simple tax upon gross income received by a taxpayer exclusively for his own benefit," as the Government's brief in *Atlas* stressed. In *Atlas* the income was partly for the benefit of the taxpayer (i.e., the Company) and partly for the benefit of the policyholders. Hence, the allocation sanctioned by the Court in *Atlas* is a far cry from the sweeping disallowance of deductions not germane to tax-exempt income received by a taxpayer exclusively for his own benefit. To do what the House Bill would purport to do makes ADR an arbitrary and discriminatory rule.

III

Sections 601 and 602 of the Bill provide for unnecessary and undesirable Federal control of State and Local financing; the Subsidy Program provided for therein is unworkable.

Section 601 of the House Bill contains provisions which purport to authorize an issuer of obligations which are presently exempt under section 103(a)(1) of the Code to issue obligations which would not be subject to such exemption. The election shall be made with respect to each issue of obligations to which it is to apply and the election with respect to any issue once made shall be irrevocable. Section 602(b) of the bill provides that the Secretary of the Treasury or his delegate shall pay a fixed percentage of the interest yield on each issue of obligations to which the foregoing election applies before the first day of each calendar quarter. The Secretary or his delegate shall determine the fixed percentage of interest yield which he determines is necessary for the government to pay "in order to encourage the States and political subdivisions thereof to make elections under section 103(b)". During the calendar quarters beginning prior to January 1, 1975, the fixed percentage shall be not less than 30 percent and not more than 40 percent; for calendar quarters beginning after December 31, 1974, the percentage shall be not less than 25 percent and not more than 40 percent. Payment of any interest required shall be made by the Secretary of the Treasury or his delegate not later than the time at which the interest payment on the obligation is required to be made by the issuer.

Section 602(c) of the bill provides that, at the request of the issuer, the liability of the United States under section 602 to pay interest to the holders of an issue of obligations for which an election has been made shall be made through assumption by the United States of the obligation to pay a separate set of interest coupons issued with the obligations.

Section 601(b) of the bill provides that, under regulations prescribed by the Secretary or his delegate, any arbitrage obligation shall not be included within those obligations exempt from taxation under section 103.

The amendments relating to the subsidy program shall apply to obligations issued in calendar quarters beginning after the date of the enactment of those provisions. The amendment in respect of arbitrage obligations shall apply to obligations issued after July 11, 1969.

A. *Sections 601 and 602 of the bill provide a vehicle for continuing federal control of the purposes for which state and local obligations may be issued.*

In order to overcome the objections to a subsidy plan which are necessary to complement a program of taxable debt instruments to finance state and local government capital outlays, the provisions of sections 601 and 602 of the House Bill, according to the Report of the House Committee on Ways and Means, are "entirely elective" and the Report further states that there "is no review of the advisability of the local project or of the issuer's ability to repay". However, such a review will be required for the subsidy provisions of the bill apply only to obligations which, but for an election under proposed section 103(b), would be obligations to which section 103(a)(1) applies. Thus, neither industrial development bonds as defined in section 107 of the Revenue and Expenditure Control Act of 1968 nor arbitrage obligations would be eligible for the subsidy program. If Congress is concerned with tax reform it is incumbent upon it truly to reform the situation created by the unfortunate definition of industrial development bonds contained in section 107 of the Revenue and Expenditure Control Act of 1968 and to prevent the taxation of "arbitrage" obligations. As Senator Baker stated on May 27, 1969 in the Senate upon the introduction of S. 2280 in respect of section 107 of the Revenue and Expenditure Control Act of 1968:

> "... This measure originated by way of amendment on the Senate floor without the benefit of hearings in either House and was adopted after brief debate. Subsequent to adoption by the Senate of the Ribicoff amendment, a provision imposing the 10-percent surtax was also added to the same bill, and the attention of the Senate-House conferees, the other Members of Congress, and the country at large was naturally and appropriately focused on the all-important issues of the surtax and expenditure cut and not on the scope of the definition relating to industrial development bonds.

> Many Members of Congress who supported the taxation of industrial development bonds later came to realize that, as a result of the cursory treatment given this subject, Congress had by means of the definition employed in the act gone much further than was ever intended. It became generally acknowledged that Congress had not only provided for the taxation of industrial development bonds but had also made a wholesale attack on numerous State and local obligations completely unrelated to industrial development. Chairman Wilbur Mills of the House Ways and Means Committee, stated this fact on the floor at the time of passage of the conference report and invited the National Governors Conference and others to provide corrective legislation.
>
> * * *
>
> The bill which I introduce today is essentially a revised version of the measure that I introduced late in the last session. Its purpose is to correct what most believe is clearly a distorted definition of the term "industrial development bond" as presently set forth in the statute."

Senator Baker has stated, and we fully concur, that section 107 of the Revenue and Expenditure Control Act of 1968 has the effect of including within the definition "industrial development bond" many bonds which would be issued to finance facilities for many "acknowledged and traditional State and local functions". He further stated at the time of the introduction of S. 2280:

> "...What the act [Revenue and Expenditure Control Act of 1968] does is set up a list of approved purposes labeled "exemptions." Bonds for these purposes remain exempt and those for all other State and local governmental purposes are, as I have said, taxable when private occupants pay to use the financed facilities.
>
> By establishing this honor roll rating, the Congress purported to classify as "good" or "bad" many legitimate functions of State and local governments, rewarding "good" purposes with exemption and penalizing "bad" purposes with taxation. Among the "bad" purposes are such fundamental governmental functions as education and health care, which obviously are totally unrelated to the development of new industrial plants, but the interest on the facilities of which is taxable if they are maintained by private occupants.
>
> * * *
>
> In my judgment, this type of continuing Federal regulation by the honor roll regulation of State and local governmental functions has no proper place in our federal system and accordingly should be abandoned."

Just as we support meaningful redefinition of the term "industrial development bond" we object to any congressional determination of "good" or "bad" purposes. The goodness or badness of purposes for which state or local obligations may be issued can best be determined by states and local government in accordance with state established concepts of public purpose and not by Congress.

The statutory authorization to exclude arbitrage obligations from the subsidy program and to include income derived from arbitrage obligations in the gross income of the recipients thereof is another ill-conceived congressional attempt involving federal review of the purposes for which state or local obligations may be issued. The Report of the House Committee on Ways and Means states that "[s]ome State and local governments have misused their tax exemption privilege by engaging in arbitrage transactions for which the funds from tax exempt issues are employed to purchase higher yielding federal obligations whose interest is not taxed in their hands." No examples of such arbitrage transactions are given. We know of no situation in which bonds have been issued in an arbitrage transaction as we believe that term to be used by the House and thus we have grave doubts as to the need for a legislative remedy for a supposed evil which does not exist. However, we are quite concerned that the term may be so defined to attack necessary and proper state and local financing methods. For example, it is quite common for state and local governments to invest in higher yielding taxable obligations pending the use of the proceeds of the bond issue. Such proceeds may be used for the construction of needed capital facilities or may be used to refund outstanding obligations. In either case it may be prudent, and indeed required, that the state or political subdivision invest those funds in the highest yielding and safest investments available to them including United States government securities, until such time as they can be used for the purpose for which they are intended.

The Report states that "it is contemplated that the regulations to be issued by the Secretary of the Treasury concerning this section of the bill will provide rules for the temporary investment of the proceeds of a state or local government obligation pending their expenditure for the governmental purposes which gave rise to their issue." However, neither the bill nor the Report provide the Secretary with any discernible standard as to what type of arbitrage obligations will be included in the definition promulgated by the Secretary of the Treasury.

We assume, but are uncertain, that the term as used in the House Bill has the ambivalent meaning given to it in the Treasury Department announcement contained in Technical Information Release No. 840, dated August 11, 1966. That Release stated that a study would be conducted to determine whether certain obligations should be considered as obligations of states, territories, possessions and their political subdivisions or the District of Columbia. The obligations which were to be the subject of the study were "obligations issued by these govermental units where a principal purpose is to invest the proceeds of the tax exempt obligations in taxable obligations, generally United States Government securities, bearing a higher interest yield."

Pending such study, the Treasury Department announced in the Release that it would decline to issue rulings that interest on obligations falling within two categories would be exempt from federal income taxation under section 103 of the Code.

The obligations were those

"1. Where all or a substantial part of the proceeds of the issue (other than normal contingency reserves such as debt service reserves) are only to be invested

> in taxable obligations which are, in turn, to be held as security for the retirement of the obligations of the governmental unit.
>
> 2. Where the proceeds of the issue are to be used to refund outstanding obligations which are first callable more than five years in the future, and in the interim, are to be invested in taxable obligations held as security for the satisfaction of either the current issue or the issue to be refunded."

The Treasury Department then gave three examples of transactions where no rulings would be issued. The examples were

> "First, a State may issue obligations and invest the entire proceeds in United States bonds with similar maturities bearing a higher interest yield. The United States bonds are then placed in escrow to secure payments of interest and principal on the States obligations. The profit on the interest spread accrues to the State over the period of time that these obligations are outstanding.
>
> Second, a municipality may immediately realize the present value of the arbitrage profits to be derived over the future by casting the transaction in the following form: It may issue obligations in the amount of $100 million, use $20 million to build schools or for some other governmental purpose, and invest the balance, $80 million, in United States bonds which bear a higher interest yield. The United States bonds are escrowed to secure payment of interest and principal on the municipal obligations. The interest differential is sufficiently large so that the interest and principal received from the United States bonds are sufficient to pay the interest on the municipal obligations as well as to retire them at maturity.
>
> Third, a municipality may issue obligations for the stated purpose of refunding outstanding obligations first callable more than five years in the future. During the interim before the outstanding obligations are redeemed the proceeds of the advance refunding issue are invested in United States bonds bearing a higher interest yield, and such bonds are escrowed as security for the payment of either of the issues of municipal obligations. During that interim period, arbitrage profits based on the interest spread inure to the municipality."

If the Treasury Department has completed its study it has not announced the results thereof* and therefore we express grave doubts of the need for a legislative remedy. We can understand the concern of the Treasury Department in respect of the problem presented by the first category or the first and second examples so long as their concern is expressed with respect to transactions where all or a substantial part (80%) of the proceeds of the issue are to be solely for the purpose of investment

* The tax reform studies and proposals of the Treasury Department submitted to the Committee on Ways and Means of the House of Representatives on January 17, 1969 make no reference to arbitrage obligations. See *Tax Reform Studies and Proposals, U. S. Treasury Department,* Joint Publication, Committee on Ways and Means, U. S. House of Representatives and Committee on Finance, U. S. Senate, Washington: Government Printing Office, 1969.

in taxable obligations and have no other purpose such as the refunding of outstanding obligations where such refunding is permitted by state or local law or the instruments pursuant to which such outstanding bonds being refunded were issued. We are of this view for it would be difficult to find a public purpose if the language means what it says. We assume that the first category does not apply to refunding bonds for it appears to have been the intent of the Treasury Department to deal with refunding in the second category. It would be impossible to justify an argument that the first category would include such refunding obligations where they are callable less than five years in the future. The second category and the third example set forth in the Release could prevent a financing which involves a justifiable public purpose under state law and the facts underlying the financing program. There is no valid reason for Congress to impose its will in respect of the desirability of particular financing programs of state and local governments by denying the tax exemption to income derived from bonds of such state and local governments for such otherwise justifiable purposes.

We further express our concern over the provision in the bill which states that the provisions in respect of arbitrage bonds shall apply to obligations issued after July 11, 1969. Since the statute provides no discernible standard as to what type of arbitrage obligations will be included in the definition promulgated by the Secretary of the Treasury and since the provisions of the bill relating to arbitrage obligations are retroactive to July 11, 1969, issuers of securities will be unable to determine whether their obligations will be deemed to be arbitrage obligations the income of which will be subject to federal income tax and which will not be obligations to which the subsidy program will apply.

B. *The subsidy plan is unworkable in several respects.*

The subsidy program is unworkable as applied to any political subdivisions of a state. Assuming that a state can exercise the election provided by section 601, it would appear that a political subdivision of the state would be unable to exercise such an election without a grant of authority to do so. We are not aware that any state presently has authorized its political subdivisions to exercise such an election.

A political subdivision is merely a creature of the state and derives all of its power from the state. It is a general and undisputed proposition of law that a municipal corporation possesses and can exercise only those powers expressly granted, those necessarily or fairly implied in or incident to the powers expressly granted and those essential to the accomplishment of the declared objects and purposes of the corporation. Any fair, reasonable, substantial doubt concerning the existence of power is resolved by the courts against the corporation and the asserted power is denied. Neither the corporation nor its officers can do any act, or make any contract or incur any liability not authorized by its charter or the statute creating it, or by some other legislative authorization. All acts beyond the scope of powers granted are void. The power of the legislatures of the states to control their respective political subdivisions without hinderance, so far as the federal constitution or its laws are concerned, has been consistently recognized by the Supreme Court. The only restraint on this broad authority is that such exercise of power shall not contravene a federally protected right of one to whom that right is guaranteed. See *Hunter* v. *Pittsburgh,* 207 U. S. 162 (1907); *Gomillion* v. *Lightfoot,* 364 U. S. 339 (1960); *Baker* v. *Carr,* 369 U. S. 186 (1962). Thus where the City of Baltimore challenged, under the equal protection clause of the Fourteenth Amendment of the federal constitution, a state statute exempting a railroad from a City ad valorem tax, the Supreme Court rejected the City's contention of unconstitutionality with the assertion that a municipal corporation "has no privileges or immunities under the federal constitution which it may invoke in opposition to the will of its creator". *Williams* v. *Mayor and City Council of Baltimore,* 289 U. S. 36, 40 (1933).

Consistent with these well-defined concepts of state law, since there is no legislation of which we are aware in any state authorizing, implicitly or explicitly, the issuance of taxable bonds, it would appear that no political subdivision of any state has the power at present to issue taxable bonds notwithstanding the passage of the bill.

In order for a municipality to be empowered to elect to issue taxable bonds each state would have to pass enabling legislation and in some states the state constitution would need to be amended prior to the passage of such enabling legislation. Anything less than passage of state legislation would entangle a political subdivision desiring to make an election in protracted litigation testing the power of such political subdivision to exercise such election without enabling state legislation. Such litigation, of course, would have to be resolved prior to selling taxable obligations. As a practical matter no political subdivision would welcome delay in financing needed projects resulting from the time required to (1) enact necessary legislation or (2) to await the outcome of litigation, the success of which is conjectural.

The bill provides that the Secretary or his delegate "shall pay a fixed percentage of the interest yield on each issue of obligations" to which an election applies. The Committee report states that "[d]etermination of the interest yield on any issue of obligations is to be made immediately after they have been issued." It must be assumed that the term "interest yield" means return on investment to a bondholder based on the cost of the bond. The choice of the term "interest yield" is unfortunate for it relates to an amount to be received by the purchaser of the state or local obligations and not to the amount of interest payments required to be made by the state or local government, i.e. "interest rate". Since we are dealing with a subsidy plan to "encourage the States and political subdivisions thereof to make elections under section 103(b)" the amount of interest to be paid or interest rate would appear to be the proper criterion. However, since the percentage is to be based on "interest yield" the interest yield may be computed to maturity or to the earliest possible redemption date. If computed to the earliest date of redemption, no subsidy payments would be available on interest payment dates subsequent to the earliest redemption date if those obligations were not redeemed. No adjustments for redemption are specifically provided for in the bill. However, it is reasonable to assume that adjustments will be required depending on the redemption date and the redemption price. However, even though there is no specific statutory basis for the view that an adjustment would be made the implication of such authority furthers the contention that there will be a substantial amount of federal control in respect of obligations to which the election applies, not only with respect to the purpose for which the obligations are issued but details of the financing transaction which are a necessary incident to such financings. This is further evidenced by the Committee Report's statement in respect of premium or discount applied in the issuance of obligations:

> "...Where it is the most practicable method of effecting the intent of the bill, adjustment for any premium or any discount at which the obligations are issued may be made between the issuer and the United States at the time of issuance or such later time or times as may be appropriate."

Section 602(c) of the bill provides that at the request of the issuer, the liability of the United States under Section 602 to pay interest to the holders of an issue of taxable obligations shall be made through assumption by the United States of the obligation to pay a separate set of interest coupons issued with the obligations. This dual coupon concept has not to our knowledge been extensively explored by the legal community associated with the issuance and sale of state or local obligations. As a result substantial legal problems may exist. Thus while the Committee Report concedes that "the use of such dual coupon obligations might be necessary to avoid violation of the maximum interest rate limitations imposed on some States and localities by local law", a review of those limitations leads one ineluctably to the conclusion that the limitations would still apply.

While we have briefly discussed the provisions of the proposed subsidy plan and the ramifications resulting therefrom, we would like to call attention to the amount of federal control which appears from the various provisions. Reference has been heretofore made to some of the items of control. The federal government would be required to have personnel available to undertake the various responsibilities, including those mentioned below, which appear explicitly or implicitly in the language of the bill. First, the federal government would appear to be required to satisfy itself that the obligations to be issued were valid and legally binding obligations of the state or political subdivision. The extent of the government's involvement in this particular role would vary with each issue of obligations. Second, contemporaneously with such review the federal government would have to satisfy itself that the obligations to be issued would not be deemed to be industrial development bonds within the meaning of the Revenue and Expenditure Control Act of 1968 or arbitrage obligations. Third, determinations of interest yield would be required to be made by the federal government in respect of each issue of obligations. The exact amount of the interest yield would be of such importance to each issuer that an official of the federal government would have to be available upon the receipt of the bid for or upon the negotiation of the sale of an issue of obligations to confirm such amount. Fourth, machinery would be required to be established to provide that the federal government's share of the interest payments would be made not later than the time at which the interest payments on the obligations are required to be made by the issuer. Finally, personnel would also be required to make adjustments in the subsidy payments in the event that taxable obligations were redeemed prior to maturity. No discussion of the necessity of administering the foregoing functions appears to have been heretofore considered by Congress. The Committee Report is silent as to the need for the creation of administrative machinery and no reference is made to the cost of such administrative machinery in that section of the Committee Report relating to "Revenue effect."

For the reasons set forth above, we recommend that sections 601 and 602 of the bill not be enacted.

Respectfully submitted,

Hawkins, Delafield & Wood
67 Wall Street
New York, New York 10005

Dated: September 19, 1969

STATEMENT OF CAST IRON PIPE RESEARCH ASSOCIATION, SUBMITTED BY EDWARD D. HEFFERNAN

My name is Edward D. Heffernan. It is a distinct pleasure and privilege to have this opportunity to appear before your Committee. I represent the Cast Iron Pipe Research Association, a group of nine manufacturers of cast iron pressure pipe. A substantial proportion of the production of these companies goes into the many public waterworks around the country.

As you are aware, I am sure, Mr. Chairman, most of the waterworks, either new or those being updated, are financed by the issuance of local bonds, the proceeds of which pay for the system. Historically, the interest on these bonds has been tax exempt, thereby allowing these lower yielding securities a competitive place in the bond market. I need not dwell on the damage caused by the efforts to tamper with the tax exemption. It is all too evident in recent bond market reactions to the proposal you have under consideration Not as apparent is the vast number of water projects (destined to provide much-needed life support water systems to both rural and urban areas) which may well be jeopardized by a decision to go ahead with exemption-limiting provisions of H. R. 13270.

Our interest in opposing these provisions is both personally and civically motivated - personal, from the standpoint that our industry stands to be greatly impacted by a probable cutback in water projects all around the country; civic-minded, in that we cannot ignore the long-range potential for havoc in communities faced with critical water shortages in the face of burgeoning populations.

The bill proposes turning to the federal government as an alternative for help in financing the water systems. The supposed election of choosing either a tax exempt bond or federally subsidized bond may turn out to be no option at all. The higher tax exempt bond interest rates would drive bond issuers to use the subsidy if the cost to them were cheaper. The economics of this will soon press every community into seeking the subsidy. Neither is it at all clear, given a predictable change in the market for taxable municipal bonds as opposed to tax exempt bonds, that the federal government would collect more money in tax revenues than it paid out in interest subsidies; in fact, there is much evidence to suggest that it would lose considerable amounts of money.

The Ways and Means Committee clearly indicated the concern of some members by stating in its report, "There is no review of the advisability of the local project or of the users' ability to repay. Despite this disclaimer, nothing was put in the language of the bill restricting the Treasury Department from setting up requirements, and, in truth, the bill gives the Secretary or his delegate broad discretionary power of regulation ("subject to such conditions as the Secretary or his delegate, by regulation, prescribes"). Annually, it will be necessary to go for appropriations, and thus changes are always a possibility. Obviously there was discussion of the specter of federal controls when a community accepts federal assistance. Our concern here is that when it comes to setting priorities for worthy projects to be funded, the local people most familiar and closest to the problems will be subordinated to the bureaucratic review. Water needs, not nearly as glamorous as many publicized national problems, will be pushed far down the list of priorities. We do not think it is wise, equitable or economically sound to put the business of providing clean water on a constant crisis basis, and yet we are concerned that the passage of H. R. 13270 in its present form will do just that.

Our comments have been mainly about the election provision for state and municipal bonds; however, several other provisions of H. R. 13270 will have an objectionable effect on tax-free local bonds. The allocation of deductions provision includes the interest from new municipal bond issues in the list of tax preferences against which an individual would now have to charge a portion of his deductions. The limit on tax preferences requires that one pay taxes on at least half of all his earnings regardless of source (which includes interest from state and local bonds). The attraction of municipal bonds on the open market would certainly be impaired by these provisions.

Another aspect that greatly concerns us is the constitutional issue inherent in this legislative provision, since the federal government would be taxing a portion of the interest from tax exempt municipal bonds through the limits on tax preferences mechanism. Undoubtedly, opponents will challenge the constitutionality in the courts, resulting in lengthy litigation. During this period of doubtful tax status, bond investors would be unlikely to invest until the issue is resolved. Thus, with the market for bonds totally disrupted, many or all water systems projects would have to be suspended.

We urge you to remove these onerous provisions affecting local tax-free bonding and let our cities and local governments get on with the job of renewal, unhampered by unwise legislation hastily drawn in the name of tax reform.

Thank you for your consideration.

Statement of Harold B. Judell, of Foley, Judell, Beck, Morel & Bewley, Attorneys at Law, New Orleans, La.

Our firm's practice is devoted exclusively to municipal and corporate finance, and particularly the approval of municipal and corporate bonds. We represent a substantial number of municipalities, school boards, special service districts (waterworks, sewerage, drainage, road, hospital, recreation, etc.) and other political subdivisions and local units of government in the States of Louisiana and Mississippi in connection with the financing of their capital outlay requirements. Our clients are directly affected by the proposed tax legislation, which strikes at the heart of their method of raising money to construct essential governmental facilities to meet the needs of their constituents. Traditionally, these local entities have financed capital improvements through the issuance and sales of bonds or other debt obligations carrying an exemption under existing law from federal income taxation. Because the proposed legislation (insofar as it relates to the treatment of municipal bonds) will adversely affect and virtually cripple their financing powers, they have requested that we vigorously oppose, on their behalf, such legislation.

We will address ourselves to the matter of specific objections to the proposed tax reform bill. We object to (1) the minimum income tax plan, (2) the allocation of deductions, and (3) the federal subsidy plan on the grounds that (a) they raise serious constitutional questions involving the immunity of states and their political subdivisions from taxation by the federal government which cannot be resolved except through lengthy and costly litigation, the effect of which will be to paralyze local finance until a final judicial determination of the issue; (b) they would prevent the orderly financing of public improvements in an established capital market in the private sector of the economy at a time when such improvements are needed to help overcome the tremendous socio-economic problems facing urban areas; and (c) they would result in a deterioration and destruction of the historic federal-state relationship in the field of public finance and centralize the control of local finance in the federal government at great cost to the citizens and taxpayers of the nation. The combined effect of the foregoing could be to fuel an economic recession of major proportions.

The foundation for the doctrine of reciprocal tax immunity between governmental entities has early foundations in constitutional law. The landmark case of *McCulloch v. Maryland*, 4 Wheat 316 (1819) one hundred fifty years ago established the basis for the principle that the federal government does not have the power to levy taxes which would interfere with the governmental functions of states or their political subdivisions and, in cases too numerous to cite, the principle has been upheld.

The successful imposition of the proposed taxes would require that the Supreme Court overrule this long-standing constitutional law. This will make litigation inevitable and doom the municipal bond market to several years of disorder, which will cost the public taxpayers hundreds of millions of dollars in additional interest costs.

The inescapable fact is that even the *threat* of removal of the tax exempt feature from municipal bonds has resulted in a drastic increase in interest rates on such bonds in recent months, to the point where nearly two billion dollars of such bonds have not been sold. This results in the delay or postponement of a corresponding amount of construction of vitally needed public improvements. The taxation of interest on such bonds would permanently impair the ability of local governments to finance such construction, just at a time when the need for public facilities is at its peak. Then the so-called "taxpayer revolt" would become the "peoples' revolution" because the working man would be required to pay *higher* taxes to finance *fewer* improvements. Nor is the answer at this point a federal subsidy to "cover the difference" in the cost of issuing tax-free and taxable bonds. We already *have* a unique and time-tested subsidy program in the tax-free privilege accorded municipal bonds. This system has worked effectively for many years and should not be changed unless there is clear evidence of a better system, which is not provided for in the proposed legislation.

At at time when state-federal "revenue sharing" is being recognized as one solution to the many economic ills at the local level, a tax on bonds is proposed which would, in effect, shift revenue from the state to the federal level, resulting in a net loss to the states and local subdivisions. Inevitably this shift would bring federal control and weaken our entire system of federal-state relationships.

One of the alleged reasons for the proposed tax is to levy a tax on the oft-cited 154 individuals in high income brackets who do not pay taxes; however, research indicates that their escape of taxes is *not* due to investment in tax-free bonds. In any event, it would seem to be the height of folly to enact a form of taxation admittedly designed to affect such a limited number when in reality its impact is far more severe on the small taxpayer.

In conclusion, the retention of our entire state-federal govermental structure and the preservation of a sound economy demands that any attempts to levy a tax on interest or municipal bonds be defeated.

Statement of Robert R. Martin, President, Eastern Kentucky University, on Behalf of the American Association of State Colleges and Universities and the National Association of State Universities and Land-Grant Colleges

Mr. Chairman, members of the committee, my name is Robert R. Martin. I am President of Eastern Kentucky University in Richmond, Kentucky. I am also chairman of the Committee on Federal Relations of the American Association of State Colleges and Universities and a member of the Association's Board of Directors. This statement is submitted on behalf of the American Association of State Colleges and Universities and the National Association of State Universities and Land-Grant Colleges. The combined membership of these two associations is 372 colleges and universities located in the 50 states. the District of Columbia, Guam, Puerto Rico, and the Virgin Island. They enroll approximately three and a half million students, or about half of all the college students in the nation.

The Associations presenting this statement have previously joined with the American Council on Education and others in testimony covering major points in H.R. 13270 of interest to higher education. While we concur generally in the position taken by the American Council on Education, we feel that the gravity of the proposals in H.R. 13270 with respect to state and municipal bonds was inadequately emphasized in that statement, and for this reason present additional testimony on this point.

We also wish particularly to emphasize the concern of these two Associations—which was expressed in the American Council's testimony—over the proposed tax on the income of private foundations. We oppose the imposition of such a tax, and support the proposal that, instead of a tax, a registration or similar fee be prescribed adequate to cover the cost of enforcement of existing laws and regulations.

The colleges and universities in our two Associations have experienced enrollment increases in the past decade that have resulted in enormous demands for additional physical facilities. During this period of time, state governments and institutions of public higher education have had to rely primarily on long-term borrowing as the source of funds to meet these capital needs. General obligation bonds and/or revenue bonds have been issued by the states or by the institutions to provide funds for necessary academic, service and housing facilities. Such bonds, being exempt from taxation by the Federal Government, have been readily marketable and have enabled the institutions to provide the facilities necessary for the academic and other programs required by the increasingly large number of young men and women seeking the advantages of higher education.

I do not believe it is an overstatement to say that the result will be "catastrophic" if the bill passes in its present form. In fact, the threat of passage has already seriously damaged markets for this type of bond.

To illustrate, I cite the experience of Eastern Kentucky University. Since 1960, Eastern Kentucky University has issued and marketed several series of its Consolidated Educational Buildings Revenue Bonds, aggregating $21,400,000, which were sold in the open market and purchased by private investors. In July, 1969, the University offered a series of such bonds in the amount of $7,400,000 for the purpose of constructing needed academic facilities. For the first time in the history of the Commonwealth of Kentucky, no bids were received for the purchase of bonds offered by a state agency. I am info:med by a respected municipal bond dealer that the threat of passage of H.R. 13270 was the sole contributing factor for the market decline during the week that this issue of bonds failed to attract a bid.

Under Secions 301 and 302 of the proposed Income Tax Reform Act of 1969, the tax exempt status of state and municipal bonds is negated, not only on future issues by these agencies but on existing issues. With reference to existing issues, the provisions of these two sections will, in my opinion, be a serious breach of faith by the United States Government. These bonds were purchased under the assumption of tax exemption and lower interest costs were realized by the seller of the bonds due to tax exemption. I am informed that that bonds issued by state and municipal government agencies have been tax exempt from the original enactment of the income tax laws until the present date. If Sections 301 and 302 become law, then earnings from such bonds will become liable to taxation and the owner will have no recourse for the resultant or potential loss of income. Obviously, the bondholder will unavoidably conclude that the state and municipal bonds are not good investments. Further, the potential purchaser of state and municipal bonds will be forced to conclude that, if such bonds can be made subject to taxation on the basis proposed by Sections 301 and 302, then subsequent legislation can make such bonds fully taxable. Accordingly, interest rates will rise markedly and the marketability of state and municipal bonds will be seriously jeopardized. Further the provisions of these sections constitute an attempt, by indirection, to provide for federal taxation on state and local governmental units.

Proponents of H.R. 13270 have pointed to Sections 601 and 602 as protection for state and municipal agencies in this matter in view of the potential effects of Sections 301 and 302. However, what appears to be a choice between the sale of taxable or tax-exempt bonds by the agency is in reality no choice whatsoever. An analysis of the effect of H.R. 13270 upon the bond market would have to conclude that the bill in its present form would make it necessary for public institutions of higher education to look to the Federal Government for federal financing of physical plant needs. The proposed subsidy will not attack the problem of debt capacity under parity formulas to which existing debt has committed the institutions. Further, a serious question arises regarding the determination of the amount of interest subsidy. Here, I am advised by a municipal bond dealer, whose qualifications I respect, who stated that he was unable to find a single individual in his business who does not believe that the result of the bill will be higher interest costs to issuers, even after the federal subsidy. Additionally, the imposition of federal regulations and "red tape" will seriously impair the flexibility and efficiency of capital financing by public institutions of higher education.

Under existing federal statutes and regulations, state and local governments have had the ability to operate freely, without federal interference or intervention, in the incurrence of long term debt. Admittedly, state colleges and universities have used federal assistance in this field at one time or another. However, when such federal assistance was used, the Federal Government was free to accept or reject this assistance under the prevailing rules. The provisions of H.R. 13270 are such that, in my opinion, this freedom will disappear. State colleges and universities will be forced to apply to the Federal Government for assistance or pay rates of interest that would be economically prohibitive. While the bill proposes a subsidy without regulation, experience in the field of federal assistance leads us to conclude that the outcome would be otherwise.

I have offered no opinion or comment concerning the remainder of the Act. Certainly, I subscribe to the concept of tax reform to the end that the burden of taxation is equitably distributed among the citizenry. I must strongly protest, however, the efforts of proponents of the Income Tax Reform Act of 1969 to use the concept of "tax reform" to disguise an attack upon the treasuries of states and municipalities. Such action is contrary to the fundamental conception of the relationships betwee.i states and municipalities on the one hand and the Federal Government on the other. I implore you on behalf of public colleges and universities of the Nation to leave for states and municipalities the freedom from federal taxation of bond issues in order that these colleges and universities may continue, with freedom from federal interference, to develop their institutions with the diversity and uniqueness that has been the hallmark of higher education in the United States.

NATIONAL SOCIETY OF PROFESSIONAL ENGINEERS,
Washington, D.C., September 29, 1969.

Honorable RUSSELL B. LONG,
Chairman, Senate Finance Committee,
Washington, D.C.

DEAR SENATOR LONG: Title VI of H.R. 13270 (the Tax Reform Act of 1969), as passed by the House of Representatives on August 7, 1969, proposes to change the Federal tax treatment of interest earned by holders of bonds issued by state and municipal governing bodies. Since the inception of Federal income tax in 1913, interest paid on the obligations of governments at the state and local levels has been exempt from the imposition of Federal tax.

H.R. 13270 seeks to eliminate this exemption by encouraging the issuance of state and local debt securities subject to Federal taxation and offering, as an incentive therefor, the payment of Federal subsidy equal to a variable percentage of the increased interest that states would be required to pay in order to make taxable securities marketable in competition with private enterprise debt obligations.

The National Society of Professional Engineers, consisting of some 67,000 individual members, all of whom are licensed to practice engineering under one or more of the various state licensing and registration laws, vigorously objects to the enactment of this portion of H.R. 13270.

Engineers are deeply concerned over the prospect that those services which the public demands, and must be provided if the basic well-being of all citizens is to be maintained, will be either delayed or abandoned due to the lack of local financing which the sale of tax exempt state and local bonds provides.

The mere consideration of removing the exemption has, in fact, resulted in an adverse effect on the municipal bond market. State governors and city mayors have publicly announced that since the passage of H.R. 13270 by the House, the cost of state and local bond financing has risen drastically.

Engineers, perhaps more than many others, are acutely aware of local needs and of the fact that they can be satisfied more efficiently at the local level. They are convinced that attempts to restrict communities in the exercise of efforts to meet challenges in this area and on the community level are most unwise.

State and local governments need every bit of help they can get in wrestling with their urban ills, environmental blights, public and private housing programs, education, welfare, transportation, and the whole host of social, industrial and technological challenges besetting them—many involving the very survival of some communities. The ability of these governments to deal with such problems, in addition to providing for the normal demands involving capital improvements such as hospitals, schools, public buildings generally, water and sewage systems, pollution-combatting facilities, flood controls, roads, streets, highways, bridges, etc., is dependent upon the financing which the sale of state and municipal bonds provides. It is essential that the Federal Government refrain from action which will curtail this local financing.

A considerable amount of testimony has already been presented to this Committee by state and city officials indicating that the only possible result of Title VI of H.R. 13270 is serious injury to local governments and the people dependent upon them for local needs. These opinions are unanimous that passage of this provision will be detrimental to taxation at the local level without appreciable benefit to the National Government, will result in a basic change in governmental structure, will result in a serious decline in the municipal bond market, a substantial curtailment or total abandonment of vitally needed public works projects, an expansion in construction unemployment, and increased financial burden on small property owers and taxpayers.

We respectfully submit that Sections 601 and 602 of H.R. 13270 are adverse to the public welfare and should not be enacted.

Very truly yours,

PAUL H. ROBBINS, P.E.,
Executive Director.

STATEMENT IN BEHALF OF THE TEXAS A&M UNIVERSITY SYSTEM, BY EARL RUDDER, PRESIDENT

My name is Earl Rudder, President of The Texas A&M University System. The provisions of HR 13270 which would subject the interest received from bonds of state and local governments to federal income taxation are of urgent practical interest to The Texas A&M University System. The impact of rapidly increased student enrollments and continuing efforts to provide adequate teaching, research and housing facilities, has resulted in unprecedented requirements for expanding and improving our physical plants. Our principal source of financing these vital plant needs is through the issuance of revenue bonds. Within the next twelve months the institutions comprising The Texas A&M University System have scheduled the issuance and sale of a total of $31,500,000 of revenue bonds. The main source of funds for the payment of principal and interest requirements on our revenue bonds is, of course, derived from student fees and charges.

By noting the comparative performance of the municipal bond markets with other debt markets during recent weeks, even the casual observer can see the devastating impact discussions surrounding HR 13270 have already had on interest rates on municipal bonds. I believe this reaction could certainly have been readily predicted, for in no other security market does the investor so heavily rely on the good faith of government at all levels. All present holders of municipal bonds have bought them with the belief that municipal bond interest would never be subjected to federal income taxation in any form. Now this historically accepted principle is being challenged.

But our experts tell us that the current chaotic conditions in the municipal bond market, while unprecedented, are mild when compared to the results which can be expected if HR 13270 is enacted into law in its present form. Once the historical principle of the exemption of income from municipal bonds is breached by even an indirect tax, any remaining municipal bond tax shelter would be of doubtful value, for there would be no protection from increased taxation of municipals by future Congresses. Massive and permanent damage to investor confidence would be done and increased interest rates on municipal bonds of as much as two percentage points have been predicted by the Municipal Advisory Council of Texas. Such an interest rate increase would cost The Texas A&M University System an additional $630,000 for interest during the first year on our $31,500,000 bonds scheduled to be issued in the next twelve months. And add to this increased annual interest cost the annual interest which would be required on our bond issues planned for 1971, 1972 and future years! The truth of the matter is that under such conditions, the cost of borrowing by our institutions would be pushed beyond tolerable economic limits—and we probably would be unable to finance even our most urgent plant expansion needs.

As mentioned earlier, the main source of funds to pay our revenue bonds must come from student fees and charges. A recent independent survey on our main campus at College Station indicated that 66% of our on-campus students had available incomes of less than $100 per month. During the last scholastic year, 7,656 loans were made to students in the A&M System under the Texas Opportunities Plan alone. All of this indicates to us that substantial increases in attendance costs to support bond issues would prevent many of our students of modest means from continuing their education.

The questions of ending reciprocal immunity from taxation between State and Federal Governments, massive damage to capital markets, costly interruptions and dislocations in capital improvement programs, and other pernicious effects of current proposals to tax interest on municipal bonds are real and frightening. But begging these very fundamental questions, it would appear that the major objective of Congress in this area should be to rectify the current imbalance between federal tax resources and state and local tax resources. Any compromise in the present tax-exempt feature of municipal bonds would only accentuate the present imbalance.

Finally, municipal bonds have developed a special place in our over-all debt market and have successfully served the needs of state and local governments in raising billions of dollars for capital improvements. Purchasers of such bonds have, in effect, paid their taxes in advance by accepting a lower rate of interest than could be obtained on taxable bonds. Our present system works, and I know of no more equitable or efficient system for state and local government capital improvement financing which would be as impartial and as free from abuse. I, therefore, strongly urge that the existing tax-exempt status afforded municipal bonds be maintained and re-affirmed.

August 1, 1969.

OFFICE OF THE PRESIDENT OF THE UNITED STATES OF AMERICA,
White House.

Re Municipal Bonds

GENTLEMEN: My wife and I retired in 1960 and sold our minority stock in a small closed corporation which equity had been held since 1925. During these thirty-five years, for lack of working capital, only nominal dividends had been paid. We realized a substantial profit of which a large part was invested in municipal bonds that were regarded at the time as second in safety and stability only to U.S. government obligations.

Since the fall of 1966 we have suffered heavy paper losses on these bonds due to adverse market conditions. I do not complain of this situation as normal market fluctuations are simply facts of life. However, an abnormal element has been introduced in the form of the House Ways and Means Committee's proposals to curb the tax exemption of interest on municipal bonds. Leaving aside the legal aspects, as I am not a lawyer, it does not appear reasonable, fair or just that these proposals should apply to already outstanding tax exempt issues which were purchased in good faith at yields and prices reflecting the then existing tax free provisions of the law. In the event these proposed tax reforms are enacted into law upon what amounts to a retroactive basis, the result would virtually be an uncompensated confiscation of income and capital. When tax exemptions were removed from what were known as industrial municipal bonds, the effect was *not* retroactive.

I trust that President Nixon will take these and perhaps more important and valid considerations into account if and when the proposed bill comes to his desk.

Respectfully,

A. J. ROSS.

September 6, 1969.

Re Municipal Bonds.

Mr. MEADE WHITAKER,
Tax Legislative Counsel,
Office of the Secretary of the Treasury,
Washington, D.C.

DEAR MR. WHITAKER: Thank you for your thoughtful letter of August 25, 1969 in which you pointed out the one provision in President Nixon's tax reform package that would have affected tax-exempt bonds, and thanks also for the memorandum prepared before H.R. 13270 was passed by the House of Representatives. I would appreciate your reading this letter in context with mine of August 1, 1969.

Self-interest prompts me to wonder how these various proposals specifically will affect Mrs. Ross and myself, citizens and residents of Puerto Rico with practically all of our taxable income from sources within, and taxable only in, Puerto Rico; while practically all of our tax-free income is from the United States due to the fact that many more municipal issues were available there than in Puerto Rico at the time we entered the market.

Speaking in general of municipal bonds, the following opinions—I would like to think of them as facts—are offered without corroboration as I would prefer you to confirm them if you see fit to do so. Why have municipals been purchased and held by investors in the past?

(1) Because they were tax-free. Investors paid a heavy premium for this feature and anything, absolutely anything, that affects the freedom from taxation of outstanding issues will inevitably adversely affect their values.

(2) Because they were relatively stable pricewise. See #1 above.

(3) Because they were free from a "Limit on Tax Preference." See #1 above.

(4) Because they were free from an "Allocation of Deductions." See #1 above.

All of the advantages and benefits that exist under present law were part and parcel of the price paid by investors for municipal bonds, some of which yielded 3% and less. Every investor knows that even in normal times price inflation erodes his fixed income by 1½% to 2% annually, and it follows that the capital invested in bonds is likewise eroded year by year until maturity. Therefore the investor's prime reason for purchasing these low yielding bonds had to be freedom from taxation. It appears to me that any retroactivity which would have the effect of destroying all or any part of the tax-free status of municipals in existence would be highly inequitable.

So far I have mentioned only the investor and taxpayer for actually there are few individuals whose portfolios consist entirely of tax-frees although I read in the press that the late President Kennedy was one of them. How about States, Cities, Counties, and Authorities themselves? If the proposal to the effect that municipalities may choose between bonds with partially tax exempt or taxable interest with the difference in the rate paid by the Federal Government, is enacted into law, the municipalities may lose on six counts:

(1) The interest rate on the partially tax-exempts would be higher than in the past due to the proposed restrictions.

(2) On account of #1 the *effective* rate paid by municipalities upon taxable interest bonds would be higher than in the past. A practical problem might arise as to the percentage differential to be paid by the Federal Government.

(3) Representative Mills, a powerful foe of government overspending, has expressed a desire to approve and supervise the spending of funds raised by means of a Federal government interest subsidy.

(4) The rates of the subsidized interest bonds will be high for certain general obligation municipals which will compete for funds with higher rated corporate issues. Certain revenue interest subsidized municipals may well find no acceptable market at all!

(5) When two interestwise varieties of municipals are offered, psychologically investment bankers and investors will tend to downgrade both of them.

(6) The time and money consuming delays that will necessarily be involved in negotiating and obtaining the Federal interest rate subsidy.

For the reasons outlined above I do not agree with the provisional conclusion reached in the penultimate paragraph of your letter. I question the wisdom of treating a taxpayer with an $11,000.00 or a $50,000.00 tax preferred income differently from another taxpayer with $10,000.00 tax preferred income without taking into consideration other income and income tax factors. Enclosed find copy of a memorandum prepared by Brown, Wood, Fuller, Caldwell and Ivey. Please note the example cited of the proposed tax treatment of a salaried man who also owns tax-exempt bonds. His salary, of course is part of his taxable income and serves to lower his possible tax liability upon his once tax-free interest. Doesn't this constitute a discrimination against a retired individual who owns tax-exempt bonds, but no longer has a salary which might serve to lower his possible tax liability upon his once tax-free interest? Another conclusion that can be drawn from the memorandum is that computer time will have to be rented by almost every substantial taxpayer who itemizes deductions and owns municipal bonds. Is this true tax reform?

Finally, I submit that a simple and fair way out of this complexity would be to leave the tax status of outstanding municipals unchanged and any equitable tax reform be applied to future issues. An impractical but just alternative would be to redeem, at cost plus accrued interest, the outstanding municipal bonds.

Sincerely yours,

A. J. Ross.

P.S.:—After drafting this letter, it occurs to me to mention the volativity of Federal Funds above the prime rate and the Bond Buyer's yield index of 6.26% on municipals as examples of why Congress should not tamper even indirectly with interest rates at this time.

The proposed limitation upon "tax preferences" of noncorporate taxpayers contained in the bill as passed by the House would not only affect relatively few holders of state and municipal bonds and even as to such group, the full impact of such provisions will not be felt for several years. This is because the adjustment would be limited to the excess of the tax "preferences" over one-half of total income (including such preferences) and particularly, as explained below, because of the ten-year "transitional rule" applicable to the receipt of tax-exempt interest.

Section 301 of the bill, which would take effect January 1, 1970, would include in the base of a minimum tax, various "tax preferences" including interest on presently outstanding and newly issued state and municipal bonds.[1] As stated in the House Report:

> ". . . a 50-percent ceiling is to be imposed on the amount of a taxpayer's total income (adjusted gross income plus the tax preference items) which can be excluded from tax. In others words, an individual is to be allowed to claim the exclusions and deductions comprising tax preference income only to the extent that the aggregate amount of these preferences does not exceed one-half of his total income. . . . The limit on tax preferences is not to apply if an individual's total tax preferences for the year do not exceed $10,000 ($5,000 for a married person filing a separate return)."

However, in applying the above limitation for 1970, for example, only 1/10th of tax-exempt interest would be taken into account; for 1971, 2/10ths of tax-exempt interest would be taken into account, etc.

For example, assume that the taxpayer receives a salary of $50,000 and $100,000 of tax-exempt interest. None of such interest would be includable in gross income for 1970 because the $10,000 interest (10% of the $100,000 interest) taken into account for such year would not exceed the $10,000 alternative limitation. For 1971, although $20,000 interest would be taken into account, none would be includable in gross income since it would not exceed one-half the "total income" of $70,000. By 1976, assuming the same facts, $60,000 interest would be taken into account and $5,000 interest includable in gross income, viz., the excess of $60,000 over $55,000 (one-half the sum of $60,000 plus $50,000); and by 1977, $70,000 interest would be taken into account and $10,000 interest includable in gross income. Assuming that in 1978 salary income is increased to $100,000, no interest would be includable in gross income for such year because the $80,000 interest then taken into account would not exceed the 50 percent limitation ($90,000). Under the bill, the amount of preferences which have been included in income may be deducted in any of the succeeding five years in which a preference is not required to be included in income; thus, a deduction of $10,000 would be allowable for such year in respect of the amounts included in 1976–1977 income.[2]

Bill Section 302 requires an allocation (disallowance) of personal deductions such as charitable contributions, taxes, interest, medical expenses, to the extent that such expenses can reasonably be assumed to be met in part out of tax-free income. Here, only interest upon tax-exempt bonds issued after July 12, 1969 (new bonds) is taken into account in determining the allocation under a ten-year transitional rule. The amount disallowed would be the lesser of (i) the amount disallowed under the allocation fraction, or (ii) the tax preference less $10,000.

[1] The five tax preference items are: Tax-exempt bond interest, the excluded one-half of capital gains, appreciation in gifts of property to charitable organizations, the excess of accelerated over straight line depreciation in the case of real estate, and certain farm losses.

[2] Such deduction is limited to the amount by which the 50% limitation for such year ($90,000) exceeds total preferences for such year ($80,000).

In addition, for 1970, only one-half of total personal deductions is to be taken into account in determining the allocable deductions to be disallowed.

Thus, assuming that the interest received in 1970 is wholly from new bonds and the taxpayer had $50,000 of personal deductions, no disallowance would result because under (ii) above, the $10,000 interest taken into account would not exceed the $10,000 alternative limitation so that the numerator of the allocation fraction would be zero. Where a tax preference has been included in income under the formula describe above in paragraphs one and two, the allocation is determined by reference to gross incomes thus increased. Thus, in 1971, one-sixth ($10,000÷$60,000 ($70,000—$10,000)) of the $50,000 deductions would be disallowed.

STONE & YOUNGBERG,
MUNICIPAL FINANCING CONSULTANTS,
San Francisco, September 17, 1969.

Senate Finance Committee,
Washington, D.C.

GENTLEMEN: As municipal financing consultants representing over 350 public entities, we wish to oppose those sections of H.R. 13270 which would subject municipal bond interest to Federal taxes. We have carefully reviewed the House Bill which is before you and wish to make the following observations regarding its content and the impact on municipalities if this bill is passed into law in its present form.

Since House passage of H.R. 13270, the proposed tax reform act, the Bond Buyer's 20 Bond Index declined from 5.86 percent on July 31 (a record low in itself) to a new low of 6.37 percent on September 4. Without question, the primary reasons for the drastically declining bond market centered around those sections of H.R. 13270 which would have the effect of subjecting the interest earned on municipal bonds to Federal income tax.

Large numbers of bond buyers all over the country have stopped buying municipal securities, and many bond dealers will tell you that there is just no municipal market. Unfortunately, the most serious threat to municipal financing as we have known it in the past is not contained in the specific provisions of the minimum income tax or allocations of deductions section of H.R. 13270, but in the real threat that if this act becomes law (and is upheld by the Supreme Court), any future Congress could effect further erosion (or elimination) of the tax exemption. This appears to be the main reason that many potential bond buyers are refusing to speculate further in low yield tax exempts. They are fearful that if they act in good faith a future Congress could pull the rug out from under them.

The victims most seriously hurt by this proposed legislation are not the bond buyers but the voters and taxpayers of those public entities forced to issue bonds at record interest rates. Equally hurt are the voters and taxpayers residing in those entities which cannot sell their bonds to finance schools, sanitary systems, or other vitally needed public improvements. The situation is especially tragic because these people are the victims of an irresponsible proposal and they will suffer (many for the next twenty to thirty years) even if the proposed legislation never becomes law.

It is our belief that if the tax reform bill is passed as it is presently written, the following ramifications, in varying degrees, are likely:

1. *General obligation bonds of many entities would be unsaleable.*—For most large taxpayers, municipal bonds would fall into substantially the same categories as corporate bonds or other taxable investment. High grade corporate bonds (AA and better) are presently yielding interest rates of 8 percent or more. It is likely, for example, that general obligation bonds of the State of California would be competitive with high grade corporates, but what about the bonds of smaller cities, counties, and special districts which have no rating

or a rating less than the minimum requirements for corporate investment? It is our opinion that the market for thees bonds may dry up completely.

2. *Many revenue bonds, assessment bonds, and other limited obligation securities would be unsaleable.*—Obligations not secured by the full faith and credit of the issuing entity traditionally, with the tax exemption, sell at higher interest rates than general obligation bonds. Since many institutional investors only purchase general obligation bonds, a larger percentage of the limited obligations are placed with individuals. If interest becomes taxable, individuals would probably seek other investments or demand such high returns that project financing with limited obligation securities would be unfeasible.

3. *Interest rates on all municipal securities would increase.*—Interest rates on all municipal bonds would probably increase but not on a proportionate basis. Entities issuing bonds which do not fall into the higher categories of investment quality would unquestionably have to pay interest rates far exceeding even today's record levels. Investors could pick and choose between corporates and municipals and would have no special inducement to invest in municipal securities, especially since at any time congressional whim could possibly eliminate all advantages of investing in municipal bonds.

4. *Property taxes would necessarily increase.*—One could anticipate property tax increases for two reasons. First, if bonds were sold, taxes would have to be higher to meet higher interest costs. Secondly, if bonds were unsaleable and a project were vital, it might have to be financed on a pay-as-you-go basis. In such event, the cost would be met by present taxpayers and not spread over future beneficiaries of the project as would be the case if bonds were sold.

5. *Charges for municipal services would increase.*—Water, sewer, and other service charges would have to be increased substantially in order to pay higher debt service on new issues of bonds secured by and payable from service charge revenues.

6. *Expensive new Federal grant and/or loan programs would be required.*—To alleviate the infinite of problems summarized above, a massive Federal grant and/or loan program would undoubtedly be required; and such a program has already been proposed by Chairman Mills of the Ways and Means Committee and others. Regardless of the value of the program, additional Federal spending coupled with Federal guarantees for billions of dollars of new debt would further dilute the value of the dollar, which is already under tremendous pressure.

7. *Federal aid can mean costly delays in construction of local projects.*—Experience has shown that even the most workable and efficient Federal grant and/or loan programs require approximately six months to process. To qualify for Federal money, local agencies must generally:

(a) Have Federal approval of the project and concurrence that said project complies with both community and areawide general plans.

(b) Have Federal approval of engineering plans and specifications to assure that construction conforms to uniform Federal standards.

(c) Have Federal approval of construction bid documents to assure compliance with such factors as Federal wage rates, hiring practices, etc.

(d) Have a Federally approved economic and financing plan to assure project desirability (based on Federally established criteria) and feasibility.

(e) If a loan program is involved, have Federal approval of bond terms and conditions. (Said terms and conditions may or may not be the most desirable from the standpoint of the local entity, but Federal requirements would have to be met to qualify for assistance.)

(f) Have Federal inspection and approval of all stages of construction.

(g) Have a special Federal audit at the completion of construction.

We are in no way being critical of these procedures. On the contrary, we feel strongly that if Federal monies are provided to a local agency, that agency should comply with conditions determined to be in the general public interest. However, it is a well established fact that Federal grant and/or loan programs, take time to process, and resulting delays on project construction can be extremely costly. As an example, due to inflation, construction costs increased by approximately 10 percent between July 1968 and July 1969. A six month delay during this period of time, therefore, could have resulted in an increased cost of about $50,000 per $1 million of construction.

If Federal aid is involved, additional costs are also incurred at the local level as a result of the time required for local officials to prepare and process applications for Federal aid. In addition, it is not infrequent that complying with Federal construction standards results in still further additional costs to the local agency.

8. *Federal aid will mean higher costs to the Federal Government.*—At this time we have no way of estimating the amount it would cost the Federal Government to equip and staff an agency or agencies to administer a vast grant and/or loan program of the magnitude which would probably be required. However, in 1968 state and local agencies sold bonds in excess of $16 billion. Were the Federal Government to assume or guarantee a substantial portion of this amount of local financing, it would appear highly unlikely that the increased revenues from taxes on interest earned on municipal bonds would pay for the program, must less return a surplus.

9. *Federal aid in future years cannot be guaranteed.*—At the outset, Congress could probably be expected to appropriate sufficient money to fund an adequate national loan and/or grant program during its first year or so of operation. However, bitter experience shows us that many Federal assistance programs start with a bright promise, but succeeding Congresses gradually reduce program effectiveness by appropriating less and less money each year, until finally the program is no longer viable. Consider, for example, the present status of the following Federal assistance programs that were once held to be so important to the well-being of our country:

(a) This fiscal year, funds allotted to the State of California under the Federal Water Pollution Control Act are not even sufficient to cover last year's deficiency. Grants for projects which qualified for assistance in 1968/69 exceed the 1969/70 allocation by approximately $3 million. Consequently, no money will be available for any of the 185 projects on the 1969/70 priority list.

(b) The demise of the Public Facility Loans Program is expected momentarily. To our knowledge, few if any applications were accepted last fiscal year and potential applicants are being discouraged because of the lack of funding.

(c) The Program of Advances for Public Works Planning is believed to be operating solely on repayments of previous loans. (No new appropriations have been made for several years.) The waiting period for the few selected applicants now runs to a year or more.

(d) Because of funding problems, the Program of Grants for Basic Sewer and Water Facilities is restricted to very low income communities and the maximum individual grant is limited.

It is our opinion that elimination of the tax exemption would destroy a workable system of local public financing and open a Pandora's box which would haunt local taxpayers for years to come. The threat of removal of tax exemption has already done irreparable harm, and has cost communities which have recently issued bonds many extra dollars in interest.

We urge your consideration of our comments above and your rejection of all proposals effectively subjecting interest on municipal bonds to Federal taxation. We further urge Congressional re-affirmation of the basic principle of keeping interest earned on municipal bonds free from Federal taxation to restore confidence of current and potential investors in this type of security. We attach a list of public entities that we have represented and are currently representing in matters relating to public finance. A majority of the public entities on the list have asked us to speak for them in objection to this current proposed legislation.

Respectfully submitted.

D. E. HARTLEY.

CITIES

- Alameda
- Alturas
- Anderson
- Antioch
- Arroyo Grande
- Atwater
- Auburn
- Bakersfield
- Baldwin Park
- Banning
- Bellflower
- Bell Gardens
- Beverly Hills
- Blythe
- Brawley
- Buena Park
- Burbank
- Calistoga
- Carlsbad
- Carmel-By-The-Sea
- Ceres
- Chico
- Chino
- Chula Vista
- Claremont
- Clovis
- Coalinga
- Corcoran
- Costa Mesa
- Crescent City
- Cupertino
- Cypress
- Delano
- Dinuba
- Duarte
- Dunsmuir
- El Cajon
- Fairfield
- Fort Bragg
- Fremont
- Fresno
- Garden Grove
- Glendale
- Glendora
- Gridley
- Grover City
- Gustine
- Hanford
- Healdsburg
- Hollister
- Huntington Beach
- Imperial Beach
- Industry
- Inglewood
- King City
- Lakeport
- Lakewood
- La Mesa
- Las Vegas, Nevada
- Lemoore
- Lincoln
- Livermore
- Livingston
- Lodi
- Lompoc
- Los Altos
- Los Angeles
- Los Banos
- Los Gatos
- Manteca
- McFarland
- Montclair
- Montebello
- Monterey
- Monterey Park
- Monterey Peninsula Cities
- Napa
- National City
- Needles
- Newman
- Newport Beach
- North Sacramento
- Oakdale
- Oceanside
- Orange Cove
- Oroville
- Oxnard
- Pacifica
- Pacific Grove
- Palm Springs
- Petaluma
- Pittsburg
- Placerville
- Pomona
- Red Bluff
- Redding
- Redlands
- Redwood City
- Reedley
- Richmond
- Riverbank
- Riverside
- Sacramento
- St. Helena
- Salinas
- San Anselmo
- San Bernardino
- San Bruno
- San Carlos
- San Diego
- San Fernando
- Sanger
- San Jose
- San Leandro
- San Luis Obispo
- San Rafael
- Santa Ana
- Santa Fe Springs
- Santa Maria
- Santa Monica
- Santa Rosa
- Selma
- South San Francisco
- Stanton
- Stockton
- Tiburon
- Tracy
- Turlock
- Union City
- Vacaville
- Vallejo
- West Covina
- Westminster
- Willits
- Woodland
- Yreka
- Yuba City

DISTRICTS

- Almonte Sanitary District
- Alpine Springs County Water District
- American Canyon County Water District
- Antelope Plains Water District
- Arcade County Water District
- Arvin-Edison Water Storage District
- Bellflower County Water District
- Biggs-West Gridley Water District
- Bolinas Harbor District
- Burney County Water District
- Calaveras County Water District
- Cambria County Water District
- Capitola Sanitation District
- Carmichael Irrigation District
- Cascade Community Services District
- Central Contra Costa Sanitary District
- Citrus Heights Irrigation District
- Clark County School District, Nevada

Clearlake Oaks County Water District
Coastside County Water District
Contra Costa County Flood Control and Water Conservation District
Contra Costa County Water District
Contra Costa Drainage District
Cordova Recreation and Park District
Corning Water District
Costa Mesa County Water District
Cotati Public Utility District
Cucamonga County Water District
Daggett Community Services District
Douglas County Sewer Improvement District No. 1, Nevada
East Bay Municipal Utility District
East Contra Costa Irrigation District
East Orange County Water District
East Quincy Services District
El Dorado County Sanitation District No. 2
El Dorado Irrigation District
El Toro Water District
Enterprise Public Utility District
Fair Oaks Irrigation District
Fallbrook Public Utility District
Florin Community Services District
Foresthill Public Utility District
Fulton-El Camino Recreation and Park District
Goleta County Water District
Goleta Sanitary District
Granada Sanitary District
Grover City County Water District
Hagginwood Sanitary District
Helix Irrigation District
Indio Sanitary District
Interlochen Sanitation District
June Lake Public Utility District
Jurupa Community Services District
Kootenai Hospital District, Idaho
Lamont Public Utility District
La Presa County Water District
Las Vegas Valley Water District, Nevada
Leucadia County Water District
Livermore Area Recreation and Park District
Los Alisos Water District
Lost Hills Water District
Mammoth County Water District
Marina County Water District
Mendocino County Flood Control and Water Conservation Improvement District
Menlo Park Sanitary District
Merced Irrigation District*

Millview County Water District
Modesto Irrigation District*
Montara Sanitary District
Montecito Sanitary District
Monterey Peninsula Municipal Water District
Moulton-Niguel Water District
Mt. Diablo Unified School District
Murphys Sanitary District
Napa County Flood Control and Water Conservation District
Napa Sanitation District
Nevada Irrigation District*
North Area Community Services District
North Coast County Water District
North Kern Water Storage District
North Marin County Water District
North Tahoe Public Utility District
Oakdale and South San Joaquin Irrigation Districts*
Oakley County Water District
Orange County Harbor District
Orange County Sanitation District No. 7
Orange County Sanitation District No. 12
Oroville-Wyandotte Irrigation District*
Palmdale Irrigation District
Palos Verdes Library District
Paradise Irrigation District
Pioneer, Pine Grove, Volcano County Water District
Placer County Assessment District
Placer County Waterworks District No. 1
Pleasant Valley Recreation and Park District
Purissima Hills County Water District
Richvale Irrigation District*
Rio Linda County Water District
Rocklin-Loomis Municipal Utility District
Rodeo Sanitary District
Rosedale-Rio Bravo Water Storage District
Russian River Sanitation District
Sacramento Municipal Utility District*
Sacramento-Yolo Port District
Salton Sea Water District
San Benito County High School and Junior College District
San Diego Unified Port District
San Francisco Bay Area Rapid Transit District
San Juan Suburban Water District
San Luis Obispo County Flood Control and Water Conservation District
San Pablo Sanitary District
Santa Ana Mountains County Water District
Santa Barbara County Flood Control and Water Conservation District

**Co-consultants*

Santa Clara County Sanitation District No. 4
Santa Clara County Flood Control and Water Conservation District
Santa Clara Valley Water Conservation District
Santa Cruz County Flood Control and Water Conservation District
Santa Nella County Water District
Santee County Water District
Santiago County Water District
Scotts Valley County Water District
Shasta Community Services District
Shasta Joint Junior College District
Solano Irrigation District
Sonoma County Flood Control and Water Conservation District
Sonoma Valley Sanitation District
Soquel Creek County Water District
South Bay Irrigation District
South San Luis Obispo County Sanitation District
South Sutter Water District
Stanton County Water District
Susanville Consolidated Sanitary District

Tehachapi-Cummings Water Conservation District
Terra Bella Irrigation District
Thermalito Irrigation District
Tuolumne County Water District No. 1
Tuolumne County Water District No. 2
Turlock Irrigation District*
Union Sanitary District
Upper San Gabriel Valley Municipal Water District
Vallejo Sanitation and Flood Control District
Valley of the Moon County Water District
Vista Irrigation District*
Vista Sanitation District
Walnut Valley Water District
Wasco County School District No. 9, Oregon
Weaverville Sanitary District
West Kern County Water District
West San Bernardino County Water District
Wildwood Sanitary District
Yolo County Flood Control and Water Conservation District
Yorba Linda County Water District
Yountville Sanitation District

*Co-consultants

OTHER AGENCIES

Bear Valley Development Company
California State Fair and Exposition*
California, State of (California Toll Bridge Authority)
Crescent City Harbor
Downey Community Hospital Foundation
El Dorado County
El Dorado County Water Agency
Garapito Creek Realty Investing Corporation
Kern County Water Agency
Lake County
Nez Perce County - Lewiston, City of, Idaho
Los Angeles County
Los Angeles Harbor Department
Malibu-Topanga Water Research, Inc.
Marin County
Mariposa County Water Agency
Metcalf & Eddy and Charles S. McCandless & Co.
Mojave Water Agency
Napa County
Orange County
Orangevale Mutual Water Company

Placer County
Placer County Water Agency*
Port of Oakland
Port of Redwood City
Redevelopment Agency of the City of Richmond
Rustic Ridge Realty Investing Corporation
San Bernardino County
San Diego County
San Diego Stadium Authority
San Mateo County
Santa Clara-Alameda-San Benito Water Authority
Santa Cruz County
Parking Authority of the City of Santa Monica
Redevelopment Agency of the City of Seaside
Shasta County
Solano County
Solano Water Users' Association
Sonoma County
State of California (Reclamation Board)
State Senate Interim Committee (Water)
Tahoe Southside Water Utility
Port of The Dalles, Oregon
Yuba County Water Agency*

*Co-consultants

STATEMENT OF FLOYD O. SHELTON. VICE CHAIRMAN, INVESTMENTS, TRUSTS AND LANDS, UNIVERSITY OF TEXAS SYSTEM

My name is Floyd O. Shelton. I am Vice Cancellor for Investments, Trusts and Lands of The University of Texas System. My office has the responsibility for planning and marketing all bond issues for funding capital improvements and expanding the physical plants of our component institutions. Like most other state colleges and universities, our principal means of expanding and improving our facilities is through the issuance and marketing of bonds.

Within the past three years The University of Texas System has issued approximately $115 Million in bonds.

Within the ensuing three year period substantial additional capital funds will be needed to meet the expansion requirements of our many component institutions.

During this calendar year the Legislature of the State of Texas has provided for the establishment by The University of Texas System of one new four year University, two upper level (two year) Universities, one new Medical School, one new Dental School, and one new Nursing School.

These facts are cited in support of the proposition that any legislation which adversely affects the normal market for our bonds is a matter of grave concern to us, and we submit, to higher education in general. Out of respect for the time and patience of the Committee, it shall be my purpose to limit my observations to this aspect of H.R. 13270.

We have a system of municipal bond marketing that works! Surely there can be no doubt of this. The fact that we have in the past three years satisfactorily arranged $115 Million in financing, and that Municipal bond volume increased nearly 50% in a two year period to an unprecedented level of $16 Billion in 1968—all in the face of drastically increasing interest rates—would seem ample proof of the proposition that our present system works. Before doing away with the existing system, responsible conduct requires an affirmative determination that the alternative system will serve the people at least as well. Will the proposal of H.R. 13270 meet this test? That is the real question.

Will the System of Municipal Bond financing proposed by H.R. 13270 serve the interests of the people as well as the existing traditional system? It seems quite elemental that one of the immediate effects of this legislation would be a substantial drying up of investor interest in acquiring municipal bonds. Laying aside all legal considerations involved in this reversal of traditional National policy, I feel that there would be such a shattering of confidence among our normal investors that we would be forced to look to others for our capital needs. If the Congress can now subject our bonds, either outstanding or hereafter issued, to tax in part, what is to keep them from being taxed in toto by legislation adopted next year? For this reason, it is quite likely that interest rates on Municipal bonds issued without the benefit of the proposed subsidy provisions would climb so drastically as to make the election to issue taxable subsidized bonds mandatory. This would force all Municipal borrowers into quite a different market.

What would be the market for municipal bonds after passage of H.R.13270? It seems quite obvious that The University of Texas System, and indeed every little School District for that matter, would find itself competing with the gigantic utility industry, and all of the other great borrowers of capital funds on the American scene. With pressures on our capital markets greater than they have been in several decades, we find that even the largest borrowers are having to offer goodies (conversion privileges, a piece of the action, etc.) in addition to normal interest, in order to raise their requirements. With the subsidy perhaps we could compete, but "The Lord giveth and The Lord taketh away." If the Congress can now agree to subsidize, might it not agree NOT to do so next year? Surely, this would be a disastrous development for all Muncipal borrowers. It certainly would be for The University of Texas System.

To summarize, it is my firm and considered opinion that any direct or indirect tax on state and local government municipal bonds by the Federal Government would do irreparable damage to municipal bond markets, and be detrimental to other debt markets, as well. These adverse affects would be much greater in impact than any additional revenue gained by the Federal Government or any equity attained in its income taxation system.

Respectfully submitted.

FLOYD O. SHELTON,
Vice Chancellor for Investments, Trusts, and Lands.

STATEMENT OF PAUL T. SALATA PRESIDENT, SALATA, INC.

Paul T. Salata alleges as follows:

1. He is the president, a director, and a shareholder (apprixlmately 35% interest) of Salata, Inc., a California corporation.

2. Salata, Inc. is a construction contractor, its business being limited primarily to underground construction, such as the installation of sewer lines and flood control systems. Almost all of its construction work is performed for Governmental authorities, including counties, cities, flood control districts, sewer districts, and other special assessment districts in Southern California.

3. Almost all of Salata, Inc.'s construction work is acquired pursuant to a competitive bid system wherein it bids for the acquisition of jobs in competition with the bids of many other construction contractors that usually bid the same type of jobs.

Salata, Inc. has successfully bid on jobs ranging in size up to $1,200,000. Such jobs are bonded with respect to performance and the payment of labor and material.

Salata, Inc. performs the most usual type of public construction job in consideration of cash, with the payment thereof being made by "progress payments" that are received as the work progresses, subject, however, to a 10% retention which is set aside until the job is not only completed but also accepted by the contracting authority.

4. The business practice where jobs are acquired on competitive bids is that, prior to filing a bid, the contractor estimates his direct and indirect costs to perform the job and then adds on a profit margin between 10% to 15%, usually depending upon how anxiously the contractor wants the particular job. Salata, Inc. follows this practice.

5. In the State of California, some public improvement jobs are performed pursuant to special assessment acts, such as the "Improvement Act of 1911", where the consideration to the contractor for the performance of the job is the issuance of a warrant and bonds, which are not received until after the job is completed. There are no "progress payments," and the bonds issued to the contractor usually are payable over a period of 10 to 15 years. The bonds bear interest at the rate of either 6% or 7% per annum and are understood to be exempt from both State of California and Federal income taxes. Governmental authorities invite bids under a special assessment law such as the "Improvement Act of 1911" because the area being improved cannot carry the cost burden of the improvement without spreading the cost several years.

As construction contractors must depend on progress payments or other interim financing in order to perform and complete an improvement work, those contractors who are successful in bidding jobs involving payment in bonds must depend upon interin loans and/or sale commitments against the bonds in order to raise the necessary working capital requirements to carry the performance of the job; and, in any event, after completion of their work and the receipt of the warrant and bonds, the contractors must sell those bonds which have not been previously committed in order to finance the commencement of their next job. The contractors bid on assessment bond jobs with knowledge of these financing requirements and with plans as to what arrangements they can make in connection therewith.

6. As a contractor realizes at the time he estimates his bid on an assessment job, such bonds are never salable at their face value. Therefore, the contractor makes an adjustment in his bid to discount for the marketability of the bonds. If some event then occurs to adversely affect the marketability of the bonds between the time that the contractor bids the job and the time he sells the bonds, the contractor will have acquired a "losing job" which could result in financial ruin. This will have occurred, not because of error in judgment in bidding the job costs, but because of error in judgment in analyzing the financial markets (which is not within the contractor's competence). Some of the factors that have contributed to adversities in the assessment bond market (between the time a contractor bids a job and the time he sells his bonds) have been changes in the money market, recessions in land values in the area being improved, recessions in the local or national economy, and unfavorable publicity with respect to laws or other conditions that will affect the bonds or their marketability.

When the adverse condition is due to some event that could not have been foreseen at the time the contractor bid the job, the contractor then is an unfortunate victim of circumstances beyond his control.

7. In the past year, Salata, Inc. has discovered that one of the most serious, but unforeseen, factors than can adversely affect the value of a contractor's bonds between the date he bids a job and the date he sells the bonds is proposed changes, or publicity as to changes, in the Internal Revenue laws which would remove the tax exemption for municipal bonds.

8. The manner in which the proposed change in the exemption for municipal bonds can affect a contractor performing an assessment bond job is illustrated as follows.

(*a*) In July, 1968, Salata, Inc. was the successful bidder for a sewer installation job in Rosamond, California. The bid price was approximately $1,200,000 (the largest job ever for Salata, Inc.) and payment was to be made by the issuance of a warrant and bonds after the job was completed and accepted by the district. Salata, Inc.'s bid price was based on an estimate of the construction costs, overhead expenses, a 10% profit margin, and a 10% discount in the sale price of the bonds that would be received.

(*b*) At the time Salata, Inc. bid the job, it estimated that it would complete the job within about one year. The job was, in fact, completed on May 1, 1969, and it received the warrant and assessment therefor on September 3, 1969.

(*c*) During the winter of 1968–1969, and the spring of 1969, the conditions in the money markets of the nation deteriorated further. This condition seriously affected Salata, Inc.'s ability to obtain loan and sale commitments against the bonds expected to be received on the job. Where Salata, Inc. originally expected to obtain loans or sale commitments at not less than 90% of face value, the loan commitments and sale commitments actually received were at 80% of face value (and only on the choicest portion). This 10% reduction affectively eliminated any profit margin that Salta, Inc. incorporated in its bid price.

(*d*) Thereafter, conditions got even worse when the Congress introduced, publicized and passed a House Bill which proposed to remove the exemption for municipal bonds. As a result, Salata, Inc. now finds that the market price for the bonds received in payment on the Rosamond job (and not previously sold) is at 50–60% of their face value. This has guaranteed Salata, Inc. a substantial loss on its Rosamond job. In addition, if Salata, Inc. is not able to realize immediate profits from other jobs presently pending, the reduction in the sales price of the bonds on the Rosamond job my result in the financial ruin of Salata, Inc.

8. It is recommended that the Congress provide in any law relating to the exemption of municipal bonds that it shall be prospective only and not apply to bonds issued with respect to public improvement contracts let prior to enactment. In addition, it is recommended that the Senate Finance Committee announce in the press that it intends to make such a provision in the law. This should be done immediately.

Statement of Tom Sealy, Chairman, Coordinating Board, Texas College and University System, Midland, Tex.

The State of Texas college student loan program is unique. To date over 100,000 loans have been made to almost 36,000 students for over $30,000,000. During 1969–70 we expect to make an additional $21,000,000 loans. No other state has a program of this magnitude. You may be aware of the lack of lender interest in the Federal Guaranteed Loan Program due to the maximum interest charge of seven per cent of these loans. Such lack of interest has significantly increas·d the demand for loans under the direct State loan program.

The Coordinating Board recently sold $14,000,000 State of Texas College Student Loan Bonds and is contemplating the sale of an additional amount of these Bonds in order to have sufficient funds for loans to Texas college students for the remainder of fiscal year 1969–70.

This obviously beneficial State program is in jeopardy, however, because of the uncertainty of the municipal bond market which could result in the Board not being able to sell bonds necessary for continuance of this program.

Because of the question concerning the tax exempt status of these Bonds, the Coordinating Board was forced to issue an Addendum to the Official Notice of Sale for the $14,000,000 Series 1969 issue which permitted all bidders to refuse to accept delivery of the Bonds should Congress have modified existing tax laws to affect adversely the tax exempt status of the interest before delivery was completed. Such an addendum was critical to receipt of any bids on the Bonds. Notices of sale of future issues must also contain such qualifications if the Board is to receive any bids.

It is respectfully requested that no modifications of any kind of existing tax laws be enacted which would adversely affect the Federal tax exempt status of the interest on such Bonds or on any municipal or other bonds issued by State or local authorities.

Respectfully submitted,

TOM SEALY.

IMPACT OF "TAX REFORM" PROPOSALS ON THE MUNICIPAL MARKET

(A speech given by John F. Thompson, Vice President, Equitable Securities, Morton & Co., Inc., New York, N.Y., before the 63rd Annual Convention of the Municipal Finance Officers Association, Toronto, Canada, May 26, 1969)

IMPACT OF "TAX REFORM" PROPOSALS ON MUNICIPAL MARKET

In recent months two programs of tax reforms have been presented to Congress through the House Ways & Means Committee, and many of us whose business and professional duties center in the working of the municipal bond market have become greatly concerned with the potential impact of certain of these proposals on that market. As you all know that market is your market, the market in which your states and cities and other local public bodies raise money to finance capital projects. The proposals in question are (1) the "minimum individual income tax" proposed by Treasury officials of the outgoing Administration, (2) the "limit on tax preferences" proposed by the Nixon Administration, and (3) the "allocation of deductions proposed by both.

The minimum income tax proposed an alternative tax calculation at one-half the regular tax rates, with the base enlarged by adding to adjusted gross income four presently excluded items:

(1) The excluded one-half of long-term capital gain.

(2) Interest on state and local government bonds.

(3) The excess of percentage depletion over capital investment in oil and minerals.

(4) The untaxed appreciation on taxable gifts of property. Note Item 2. If the sum of these four items exceeded adjusted gross income the result could be a tax at one-half rates on part of an individual's tax-exempt interest.

The limit on tax preferences proposed by the new Administration attempts to arrive at a similar result by providing that no more than one-half of total income would be sheltered from tax, total income to include adjusted gross income before long-term capital gains plus the following "tax preferences":

(1) Percentage depletion on minerals and intangible drilling and exploration expenses to the extent they exceed what would be normal deductions under regular accounting rules.

(2) Deduction of the excess of accelerated depreciation over straight-line depreciation on buildings.

(3) Deduction against non-farm income of farm losses arising from unrealistic accounting methods.

(4) The excess of market value over cost of property contributed to charity.

Here there is a different list of tax preferences and, more important to us, tax-exempt bond interest is not included among them.

The proposal for "allocation of deductions" as made by the new Administration would use the base established for the limit on tax preferences with the addition of one-half of capital gains on each side and with the addition of tax-exempt interest to the tax preferences side. The proportion of tax preference income (less an exemption of $10,000) to the total would be computed and non-business deductions wo'ld be reduced in that proportion. There are other details but this is the main framework.

The inclusion of tax-exempt interest on State and local bonds in any of these proposals (minimum tax, L.T. P., allocation of deductions) can lead to a serious adverse impact on the municipal bond market. This is a very large market and an important part of our total capital structure; tampering with it would be extremely hazardous. For perspective, here are a few approximate figures.

Total outstanding tax-exempt obligations, nearly $130 billion; Annual increase in outstanding total, $9 to $10 billion; Annual gross amount of new tax-exempt bond issues, $14 to $16 billion; Estimated annual interest cost on outstanding total, $4.6 billion; and Estimated saving in annual interest cost due to tax-exemption, nearly $2.0 billion.

The estimated saving is based on the approximate 70% relationship between tax-exempt interest cost and the interest cost on taxable bonds which has prevailed for a number of years. We stay close to this even in today's stringent market conditions.

These proposals are supposed to be the answer to "the taxpayers' revolt." Much of this revolt has stemmed from the highly publicized statement that 154 individuals with Adjusted Gross Income of $200,000 or more paid no tax for the year 1966. Initially no figures were given analyzing this situation, and the inference was permitted to develop that tax-exempt bond interest was partly responsible. Treasury officials of the new Administration provided aggregate figures in their April 22nd presentation to Ways & Means. This tax-free result was achieved entirely by the use of other tax shelters. I think it is so important for us to be able to say that tax-exempt income was *not* reported as part of this picture that I have had copies of the two schedules from Assistant Secretary Cohen's testimony reproduced for your use.

Looking first at the minimum individual income tax and the limit on tax preferences, only taxpayers with over one-half their income from excluded sources would be affected. As far as tax-exempt bond interest is concerned most individual investors would not have more than 25% of their capital in these bonds. A limited number may have more, and I am giving you another tabulation which shows in a general way (1) the relative benefit of tax exemption to the investor and to the borrowing municipality, and (2) the impact of the minimum tax proproposal, on an investor who receives $50,000 annually of tax-exempt bond interest. This is not small, it represents a capital investment of $1 million dollars or more. In these figures it is assumed that any other income is protected from tax by various exclusions or deductions. If the investor had purchased taxable bonds instead he would have received $71,400 in taxable income (100/70 x $50,000).

The tax on $71,400 would be $28,490 (which is an average rate of 40%), and there would remain $42,910 after tax. By having tax-exempt income the taxpayer has benefited $7,090 ($50,000—$42,910). The borrowing municapilty—assuming for simplicity that only one is involved—has saved $21,400 ($71,400—$50,000) by being able to do its financing in the tax-exempt market instead of having to sell taxable bonds. If the minimum tax as proposed were applied to the $50,000 tax-exempt income and it became taxable at as much as a 30% rate, the $15,000 tax would wipe out the taxpayer's benefit in having bought tax-exempts and in fact he would be penalized $7,910 net annually. (Using this same method an investor would have to have $150,000 of tax-exempt interest income to be able to pay the proposed minimum tax, and not have it exceed the benefit he gained from buying tax-exempts. The maximum benefit of owning tax-exempts goes to an investor with at least $200,000 of *taxable* income, and the minimum tax would probably not apply to him at all.)

The "limit on tax preferences" plan of the new Administration properly omitted tax-exempt bond interest, in part because of the Constitutional question that would be raised and the prospect of prolonged litigation, and in part because they recognized the possible adverse market impact. However, Congress may not agree to leave it out, as is indicated by statements made by certain members of the Ways & Means Committee. If it should be included there is no doubt that it would significantly reduce bond purchases on behalf of individuals—if the initial minimum tax didn't affect them, they would wonder if the next step in this direction would not. Undoubtedly there would be a legal test as to whether or not a law taxing interest on state and municipal bonds would be Constitutional. Because of diversity of legal opinion upon this point, no one could be certain of the outcome until a decision was reached by the U.S. Supreme Court. In the meantime, the municipal market would be thrown into apprehension and uncertainty, and the net effect would be to diminish sharply the acquistion by individuals of state and municipal bonds until this question was settled. In fact, such a legal test might well stimulate a very large *disinvestment* by individuals in anticipation of an unfavorable decision.

Under these circumstances, banks and other institutional investors in tax-exempts might well assume that the next change in the tax law could directly reduce the value of tax exemption to them. Any municipal financing that could be done at all would doubtless be at sharply higher interest rates, the cost of which would be borne by the general taxpayers in the borrowing municipalities.

Investors in these securities bought them in the belief that the income would never be taxed by the Federal Government. Once this principle is breached, there is theoretically no limit to the extent to which they could then be taxed by succeeding Congresses. More than any other sector of the security markets, the market for bonds of state and local governments is based on belief in the good faith of Government at all levels. Any change in the tax status of these bonds would in our opinion irreparably damage investor confidence, with far reaching effects on the cost of future local government financing. Consideration also should be given to the impact of such action on the value of outstanding municipal bonds and the capital losses on them which necessarily would be sustained by thousands of banks and other financial institutions, as well as individual investors. This would be a serious miscarriage of the intent to improve equity in taxation.

Putting this matter in proper perspective, tax exemption is not simply a gift from the Federal Government to certain investors. It is a *quid pro quo* for the acceptance of lower rates of return than the investor could obtain on alternative investments. Here is a major and I think conclusive thought on this point. The minimum income tax proposal purports to be an attempt to reach tax sheltered income at roughly half the regular income tax rates, that is up to 30% or 35%. An investor in tax-exempt bonds has accepted close to ⅓ less income than he could receive from taxable obligations—this is what he has paid for the tax exemption. Thus in a very real sense, and certainly in terms of equity, the investor in tax-exempt bonds has *already paid* his minimum income tax and has paid it in advance.

Turning to the proposal for allocation of deductions, the new Administration *has* included this in its recommendations. There is probably no legal or Constitutional problem here, and thus this does not raise the prospect of prolonged litigation. In theory it would increase the taxes collected from taxable income rather than collect tax on tax-exempt bond interest income. Nevertheless, this proposal can have an important adverse effect on the tax-exempt market. The aggregate dollar impact on investor taxpayers would be much greater, because this would have *some* effect on nearly all individual investors in tax-exempt bonds. The extent of the effect depends upon the relationship between the size of aggregate nonbusiness deductions and total income; the larger the relative amount of deductions the greater the impact. To the investor it could reduce the yield of tax-exempt income by ¼ to ¾ of 1%, — some have calculated ½ of 1% as about the average. This would mean that a 5% tax-exempt yield for example would then be only worth about 4½% to the investor.

By making tax-exempt income less attractive some individual investors will be persuaded to follow the present trend toward complete concentration in common stocks or other equity investments. We spoke earlier of an individual with $1 million dollars or more in tax-exempt bonds. It is probable that the lower prices which go with high current yields have already reduced the capital value of his investment to about ¾ of a million dollars. (Figures prepared for the I.B.A. testimony to the Ways & Means Committee show that a 25% loss in capital value could actually have been incurred in the past five years.) He is certainly in no mood to absorb a blow from another direction. His reaction may be partly emotional or "psychological". However, a rational and sophisticated approach could also dictate some changes. As one formerly involved in the investment counsel business I would judge that some types of accounts—such as those in medium tax brackets, or those concentrating on capital performance, might receive professional advice to move out of tax-exempts. This, of course, would narrow the market.

The application of allocation to individuals would raise serious questions for institutional investors, particularly commercial banks; who would seriously consider whether they might be next in line for some application of this proposal. Congressional discussions have already included this possibility. Given the banks' dominant position as buyers of tax-exempt bonds this could have a most serious effect.

Our market has experienced the results of an allocation arrangement before; such an arrangement was a part of the Life Insurance Tax Act of 1959. The Atlas Life Insurance Company contested these provisions in litigation which lasted from May 1962 until May 1965. There was one victory along the way in the Circuit Court of Appeals, but the Company finally lost in the U. S. Supreme Court. As generally predicted, the life insurance industry has been a negative factor in the municipal market since that time. Holdings of $3.9 billion in 1961 have declined to $3.2 billion in 1968. Since 1962 the life companies as a whole have been net sellers of state and local bonds each year.

As we look at this precedent and contemplate the possible application of allocation of deductions to individuals, we should note that individual investors are a factor in the tax-exempt market some ten times as large as were the life companies at their peak.

The three principal categories of non-business deductions which would be involved in the allocation proposals are (1) contributions, (2) interest paid, (3) state and local taxes. I submit that proper tax reform should deal with each of these (and the other less used ones) on their individual merits. You can see their relative importance from the schedules covering the 154 individuals. One point I will make in passing. With the overriding current revenue needs of State and local governments being such that proposals like Federal tax sharing or tax credits are seriously being considered, it would be unfortunate to downgrade in any way the present deductibility of State and local taxes.

We have properly not talked about the many suggested alternative borrowing devices now being discussed. I believe it is fair to say the more you study them the better your present tax-exempt market looks to you. Any new arrangement which would satisfy the competing needs and be acceptable to both state and local governments and to the Treasury would require a long period of consideration, if indeed this is possible at all.

Your immediate problem is to maintain the integrity of the present tax-exempt market. This is your market. Only you and your associates can make it clear to your Congressmen that it should be protected and that you have an important stake in its protection. You can emphasize to them the dangers to this market which would flow from inclusion of tax-exempt bond interest in either a minimum income tax scheme or an arrangement for allocation of deductions. You can say to them "The tax-exempt market provides us with an effective and advantageous vehicle for financing public capital projects, and we regard our financial independence as an important feature of our federal system of government. The horror stories about non-taxed wealthy individuals were based on figures which did not include tax-exempt bond interest and they give you no reason to strike at us. The individual investor has paid the equivalent of a minimum tax when he purchased tax-exempt bonds through acceptance of a much lower rate of return. If you aim a blow at him the real target you hit will be state and local government and their taxpayers."

ATTACHMENT 1

TABLE 4.—SOURCES OF INCOME AND ITEMIZED DEDUCTIONS FOR THE 154 NONTAXABLE INDIVIDUALS WITH ADJUSTED GROSS INCOME OF $200,000 OR MORE, 1966

[Amounts to nearest thousand dollars]

Income category	Gain	Loss	Net	Deduction category	Amount
Adjusted gross income (AGI)	112,145		112,145	Total itemized deductions	130,458
(Adjusted gross income plus excluded capital gains).	137,169		137,169	Contributions	78,580
				Cash	24,015
Investment income			125,257	Noncash	54,948
Dividends	85,015		85,015	Interest	27,802
Taxable interest	10,457		10,457	Home mortgage	1,102
Capital gains (including 50 percent of long-term gains).	26,504	[1] 26	26,478	Other	27,699
				Taxes	8,681
Estate and trust income	2,246	2	2,244	State and local income	4,657
Royalty income	1,035	274	761	Real estate	2,072
Business income			−12,758	Other	1,953
Wages and salaries	6,536		6,536	Medical	239
Farm	32	2,655	−2,623	Miscellaneous	15,156
Other business	1,899	10,125	−8,226	Tax computation and credits:	
Partnership	797	8,761	−7,964	Taxable income	1,505
Subchapter S corporation	133	1,151	−1,018	Tax before credits	836
Rental income	1,150	613	537	Tax credits	838
Other income	1,460	1,172	288	Tax after credits	
				Depletion [2]	927
				Depreciation [2]	3,569

[1] Capital loss after $1,000 limitation.

[2] Limited to depletion and depreciation reported on individual income tax returns.

TABLE 5.—THE 154 NONTAXABLE INDIVIDUAL INCOME TAX RETURNS REPORTING AGI OF $200,000 OR MORE IN 1966, CLASSIFIED BY MAJOR TAX REDUCING FACTORS [1]

Major tax-reducing factor	$200,000 to $500,000 AGI	$500,000 to $1,000,000 AGI	Over $1,000,000	All nontaxable returns over $200,000 AGI
Deductions:				
Charitable contributions	19	13	17	49
Interest	55	16	1	72
Taxes:				
State and local income	12			12
Real estate	1			1
Not specified	1			1
Miscellaneous, not specified	12	3		15
Credits [2]	3	1		4
Total	103	33	18	154

[1] Returns are classified according to the principal factor reducing tax from a high adjusted gross income base.
[2] Primarily investment credits and foreign tax credits.

ATTACHMENT 3—BENEFIT FROM TAX-EXEMPT INTEREST

IMPACT OF MINIMUM TAX

$50,000 from Tax-Exempts

$$\$50\text{M} \times \frac{100}{70} = \$71{,}400 \text{ Alternative Taxable Income}$$

Tax on $71,400 = $28,490 = 40%

```
        $71,400
         28,490
        -------
        $42,910 After Tax
```

Distribution of Benefit:

```
Municipality $71,400.— $50,000 = $21,400
Taxpayer      50,000 —  42,910 = $ 7,090
                                 -------
                                 $28,490
```

Should the $50,000 tax-exempt income become taxable at as much as 30% i.e. $15,000, the taxpayer's benefit would be wiped out and he would be penalized $7,910 net.

U.S. LIFE INSURANCE CO. HOLDINGS AND ACQUISITIONS—STATE AND LOCAL BONDS, 1959-68

[In millions]

Year	Holdings	Total assets	Holdings as percent of total assets	Acquisitions	Total acquisitions	Acquisitions as percent of total acquisitions
1959	3,200	$113,650	2.82	670	20,022	3.35
1960	3,588	119,576	3.00	466	20,354	2.29
1961	3,888	126,816	3.07	506	25,150	2.01
1962	4,026	133,291	3.02	486	28,558	1.70
1963	3,852	141,121	2.73	371	32,167	1.15
1964	3,774	149,470	2.52	365	33,959	1.07
1965	3,530	158,884	2.22	296	39,451	.75
1966	3,260	167,455	1.95	215	36,955	.58
1967	3,145	177,832	1.77	212	43,447	.49
1968	3,194	188,636	1.69	278	47,970	.58

Source: Institute of Li e Insurance.

PECK, SHAFFER & WILLIAMS,
Cincinnati, Ohio, September 17, 1969.

Senate Finance Committee,
New Senate Office Building,
Washington, D.C.

TAXATION OF INTEREST INCOME ON MUNICIPAL BONDS

DEAR MR. VAIL:

Tax-exempt bonds are historically the chief method of financing capital improvements in the State of Ohio and almost all other states. In Ohio, they are issued by the State itself, state and state-affiliated universities, counties, cities and villages, townships, and various special-purpose districts, including conservancy districts. Typically, these bonds (and the notes or other interim financing obligations issued in anticipation thereof) are sold either by negotiation or on the open market after public advertising, in competition with investment securities of many kinds. Until a few months ago, these bonds, together with a very few issues of Federal obligations, enjoyed a unique advantage in the eyes of institutional and individual investors, *i.e.*, the unquestioned exemption of interest income received thereon from taxation by the Federal government. These bonds, of course, have always been subject to capital gains taxes. This exemption has meant that the issuers of the bonds—and thus, in many instances, the taxpayers whose taxes or service charges secured and retired the bonds—paid much lower interest rates than did the issuers of corporate bonds of comparable quality. Ignoring constitutional considerations for the moment, the fiscal effect of the tax exemption for these bonds was of course a federal subsidy to such issuers (and, indirectly, their taxpayers) for the public projects financed by issuance of the bonds.

Since the Ways and Means Committee of the House of Representatives began consideration of various tax reforms a few months ago, and it became known that that Committee proposed to have the interest income on these bonds be taxable in the hands of certain holders, the effect on the municipal bond market has been dramatic and nearly catastrophic. The bonds of many prospective issuers have become unsalable at rates within statutory interest rate limitations. Bonds which would have sold at a net interest cost of 4% or 5% per annum as recently as six months ago sold last week at the 7% level. Differentials of this magnitude over the life of a 20 or 30 year bond issue of substantial size can amount to millions of dollars. To the taxpayer whose taxes are automatically increased or reallocated to cover the differential, or to the user of revenue-supported facilities such as sewer and water lines or state parks, the increased cost is very burdensome, especially in view of the heavy inflationary pressures now at work in the economy.

Although the bill as finally passed by the House of Representatives does not have the effect of taxing interest income from municipal bonds in the hands of corporate holders, the fact that these bonds may become taxable in the hands of certain individual holders of necessity limits the marketability of bonds held by corporations and banks, and thus conduces to higher interest rates for origin issues.

As attorneys actively engaged in the practice of the law of public finance for more than eighty years, we have watched with dismay as the market reacted to the threat of taxation of municipal and other tax-exempt bonds, and are certain that any revenue gains to be derived by the Federal Treasury from the proposed modification of the present tax exemption for these bonds will be overborne by the higher interest costs which an uneasy market has demanded and will demand for bond issues for critical public improvements.

Passage of H.R. 13270 by the House of Representatives has by virtue of the bond market's near-collapse cost issuers across the country hundreds of millions of dollars in increased interest costs on bonds sold during the last few months, and has caused postponement of many vital public projects with no concomitant federal benefit. Approval by the Senate of the United States or passage of a bill taxing the interest income on municipal bonds by the Congress would compound and perpetuate the damage.

Very truly yours,

PECK, SHAFFER & WILLIAMS.

LEBENTHAL & CO., INC.,
New York, N.Y., October 2, 1969.

Hon. RUSSELL B LONG,
Chairman, Committee on Finance, U.S. Senate, Office Building, Washington, D.C.

MY DEAR SENATOR: If you can abide one more piece of testimony on those sections of the Tax Reform Act having to do with the tax status of Municipal Bonds, I respectfully urge your consideration of the enclosed survey of How the Proposed Tax on Municipal Bonds Would Affect the Average Individual Investor, which speaks for 770 individual owners and prospective owners of Municipal Bonds.

Briefly, the survey indicates how few owners of these securities would be personally affected by the proposed tax. And yet, more than half the individuals queried indicate they would be unwilling to invest in Municipal Bonds with the taint of any tax at all upon them, apparently sensing that a tax on one man's Municipal Bonds changes the nature of the security for all.

The survey also reveals that present investors show no enthusiasm for rates of less than 10%, should our towns and cities elect to issue fully taxable bonds in exchange for a federal interest subsidy. Many investors who have been willing to own bonds of small towns and big cities with the tough problems as tax-free bonds indicate they would not re-buy such bonds as taxable issues at any price at all.

It seems to us that the real loser from a tax on Municipal Bonds is every local taxpayer who will have to pay more to build his schools, unfoul his rivers, unclog his highways.

Unfortunately, the results of our study were tabulated after the date fixed for presentation of testimony on this phase of the Tax Bill. But I respectfully submit the enclosed copies for such use as your Committee may wish to make of them at this time.

As a courtesy, I do want you to know that we have also sent copies of the enclosed to the press, specifically to John Allan, who reports on Municipal Bonds for the New York Times.

Very truly yours,

LEBENTHAL & CO., INC.,
By JAMES A. LEBENTHAL, *Vice President.*

c.c. John Allan, New York Times.

LEBENTHAL & CO., INC.

HOW THE PROPOSED TAX ON MUNICIPAL BONDS WOULD AFFECT THE AVERAGE INDIVIDUAL INVESTOR AS SET FORTH IN H.R. 13270

Results of a Lebenthal & Co., Inc. Survey

INTkODUCTION

Briefly, the sections in H.R. 13270 having to do with Municipal Bonds, say that if more than 50% of your income comes from items that are treated preferentially at taxtime-- one half of the excess has to be added to your tax base and be taxed in the ordinary manner. The proposed formula doesn't apply if your tax-free income is $10,000 a year or less.

If you do get more than $10,000 a year tax free, there is also a provision for reducing your personal deductions by the ratio of your tax-free income to taxable income. And another section of the bill would let our cities and towns decide for themselves whether to issue tax-free bonds, or fully taxable bonds, Uncle Sam making up the difference in the additional cost of borrowing.

To ascertain what effect the proposed tax might have on the average individual investor (and the effect it might have on our great American cities and States), Lebenthal & Co., Inc., dealers in Municipal Bonds, specializing in Municipal Bonds for the individual investor, large and small, drew up and sent this questionnaire to 6,500 individual owners and prospective owners of Municipal Bonds.

The questionnaire was mailed September 5th.

This report is based on 770 replies received by Lebenthal in the one week of September 9th through 16th.

1. Do you own any Municipal Bonds? ______ Yes ______ No

2. Do you get anywhere near $10,000 a year from them?

   ______ No ______ Yes ______ More than $10,000

3. Do you get anywhere near $10,000 a year from the combination of your Municipal Bonds plus these tax favored items: the excluded half of capital gains; appreciation in value of property such as artwork donated to charity; accelerated real estate depreciation; farm losses?

   ______ No ______ Yes ______ More than $10,000

4. Does more than 50% of your total income come from these tax-free sources?

   ______ No ______ Yes

5. Your total income is approximately $______

6. Please rank these reasons for buying Municipal Bonds in the order of their importance to you.

   (A) They make good collateral ______
   (B) They're safe ______
   (C) You can always sell them if you have to ______
   (D) They're tax-free ______
   (E) Income doesn't have to be reported ______
   (F) They can be handed over easily to members of family and others ______
   (G) Good possibility of capital gains, if interest rates come down ______
   (H) Other reason: ______

7. If enacted, would the tax bill stand in the way of your starting a portfolio in Municipal Bonds or adding to your holdings (so long as your total tax-free income therefrom does not exceed the $10,000 allowance?)

   ______ Yes ______ No ______ Don't know

8. Suppose you do reach the point, or are at the point, where you are getting $10,000 a year from tax exempts and your tax-free income does amount to 50% of your total income, would you be willing to buy more Municipal Bonds as long as there is a yield advantage to you in doing so?

   ______ Yes ______ No ______ Don't know

9. Suppose some of our towns do come out with a fully taxable bond in exchange for a federal interest subsidy. In your opinion, what is the minimum rate the municipalities below would have to pay on a fully taxable bond, when you can now get 5% from a savings bank. 6–6½% from various tax free Municipal Bonds, 7¾% from a U.S. Government note, 8.20% from an indirect U. S. Government obligation, 8–8½% and more from various corporates, and over 9% from foreign securities?

MUNICIPALITY	MOODY'S RATING	MINIMUM INTEREST ACCEPTABLE TO YOU ON FULLY TAXABLE BOND
STATE OF NEW JERSEY	Aaa	______%
BALTIMORE, MARYLAND	A	______%
NEW YORK CITY	Baa–1	______%
BLOOMINGTON, MINNESOTA	Baa	______%
WEEDSPORT, N.Y.	Non–rated	______%

10. From the standpoint of Moody's rating, or just your own peace of mind, what is the least desirable municipality in your portfolio?

    ______

11. What interest rate would it take on a fully taxable bond of this issuer for you to buy such a bond again?

    ______%

12. Where do you stand on the tax bill as it pertains to Municipal Bonds?

    ______ For ______ Against.

(REFOLD - USE ENCLOSED STICKER TO SEAL - AND MAIL - NO ENVELOPE OR STAMP NECESSARY)

SUMMARY

72% of the individual investors in Municipal Bonds do not receive $10,000 a year tax free and would not be affected by the proposed tax.

28% do earn $10,000 a year in tax-free income and might have to allocate deductions.

Only 5% earn both $10,000 a year and more than 50% of their total income from tax-free sources, and would have to pay some tax on their Municipal Bonds, as well as allocate deductions.

Average income those unaffected by proposed tax bill: $30,000. Those affected: $55,000.

Investors rank tax exemption as the most important reason for investing in Municipal Bonds and income that doesn't have to be reported as the third most important reason. (Safety is second.) Although the tax bill would not hurt the average owner personally, investors apparently sense that a tax on one man's Municipal Bonds changes the very nature of the security for all.

56% say they would not start a portfolio in Municipal Bonds or add to their holdings if the proposed bill goes through, although unaffected personally.

As for fully taxable bonds, issued at the option of the municipality with a federal interest subsidy--to make them acceptable to individuals would take interest rates of 9-10% for the average A-rated, trouble-free community, with small non-rated towns and the big cities with the tough problems having to pay 10-11%.

87% with a point of view are against the tax bill as it pertains to Municipal Bonds.

1. Do you own any Municipal Bonds?

699	Do Own
63	Do Not
8	No Answer
770	Total

91% REPLIES CAME FROM OWNERS

2. Do you get anywhere near $10,000 a year from them?

618	Do not receive $10,000 a year from Municipal Bonds
72	Receive about $10,000
59	Receive more than $10,000
21	No answer
770	Total

82% RECEIVE LESS THAN $10,000 FROM MUNICIPAL BONDS

3. Do you get anywhere near $10,000 a year from the combination of your Municipal Bonds plus these tax favored items: the excluded half of capital gains; appreciation in value of property such as artwork donated to charity; accelerated real estate depreciation; farm losses:

533	Do not receive $10,000 a year tax free from all sources
111	Do receive about $10,000
93	More than $10,000
33	No answer
770	Total

72% RECEIVE LESS THAN $10,000 A YEAR IN TAX-FREE INCOME AND WOULD BE UNAFFECTED BY EITHER THE PROPOSED LIMIT ON TAX PREFERENCES OR PROPOSAL FOR ALLOCATING DEDUCTIONS

28% MIGHT HAVE TO ALLOCATE DEDUCTIONS.

4. Does more than 50% of your total income come from these tax-free sources?

711 Less than 50% of total income is tax free
37 More than 50% of total income is tax free
22 No Answer
770 Total

5% WOULD HAVE TO ALLOCATE DEDUCTIONS AND PAY SOME TAX ON MUNICIPAL BONDS

5. Your total income is approximately $______________?

$38,000. AVERAGE INCOME FOR 676 REPORTING AN INCOME
$30,000. AVERAGE INCOME OF THOSE PERSONALLY UNAFFECTED BY BILL
$55,000. AVERAGE INCOME OF THOSE AFFECTED

BREAKDOWN BY INCOME GROUPS

Income	Total Replies	Municipal Bond Owners	Unaffected By Proposed Tax Bill	Required to allocate	Required to allocate and pay tax
Less than $5M	6	4	6	0	0
$5M - $10M	27	24	27	0	0
$10M - $15M	54	46	50	3	4
$15M - $20M	59	53	57	2	1
$20M - $50M	340	310	263	71	16
$50M - $100M	154	145	73	75	7
$100M - $1,000M	36	35	9	26	4
Did not report	94	82	48	27	5
TOTAL	770	699	533	204	37

6. Please rank these reasons for buying Municipal Bonds in the order of their importance to you.

(A) They make good collateral
(B) They're safe
(C) You can always sell them if you have to
(D) They're tax free
(E) Income doesn't have to be reported
(F) They can be handed over easily to members of family and others
(G) Good possibility of capital gains, if interest rates come down
(H) Other reasons:______________________

		VOTES RECEIVED								Checks & Blanks
RANK	REASON FOR BUYING	1st	2nd	3rd	4th	5th	6th	7th	8th	(Invalid)
6	(A) Collateral Value	6	31	56	53	56	38	33	1	596
2	(B) Safety	58	143	108	59	21	8	12	1	360
4	(C) Marketability	7	25	75	77	57	43	12	0	474
1	(D) Tax free	428	65	16	11	4	1	1	0	243
3	(E) Non-reporting	26	165	55	31	23	22	26	0	421
7	(F) Transferability	4	24	62	51	49	54	41	1	483
5	(G) Capital gains	7	50	52	37	36	40	45	3	499
8	(H) Other reasons	5	1	4	3	1	1	1	5	749

Investors make no bones about why they invest in Municipal Bonds. Reasons in order of importance:

THEY'RE TAX FREE
THEY'RE SAFE
INCOME DOESN'T HAVE TO BE REPORTED

Change the tax exemption of Municipal Bonds, and you change the very nature of the security. Change the nature of the security, and you change the very basis for investing in Municipal Bonds.

7. If enacted, would the tax bill stand in the way of your starting a portfolio in Municipal Bonds or adding to your holdings (so long as your total tax-free income therefrom does not exceed the $10,000 allowance?)

321	Say tax bill would stand in way of investing
255	say it would not stand in way
166	Don't know
28	No answer
770	Total

56% OF THOSE WHO ANSWERED YES OR NO WOULD NOT BE WILLING TO BUY MUNICIPAL BONDS EVEN THOUGH THEY WERE NOT PERSONALLY AFFECTED BY THE TAX BILL.

8. Suppose you do reach the point, or are at the point, where you are getting $10,000 a year from tax exempts and your tax-free income does amount to 50% of your total income, would you be willing to buy more Municipal Bonds as long as there is a yield advantage to you in doing so?

229	Say they would be unwilling to buy more Municipal Bonds
222	Are willing to buy
214	Don't know
35	No answer
770	Total

52% OF THOSE WHO ANSWERED YES OR NO WOULD NOT BE WILLING TO ADD TO HOLDINGS ONCE HAVING REACH POINT WHERE REQUIRED EITHER TO ALLOCATE DEDUCTIONS OR PAY SOME TAX ON MUNICIPALS.

9. Suppose some of our towns do come out with a fully taxable bond in exchange for a federal interest subsidy. In your opinion, what is the minimum rate the municipalities below would have to pay on a fully taxable bond, when you can get 5% from a savings bank, 6-6 1/2% from various tax free Municipal Bonds, 7 3/4% from a U.S. Government note, 8.20% from an indirect U.S. Government obligation, 8-8 1/2% from various corporates, and over 9% from foreign securities?

MUNICIPALBITY	MOODY'S RATING	MINIMUM INTEREST RATE ACCEPTABLE TO YOU ON A FULLY TAXABLE BOND
STATE OF NEW JERSEY	Aaa	______%
BALTIMORE, MARYLAND	A	______%
NEW YORK CITY	Baa-1	______%
BLOOMINGTON, MINNESOTA	Baa	______%
WEEDSPORT, NEW YORK	Non-rated	______%

STATE OF NEW JERSEY (Aaa)

Rate Range	No. Replies
0-5%	3
6-7%	12
7-8%	28
8-9%	60
9-10%	211
10-15%	91
Over 15%*	27
No answer	266
Total	770

AVERAGE ACCEPTABLE RATE 8-9%, WITH 23% SAYING THEY WOULD NOT BUY AT LESS THAN 10% IF AT ANY PRICE AT ALL.

BALTIMORE, MARYLAND (A)

Rate Range	No. Replies
0-5%	3
5-6%	9
6-7%	20
7-8%	47
8-9%	176
9-10%	82
10-15%	105
Over 15%*	35
No answer	293
Total	770

AVERAGE ACCEPTABLE RATE 8-9% WITH 30% SAYING WOULD NOT BUY AT LESS THAN 10% IF AT ANY PRICE

*Including "not at any price at all"

NEW YORK CITY (Baa-1)

Rate Range	No. Replies
0-5%	5
5-6%	5
6-7%	21
7-8%	28
8-9%	137
9-10%	117
10-15%	182
Over 15%*	57
No answer	218
Total	770

AVERAGE ACCEPTABLE RATE 10-11%, WITH 43% SAYING WOULD NOT BUY AT LESS THAN 10% IF AT ANY PRICE

BLOOMINGTON, MINNESOTA (Baa)

Rate Range	No. Replies
0-5%	5
5-6%	5
6-7%	5
7-8%	21
8-9%	92
9-10%	94
10-15%	137
Over 15*	98
No answer	313
Total	770

AVERAGE ACCEPTABLE RATE 9-10% WITH 51% SAYING WOULD NOT BUY AT LESS THAN 10% IF AT ANY PRICE

WEEDSPORT, NEW YORK (NON-rated)

Rate Range	No. Replies
0-5%	8
5-6%	3
6-7%	3
7-8%	14
8-9%	45
9-10%	64
10-15%	131
Over 15%*	181
No answer	321
Total	770

AVERAGE ACCEPTABLE RATE 10-11% WITH 69% SAYING WOULD NOT BUY AT LESS THAN 10% IF AT ANY PRICE

*Including "not at any price"

10. From the standpoint of Moody's rating, or just your own peace of mind, what is the least desirable municipality in your portfolio?

181 OWNERS INDICATED THAT NEW YORK CITY BONDS WERE THEIR BIGGEST WORRY.

11. What interest rate would it take on a fully taxable bond of this issuer for you to buy such a bond again?

Rate Range	No. Replies
0-5%	6
5-6%	2
6-7%	15
7-8%	36
8-9%	104
9-10%	68
10-15%	166
Over 15%*	75
No answer	298
Total	770

AVERAGE ACCEPTABLE RATE 9-10%, WITH 51% SAYING THEY WOULD NOT REBUY PRESENT HOLDINGS AS TAXABLE BONDS AT LESS THAN 10% IF AT ANY PRICE AT ALL.

CONCLUSION: COST OF BORROWING THROUGH THE DEVICE OF TAXABLE MUNICIPAL BONDS WITH FEDERAL INTEREST SUBSIDY WOULD BE PROHIBITIVE FOR THOSE MUNICIPALITIES IN WHICH INVESTORS FEEL LEAST CONFIDENCE--NAMELY, THE SMALL NON-RATED TOWNS AND THE BIG CITIES WITH THE TOUGH PROBLEMS--ALTHOUGH INVESTORS ARE WILLING TO BUY SUCH BONDS AS TAX EXEMPT ISSUES.

12. Where do you stand on the tax bill as it pertains to Municipal Bonds?

111	Say they are for the bill
614	Against
65	No answer
770	Total

87% REPORTING POINT OF VIEW ARE AGAINST TAX BILL AS IT PERTAINS TO MUNICIPAL BONDS.

*Including "not at any price"

CONCLUSION

You would expect owners of Municipal Bonds to oppose a tax on Municipal Bonds because it hurts them personally and is inimical to self-interest.

In point of fact, the sections in H.R. 13270 having to do with Municipal Bonds affect few investors directly. 28% might have to allocate deductions. 5% might additionally have to pay some tax on their Municipal Bonds.

And yet, more than 50% of the individuals surveyed indicated that they would not be willing to invest in Municipal Bonds if the proposed bill goes through, apparently sensing that a tax on one man's Municipal Bonds changes the nature of the security for all.

As for fully taxable Municipal Bonds, issued by the community with a federal interest subsidy, present investors in Municipal Bonds show no enthusiasm for such instruments at rates less than 10%. Many investors who have been willing to own the bonds of small towns and the big cities with the tough problems as tax-free bonds, indicate they would not rebuy such bonds as taxable issues at any price at all.

Conclusion: Tax one Municipal Bond--even just a little--and it's goodbye to a substantial segment of the market for Municipal Bonds, not to mention the relatively low cost of borrowing for every town, city, and State in the Union.

MEMORANDUM PREPARED BY PRESTON, THORGRIMSON, STARIN, ELLIS & HOLMAN, BY MICHAEL B. CRUTCHER

It is unconstitutional for a municipal corporation to waive Federal income tax immunity on bonds it issues without specific enabling legislation by the State.

The problem presented

The interest from municipal bonds has long been exempt from federal income tax by virtue of federal constitutional law and specific statutory exemption. Proposed tax legislation would permit the federal government to levy income tax on municipal bond interest where the municipality issuing these bonds elects to waive that constitutional immunity. Apart from the question of whether the federal government possesses the constitutional authority to levy that tax upon a valid waiver, who would be entitled to waive that immunity? Is it constitutional for a municipality to waive such immunity in the absence of state consent in the form of enabling legislation?

Conclusion

A municipality cannot constitutionally waive immunity from federal income taxation in the absence of state consent in the form of enabling legislation.

Analysis

1. The conclusion summarized.—The federal constitution requires that the states be immune from taxation by the federal government. This immunity extends to municipal corporations because they are agents of the state. Such immunity is a right reserved to the state and only the state is entitled to waive that right. Where the state does not specifically consent to such waiver, any purported waiver by a municipality is totally without authority and is constitutionally invalid.

2. The origin and nature of the immunity doctrine.—(a) The origin of federal immunity from state taxation: *McCulloch v. Maryland.*

The doctrine of federal immunity from state taxation was early established in American law by the landmark decision of the United States Supreme Court, per Marshall, C. J., in *McCulloch v. Maryland* 4 Wheat. 316, 4 L. Ed. 579 (1819). Maryland attempted to assess a discriminatory tax against bank notes issued by the Bank of the United States. The Supreme Court held that the federal government enjoyed an immunity from state taxation and that the Maryland tax was unconstitutional. Although there was no specific constitutional prohibition against such taxation, the court found that "the power of the tax involves the power to destroy," and that this danger could be avoided by refusing to confer "on one government a power to control the constitutional measures of another." 4 Wheat. at 436. Accordingly, Marshall held that under the federal system it was unconstitutional for a state to levy a tax on the federal government. This constitutional doctrine would protect the national government and prevent the spectre of "clashing sovereignty . . ." 4 Wheat. at 435.

Marshall found an immunity from taxation because "the sovereignty of the state extends to everything which exists by its own authority, or is introduced by its permission." 4 Wheat. at 435. This state sovereignty could not extend over the federal government, however, because the federal government was itself a sovereign and supreme under the federal constitution. *McCulloch* did not decide that the federal government was likewise powerless to tax the states. Marshall did not reach that question, but did imply that the federal government might be constitutionally permitted to levy such a tax. Marshall reasoned that because the states were represented in the national congress any decision by that congress to tax the states would reflect the views of the individual states. But the other states were not represented in a single state legislature; any action by that legislature to tax the federal union would be without this built-in political check. As Marshall wrote for the court:

"The difference is that which always exists and always must exist, between the action of the whole on a part, and the action of a part on the whole—between the laws of a government declared to be supreme, and those of a government which, when in opposition to those laws, as not supreme." 4 Wheat. at 438.

See further *First Agricultural National Bank* v. *State Tax Commission* 392 U.S. 339, 88 S. Ct. 2173 (1968).

(*b*) The origin of state immunity from federal taxation: *Collector* v. *Day.*

Despite Marshall's argument that *McCulloch* v. *Maryland* did not require reciprocity, the United States Supreme Court held that the state sovereign enjoyed an immunity from federal taxation in the case of *The Collector* v. *Day* 11 Wall. 113, 20 L.Ed. 122 (1871). There the court held that the salary of a Massachusetts judge was immune from federal income taxation.

The court reasoned that the state government was itself a sovereign under the federal system. Taxation of that sovereign by the federal sovereign was incompatible with the concept of state sovereignty and the rights reserved to the states under the Tenth Amendment to the federal constitution. As the judge was a "means or instrumentality" of the state sovereign, his salary was constitutionally immune from federal taxation. 11 Wall. at 127. See also *Dobbins* v. *The Commissioner of Eire* 16 Pet. 435 (1842). The court found reciprocal immunity from taxation required by the reasonable implications of the federal system as embodied in the Constitution:

"Such being the separate and independent condition of the States in our complex system as recognized by the Constitution . . . it would seem to follow, as a reasonable, if not a necessary consequence, that the means and instrumentalities employed for carrying on the operations of their governments, for preserving their existence, and fulfilling the high and responsible duties assigned to them in the Constitution, should be left free and unimpaired, should not be liable to be crippled, much less defeated by the taxing power of another government, which power acknowledges no limits but the will of the legislature imposing the tax." 11 Wall. at 125, 126.

What *The Collector* v. *Day* decisions did was to formally erect a constitutional theory of intergovernmental immunity which reciprocally limited the authorities of the state and federal governments. This limitation protected the twin sovereigns and the "means and instrumentalities" by which each exercised its powers. Without express constitutional authority, the court fashioned an enduring pattern of reciprocal immunities from the logical consequences of federalism.

(c) State immunity from federal taxation is extended to municipal bonds: *Pollock* v. *Farmers Loan & Trust Co.*

Earlier cases had already established that a tax on the revenue of federal securities was invalid as a tax on the securities themselves. *Weston* v. *City Council of Charleston* 2 Pet. 449 (1829), and that state securities enjoyed protection from other forms of federal taxation. *VanBrooklin* v. *Tennessee* 117 US 151, 6 Sup. Ct. 670 (1886), *Mercantile Bank* v. *City of New York* 121 US 138, 7 Sup. Ct. 826 (1887). In *Pollock* v. *Farmers Loan and Trust Co.* 157 US 429, 15 Sup. Co. 673 (1895) the court married these concepts and held that federal taxation of the interest on municipal bonds was unconstitutional.

In *Pollock* the court started with the principle that "a municipal corporation is the representative of the state, and one of the instruments of the state government." 15 Sup.Ct. at 690. Any tax on the revenue from bonds issued by a municipality acted as a tax on the municipality itself; municipal bonds are the "means for carrying on the work of the [state] government." 15 Sup.Ct. at 691. Because the municipal corporation stands in the shoes of the state, bonds issued by that corporation enjoy the state sovereign's immunity from taxation. The *Pollock* court cited with approval language from *US* v. *Baltimore & O.R. Co.*, where the court said:

". . . because the municipal corporation was a representative of the state created by the state to exercise a limited portion of its powers of government, and therefore its revenues, like those of the state itself, were not taxable by the United States." 15 Sup.Ct. at 691.

See also *National Life Insurance Company* v. *United States* 277 US 508, 48 S.Ct. 591, 72 L.Ed. 968 (1928).

(*d*) Further developments in the immunity doctrine.

After a period where the immunity doctrine was expanded to some degree, there has been a gradual erosion on the limits of the doctrine over the last fifty years.

The salaries of state employees has been held taxable in common with that of other citizens *Helvering* v. *Gerhardt* 304 US 405, 58 Sup.Ct. 969, 82 L.Ed. 1427 (1938). In *Gerhardt*, the court determined that taxation of salaries of state employees "neither precludes nor threatens unreasonably to obstruct any function of the state government." 58 S.Ct. at 977. To decide whether state immunity ought to be maintained, the court said that it should be asked 1) was the activity essential "to the preservation of state governments," and 2) was the burden imposed on the state "so speculative and uncertain that if it [the immunity] were allowed it would restrict the Federal taxing power without affording any corresponding tangible protection to the state government . . ." 58 S.Ct. at 975.

Other decisions have held that state income from the sale of liquor and income from the sale of bottled mineral water was not exempt from federal income taxation. *South Carolina* v. *United States* 199 US 437, 26 S.Ct. 110 (1905); *Ohio* v. *Helvering* 292 US 360, 54 S.Ct. 725 (1934); *New York* v. *United States* 326 US 572, 66 S.Ct. 310, 90 L.Ed. 326 (1946). In the *New York* case Mr. Justice Frankfurter argued that the immunity doctrine should be limited to those cases where there was the danger that the state would be taxed "as a State," 66 S.Ct. at 314.

Federal immunity from non-discriminatory state taxation was narrowed in *City of Detroit v. Murray Corporation* 355 US 489, 78 Sup.Ct. 458, 2 L.Ed. 2 441 (1958). In that case the Supreme Court upheld a local tax imposed on building material used by a contractor under a federal contract. By the title vesting provisions of the contract, title in these building materials was in the federal government. Yet Black, J., for the majority, said that there was "no crippling obstruction of any of the government's functions . . . not even the slightest interference with its property." 78 S.Ct. at 462. The state tax was upheld as constitutional.

Revenue from municipal bonds continues to enjoy immunity from federal income taxation. The Supreme Court decided early in this century that the value of municipal bonds could be computed in the estate of an individual for purposes of federal inheritance tax. *Snyder v. Bettman* 190 US 249 (1903). The Supreme Court has further held that capital gains upon sale of municipal securities is taxable under the federal income tax, for here the effect on the state is remote. *Willcuts v. Bunn* 282 US 216 (1931).

The federal government sought to indirectly tax municipal bonds held by a life insurance company by assessing a greater tax burden on that company's non-exempt holdings. The court struck down that tax as unconstitutional in the *National Life Insurance* case, *supra*. Later the federal government devised a complicated formula for the taxation of insurance companies. The government assessed a tax on a percentage of the life insurance company's income as "investment yield" for the company. The company was only allowed to deduct from investment yield that portion of its tax exempt income which corresponded on a pro-rata basis to the percentage of investment return which was income. The company sought to deduct one hundred percent of its exempt income from its investment yield. The federal government's taxation was upheld in *United States v. Atlas Life Insurance Company*, 381 US 233, 85 S.Ct. 1379 (1965).

The federal government has several times considered the possibility of challenging the tax exempt status of municipal bonds. In 1938 the Department of Justice contended in an official report that it was constitutional for the federal government to levy an income tax on the revenue from municipal bonds. See 52 Harv. L. Rev. 180 (1938). The constitutional issue has not recently been raised, however, because currently such bonds enjoy specific statutory exemption. See *Comm. of Int. Rev. v. Shamberg's Estate* 144 F2 998 (1944), cert. denied 323 US 792 (1945). Were the constitutional issue raised again, the Supreme Court would have to consider the effect of the Sixteenth Amendment to the federal constitution: does it authorize taxation of municipal bonds because it gives authority to tax income from whatever source derived? See dissent by Holmes, J., in *Evans v. Gore*, 253 US 245 (1920), and the message to the New York Senate by Governor Hughes in 1910. For a more detailed discussion of the history of the immunity doctrine, see Powell, "The Waning of Intergovernmental Tax Immunities," 58 Harv. LR 633 (1945), and Freund, et al., *Constitutional Law* (1), 847 (1967).

3. The immunity of municipal bond revenue is the immunity of the state.— The entire history of the reciprocal immunity doctrine reaffirms the fact that the immunity of municipal bond revenue is the immunity of the estate. It was just because the federal government was sovereign that Chief Justice Marshall found immunity from state taxation in *McCulloch v. Maryland*. This immunity was reciprocated by the court in *Collector v. Day*, which took as its starting point the premise that the states were sovereign as well. In each case, it was sovereignty that created immunity from taxation.

It was by virtue of being a "means" or "instrumentality" of the state that specific agencies enjoyed immunity from federal taxation. Thus in the early cases the court held that employees were "instrumentalities" of their governments. While the court later overtuned this finding, it was because the court determined that the link between the taxation of individual employee salaries and the preservation of state government was too remote to warrant continuation of the immunity. But the court has never abandoned the heart of the immunity doctrine: in its vital functions, the state must be free to act, and therefore federal government is prohibited from levying an impost on that activity.

Nothing in the inherent nature of a municipal corportion requires special tax treatment—save for the effect that it is an agency of the state. It was as an instrument of the state sovereign that municipal corporations enjoyed a special status. Because municipal credit depended upon the status of those bonds the revenue therefrom likewise enjoyed favored constitutional status. Thus in *Pollock* the court granted immunity to municipal bonds because "the municipal corporation was a representative of the state, created by the state to exercise a limited portion of its powers of government, and therefore its revenues . . . [are] like those of the state itself . . ." 15 Sup.Ct. at 601.

Whether the doctrine of immunity has been expanded or contracted has always depended in a particular case on the degree to which a tax on an agent of the state acted as a tax upon the state "as a State." See concurring opinion of Frankfurter, J., in *New York v. United States, supra*. In the case of municipal bonds, the court has consistently recognized the link between the revenue of those bonds and the requirements of the state itself. This is not like an indirect burden, such as the taxation of the salary of an individual who is employed by the state. See *Helvering v. Gerhardt, supra*. Here the immunity of the revenue from municipal bonds bears directly upon the activity of the state:

"These obligations [municipal bonds] constitute the contract made by the State, or by its political agency pursuant to its authority, and a tax upon the amounts payable by the terms of the contract has therefore been regarded as bearing directly upon the borrowing power of the government." *Willcuts v. Bunn* 51 S. Ct. at 127.

Retention of immunity for municipal obligations is consonant with the basic purposes of the doctrine, to keep "federal and state governments in a position to be supreme within the scope of their own sovereignty by keeping the taxing power of each from preventing, or substantially interfering with, the exercise by the other of those powers necessary to its supremacy as a government within its own field." *Brush* v. *Comm. of Int. Rev.* 85 F2 32 (1936) at 34.

Thus, immunity from federal taxation is granted to the respective states and to the essential agents and instrumentalities of the states. Municipal corporations enjoy this immunity only by virtue of their standing as representatives of the state. The right to immunity is not vested in the municipality—the immunity belongs to the state.

4. *Only the state can waive the immunity of local municipal bonds.*—Because the right to immunity from federal taxation is exclusively vested in the state, only the state may waive that immunity. Any attempted waiver by the municipality issuing those bonds without the joinder of the state is without authority.

It is a fundamental principle that the only party with authority to waive a right or immunity is the party who possesses that right or immunity.

Immunity from taxation exists because the state is a sovereign. Municipalities enjoy no such sovereignty. They are merely agents or instrumentalities of the state sovereign; any power they possess they derive from the legislature. Such grants of authority are narrowly construed. See Trautman, Legislative Control of Municipal Corporations in Washington, 38 Wash LR 743 (1963). Although certain municipalities may be granted broadly construed powers and are said to have authority to act so long as they do not conflict with state law [see *Winkenwerder* v. *Yakima* 52 Wn 2d 617, 328 P. 2d 873 (1958)] no municipality can surrender a right which the state enjoys without the express authority of the state to do so.

This proposition becomes self-evident upon an examination of the nature of the right involved and the nature of the relationship between the muncipality and the state. The right to freedom from federal taxation is a right reserved to the state against interference by the federal government. This right to freedom from interference belongs to the state and protects it from federal taxation of its constituent municipalities. Any such right can only be relinquished by the action of the state legislature, which is representative of the entire state. Action by the state takes into account political sentiment from the people of every part of the state. A municipality represents only a fraction of the people of the state.

Action by the municipality may be contrary to the interests of others in the state and is without the political check of their approval. Thus where a municipality purports to surrender a right possessed by the entire state, then that act is an illegitimate exercise of political power. As Chief Justice Marshall has expressed it, it is the action of the part on the whole. Such action is without the sanction of the people of the entire state and permits federal intrusion in state affairs by the action of a potentially small minority of persons within the state.

The right to waive intergovernmental immunity from federal taxation has been discussed in a slightly different context by the United States Supreme Court. In the case of *James* v. *Dravo Contracting Co.* 302 US 134, 58 Sup. Ct. 208, 82 L. Ed. 155 (1937) the court denied immunity to the profits of a contractor under a contract with the federal government. The contractor claimed immunity from state taxation. The court pointed out that if the contractor had immunity, it was only as an instrumentality of the Federal government. The federal government had disclaimed that immunity insofar as it touched profits of private contractors employed by the government. Because the government had so acted, the court brushed aside the contractor's claim:

". . . respondent's right is at best a derivative one. He asserts an immunity which, if it exists, pertains to the government and which the government disclaims." 58 Supt. Ct. at 220.

In *Dravo* the federal government waived its immunity from state taxation; the court held that this act bound an agent of the government who sought to claim immunity as a representative of the government. From this it should equally follow that where the state government continues to claim an immunity, an agent of that government, a municipal corporation, is powerless to waive it.

Immunity from taxation is a doctrine of federal law. For purposes of federal law the right to immunity is vested in the states; in the absence of specific consent by the state legislature, the federal law will not recognize any implied power in the municipalities under state law to waive immunity. This is shown by two cases involving federal bankruptcy proceedings for municipal corporations. These cases involve the same right discussed above, the freedom of a state from interference in its internal affairs, and provide strong authority for the proposition that such right cannot be waived by municipalities in the absence of state consent.

In *Ashton* v. *Cameron County Water Improvement Dist. No. 1* 289 US 513, 56 S. Ct. 892 (1936) a municipal corporation heavily in arrears on payments of its bonded indebtedness sought to avail itself of a newly enacted provision of the federal bankruptcy act which permitted local municipal corporations to go through federal bankruptcy. The act required that the municipality consent to such proceeding; the filing must be voluntary on its part. But the act did not expressly require the state to affirmatively approve such action by its political subdivisions. Instead, the act only required the consent of the state "whenever such consent is necessary by virtue of local law." 56 S. Ct. at 900. A Texas water district petitioned for bankruptcy. Texas had no law prohibiting such action; neither, at the time of filing, did Texas have a law approving such action. The Supreme Court held unconstitutional the provisions of the act which permitted municipalities to file for bankruptcy and disallowed the district's petition.

Mr. Justice McReynolds, for the majority, recalled the immunity extended municipal bonds:

". . . opinions here plainly show that Congress could not levy any tax on the bonds issued by the respondent or upon income derived therefrom. So to do would be an unwarranted interference with fiscal matters of the state—essential to her existence." 56 S. Ct. at 895.

The Justice argued that "the especial purpose of all bankruptcy legislation is to interfere with the relations between the parties concerned—to change, modify, or impair the obligation of their contracts." 56 S. Ct. at 896. To permit the federal government here to so interfere would exceed the constitutional authority of the federal government and destroy "the sovereignty of the state." 56 S. Ct. at 896. The court held that such interference was unconstitutional and that under the Bankruptcy Act, the federal government could not "impose its will and impair state powers—pass laws inconsistent with the idea of sovereignty." 56 S. Ct. at 896.

A dissenting opinion by Cardozo, J., and joined by Hughes, C.J., Brandeis, J., and Stone, J., argued the act was constitutional because in fact the state had consented to the action. Cardozo said that the district had consented and that the federal act only required that the district not violate Texas law. Further, Texas had passed a law authorizing municipalities to proceed under this Bankruptcy Act. The enabling statute was passed after the petition had been dismissed in district court but before that dismissal had been reversed by the court of appeals. Cardozo maintained that this law should be applied and that any issue of state consent was thereby resolved. Consent being given, the federal system remains unimpaired:

"Persuasive analogies tell us that consent will preserve a balance threatened with derangement. A state may not tax the instrumentalities of the central government. It may do so, however, if the central government consents. *Baltimore National Bank* v. *State Tax Commission of Maryland*, 297 U.S. 209, 56 S.Ct. 417, 80 L.Ed. 586. Reciprocally, the central government, consent being given, may lay a tax upon the states. Cf. *United States* v. *California, supra*. So also interference by a state with interstate or foreign commerce may be lawful or unlawful as consent is granted or withheld. *In re Rahrer*, 140 U.S. 545, 11 St. Ct. 865, 35 L.Ed. 572; *James Clark Distilling Co.* v. *Western Maryland Ry. Co.*, 242 U.S. 311, 37 S.Ct. 180, 61 L.Ed. 326, L.R.A. 1917B, 1218, Ann.Cas. 1917B 845; *Whitfield* v. *Ohio*, 297 U.S. 431, 56 S.Ct. 532, 80 L.Ed. 778, March 2, 1936. The prevailing opinion tells us in summing up its conclusions that the bankruptcy power and the taxing power are subject to like limitations when the interests of a state are affected by their action. Let that test be applied, and the act must be upheld, for jurisdiction is withdrawn if the state does not approve." 56 S.Ct. at 900.

Congress heeded the court's ruling in *Ashton* and in 1937 amended the Bankruptcy Act to require that the state must "authorize by law" bankruptcy proceedings by its political subdivisions. The newly amended act was considered by the Supreme Court in *United States* v. *Bekins* 304 U.S. 27, 68 S.Ct. 811 (1938). There a California irrigation district petitioned for bankruptcy in federal court. California had previously enacted a statute that expressly authorized municipalities to go into bankruptcy at their option. The Supreme Court, per Hughes, C.J., distinguished *Ashton* and upheld the constitutionality of the federal statute and permitted the district to file its petition. After discussing the new federal requirements that the state affirmatively give its consent by law, Hughes noted that the "statute is carefully drawn so as not to impinge upon the sovereignty of the state. The state retains control of its fiscal affairs . . ." by giving its consent. 58 S.Ct. at 815.

Hughes then elaborated on the nature of a state's sovereignty and how that sovereignty could not be relinquished in the absence of consent.

"It is of the essence of sovereignty to be able to make contracts and give consents bearing upon the exertion of governmental power. This is constantly illustrated in treaties and conventions in the international field by which governments yield their freedom of action in paritcular matters in order to gain the benefits which accrue from international accord. Oppenheim, International Law, 4th Ed., vol. 1, Sec. 493, 494; Hyde, International Law, vol. 2, Sec. 489; *Perry* v. *United States*, 294 U.S. 330, 353, 55 S.Ct. 432, 426, 79 L.Ed. 912, 95 A.L.R. 1335; *Steward Machine Company* v. *Davis*, 301 U.S. 548, 597, 57 S.Ct. 883, 895, 81 L.Ed. 1279, 109 A.L.R. 1293. The reservation to the states by the Tenth Amendment protected, and did not destroy, their right to make contracts and give consents where that action would not contravene the provisions of the federal constitution. The states with the consent of congress may enter into compacts with each other and the provisions of such compacts may limit the agreeing states in the exercise of their respective powers. Const. art. 1, Sec. 10, cl. 3; *Poole* v. *Fleeger*, 11 Pet. 185, 209, 9 L.Ed. 680; *Rhode Island* v. *Massachusetts*, 12 Pet. 657, 725, 9 L.Ed. 1233; *Hinderlider* v. *La Plata River Company*, 304 U.S. 92, 58 S.Ct. 803, 82 L.Ed. The state is free to make contracts with individuals and give consents upon which the other contracting party may rely with respect to a particular use of governmental authority. See *Fletcher* v. *Peck*, 6 Cranch 87, 137, 8 L.Ed. 162; *New Jersey* v. *Wilson*, 7 Cranch 164, 8 L.Ed. 303; *Dartmouth College* v. *Woodward*, 4 Wheat. 518, 643, 644, 4 L.Ed. 629; *Charles River Bridge* v. *Warren Bridge*, 11 Pet. 420, 549, 9 L.Ed. 773; *Jefferson Branch Bank* v. *Skelly*, 1 Black 436, 446, 17 L.Ed. 173. While the instrumentalities of the national government are immune from taxation by a state, the state may tax them if the national government consents (*Baltimore National Bank* v. *State Tax Commission* 297 U.S. 209, 211, 21–, 56 S.Ct. 417, 418, 80 L.Ed. 586) and by a parity of reasoning the consent of the state could remove the obstacle to the taxation by the federal government of state agencies to which the consent applied. 58 S.Ct. at 815, 816.

Because here California had consented to the district's bankruptcy, there was no "interference" with the "fiscal affairs" of the state and *Ashton* did not control.

McReynolds, J., and Butler, J., dissented on the authority of *Ashton*.

These bankruptcy cases involve the same principle as the problem presented in the waiver of immunity. In each case the state, and not the municipality, is sovereign. Sovereignty creates certain rights and privileges which reside in the state. One of these privileges is a freedom from federal intereference with the state's domestic fiscal affairs. In Ashton, the court saw federal bankruptcy as a threat to the state's right of freedom from intereference and struck down as unconstitutional an Act of Congress which impinged on that right without the consent of the state as a whole. In the case of municipal bonds, the state enjoys the same freedom from federal interference in its fiscal affairs. The state enjoys the right of unhampered local credit through the issuance of municipal bonds. This is a state right and only the state as a whole may waive it. Absent express state approval, any purported waiver by a local municipality would subject the state to federal interference in its fiscal affairs.

In *Bekins* there could be no objection to the waiver because the state had specifically consented to the bankruptcy procedure. This consent safeguarded the rights of the state. The same safeguard would be required before the constitution could authorize a waiver of tax immunity by a municipality. Insofar as the proposed federal legislation would vest the right to waive in the municipality, and in the absence of state enabling legislation, that legislation is unconstitutional.

This proposition was given recognition by Chief Justice Hughes in the *Bekins* decision. In pointing out that state consent could validate the municipalities petition for bankruptcy, the Chief Justice used as an example the nature of state tax immunity:

". . . the consent of the state could remove the obstacle to taxation by the federal government of state agencies to which the consent applied." 58 S.Ct. at 816.

As Hughes was demonstrating that the state, as opposed to the municipality, was empowered to consent, by inference, this statement reaffirms the proposition that the municipality is powerless to so effect a waiver as to tax immunity.

In light of *Ashton* and *Bekins* there can be no argument that the state by implication has granted this right to the municipalities by state law. In dealing with a right vested in the state by the federal constitution, the court required a specific consent by the state in the form of enabling legislation. Thus as a doctrine of federal constitutional law an express approval is required; the court will not stop to consider whether state law implies such right in a municipality, regardless of the powers otherwise granted to the municipality by the state legislature.

It is no argument that the municipality only waives the right of immunity as to itself and that the rest of the state continues to enjoy that right. *Ashton* and *Bekins* show that what is waived is a state right from federal interference. The right to freedom from such interference is state-wide and cannot be surrendered by a small fraction of the state. In *Ashton*, the bankruptcy proceeding only involved a single water district. Yet the Supreme Court recognized that the larger right of the state to freedom from federal interference was involved. This right could not be waived by the municipality alone. Even the dissenting opinion in *Ashton* did not question the state's basic right to freedom from interference; it only argued that state consent had in fact been given. Where consent was proved as in *Bekins*, the municipality was permitted to file for bankruptcy.

5. *The proposed federal legislation.*—The proposed federal legislation purports to exercise federal taxing power upon the waiver of immunity by a municipality, and if the state has not consented to such waiver by enabling legislation, then any such exercise of federal power is unconstitutional. At a minimum each state legislature must first consent to such waiver by specific legislation. If a state chooses not to enact such legislation, then the municipalities of that state are totally without authority to waive their tax exempt status. Any attempt to make such waiver and levy such tax could be struck down as unconstitutional. There is also the further question as to whether the federal constitution empowers the federal government to levy a tax against municipalities even assuming consent by the state, but that is beyond the scope of this memorandum. It is sufficient for purposes of this discussion to note that the proposed federal legislation contains a fatal constitutional flaw; even if this legislation is amended to require state consent, it will still be within the power of the legislatures of the states to determine whether or not they choose to waive immunity from federal income taxation.

LAW OFFICES OF CHAPMAN AND CUTLER,
Chicago, October 8, 1969.

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.

GENTLEMEN: I agree with the other municipal bond lawyers who have pointed out to the Committee that there is serious doubt whether any tax on income derived from the interest on bonds of a state or political subdivision thereof can constitutionally be imposed by the United States. Any law which purports not to tax such interest, but has the effect of increasing a person's taxes over what they would otherwise be by virtue of his receipt of such interest, seems little different from a tax on such interest. However, if the Internal Revenue Service should take the position that the United States can constitutionally impose a tax on such interest, or that the arrangement contemplated by the particular law involved was not a tax thereon, the question could be finally determined only by litigation before the Supreme Court of the United States. As a practical matter, investors will not wish to buy bonds as tax exempt obligations if, in order to establish their status as such, they would have to pay a portion of their federal income tax under protest, sue for a refund and then continue with appeals of the case to the Supreme Court of the United States. A prospective bondholder would simply buy some other security or buy a municipal bond at the price he would pay for a non-tax-exempt bond or a partially exempt bond. Even in buying a partially exempt bond, a purchaser would consider the risk that the Congress might later eliminate the exemption altogether, if he doubts the efficacy of constitutional protection against all taxation, and would determine the price he is willing to pay for such a bond accordingly.

I believe that any litigation on this question would have to go through two lower courts before reaching the Supreme Court, and could be filed only after somebody paid a tax on income subject to the proposed tax; therefore it could well be four years before the question would be settled. During that time we would have to advise our clients that the constitutionality of the tax is in question or under litigation. Assuming that other bond counsel would do the same, this would mean that for a period four years purchasers of municipal bonds simply would not know whether or not the interest on the bonds they are buying is fully tax exempt under the Constitution of the United States.

In connection with the obligation of each member of the Congress to observe the Constitution of the United States, he will doubtless consider whether the essence of our Federal system reqnires that neither the state nor the Federal government impose a tax affected by the taxpayer's receipt of interest on the obligations of the other. I understand that the Sixteenth Amendment to the Constitution was ratified only after assurance had been given, on the floor of the Senate, that this amendment would not result in the taxation of interest on municipal bonds. Presumably the Congress would not wish to do anything which could raise a question as to its good faith in proposing a constitutional amendment for ratification. If the Congress should adopt and the President should sign H.R. 13270, as adopted by the House of Representatives, on the theory that this does not constitute the taxation of interest on municipal bonds, then that theory should apply to a state using the same technique with respect to the interest on United States government bonds under state income tax laws. This could hardly be beneficial to the government bond market.

If the Supreme Court should finally hold that the United States can, under the Sixteenth Amendment to the United States Constitution, impose a tax on income derived from interest on municipal bonds, I would expect that local officials in the various states would promptly request their Congressmen to propose a constitutional amendment either prohibiting such taxation or permitting the states to tax the income on United States bonds, and perhaps to permit the states to impose ad valorem taxes on federally owned property, as the doctrine of reciprocal immunity can hardly survive without reciprocity.

Your very truly,

MANLY W. MUMFORD.

ORRICK, HERRINGTON, ROWLEY & SUTCLIFFE,
COUNSELORS AND ATTORNEYS AT LAW,
San Francisco, Calif., October 7, 1969.

Re taxation of interest on municipal bonds under the Tax Reform Bill of 1969 (H.R. 13270)

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.

GENTLEMEN: Nearly three-quarters of a century ago the Supreme Court of the United States in a unanimous decision held that taxation of interest on municipal securities would operate on the power to borrow money; would be a burden on the operations of government; and that such a tax upon the interest would be a tax on the power of the states and their instrumentalities to borrow money and consequently repugnant to the Constitution of the United States of America. The wisdom of this decision has never been questioned. The states and their political subdivisions have issued securities for essential public improvements which are of vital importantce to the public. The right to borrow money by the issuance of bonds is as important to the states and their political subdivisions as is the like power of the United States of America to borrow money by the issuance of bonds. The states cannot tax interest on bonds of the United States of America. If the taxing power of the Federal Government is extended to the borrowing power of the states, the essential functions of the states and their political subdivisions will be paralyzed by the burdens of such taxation. The warnings inherent in the decision of the Supreme Court of the United States have now been realized by the very pendency of H.R. 13270. As a direct result of this bill, the municipal bond market has been demoralized and essential public improvements have been thwarted.

The State of California is engaged in a gigantic water program, with construction under way at a cost of nearly one million dollars per day. This was to have been financed by the sale of State bonds and would have been under normal circumstances financed in this manner. The State cannot sell its Water Resources Development Bonds in today's demoralized municipal bond market. Many local communities and political subdivisions find themselves in a similar situation. The City and County of San Francisco has authorized airport construction bonds in the amount of $98,000,000. Vital improvements to the airport cannot be made unless these bonds are salable as tax exempt securities. The school population of California comprises over 5,000,000 students in the lower grades and nearly 300,000 in the State Colleges and the University of California. The population has been steadily increasing in the lower grades at the rate of approximately 200,000 students per year. To keep up with the growth of students attending public schools, it will be necessary to build at least 150 new classrooms each week. Many school districts in California have contracted for the construction of school buildings to be financed by the future sale of bonds. These schools cannot be built as the bonds cannot be sold under present circumstances. Sacramento Municipal Utility District is engaged in the essential public work of providing electric energy to the inhabitants of the City of Sacramento and surrounding area and has under construction hydroelectric facilities which can only be financed by the sale of bonds. Under present circumstances, these bonds cannot be sold. The demoralization of the municipal bond market resulting from the mere pendency of H.R. 13270 will prevent the construction of such vital and necessary public improvements as jails, fire stations, sewer systems, public water systems and garbage collection and disposal facilities.

In the light of the foregoing comments—which I believe represent conditions prevailing throughout the entire United States—I submit it is imperative that H.R. 13270 be immediately amended to delete all reference to interest on bonds of the states and their political subdivisions to the end that such interest will be, as in the past, fully tax exempt.

Respectfully submitted.

GEORGE HERRINGTON.

O'MELVENY & MYERS,
Los Angeles, Calif., October 6, 1969.

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.

GENTLEMEN: Referring to the statement dated September 19, 1969, to you by Mr. Robert M. Johnson of the firm of Dawson, Nagel, Sherman & Howard of

Denver, Colorado, regarding the proposed taxation of interest on municipal bonds under the Tax Reform Bill of 1969 (H.R. 13270), and also referring to the oral presentation made to you by Mr. Johnson on September 25, 1969, we wish to state:

1. That we, as nationally recognized municipal bond counsel, concur with Mr. Johnson's opinion that there exist serious questions as to the constitutionality of the provisions of the proposed bill insofar as they relate to the taxation of interest on municipal bonds, and that such questions exist not cnly as to thė provisions pertaining to the limit on tax preference but also as to the provisions pertaining to allocation of deductions, and

2. That such provisions, if enacted, will inevitably lead to protected litigation, and that in our opinion it would take a minimum of two years, and possibly as long as ten years, to settle the legal questions which will be raised.

Respectfully submitted.

By O'Melveny & Myers.
Ray H. Lindman.

Dumas, Huguenin and Boothman,
Dallas, Tex., October 6, 1969.

A STATEMENT UPON THE CONSTITUTIONALITY OF THE PROVISIONS OF "THE TAX REFORM ACT OF 1969" (H.R. 13270) PERTAINING TO TAXATION OF INTEREST ON MUNICIPAL BONDS

Hon. Russell B. Long,
Chairman, Senate Finance Committee,
New Senate Office Building,
Washington, D.C.

Gentlemen: This firm's practice is devoted almost exclusively to matters of municipal finance. In this position we have observed that of which you are now quite aware—the disastrous effect of H.R. 13270 upon the financing of necessary public improvements.

If municipal bond tax exemption has been legally justified in the past, it is no less so today. The rightness or wrongness of this doctrine cannot be measured by the fact that a few individuals have been able to reduce tax liability by investment in constitutionally exempt securities. There are no doubt other and legitimate means of increasing the tax burden of the affluent without subverting fundamental rights in the process.

Since Federal income taxes were first imposed on individual income, interest on municipal bonds has been exempt therefrom. This exemption has survived these many years although a continuing effort to remove the exemption has been undertaken from time to time.

The Doctrine of Reciprocal Immunity, as applied to this policy of exemption, has been honored by all court decisions and Federal legislation to this time. The reasons are compelling. They are have been clearly and consistently announced by the United States Supreme Court in holding that (i) the Federal Constitution contemplates the independent exercise by the General Government and the States, severally, of their Constitutional powers, (ii) the General Government in its appropriate sphere is supreme, but the States within the limits of their powers not granted that General Government or, in the language of the Tenth Amendment, "reserved" as as independent of the General Government as that Government, within its sphere, is independent of the States, (iii) to tax municipal bond income to any extent would operate on the power to borrow money before it is exercised and have a sensible influence on the contract, (iv) the extent of this influence would depend solely upon the will of the Government, and (v) to any extent, however inconsiderable, it is a burden on the operations of government and may be carried to an extent which may arrest them entirely.

All have witnessed the rapid deterioration of the ability of the States and their subdivisions to finance much needed public improvements since the House Ways and Means Committee first reported favorably H.R. 13270. It is difficult to estimate the millions of dollars which the ordinary property taxpayer has already been forced to sacrifice in increased interest costs due in large part solely to the threat of H.R. 13270. These circumstances urge that the objectionable provisions of this law be entirely removed or, lacking this, that judicial action be resorted to. The latter is inevitable if there be a default of the former.

To this time, there have been no court decisions qualifying the established Doctrine of Intergovernmental Immunity in such manner as would permit a reasonable conclusion that income derived by individuals from municipal bonds and sought to be taxed in H.R. 13270 may no longer be protected by that doctrine. The provisions of this proposed legislation present the first undertaking openly designed to impose taxes on income derived by individuals from municipal bonds as a specific and direct object of taxation. So-called "judicial qualifications" of the past have been derived from legislation imposing income taxes upon specified objects other than municipal bond income. In no case has individual earnings derived from that source been directly involved. In every instance the Courts, including the United States Supreme Court, have carefully recognized and sustained the Doctrine of Reciprocal Immunity. The tax now proposed places an undue and unreasonable burden upon State and local governments not countenanced by any previous interpretation.

One thing does appear as certain as anything can—the long-range difficulties and expense of municipal finance under H.R. 13270 will buy, at an outrageous price to State and local governments and their taxpayers, any satisfaction in money or otherwise which may be realized from taxing municipal bonds. Furthermore, we would but delude ourselves if, being aware of the history of Federal Legislation, we should fail to realize that any small or temporary incursion into this new field of taxation will inevitably become permanent and total. We recall no instance in Federal tax history which would argue the contrary.

We believe H.R. 13270 presents far-reaching questions of first impression which, if enacted, will not be allowed to rest. These will, of course, be resolved but only after years of expensive litigation. Many questions will be raised, including the immunity of Federal obligations and properties. Another is whether voluntary waiver of exemption may offer a method of legitimately renouncing immunity.

You gentlemen are certainly informed and capable of judging the seriousness of the conditions that prevail and which must be expected to continue and worsen should the provisions of H.R. 13270, to which we have alluded, be enacted.

Respectfully submitted,

DUMAS, HUGUENIN, AND BOOTHMAN.

ROY L. POPE & SPILLERS CO.,
San Antonio, Tex., September 26, 1969.

HON. RALPH YARBOROUGH,
U.S. Senate
Washington, D.C.

DEAR SENATOR YARBOROUGH: As a practicing Certified Public Accountant and concerned citizen, I am writing to protest many of the facets of the new tax law which will severely hamper American business and will hurt the taxpayers at the state and local level.

I am enclosing a reprint by *The Bond Buyer* of an advertisement in the *New York Times* for your information. I am very concerned that the Federal Government under the guise of equity will do inequity. Interest on state and local bonds must remain exempt or the taxpayers will pay the tax through higher bond interest rates. Bond markets will suffer.

Many elements of the new tax law are unduly complicated, hard to understand, perhaps impossible to enforce, and can only cause lack of respect by the business community. Because of the nature of the self-assessment system, respect by the taxpayer of the system is imperative!

I would welcome the chance to discuss with you or with any of your staff concerning the specific problems in the tax law. They are too voluminous to go into a letter, and I am not certain that you would have the time to go into a detailed letter which would be required. So I will close this letter by offering to discuss by phone or in person the problems I see in the tax law.

I do not oppose tax reforms as long as they are practical, sensible, and reasonable. Harmful changes are damaging and should not pass.

Very truly yours,

CHARLES W. POPE.

This is a reprint of advertisement inserted by THE BOND BUYER in THE NEW YORK TIMES, Monday, Sept 15, 1969

Must Congress cripple the financing power of State and local government?

The Bond Buyer, the financial trade newspaper that has been serving the municipal borrowing and lending community for 78 years, is taking this space to bring into question the pending tax reform legislation because some of the legislative proposals affecting State and local government finance have neither been submitted to adequate public hearing nor reported in significant depth in the general circulation press.

The Bond Buyer believes that State and local government should be able to carry on responsibly and independently in the field of market finance and that the continuing independence of State and local governments depends in part upon the continuing immunity of local government functions - including that of public finance - from Federal taxation. The legislation before Congress proposes to end this immunity

This newspaper's exceptions to certain legislative proposals are not intended to reflect adversely on many constructive Congressional recommendations. However, there are certain proposals - such as the revision of capital gains taxation as regards commercial banks, and the application of tax deductions under circumstances involving tax-exempt interest income, that, while having equitable objectives, are either unnecessary, or would be imprudent to apply at this time.

The Injury to the $130 Billion Market

The new statement of Congressional purpose to infringe the historic tax immunity of the State and local government financing function has inflicted a drastic setback to the going values of State and local government bonds in the market, and, thereby, has brought about a rise of corresponding extent in local government borrowing costs. By one trade estimate, a rise of about $300 million in the borrowing costs to State and local governments over the past four months must be traceable to a large extent to the adverse market implications of the House of Representatives' treatment of the issue

Since early July, when the Ways and Means Committee opened hearings on its final proposals, investment yields on new issues of local government AA-rated bonds have risen by about 75 basis points (from about 5 50 per cent to 6.25 per cent), while yields on similarly rated corporate taxable bonds have risen by only about 10 basis points (from 7.95 percent to 8.05 per cent) New York City had to pay from 7 43 to 7.46 per cent in late August to borrow on notes due next February and March. A long-term borrowing cost Baltimore, Md , 6 35 per cent.

Moreover, the size of the new-issue market in local government financing is shrinking because of the decision of local officials to postpone or cancel bond sales on account of the progressive deterioration of the market.

Displacements of this kind, mostly from municipalities that cannot afford the costs of borrowing forced by the suggested removal of tax-exemption, have soared as high as one-third of a week's total volume - or as much as $127,687,000 in a single week - from a previous average of well below 21 per cent

With this first adverse impact likely to be compounded by the prospect of prolonged litigation of the tax immunity issue in the courts, the Congressional move can be viewed as the start of a dismantling of market machinery that, since the end of World War II, has succeeded in broadening the outstanding float of local government bonds from $13 7 billion to $130 billion. An endorsement by the Senate of the Lower House's action would be a summary requisition on the bond market to find new buyers for from $10 billion to $20 billion of new local government bonds annually, as well as to find non-bank buyers for the Treasury's debt securities of other than short term.

As things now stand, the uncertainties abounding in the stricken market are raising questions not so much of price as of what the nature of local government obligations may really be from now on The investor just does not know what he is asked to buy: is it something taxable instead of tax-exempt? something tax-exempt now but taxable later? something marketable at a price now, but perhaps unmarketable at any price later?

Revision of Capital Gains Taxation Practices Affecting Investment of Commercial Banks

The pending legislation proposes to make both the profit and loss transactions of commercial bank investment portfolios answerable to the same tax liability - the corporate income tax rate

This is the worst possible time to effectuate such a reform, and not the prudent way to do it If put into effect at this time, the proposal would affect injuriously the market for bank-held tax-exempt securities of local government, as well as for bank-held taxable securities of the United States Treasury

Banks having large bookkeeping losses on fixed-income securities with years to run before maturity would be inhibited from switching out of such securities in the present "tax swap" market Instead, such banks would be compelled to reclassify liquid investment assets into fixed assets overnight Besides, banks would be unwilling to add any fresh local government or Treasury bonds to the portfolio

Long-dated tax-exempt municipal bonds or Treasury bonds in the bank portfolio would take on a frozen status If required to write down the value of portfolio investments thus frozen, as is common practice in private sector accounting, many banks would find their money position threatened to the point of technical insolvency.

The idea of revamping the tax liability governing bank investments in debt securities is not unreasonable However, this is neither the time to effectuate the reform nor the way to do it.

The present practice dates back to 1942, when the Government financiers of World War II thought it expedient to encourage commercial banks to buy bonds. Since then, the deposit institutions have been privileged to lump losses on portfolio investments with operating losses governable by the rate of corporate income tax, at the same time, the banks were allowed to claim lower taxes on portfolio profits computed at capital gains rates.

The reform now proposed could have been carried out years ago without embarrassment to the banks when interest rates were lower and when bookkeeping losses on bank investments were less. After 17 years, to move to enforce the reform overnight in today's high-interest economy would compel the deposit institutions to reappraise much of their investment portfolios as frozen instead of liquid assets and thereby to cramp their ability to fulfill their primary function the making of commercial loans.

The time to effectuate the proposed reform is not when the economy is strained with inflation and high interest rates. The way to effectuate it is not in one precipitant step, but in phases related to the maturity structure of debt securities that bank investment portfolios were induced to hold by the war finance-inspired Revenue Act of 1942

Ways to Improve the Market for Tax-Exempt-Interest Bonds and thereby to Lower the Financing Costs of Local Government:

The purpose here is to impart more breadth, depth and resiliency to the market for local government tax-exempt securities and, by reducing investment yields in this sector of the bond market, to thereby reduce local government borrowing costs and enforce a rise in the direct subsidy or "market tax" being paid by buyers of tax-exempt bonds under the present system. Here are specific proposals toward this end

(1) The promotion of a sweeping tax reform - perhaps by constitutional amendment - aimed at reversing to the states of origin the flow of much of the nation's revenues generated by the personal income tax and now virtually monopolized by Washington. Such a reform would improve lastingly the credit standing of major urban centers and would arrest the decline now going on. Urban borrowing costs would drop and the direct subsidy or "market tax" - that buyers of tax-exempt bonds are now bestowing on local government would rise as the market yields to investors in tax-exempt securities shrank.

(2) By Congressional legislation, the full-faith-and-credit bonds issued by state and local governments could be made eligible for portfolio purchase by the Federal Reserve System. The central bank's investment account holds about 14 per cent of the direct debt of the United States Treasury. If the central bank held a like percentage of the general obligations of local government, and if this investment acquisition were to be offset by a corresponding divestment of United States Government securities, the improvement in the relative market standing of tax-exempt securities would be sizable, and the costs of financing local government operations compared with those of the United States Treasury would be reduced correspondingly

(3) Tax reform proposals aimed at reducing or eliminating less warrantable exemptions and deductions permitted by the present tax law would, if adopted, have the secondary effect of increasing the demand of individual investors for the tax-exempt bonds of local government. This increase in demand would work to reduce market yields and the borrowing costs of local government, and would thereby increase the subsidy, or "market tax", now being paid by all tax-exempt bond buyers direct to local government

Proposed Federal Subsidy to Local Government Financing on Taxable Bonds

Buyers of such bonds will have to be found in great part away from the sources of demand supporting the existing market for tax-exempt securities. Commercial banks, a major buyer of local government tax-exempts, would be buyers of local government taxable bonds only in short-term maturities, that is obligations due within a year, or - at the most two years. Individual investors, having been notified of the Congressional wish to do away with the tax-exempt market altogether, may be buyers of the new local government taxable bonds due in one year or less, but otherwise, their investment money will be attracted to equity securities or to whatever tax shelters may still be around in other fields, such as real estate or oil

It must be kept in mind that the tax-exempt financing privilege enjoyed by municipal or county governments or their subdivisions cannot be renounced by such entities without the consent of the parent state, and that any unauthorized moves so to do will likely be contested in the courts. The same goes on the state administrative front No governor or state legislature has the right to waive the right of the state community to borrow money on a tax-exempt basis, the authorization must come from a state constitutional convention. The legal complications attending any waiver of local government tax exemption, therefore, are bound to compound the uncertainties otherwise related to the founding of a new public market capable of absorbing the $10 billion to $20 billion of new local government securities annually.

The Minimum Tax: A Betrayal of Good Faith

No matter by whom paid, a tax on the interest of a State or local government bond is necessarily a tax levied on a function of government. The Treasury-sponsored decision of the House of Representatives to recommend that a minimum tax be enforced on all people within the national jurisdiction thus involves conflict with the reciprocal immunity enjoyed by the Federal State and the constituent states from taxation levied by each other. Besides, the pending legislation would represent a repudiation of the statutory pledges made by the Congress in 1949, 1950 and 1954 that local government housing authority bonds as well as government bonds issued by the Affiliated Free Commonwealth of Puerto Rico and the Virgin Islands would be exempt from Federal taxation.

THE BOND BUYER

Founded in 1891 by Wm F G Shanks

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THE DAILY BOND BUYER • THE WEEKLY BOND BUYER • THE MUNIFACTS NEWS WIRE

67 PEARL STREET • NEW YORK, N.Y.

EXPRESSIONS OF CONCERN BY GOVERNORS AND OTHER RESPONSIBLE AUTHORITIES

"The National Governor's Conference affirms the basic Constitutional principle that neither the Federal nor State governments without mutual agreement have the authority to tax the other. The Conference therefore asserts that state and local bonds issued for general governmental purposes must remain tax-exempt. The Conference also strongly opposes those aspects of the tentative House Ways and Means proposal announced July 11, 1969, which would adversely affect the marketability of state and local securities and thus the provision of needed public services and facilities."

This statement, approved by the Governors Conference at Colorado Springs, Colo., was prepared and signed by the following governors

Daniel J. Evans, Washington
John A. Burns, Hawaii
Kenneth M. Curtis, Maine
Deane C. Davis, Vermont

Claude R. Kirk, Jr., Florida
Harold LeVander, Minnesota
Marvin Mandel, Maryland
Raymond P. Shafer, Pennsylvania

John Bell Williams, Mississippi
Winthrop Rockefeller, Arkansas

Mayor Beverly Briley, of Nashville, Tenn., and president of the National League of Cities: "We strongly reaffirm our position that Congress should take no action which will remove the tax-exempt status of local government bonds, which will smother the functioning of the tax-exempt bond market as an independent source of capital funds, or which will shift control of local capital financing in any way to the Federal Government."

State Finance Director Caspar Weinberger of California: "Federal taxation of state bonds would have an almost catastrophic effect on the California State Water Project."

Congressman James B. Utt of California, a member of the House Ways and Means Committee: "These steps taken toward eroding the tax-exempt privilege of state and local government bonds create a precedent for altering the division of responsibilities within our Federal system. The reaction in the bond market has been chaotic."

Wade S. Smith, director of municipal research of Dun & Bradstreet: "Taxation of municipal bond interest would increase State-local borrowing costs. It would be a breach of faith with holders of outstanding bonds. It would impair a normally thriving industry. It would dislocate the [illegible] of investors. Whereas the benefits claimed are public gains in tax equity the disadvantages are public, too, and will extend to every taxpayer in the nation."

Alan K. Browne, senior vice president of the Bank of America: "It is simply an illusion that governmental subsidies will equalize costs to local borrowers. Funds for subsidies will have to be raised, and by what other means than increasing Federal taxes? Higher individual taxes on the Federal level would additionally fire the taxpayer revolt on the local level, endangering further already shaky municipal funding programs."

James A. Alloway, director of the Division of Local Finance of the New Jersey Department of Community Affairs: "With the unprecedented need for new financing in New Jersey, we cannot afford to lose the tax-exempt feature. We are confident that such action would be successfully challenged in the courts, but the market for our bonds would be virtually destroyed during the period of litigation. Such a situation should be avoided at all costs."

Mrs. Mary Evelyn Parker, State Treasurer of Louisiana: "During the next two years municipal bond issues in Louisiana will exceed $600 million. The making of such borrowing dependent upon Federal interest subsidies will only further strain the financial position of all state and local governments and the Federal Government. We feel that this is a matter of great urgency and request you (The Congress) to exert every effort to maintain the existing tax-exempt status afforded municipal bonds."

THE AUSTIN NATIONAL BANK,
Austin, Tex., August 28, 1969.

SENATOR RALPH YARBOROUGH,
Senate Office Building,
Washington, D.C.

DEAR RALPH: Following the recess of Congress, the Senate will begin consideration, I'm sure, of the so-called Tax Reform Bill. May I add my voice to several others, which I'm sure have been raised, concerning features of the tax which are not reforms, but will end inevitably in higher taxes on every person living in a municipality or other taxing unity which issues bonds.

I can understand the desire of the tax writers to get at a few very wealthy people who pay very little tax, but by doing so we are raising the interest rate on bonds and as a consequence, raising the tax which I would pay and which other taxpayers in every walk of life would have to pay. It is my understanding that a subsidy is suggested so that this tax bite would be even heavier on the Federal side if a subsidy were provided. I would also object to the subsidy because it would bring with it added control from the Federal level. I am unalterably opposed to changing the tax-exempt status of municipal bonds, school bonds, etc.

I'd like to also point out to you that this is in my opinion, a revocation of a contract which was entered into earlier by the Congress, I believe back in 1949, on certain bonds issued and may I also suggest that it's also completely contrary to the important separation of our governmental units. I hate to see any move by the Federal government to take added control in the guys under the guys of the tax reform.

May I also suggest that some of the tax reform measures aimed at Commercial banks are quite stringent. This is particularly true of the one which relates to the reserve for bad debts, and which would limit that reserve to an average for a six year period prior to the date that the reserve is set. During good times such as we have had, such a reserve would not be adequate if we came upon bad times. I would suggest that perhaps a real heavy poke is being taken at Commercial banks in this tax reform bill, and I can't understand why unless it might be the influence of Congressman Wright Patman in the House. I hate to see a trend however, which would increase taxes under the guys of "Tax Reform".

It is my sincere hope that you, together with the other Senators will take a very close look at this bill and if we need more taxes, lets pass higher taxes, but let's don't do it with this sort of a blanket over it. The length of the bill itself makes it impossible to make any determination of what its full meaning may be and I recognize that it's put in this form so that those who are for some portions of it will have to vote for the whole thing whether they are against other portions or not. This, too, is bad legislative process.

It is my hope that you will do everything that you can to right the inequities that appear in this bill, perhaps even go so far as to break it up into its various parts and consider them on their own. If this cannot be accomplished it is my suggestion that the bill be killed and we begin again.

Sincerely yours,

JOE K. WELLS.

COMMONWEALTH EDISON CO.
Chicago, Ill., October 13, 1969.

HON. RUSSELL B. LONG,
U. S. Senate,
Senate Office Building,
Washington, D. C.

DEAR SENATOR LONG: The Internal Revenue Service recently issued a ruling to the New York State Atomic and Space Development Authority that interest on bonds issued to provide nuclear fuel for investor-owned electric companies would be tax-free. The effect of this ruling is not confined to nuclear fuel. It also directly affects all generating facilities, both nuclear and non-nuclear.

We cannot believe that the full range of implications was fully understood by the Service. Other states would, of course, be forced to follow the New York pattern. This could result in a major erosion of federal revenues.

Investor-owned electric companies pay well over $3 billion annually in federal, state and local taxes, about half of the total in federal income taxes. If state and local tax-free financing of fuel and generating facilities is permitted, taxes paid directly by utilities to the federal government could be reduced drastically. Moreover, the federal government could lose many, many millions more as individuals replaced taxable with non-taxable investments.

I am enclosing a memorandum which discusses this matter in greater detail.

Your consideration of this important matter is greatly appreciated.

Sincerely,

J. HARRIS WARD, *Chairman.*

MEMORANDUM OF COMMONWEALTH EDISON CO. ON INTERNAL REVENUE RULING AND PROPOSED REGULATION UNDER SECTION 103(C) OF INTERNAL REVENUE CODE

The Tax Reform Bill of 1969, now pending before the Senate Finance Committee as H.R. 13270, deals with the non-taxability of interest on state and municipal bonds in two ways, first by restricting the advantage to individuals of investment in such bonds, and second, by encouraging states and municipalities to substitute taxable for tax-free instruments. In addition, P.L. 90-364 in the preceding Congress imposed severe limitations on so-called industrial development bonds to prevent the use of the tax advantage for essentially non-governmental purposes. These legislative actions manifest a deep Congressional concern with the revenue problems created by tax-free financing. A recent ruling by the Internal Revenue Service and a proposed regulation under Section 103(c) of the Internal Revenue Code threaten to aggravate these problems significantly.

The Internal Revenue Service has issued a ruling to the New York State Atomic and Space Development Authority that interest on bonds issued to provide nuclear fuel for investor-owned electric utilities would be tax-free and that such bonds are not within the scope of Internal Revenue Code, Section 103(c)(2), denying tax exemption to industrial bonds. The Service took the position that the provision of the Code exempting from the industrial bond restrictions (Section 103(c)(4)(E)) "sewage or solid waste disposal facilities or facilities for the local furnishing of electric energy, gas or water," was sufficiently broad to include nuclear fuel for electric generating stations. The extension of this exemption to cover nuclear fuel (in the ruling) and the implicit acceptance of the ruling and its further extension to facilities for the reprocessing of nuclear fuel after it has been removed from a generating station (in the proposed regulation) appear to conflict with Congressional language and intent. The action either discriminates in favor of nuclear fuel or makes possible tax-free financing of coal mines and gas and oil supply facilities.

To support the ruling issued to the New York State Atomic and Space Development Authority, the Internal Revenue Service had to take two steps. First, it had to decide that nuclear fuel was as much a "facility" as the generating plant that burns it. Second, the Service also had to decide that the huge nuclear plants now being built are facilities for the local furnishing of electric energy. Nuclear units, however, have the ability to meet the electrical demands of as many as 1,000,000 households. They will operate as parts of a huge interconnected interstate system linked by high voltage transmission lines, and the energy produced will flow not just to single municipalities but to broad regional areas without regard to state boundaries. The Congress, in describing the exemption in the conference report, noted that it did not include "facilities for regional or broader transportation of gas or water by pipeline or long line transmission of electric energy." The conclusion, necessary to support the New York ruling and the proposed regulation, that exempt facilities include nuclear generating plants as well as their fuel, goes beyond the Congressional mandate.

Even if limited to nuclear fuel and nuclear fuel reprocessing, the position of the Service could make serious inroads in federal revenues. About a quarter of the cost of the heat output of nuclear fuel is accounted for by the cost of carrying the investment in the fuel. By 1972, Commonwealth Edison Company will have an investment in nuclear fuel in excess of $150,000,000. With the growth of nuclear generation of electricity, it is clear that the amounts involved in the fuel decision alone are very large.

But the effect of the ruling is not confined to nuclear fuel or reprocessing. It directly affects all generating facilities, nuclear and non-nuclear. Commonwealth Edison Company alone will spend $880,000,000 on the construction of generating facilities in the five years 1969-1973, as a part of a $1.7 billion construction program for those years. A recent McGraw-Hill survey reported that "by 1970 the utilities will be the largest industrial category in terms of capital investment."

The importance of the erosion of tax revenue threatened by an extension of tax-free financing can hardly be overstated. The investor-owned electric utility industry pays well over $3 billion in federal, state and local taxes, with about half of the amount being accounted for by federal income taxes. The liability for income taxes arises from the earnings on equity securities issued by the utilities to finance their construction programs. Under the ruling and regulation discussed, such equity financing could, of course, be replaced by state and local government debt financing. In addition to the effect of such financing on taxes paid directly by the utility companies, the federal government could also lose millions of dollars from the replacement of taxable interest and dividend payments by non-taxable interest payments on state and local bond issues. Commonwealth Edison Company, for example, will raise nearly $1 billion by the sale of debt and equity securities to finance its 1969–1973 construction program.

If the position of the Internal Revenue Service stands, it would provide an irresistable attraction for the State of New York to finance not only nuclear fuel but nuclear and other generating plants for investor-owned utilities. Since all states compete for industry and low-cost electric power is a major tool in such competition, other states would be hard put to resist following a similar course. Indeed, legislation to take advantage of the New York ruling is already pending in New Jersey.

The importance of tax-free bonds and the difficulties of dealing with them will become much greater unless the Service reverses its position. Absent such a reversal, the statute should be amended to avoid the very serious consequences likely to flow from adhering to that position. Needless to say, such an amendment need not affect in any way the position of communities now generating or distributing their own power as a part of their municipal operations. As exempt persons, these governmental units may continue to serve their own customers. Any amendment need make certain only that they do not use their tax-exempt financing powers for facilities to be used by investor-owned utilities to serve the latter's customers.

JOHN NUVEEN & CO.,
Chicago, Ill., August 18, 1969.

Re: Proposed Tax-Reform Legislation.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate,
Washington, D.C.

DEAR SENATOR LONG: In the interest of trying to cover as much ground as possible in a short period of time, the House Ways and Means Committee has not considered sufficiently the effect of at least two of the tax measures it proposes. These are (i) making the interest on municipal bonds subject to the new minimum income tax and (ii) the changed provisions for the computation of capital gains tax. I hope the Senate Finance Committee will consider these two measures with greater deliberation. If so, I feel confident that the Committee will decide to omit both of these proposals from the bill it recommends to the Senate for passage.

With respect to the interest on municipal bonds owned by individuals, there are a number of reasons why this interest should not be included in the computation of a minimum tax:

1. Increased taxes received from this source by the Federal Government will amount to only a fraction of the increased interest cost that the states and cities will have to pay on their bond issues because of this tax provision.

2. Inflation-conscious investors will be discouraged from financing the Nation's schools and other types of public improvement and will divert the investment funds they now utilize for this purpose to stocks, real estate and other types of so-called inflation hedges.

3. Investors who have purchased tax-exempt municipal bonds on the basis of their being tax exempt, and who accordingly paid a premium price for them, will be subjected to taxation that they could not have anticipated—this would be a breach of good faith on the part of the Federal Government.

4. To increase the local tax bills of millions of citizens to pay higher interest rates on local government bond issues in order to try and tax a few who are allegedly escaping taxes through the ownership of municipal bonds is unfair, uneconomic and unsound.

5. Very wealthy investors do not generally own tax-exempt bonds (or any other type of fixed-income securities)—their investments are in real estate (on which they obtain depreciation), oil and minerals (on which they realize depletion benefits) and business ventures (on which they are taxed at the capital gain rate).

With respect to the proposed revision of the capital gains tax:

1. A shorter holding period, rather than a longer holding period, would benefit the Federal Treasury and the Nation's economy as a result of the more rapid turnover of investment dollars that would occur.

2. Lowering the capital gains tax, rather than increasing it, would encourage investors to take profits, pay taxes and utilize their investment funds more frequently and to a greater extent for new investments.

3. The economy's demand for capital funds should be the primary consideration in drafting a capital gains tax law; the law should be designed to encourage as rapid turnover as possible of venture capital in order to maximize the benefits to the Nation's economy from the greatest utilization of investment funds for this purpose.

I will be glad to go into greater detail on these tax measures if you have any question with respect to my comments about them. I assure you that the House action on these two tax measures should not be approved by the Senate in the national interest.

Sincerely,

FRANK O. CARR, *Chairman.*

P.S.—The enclosed Dun & Bradstreet summary of the prejudicial effect of making municipal bonds subject to a minimum income tax will be of interest to you, I am sure.

THE COMING CRISIS IN INTERGOVERNMENTAL RELATIONS

> "And if the means and instrumentalities employed by (the general) government to carry into operation the powers granted it are, necessarily, and, for the sake of self-preservation, exempt from taxation by the states, why are not those of the states depending upon their reserved powers, for like reasons, equally exempt from federal taxation?"
>
> Nelson, J., in The Collector v. Day.

Certain "tax reform" proposals before the Congress relating to state and local bond taxation, promise, if adopted, to effect a more far-reaching alteration in Federal-State-Local relations than any single piece of legislation heretofore enacted. The proposals, moreover, are apparently to be rushed to the floor of the House of Representatives as part of a "take it or leave it" tax package which the sponsors have successfully tied to the surtax extension. There is a real risk that argument on the merits of the proposals will not occur until the bill reaches the Senate.

So hasty has been the action of the Ways and Means Committee in bringing out its bill that the utmost confusion exists at this writing as to its actual provisions. Accounts of the tax reduction features seem complete enough, in truth, but on the treatment of tax exempt bonds no two press accounts are in full agreement. A "minimum income tax" provision would by all accounts include interest on state and local government bonds, as would an "income allocation" procedure (similar to that applicable to life insurance companies upheld in the so-called Atlas case), but it is not clear that the "preference" feature often discussed is included. At least one account describes as part of the bill a Federal banking intermediary to subsidize fully taxable state and local bonds. But whatever the exact provisions of the Committee bill, their intended effect will be to impair, and ultimately eliminate, the tax exemption of municipal bonds.

Opposition to the proposals has not been lacking, but it has not always been in the most pertinent terms. Taxation of municipal bond interest would increase state-local borrowing costs, but that is by no means the whole story. It would be a breach of faith with holders of outstanding bonds, it would impair a (normally) thriving industry, it would dislocate the habits of investors, and so on—all perhaps relevant, but not necessarily overriding. Most of the disadvantages generally cited, in fact, are private, whereas the benefits claimed by the sponsors of the legislation are public—gains in tax equity. On the contrary, one must be bound to argue from the facts that the disadvantages are public, and will extend to every citizen and taxpayer of the nation. It is these public disadvantages that are the subject of this paper.

The essential argument against impairment of the existing exemption from Federal income taxes of the interest on state and local government obligations is that such impairment would wreak havoc with the capital improvement programs of the state and local governments. In the process it may be expected to produce dislocations, perhaps chaotic, in the entire capital markets, and ultimately it may be expected to alter fundamentally the preexisting balances in our Federal system. Since such pernicious results were hardly anticipated by sponsors of "reforms" intended to correct inequities respecting a few wealthy taxpayers, explanation is obviously in order:

1. Impairment or elimination of tax exemption of municipal bonds would wreak havoc with the capital improvement programs of state and local governments

Successful execution of capital facilities construction programs requires advance planning, careful scheduling of work, and a flow of funds adequate to meet cash requirements as construction progresses. The task is quite demanding even for small projects, and for the projects of large state and local governments, extending over many years or even over decades, it is intricate and complex. Order and continuity are essential, and abrupt changes or interruptions can be quite costly in increased expenditures or deferral of benefits or both.

Foresight and competence at the state and local level can minimize the risks associated with threats to order and continuity that are controllable at the state and local level. Changes and interruptions that are not so controllable are another matter, and have not been lacking. The Great Depression of the 1930s was such an inerruption as was World War II. The combined impact of these two events, which were beyond state-local control, are at the root of some of the problems with which state and local units are coping today. Since early 1966, inflation and a strained money market have been equally upsetting to the execution of state-local capital programs. Further, individual programs initiated at the Federal level have dislocated state-local programs or created or exacerbated state-local problems. Thus federally-guaranteed mortgages facilitated the flight of city-dwellers to the suburbs, not only creating a demand for additional public facilities in the suburbs but also destabilizing older central-city neighborhoods. The interstate (i.e., national) highway system took vast land areas through and around the central cities and their suburbs, often drastically altering land-use patterns and necessitating costly construction and reconstruction of public facilities to adjust to the new patterns. Federal-aid programs offering debt-service reimbursement rather than capital-cost contributions have required state-local borrowing not originally contemplated, with replanning, reprogramming, and delays. In some instances, Federal programs have been changed in mid-stream, with additional state-local work, cost, and deferral of benefits. These are cited not to pass judgment on the merits of the programs involved, but to exemplify the dislocations resulting from factors not controllable at the state-local level.

Presently, financial continuity at the state-local level is facilitated by the fact that the state and local governments have as full control as is practical through possession of the initiative in the issuance of their bonds, which are used to finance a high proportion of the improvements. Such outside control as is exerted stems from the operation of the market in which they sell their bonds, and they are no more vulnerable than other borrowers to the factors which affect that market. Moreover, it is a competitive market.

Competitively, in the money market, state and local governments occupy a unique position, in that their obligations are exempt from Federal income taxes, and generally from state and loçal taxes in the state of issuance at least. Because of tax exemption, the state and local units do not compete directly for funds with the U.S. Treasury, Federal agencies, corporate bonds, savings banks, mortgages, and so on. This lack of competition is fortunate, for municipal bonds are in truth exotic fare. The merchandise is completely unstandardized. Not only are no two communities identical, but the laws of the respective states differ, and within individual states differing provisions for government, powers, taxation, are made for the several types of local subdivisions and often for distinct classes of like types—cities, counties, and so on. Moreover, continuity of management appears uncertain, the governing body (board of directors, so to speak) being elective.

If the real attraction of municipals to investors is their tax exemption—and technical studies so suggest—it follows that impairment of that exemption will adversely affect the ability of the state and local governments to borrow.[1] It cannot be doubted that the smaller borrowers would with few exceptions be unable to sell taxable obligations, and that only the very largest, best managed, and financially and economically strongest units would, in competition with taxable securities, find a sustained and stable market comparable to that now existing for their tax exempt bonds. The number of state-local obligors who might be expected to be able to compete with the debt securities of the larger corporations and the public utilities is absurdly small—probably less than 500 and certainly no more than 1,000.[2]

This is of course not intended to suggest that inability to sell their bonds directly in the market place would make it impossible for state and local governments to borrow. The Congress appears to have spent some years in the development of alternative means of financing, prior to the introduction of specific suggestions to modify or eliminate the tax exemption. The alternative proposals typically provide (1) that a Federal agency or Federally-created corporation will issue its taxable bonds to raise money to loan to state and local borrowers at rates approximating rates on tax exempt bonds, the Federal government absorbing the difference, or (2) that the state and local borrowers issue fully taxable bonds in return for an interest subsidy estimated to represent the difference between the cost of taxable and tax exempt loans. There are numerous variants; the so-called urban development bank is an example of the first type of arrangement, the so-called Patman-Proxmire guarantee corporation the latter.

Much is made by the Congressional sponsors of these various alternatives of the assertion that their use by state-local borrowers would be voluntary. But, to just the extent that impairment or elimination of tax exemption makes it difficult or impossible for state-local borrowers to sell taxable obligations in the market place, the alternative becomes compulsory, not voluntary. The alternative to using the Federally-sponsored financing device would be to forego capital construction.

Bills introduced to implement the proposals establish various eligibility criteria for the making of the loans or extension of the guarantee and reimbursement. Under the Patman-Proxmire proposal, projects must be "needed", bonds shall contain "satisfactory amortization provisions," the public facility to be financed must be "economically sound", and the borrowers' debt payment record over the preceeding 25 years must be taken into consideration, among other things. The Urban Development Bank bill requires that loans be "in accordance with sound and prudent banking principles", for public works and community facilities "serving public needs", "not inconsistent with comprehensive planning for the development of the community" or "disruptive of Federal programs which authorize Federal assistance for the development of like or similar . . . projects." It is, moreover, inconceivable that *any* Federal assistance program can or should be drawn that does not impose eligibility criteria and define the what, when, where, and how of the activity.

This brings us inevitably to the nub of the matter: control is at the center of *any* system of subventions. He who pays the piper calls the tune. With the market for tax exempt bonds badly impaired (probably, for the great mass of small and medium-sized communities, destroyed) some state and most local governments will be in the position of having to turn to the only banker available, the Federal government, and they will have to meet its terms to borrow at all. A Federal agency, not the state or local governing body and the market place, will determine what constitutes a public need, what is acceptable planning, whether the master plan is "economically sound", what building standards should be, when the project should be built, etc., etc.

This prospect will please some who believe that increased centralization and standardization are desirable, but it is sending waves of apprehension through state and local administrators, planners, and finance officers, who are aware of the diversity of needs and programs involved, the intricate planning years ahead

[1] Cf. Personal Trusts as Sources of Funds, Chapter 28 in ***State and Local Public Facility Needs and Financing,*** Subcommittee on Economic Progress of the Joint Economic Committee, December 1966, Volume 2, page 434.

[2] About 500 is the estimated number of state-local borrowers each having at least $50,000,000 of bonds outstanding, about 1,000 of those with at least $25,000,000. Not many more than 200 of these have a supply of debt securities exceeding $100,000,000.

of time that is required, and the myriad of ways in which third parties can intrude to defeat the best laid plans.[3] They are aware that every major new Federal-aid program involves readjustments that result in costly interruptions to projects already under way and delays and often added expense for projects in the planning stage. Heretofore, these delays and added costs have been isolated, applicable to one individual program at a time. The vast readjustment in borrowing practices and the changes resulting from the degradation of control by state-local governments and the market place and substitution of control by the Federal government, will apply to *all* programs. It will not only affect projects under construction and those scheduled for initiation in the current budget year or next year; it will also affect projects approaching the drawing-board stage, those only in preliminary form, and those blocked out on the agendas for study in future decades. Moreover, not the market but the Congress will determine just how much in total is to be loaned each year, and state and local construction will fluctuate with the Federal budget.

The dual nature of the proposals involved is particularly to be noted: on the one hand, impair or eliminate the tax immunity of the debt obligations of the state and local governments, and on the other, make continued financing feasible by extending Federal loans on terms prescribed by the Congress. State and local governments were delivered a similar one-two punch a generation ago. In the 1930s, "tax reformers" concerned with shifting support of local government from income-producing property to the great mass of the population devised the strategy of rigorously limiting real estate taxes by state constitutional amendment and, after the limits wrecked local budgets, stepping forward with general sales taxes as the needed "replacement" revenue.[4] Today, these tax limitations are properly decried as a major contributor to serious local problems, and they have certainly proved in the long run to be a costly "reform". There is no reason to believe that the present tax reform proposals will be less serious in their impact on state-local government capital facilities programs.

2. *Disruption of the capital markets*

State and local government loans are an important component of the capital market structure. In many recent years the net demand for state-local long-term funds has exceeded the change in publicly-held Federal and Federal-agency securities, and municipal bonds sometimes dwarf corporate bonds in net demand on capital funds.[5] Evidently, significant alterations respecting so sizeable a component may be expected to have significant effects on the whole market.

Under present arrangements, the importance of state-local bond financing is obscured by the fact that the tax exemption feature of these loans isolates them from the remainder of taxable securities. Municipal bonds do not compete with Governments, or corporates, or utilities, or mortgages, and other taxable investments. They of course experience the handicap of a segmented market restricted in the main to taxable savings, but in return they receive high preference among the owners of such savings.

At this point, it is desirable to comment on what are often termed inequities in taxation between the owners of taxable securities and the owners of tax exempt securities. Actually, the variations are more meaningfully described as disparities resulting from a system of graduated tax rates. The effective interest rates received by holders of state and local obligations *discounts the tax exemption*, while the effective interest rates received by investors in taxable securities *capitalizes the tax*. That is, the municipal bond holder accepts less interest than

[3] Capital improvement programs are like icebergs—only the top shows. The most prevalent capital budget format presents appropriations for one year and planned outlays for the ensuing five years, with some documents including an estimate of cost to completion for any projects running beyond the six-year term. Studies, however, are based on a "foreseeable future" time span, with progressive refinement and added detail as needs become more specific and the timetable becomes determinable. Most individual bond authorizations cover construction periods of two to five years, and many contemplate construction, and piecemeal bond issuance, over a decade or longer.

[4] Cf. "Bitter Fight Promised Over Tax Rate Laws," in Taxation and Government, *National Municipal Review*, Vol. XXIII, No. 12, December, 1934, pgs. 700–702, for an account of the strategies employed in the sales tax-tax rate limit campaigns, with consequences which the last 35 years experience have demonstrated to have been accurately foreseen.

[5] Over the ten years 1959–68, the median annual change in outstanding municipal bonds was roundly $6.5 billion, in corporate bonds $5.8 billion, and in publicly held Federal and Federal-Agency securities, $5 billion. The net demand on the capital markets for municipal bonds exceeded that for publicly held Federal and Federal-Agency securities in six of the ten years.

he would otherwise demand, because his interest will not be subject to tax, while the corporate or government bond holder demands more interest to compensate him for the tax he will pay. The discounting and capitalizing process is of course approximate and imperfect, and imputes an identical value of the tax to all holders. In fact, however, holders taxed at an effective rate lower than that implied by the market's determination as to the value (or cost) of the tax will derive a benefit (or suffer a penalty) opposite to that experienced by holders in a tax bracket higher than that implied by the market determination. In other words, inequities between holders in different tax brackets extend to taxable as well as to tax exempt securities.

Another factor to be noted is that impairment of tax exemption has the same implications for market changes as has the complete elimination of tax exemption. A taxable security that is a little bit taxable is like the young bride who was a little bit pregnant—the ultimate outcome is not in doubt. Any invitation to doubt should be dispelled by the experience of the legal reserve life insurance companies under the Life Insurance Tax Act of 1959; after the courts affirmed the validity of income allocation with respect to interest on municipal bonds, their municipal bond holdings fell from more than 6% of their investments to less than 1%.[6]

Two types of market changes can be anticipated to occur if the taxation of state and local debt securities is impaired. In the long run (but perhaps in a relatively short span of time) the added volume of taxable securities will bring about a new equilibrium in the sources and allocations of savings and in the interest rate structure. That is, a new "model" of the capital markets will be created. It is beyond the scope of this memorandum to explore the possibilities, but several probabilities appear: one is that interest rates on taxable securities generally may be expected to come to rest at a level somewhat higher than they would otherwise occupy, another is that if state-local borrowing is financed with Federal or Federal-agency taxable securities, interest rates on Federal securities will rise relatively more than will interest rates on other securities.[7]

In the short run, the changes are likely to be dramatic, even chaotic. As investors begin to believe that bonds offered as tax exempt *may* become taxable, they will hesitate to buy more bonds, and some will attempt to start selling off their holdings; prices will drop, and interest rates rise. This has already happened. Then, as investors in numbers begin to believe that bonds offered as tax exempt *will* become taxable, they will either stop buying altogether or will buy only if the interest rate is comparable to that obtainable on other taxable securities. At this point, state and local borrowing will halt and remain moribund until the situation is clarified.[8] Even if the proposals presently before the Congress come to nothing, confidence will have been eroded and it is not likely to be restored quickly.[9]

In considering interest rate levels, it would be pertinent to distinguish between the increases since 1966 resulting from strong inflationary pressures and the

[6] This occurred despite the fact that a tax-exempt bond has *some* advantage in yield over a taxable bond for *any* life insurance company, although the relative advantages depend on a number of variables. It appears that the life companies tend to concentrate their investment management resources on those investment outlets which as a class promise to be most productive, and to ignore the least productive. It seems likely that other institutional investors follow a like policy. The behavior of individual investors is less clear, but the absence of tax-exempt municipal-bond interest as a factor in the tax avoidance of 154 individuals on whom data has been summarized by the U.S. Treasury suggests that wealthy individuals already concentrate on other investment outlets more remunerative than debt securities.

[7] Municipal bonds are almost entirely serial (i.e., mature in annual principal installments) and have an average term of not much over ten years. The Federal debt is highly concentrated in the shorter maturities. Corporates, on the other hand, are typically "term" bonds, due in 20 to 30 years. With municipals tax exempt, they offer no competition with short Governments; taxable the situation may be expected to differ, particularly if the expected response to tax immunity impairment materialized--Federal taxable bonds are used to make the loans to the state and local units, increasing the supply of Federal short term paper.

[8] Some of the municipal units, anticipating the hiatus, have already accelerated their borrowing programs to sell (at abnormally high rates) bonds sufficient to keep construction progressing in the event the market grinds to a halt.

[9] Faith is a fickle thing. Retroactive taxation is regarded by investors as probably illegal, certainly a breach of faith. At the same time, they find it difficult to discover how retroactivity is to be avoided in minimum income tax, tax preference, and income allocation schemes. As to the constitutional question, *caveat emptor* is an adequate legal defense, but not likely to inspire the confidence of the investor who ignorantly assumed his exemption was constitutionally based.

extraordinary monetary restraints imposed as counter-inflationary measures, and that portion of the increases which may or will be attributable to expectations (or the realities) respecting tax exemption of municipal bond interest. Unfortunately, the two influences are not likely to prove separable; no later than July 1968 a considerable number of state and local officials and persons in the municipal bond industry became apprehensive that tax exemption might come under concerted attack, and since early 1969 these apprehensions have spread and become increasingly prevalent. Thus, historic high rate levels resulting from inflationary and counter-inflationary pressures coincide with the undermining of confidence respecting the future status of state and local loans. Nor can it be said categorically that corporate and Government rates also have not been affected already by the municipal bond situation.

3. Alteration of the Federal system.

The proposals to impair or even eliminate the immunity of interest on state and local securities to the Federal income tax are made in the name of tax reform. The tax exemption enjoyed by municipal bonds is stated to be a "loophole" in the tax laws. In realty, the exemption is a necessary and proper consequence of an intergovernmental immunity basic to the functioning of our Federal system of government. To characterize it as a "loophole" is as absurd as it would be to characterize as a "loophole" in the criminal law the immunity of the President of the United States from arrest.

It is not necessary here to argue the legal basis of the doctrine of intergovernmental immunity. It need only be observed that the doctrine is necessary for the functioning of our Federal system as it has evolved, and if and to the extent necessary must be inferred, just as the doctrine of implied powers must be inferred; the one is as necessary to the effective functioning within the Federal system of state-local government as is the other to the functioning of the Federal government.[10] Alter either, and the Federal system as it now stands will be functionally altered.

Of course, it might be argued that the system has already been altered out of all recognition by the Founding Fathers, or even by the grandfathers of those presently living. Certainly, state-local borrowing is already encumbered with sizeable loans for essentially *Federal* programs, and it seems likely to become increasingly so. In fact, there appears to be growing emphasis at the Federal level for eliminating direct grants for aided programs and substituting "debt service reimbursement", a device clearly contrived to reduce Federal appropriations for the programs, or eliminate Federal borrowing by shifting it to the State and local units, or both. These developments, however, are not justification for the proposals now pending, nor does their existence prove their wisdom. Further, there appears to be a clear distinction between present arrangements, in which the *majority* of capital improvement programs remain within the initiative and control of the states and their local subdivisions, and the control of *all* programs at the Federal level as is likely under the pending proposals.

It might be argued that it is absurd to postulate fundamental changes in intergovernmental relationships in powers and function from so isolated an act as making taxable the interest, or part of the interest, on municipal bonds. But we have already seen that the impairment of tax exemption will hinder all state-local governmental units in borrowing directly, and may be expected to deny some of them access to the market; that this will necessitate the creation of a Federal banking intermediary to raise the funds needed for state and local improvements and lend those funds to the state and local governments; and that the Federal government in the process will inevitably and necessarily exercise controls over the use of the funds it lends. This will shift the decisions as to what should be constructed, and when, and how, from the state-local level to the Federal level. It will also shift to the Federal level the decisions as to how much should be borrowed.

That such far-reaching consequences should inhere in proposals for a minor tax reform may appear remarkable. More remarkable is that the proposals have been heretofore threshed out before the Congress, so that their pernicious nature is not unknown. And yet more remarkable is that measure whose consequences will be to place under Federal control even the most insignificant of physical

[10] The doctrine of reserved powers, however, is explicity constitutional. It is deemed by some jurists to *contain* the doctrine of intergovernmental immunity.

improvements, should be advanced at a time when all the evidence at our disposal suggests that community participation in the decisions affecting matters of community importance should be increased, not decreased; that highly standardized programs should be made more flexibly responsive to meet diverse needs, and that decentralization, not increased centralization, is desirable,

The proposals, both for the impairment of tax exemption and for the "voluntary" substitution of taxable bonds under Federal loan arrangements, should be defeated, and defeated so decisively that they will not again appear before the Congress. The damage they are capable of inflicting is massive, the improvements from the desired "reforms" paltry by comparison.

WADE S. SMITH.

STATEMENT OF JACK S. BURK, PRESIDENT, BARNARD & BURK, INC., CONSULTING ENGINEERS, BATON ROUGE, LA.

Our firm's consulting engineering practice includes a large volume of municipal and other public works. We represent a substantial number of municipalities, school boards, special service districts (waterworks, sewerage, drainage, road, etc.) and other political subdivisions and local units of government in the Southern and Southeastern States in connection with the above. Our clients are directly affected by the proposed tax legislation, which strikes at the heart of their method of raising money to construct essential governmental facilities to meet the needs of their constituents. Traditionally, these local entities have financed capital improvements through the issuance and sale of bonds or other debt obligations carrying an exemption under existing law from federal income taxation. Because the proposed legislation (insofar as it relates to the treatment of municipal bonds) will adversely affect and virtually cripple their financing power, they have requested that we vigorously oppose, on their behalf, such legislation.

We will address ourselves to the matter of specific objections to the proposed tax reform bill. We object to (1) the allocation of deductions and (2) the federal subsidy plan on the grounds that (a) they raise serious questions involving the immunity of states and their political subdivisons from taxation by the federal government which cannot be resolved except through lengthy and costly litigation, the effect of which will be to paralyze local finance until a final judicial determination of the issue; (b) they would prevent the orderly financing of public improvements in an established capital market in the private sector of the economy at a time when such improvements are needed to help overcome the tremendous socio-economic problems facing urban areas; and (c) they would result in a deterioration and destruction of the historic federal-state relationship in the field of public finance and centralize the control of local finance in the federal government at great cost to the citizens and taxpayers of the nation. The combined effect of the foregoing could be to fuel an economic recession of major proportions.

The successful imposition of the proposed taxes would require that the Supreme Court overrule certain long-standing constitutional law. This will make litigation inevitable and will doom the municipal bond market to several years of confusion and disorder, which will seriously delay the financing of and thereby the realization of important health and community services. In addition, but of secondary importance, it will cost the public taxpayers hundreds of millions of dollars in additional interest costs.

The inescapable fact is that even the *threat* of removal of the tax exempt feature from municipal bonds has resulted in a drastic increase in interest rates on such bonds in recent months, to the point where nearly two billion dollars of such bonds have not been sold. This results in the delay or postponement of a corresponding amount of construction of vitally needed public improvements. The taxation of interest on such bonds would permanently impair the ability of local governments to finance such construction, just at a time when the need for public facilities is at its peak. Then the so-called "taxpayer revolt" would become the "peoples' revolution" because the working man would be required to pay *higher* taxes to finance *fewer* improvements. Nor is the answer at this point a federal subsidy to "cover the difference" in the cost of issuing tax-free and taxable bonds. We already *have* a unique and time-tested subsidy program in the tax-free privilege accorded municipal bonds. This system has worked effectively for many years and should not be changed unless there is clear evidence of a better system, which is not provided for in the proposed legislation.

At a time when state-federal "revenue sharing" is being recognized as one solution to the many economic ills at the local level, a tax on bonds is proposed which would, in effect, shift revenue from the state to the federal level, resulting in a net loss to the states and local subdivisions. Inevitably this shift would bring federal control and weaken our entire system of federal-state relationships.

In conclusion, the retention of our entire state-federal government structure and the preservation of a sound economy demands that any attempts to levy a tax on interest or municipal bonds be defeated.

STATEMENT OF THE EDISON ELECTRIC INSTITUTE

SUMMARY

1. We urge the elimination of an existing inequity in our tax structure and an increase in the Federal revenue by requiring presently tax-exempt electric power systems to pay Federal taxes equivalent to those now paid by tax-paying systems.

Since taxes are an operating expense of electric utility systems and since their rates must be fixed to cover all such expenses, the customers of government-owned and government-financed power systems, which do not now pay any Federal income taxes, escape the tax contributions which customers of the investor-owned systems are required to pay. We urge that this inequality and inequity in the discriminatory treatment of one group of citizens as against another should be eliminated.

2. We urge that Section 103 of the Internal Revenue Code be amended to except from interest exemption all bonds issued to acquire facilities used in the business of furnishing electric energy or in any other comparable business functions.

The furnishing of electric energy to the public is a proprietary or business function as is evidenced by the fact that approximately 78% of all electric customers in the United States are served by investor-owned companies. When Congress, in 1959, authorized TVA to issue revenue bonds to finance its electric power business, Congress expressly provided that the interest on such bonds would not be exempt from the Federal income tax. There is no valid reason why the obligations of a State or any political subdivision of a State, issued to finance the business of supplying electric energy, should be exempt from Federal income tax.

3. We urge that the Congress authorize State and local taxing authorities to impose on Federal power systems, on a non-discriminatory basis, the same State and local taxes as are levied on comparable investor-owned systems.

STATEMENT

This statement is submitted by the Edison Electric Institute, which is the national trade association of the investor-owned electric power companies. Its 181 member companies serve approximately 78% of all electric customers in the United States.

The statement of the Edison Electric Institute at this time* covers a proposal to eliminate an existing inequity in our tax structure and to increase the Federal revenue by requiring presently tax-exempt electric power systems to pay Federal taxes equivalent to those now paid by tax-paying systems and, otherwise, to achieve a greater degree of equality in the taxes imposed on electric power systems.

*In testifying before this Committee on the transition provisions of the investment credit repeal, included in H.R. 12290, the Institute urged deletion of the so-called phase-out in Section 49(d) which is in direct conflict with, and largely nullifies, a basic premise of the transition provisions—i.e., to deal fairly with the taxpayer who entered into commitments on or before April 18, 1969, in reasonable reliance on the availability of the investment credit. We also urged clarification of the definition of a "certified pollution control facility", in Section 168(d)(1), to make it clear beyond question that such portion of a high stack at a generating station as is constructed *solely* for air pollution abatement may qualify for accelerated amortization. This testimony appears in Hearings Before the Committee on Finance, United States Senate, 91st Cong., 1st Sess., on H.R. 12290, July 15, 1969, at pp. 404–415. In accordance with the direction of the Committee we are not repeating this testimony at this time; our views on these points have in no way changed and we request they be taken into account by the Committee in its consideration of H.R. 13270.

DISCUSSION

There has been increasing emphasis on tax reform proposals for the elimination of existing tax inequities and the equal treatment of taxpayers similarly situated.

The imposition of disparate tax burdens on similar businesses represents a major area in which there is substantial tax inequity and discriminatory treatment.

In testimony before the House Ways and Means Committee on February 24 of this year, Mr. Mortimer Caplin emphasized this point and stated:

"The tax immunity of exempt organization businesses produces substantial losses of federal revenues. Even more serious, however, is the fundamental problem of unfair competition. The businesses with which the exempt organization competes must pay taxes on their earnings. The exempt organization, on the other hand, can make a variety of effective uses of the additional funds which it derives from its exemption. It may cut its prices below those which are economically feasible for its competitors. It may reinvest its tax savings in capital improvement and expansion programs . . . It is, in sum, permitted to wage business competition with a major and often decisive advantage over other businesses." (Hearings on Tax Reform Before the House Committee on Ways and Means, 91st Cong., 1st Sess., pp. 968–9.)

The elimination of such tax inequities may have the additional salutary effect of broadening the tax base and increasing the Federal revenue in a significant amount.

In the broad field of tax inequity between similar businesses, one of the most flagrant instances of unequal tax treatment is in the electric power business.

Since taxes are an operating expense of electric utility systems and since their rates must be fixed to cover all such expenses, the end result is that customers of the tax-exempt power systems escape the tax contribution which customers of the non-exempt systems are required to pay.

The Edison Electric Institute urges that this inequality and inequity in the discriminatory treatment of one group of citizens as against another should be eliminated by requiring tax-exempt power systems to pay a Federal tax equivalent to the Federal taxes paid by the non-exempt systems.

The electric utility industry in the United States is comprised of the investor-owned systems which serve about 78% of all customers and the government-owned or government-financed systems which serve the other 22%.

Investor-owned electric systems are, of course, subject to the Federal income tax and pay State and local taxes which, in most cases, are higher than those paid by other businesses.

The government-owned and government-financed systems pay no Federal income tax whatever and their State and local taxes, or payments in lieu of taxes, are a great deal lower than those paid by investor-owned systems.

Total taxes of the investor-owned electric utilities for 1968 are estimated at $3,484,000,000, of which $1,763,000,000 are for Federal tax. These total taxes represent 22% of operating revenues.

By way of contrast, total taxes of government-owned and government-financed power systems are estimated for 1968 at approximately $130,000,000, representing about 3½% of their electric revenues, *not one cent of which was paid in Federal income taxes.*

In other words, the government-owned and government-financed power systems—which represent about one-quarter of the total industry—accounted for only about one-thirtieth of the total tax bill of the industry and *made no payment whatever of Federal income taxes or the equivalent.*

As indicated in the attached Table, it has been estimated that, in 1967, the Federal, State and local governments lost over $900,000,000 in taxes as a result of the preferential tax treatment of government power systems; and that the total tax revenue lost by preferential treatment, in the period 1953 through 1967, is over $10 billion.

If government-owned and government-financed power systems were required to pay Federal taxes equivalent to the Federal income taxes imposed on investor-owned companies, on the basis, for example, of an equivalent ratio to plant investment, it is estimated that such Federal taxes would have amounted to over $500 million in 1966, and for the last 10 years to over $4 billion.

There are four western European countries which have both investor-owned and government-owned power systems. It is interesting to note that, in those countries, an obvious effort has already been made to minimize the difference in the tax burdens imposed on the different segments of the industry; and the disparity in taxes, as between investor-owned electric companies and government agencies, is far less than that in the United States. The tax burden on investor-owned systems in the United States in 1966, computed as a percentage of gross revenue, was about 7 times the tax burden of government-owned and government-financed systems. In 1965 (the latest year for which figures are available) the comparable factor in Finland was 2.25; in Germany, 1.2; in Norway, 1.25; and in Sweden, 1.76.

It is particularly important to emphasize again that, in the electric utility business, taxes are an operating expense which must be included in rates so that the tax inequity is, in fact, carried over to a highly disparate treatment of the individual customers of the investor-owned utilities, on the one hand, and those of the government-owned and government-financed power systems, on the other.

It is submitted that it is obviously unfair for the 78% of the electric customers in the country, who are served by the investor-owned power systems, to pay almost 7 times as much as in their rates to cover tax costs as is paid by the 22% served by the government-owned and government-financed systems.[*]

Unless something is done to eliminate this inequity, the tax disparity among users of electricity will continue year after year and will become even greater. As the favored government-owned and government-financed power systems continue to expand, they will grow at the expense of all the country's taxpayers and further emphasize the unfair discrimination. Where two groups of America's electric customers, distinguishable only by the source of electricity, bear highly unequal tax burdens, tax inequality exists which deserves the attention of this Committee and the Congress.

PROPOSED SOLUTIONS

1. A start in the direction of achieving tax equality among power suppliers, and increasing the Federal revenue, can be made by imposing a tax on the activities of government-owned and government-financed power systems in generating, transmitting or distributing electric energy. Such tax should be at a specified rate, applied to a base measured by gross plant investment or by electric revenues, which rate should be comparable to the ratio of Federal income taxes paid by investor-owned systems to their plant investment or electric revenues. Federal agencies, such as the Federal Power Commission, now have all the necessary statistics to derive the required figures.

Such a tax should be imposed on cooperative systems without regard to whether they allocate their profits or so-called "margins" to their members or patrons. In the light of the emphasis on the non-profit character of the electric power cooperatives, it may be of some interest to note that the "net margins" of electric power cooperatives in 1968—i.e., the amount available after deducting all expenses, taxes and interest charges—amounted to over $129 million—on which not one cent of Federal taxes was paid by either the cooperatives or their customers.

2. There are a large number of State, municipal and other local governmental power systems. Interest on their obligations issued to finance such power systems is exempt under Section 103(a) of the Internal Revenue Code. Recently, certain of these governmental agencies have financed electric power operations through the issuance of industrial development bonds—generally for the purpose of furnishing electric energy to large industrial customers. Exemption of the interest on such bonds is claimed under Section 103(c).

[*] The Province of Alberta, Canada, has recently faced up to this problem. To put customers of investor-owned utilities on an equal footing with those of the tax-exempt government-owned systems, it has authorized payment from its Treasury to the customers of investor-owned utilities of $9 million. This amount represents something over 95% of the Federal and Provincial income taxes paid by the investor-owned utilities in the year in question.

This is, of course, another approach to achieving tax equality in the treatment of one group of citizens as against another. The Edison Electric Institute believes, however, that, having due regard to the need for the tax revenue, the more appropriate approach in this country is to require the tax-exempt power systems—and their customers—to bear an equivalent tax burden to that now imposed on the investor-owned power systems—and their customers.

The furnishing of electric energy to the public is not a governmental function, but is rather a proprietary or business function, as evidenced by the fact that approximately 78% of all electric customers in the United States are served by investor-owned companies. It is significant that, when Congress, in 1959, authorized the Tennessee Valley Authority to issue revenue bonds to finance the electric power business of TVA, it expressly provided that the interest on such bonds would not be exempt from the Federal income tax. There is no valid reason why any other governmental agency should be permitted to use tax-exempt bonds to finance facilities used in the business of supplying electric energy.

Section 103 should be amended to except from interest exemption all bonds issued to acquire facilities used in the business of furnishing electric energy or in any other comparable business functions.

3. A further step which, in our view, ought to be taken to reduce existing tax inequality among similar businesses is for the Congress to authorize State and local governments to impose on Federal power systems, on a non-discriminatory basis, the same State and local taxes as are levied on comparable investor-owned systems.

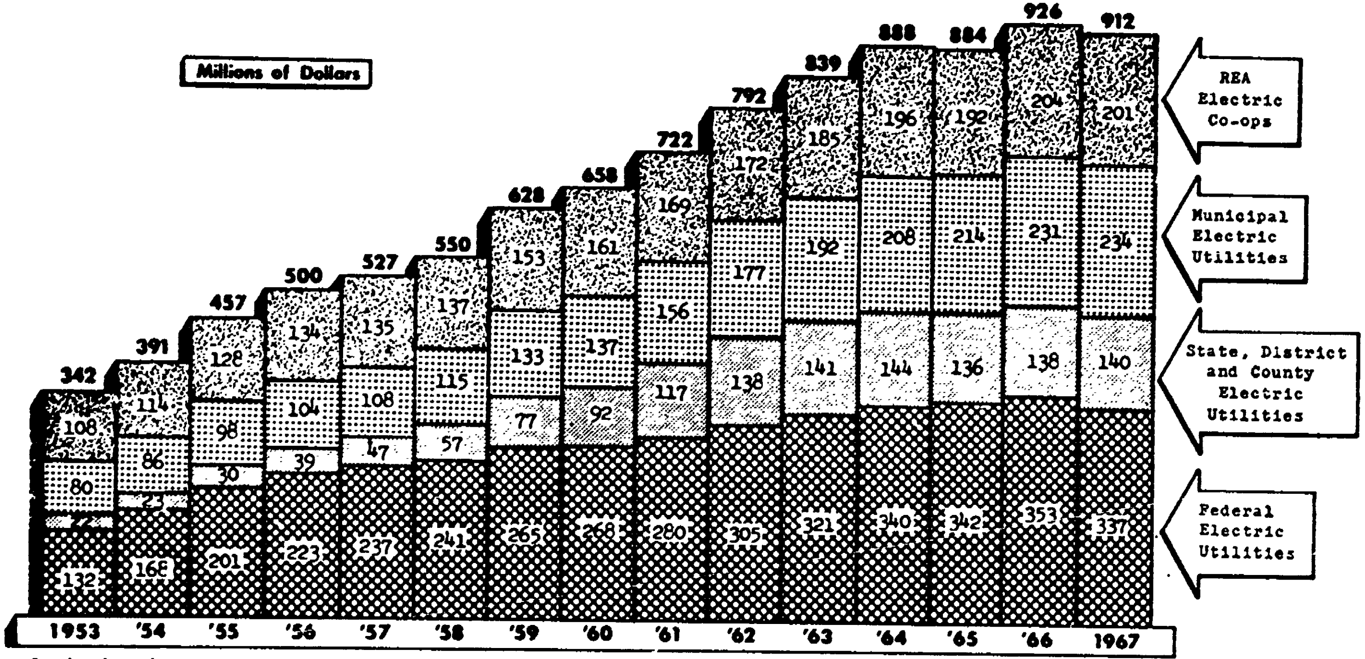
CONOLUSION

Government-owned and government-financed power systems engaged in the business of furnishing electric power—and their customers—should be required to make comparable contributions in taxes to those required of investor-owned power systems—and their customers. We urge that now, when one of the facets of tax reform being studied is the elimination of tax disparity among similar businesses, it is time to act to eliminate or at least reduce the tax inequities which exist in the vital electric utility industry.

Such action would achieve the highly salutary objectives of (1) eliminating or reducing an existing inequity between customers of the investor-owned segment, on the one hand, and customers of the government-owned and government-financed segment, on the other; (2) reducing the disparity in tax treatment between similar businesses; and (3) broadening the tax base and increasing the Federal revenue in a significant amount.

Trend in Estimated Annual Taxes Not Paid by Government-Owned or Financed Electric Utilities...

Total taxes not paid during period 1953-1967 = $10,016,000,000



Based on Ratio of Taxes Paid by Taxpaying Electric Power Companies On Electric Plant in Service and Construction Work in Progress.

Source Based on E E I ; F P C ; R E A ; and Other Data.

APPENDIX D

WRITTEN TESTIMONY RECEIVED BY THE COMMITTEE EXPRESSING AN INTEREST IN THE SUBJECTS OF LIMIT ON TAX PREFERENCES (LTP) AND ALLOCATION OF DEDUCTIONS

Written testimony received by the committee expressing an interest in the subjects of limit on tax preferences (LTP) and allocation of deductions

STATEMENT OF WALTER N. TRENERRY, ST. PAUL, MINN., PART 3 OF 4 PARTS: RE MINIMUM INCOME TAX AND ALLOCATING DEDUCTIONS

STANDING

Your realtor appears in his own right as a taxpayer and also as counsel for:

Certain taxpayers who have gross incomes of more than $1 million a year and:

a. Realize "Tax Preferences" within the meaning of H.R. 13270

b. Take deductions subject to allocation under H.R. 13270.

SUMMARY

Subtitle A of Title III of H.R. 13270 is an emotional overreaction to advantages available, for good reasons, to a tiny number of taxpayers.

Removing these advantages will attack capital further and will drive away private support of worthwhile causes which need encouragement.

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STATEMENT

Your relator, Walter N. Trenerry, of St. Paul, Minnesota, Attorney-at-Law and Member of the Minnesota Bar, respectfully states to the Honorable Finance Committee of the United States Senate:

While he does not *favor* all additions and changes created in the Tax Reform Bill of 1969 (H.R. 13270), your relator *objects* only to the matters in Subtitle A of Title III, which he mentions specifically here.

Your relator *does* object formally to all the following as unfair and short-sighted:

Title III. Subtitle A.

Sec. 301(a) Limit on Tax Preferences (Proposed New Sec. 84 of the Code)

Sec. 302(a) Allocation of Deductions (Proposed New Sec. 277 of the Code)

I. MAKE HASTE SLOWLY

Or, in the tongue of Caesar and Cicero, *festina lente.*

With all respect to the Committee, your relator feels that the authors of H.R. 13270 wrote these sections passionately, but not pensively.

An infinitely small number of Americans, among whom were Mortimer and Myra Moneybags, found lawful ways to avoid paying some or all of the income taxes which Uncle Sam wanted to extort from them.

Human nature being what it is, certain taxpayers flew to the Congress with the speed of light; and the members of Congress, being human, pressed, and also taxpayers, promptly set out upon an expedition to apply a fiscal shillelagh to Mortimer and Myra.

These sections are the cries of Congressmen and constituents for vengeance.

Now what Mortimer and Myra really did hardly calls for vengeance. These two conscientiously met all the requirements of law, spread their dollars through the economy, and carried into effect Uncle Sam's expressed policies which gave Income Tax advantages to persons who gave help to certain favored ventures.

In speed and hot temper the Congress would now like to make this kind of help to the economy impossible.

Needless to say, making it impossible withdraws from the economy this money which went into creating new capital and new taxpayers.

The cry for vengeance goes along with the ancient, and wearying, cry for more revenue. This cry is familiar to all harried taxpayers—to ordinary Joe and Judy as well as the Moneybags—and has no moral standing higher than its mere statement: the Congress wants to grab more money in order to spend more money.

Your relator suggests respectfully that the Congress should take more time thinking about these proposals. Whether to ruin taxpayers who depend on Mortimer and Myra Moneybags, and whether to kill investment in ventures formerly encouraged through tax advantages, are decisions calling for time, discussion, and thought.

II. SPECIFIC SHORT-SIGHTED MEASURES

Your relator objects to the very concepts of Minimum Income Tax and Allocating Deductions; that is, *all* of Subtitle A of Title III of H.R. 13270; but will take up specifically only those parts which he has not mentioned before and which others will doubtless discuss at length.

1. *Accelerated Depreciation as Tax Preference.*—(Sec. 301(a) of the Bill, proposed new Sec. 84(c) (1) (B) of the Code)

This section now penalizes methods of depreciation allowed before 1954 but given express approval in the Internal Revenue Code of 1954. So far as appears, the Congress has no reason beyond extracting more current money from Joe Taxpayer.

In limiting Joe to the straight line method the Congress is tossing him into the bed of Procrustes. Joe has to fit, whether it takes stretching him on the rack or lopping off his feet to make him do so.

For instance, in manufacturing or mining the unit of production method seems to work best. When production is up, and Uncle Sam collects higher taxes, he can afford to be generous and to let Joe Taxpayer have the benefit of higher depreciation. When production is down, Joe has less with which to offset Uncle Sam's claims.

If Joe buys a new machine, he knows that it falls in value chiefly in the first years of use. The Congress of 1954 apparently recognized this and gave Joe the benefits of the sum-of-the-digits method, which gives him a higher offset to taxable income in the earlier years of property life and conforms his practices to the realities of economics.

As long as income tax rates stay the same, all methods of depreciation wind up about the same. No one seriously expects any lower rates in the calculable future. At some time Joe will have his property fully depreciated, after which Uncle Sam will collect taxes free of offset.

To call anything but straight line depreciation a "preference" and to make Joe Taxpayer risk being taxable on his actual economic loss would ignore the realities of physical obsolescence and would combine with the already unreasonable proposed Capital Gains provisions to bring about a further assault on capital.

If Joe can recapture his capital quickly he will very likely reinvest that money in new buildings and machinery, to the obvious gain of the American economy and to the obvious benefit of Uncle Sam as a tax collector.

2. *Excess Cash Basis Farm Losses as Tax Preferences.*—(Sec. 301(a) of the Bill, proposed new Sec. 84(c) (1) (D) of the Code).

This section would revolutionize farm bookkeeping and again force Joe Taxpayer into the bed of Procrustes. The farm known as Blackacre, on which Joe feeds cattle with grain bought from dealers, is not the same as the farm known as Whiteacre, which Joe uses as a tree farm.

As said before, the tax effect on Uncle Sam will be the same in the long run. An item expensed is not on hand for depreciation later.

It will puzzle Joe Taxpayer to find his farm subject to the accrual method of accounting; in which he has to treat some rough and ready farmers's oral promise to pay for a cow as cash in hand, and taxable.

It will also puzzle Joe to find himself paying an income tax on his cash outgo. His money has already gone for fertilizer, which is used up, but now, even though the Internal Revenue Code gives him his choice, he finds that exercising that choice amounts to a "preference" and costs him money. This is the case of giving someone a piece of pie and making sure it has a tack in it.

If the section were not bad enough in effect, it has uncertainties in meaning.

Where does the farm loss appear? Is it averaged with ordinary income, to reach adjusted gross income, or does it appear only in the Tax Preference computations?

For instance, Joe Taxpayer has $100,000 in ordinary income, and an excess farm loss of $100,000.

If the excess farm loss does not appear in adjusted gross income, the result is:

Ordinary income	$100,000
Farm loss	100,000
Adjusted gross income	0
Tax preference base	100,000
Allowable (50 percent)	50,000
Disallowed and taxable	50,000

If the excess farm loss has to appear in adjusted gross income, the result is:

Ordinary income	$100,000
Farm loss	100,000
Adjusted gross income	200,000
Tax preference base	200,000
Allowable (50 percent)	100,000
Disallowed and taxable	0

How does this affect Subchapter S corporations? The section does not mention them, and yet a good many large farms are held in such corporations.

Does each stockholder get his own $25,000 allowable preference? How does he get his share of capital gains, particularly if the excess deduction account applies?

3. *Limiting the Deduction of Cash Outlays*—(Sec. 302(a) of the Bill, proposed new Sec. 277 of the Code)

This section chews up Joe Taxpayer's right to take in full those deductions classed as "personal"—that is, non-business deductions.

Whatever the formula used to ruin their full deductibility, these items stand for actual spending or actual losses or cash or property, to their full amounts. Joe Taxpayer has put our hard dollars or has had to mourn the loss of assets bought with hard dollars.

These are not like the non-cash deductions of amortization, or depreciation, or percentage. depletion which, while based on economic realities, are somewhat arbitrary in amount and method.

To attaint part of these deductions as paid with "preference" income is to blame Joe Taxpayer for putting his money into the very causes which the Congress made it a policy to encourage.

If Joe could control the money he kissed off this way, the Congress might have some moral basis for limiting these deductions. In that case Joe would have had a choice about how he spent his money.

Under the section as it stands, though, Joe has to take the unpleasant rap of paying taxes on money he no longer has in hand, and which for the most part he had no choice in spending or keeping.

The attainted spending is for interest on money borrowed for investing, all taxes, casualty losses, charitable gifts, medical expenses, and taxes and interest in connection with cooperative housing.

Joe could cut his borrowing—with consequent loss to the economy. The person or corporation who collects the interest pays a tax on it.

Joe could and speedily would cut down his charitable giving. It is obvious who would suffer.

Joe has no choice about paying his income, property, sales, excise, stamp, moneys and credits, and other assorted taxes to city, school district, park district, sewer district, water district, airport district, metropolitan district, county, region, and state.

Joe has no control over the wind, rain, lightning, sleet, snow, frost, volcano, earthquake, fire, drouth, accident, robber, burglar, highwayman, pickpocket, or other agent of casualty losses.

Joe has no control over the bacilli, amoebae, viruses, bugs, other disease agents, the process of aging, neuroses, other subconscious turmoils, epidemics, epizootics, accidents, and other nasty affairs which send him to doctors and hospitals.

Nevertheless the Congress wants to chisel him by making him pay a tax on money he had to disgorge, some of it under the penalty of criminal prosecution.

Obviously this whole unfair procedure gives further support to the Capital Gains sections in making further raids upon, and inroads into, Joe Taxpayer's shrinking capital.

Before the Congress enacts such harsh measures into law, the members might reflect upon the political aphorism that no encouragement to a good cause can equal a tax advantage.

To whittle away deductions for good causes will not end demands for the causes. A more than likely result is a demand for Uncle Sam to support them directly.

Such support calls for heavier taxes. Heavier taxes are political lumber of doubtful value with 1970 so close, and would not be necessary if Joe Taxpayer and his friends could continue their support and get deductions for so doing.

III. TAX PREFERENCES AND ALLOCABLE DEDUCTIONS APPEAR CHOSEN ARBITRARILY

The Congress has picked out five things which it calls "tax preferences" and makes subject to minimum income tax. These five things, plus one more, also make up the numerator of a fraction used to disallow parts of seven classes of deductions.

Since no two of these thirteen things appear related in any way, presumably another thirteen would have done as well. The Congress wanted to proscribe something, spun a wheel, and proscribed.

While this may be as good a way of lawmaking as any, someone affected by the law may not think so, and when he notices what favored subjects remain untouched, he may marvel at the criteria which screened Good from Bad. Subjects remaining untouched are presumably Good.

A trip through the Internal Revenue Code and H.R. 13270 uncovers the following examples, among others, of handiwork looked upon by the Congress and called Good:

Compensation for injuries or sickness, excluded from taxable income under Sec. 104
Amounts received under accident and health plans, excluded from taxable income under Sec. 105
Rental value of parsonages, excluded from taxable income under Sec. 107.
Improvements by lessee on lessor's property, excluded from taxable income under Sec. 109
Mustering out pay of servicemen, excluded from taxable income under Sec. 113
Sport program receipts collected for Red Cross, excluded from taxable income under Sec. 114
Scholarships and fellowships, excluded from taxable income under Sec. 117
Meals or lodging furnished for the convenience of the employer, excluded from gross income under Sec. 119
Living expenses of Congressmen, deductible under Sec. 162(a)(3)
Business lobbying expenses, deductible under Sec. 162(e)
Losses other than casualty losses, deductible under Sec. 165
Bad debts, deductible under Sec. 166
Amortization of emergency facilities, allowed under Sec. 168
Amortization of grain storage facilities, allowed under Sec. 169
Amortization of bond premiums, allowed under Sec. 171

Circulation expenditures for newspapers, deductible under Sec. 173
Research and experimental expenditures, deductible under Sec. 174
Soil and water conservation expenditures, deductible under Sec. 175
Trademark and trade name expenditures, deductible under Sec. 177
Additional first year depreciation allowance for small business, deductible under Sec. 179
Expenses for production of income, deductible under Sec. 212

Social scientists might toy with building a chart of Twentieth Century American Moral Standing, as shown by the Internal Revenue Code, modified by H.R. 13270:

Good	*Bad*
Parson	Contributor to church
Scholar	Borrower who invests
Lobbyist	Taxpayer
Congressman	Casualty loser
Newspaperman	Sick man
Researcher	Apartment dweller

Unhappily, this is very slight exaggeration, and the Congress might do well to reexamine the wisdom of leaving available, say, deductions for business lobbying and building up newspaper circulation, while applying penalties to charitable gifts and paying taxes.

Is it quite fair to extort taxes from a man and then penalize him for paving?

ARTHUR ANDERSON & CO.,
Chicago, Ill., September 19, 1969.

Re Statement Regarding H.R. 13270 Tax Reform Act of 1969—Allocations of Deductions Limit on Tax Preferences.

COMMITTEE ON FINANCE,
New Senate Office Building, Washington, D.C. 20510.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

DEAR SIRS: 1) Sections 301 and 302, whether viewed separately or together, are overwhelmingly complex.

2) Certain "tax preference" items either arise from inflationary effects, or are evidence that the affected taxpayers are particularly vulnerable to real economic loss through inflation; yet, such persons would be required to pay additional tax without realizing additional economic income.

3) Parallel records relating to "what might have been" would be required to be kept in the case of intangible drilling costs, percentage depletion, depreciable real property, and farming operations. Such dual sets of records are a serious hardship on individual taxpayers, and further complicate these provisions.

4) In view of proposed changes in Section 211, relating to farm losses, the further inclusion of farm losses in this computation seems to be a duplication.

BASIS FOR COMMENTS

1) Complexity of Provisions

Sophisticated computer programs will be necessary for tax return preparation involving limits on tax preferences and/or an allocation of deductions. The mere design of a program to accommodate the new provisions will be difficult, if not impossible. We have doubts as to whether a tax form could be designed to reflect the law as proposed. As practitioners, we find the provisions quite difficult to understand. What then of the taxpayer himself? Complex provisions such as these, of such broad applicability, could seriously damage the spirit of voluntary compliance.

2) Inflationary Effects Included in Tax Preference Items

Much of the income created by consideration of tax preference items is illusory. A large portion of the income from long-term gains is not economic gain, but merely a reflection of change in price levels. A realized gain of this nature is already being taxed, even though real economic gain has not occurred. Similarly, persons holding municipal bonds have suffered and continue to suffer real economic loss because of their investment in fixed dollars during a period of inflation. The tax-saving feature of the income received on these investments is often insufficient to offset the real dollar loss incurred. Furthermore, accelerated depreciation on buildings, which does not reflect price-level changes, in no way prevents the taxation of capital rather than real income.

3) Requirement for parallel records

Both sections, to some extent, require maintenance of dual records on oil property, depreciable real estate and farming operations. The mere nuisance effect of having to maintain volumes of detail can have an adverse effect on voluntary compliance. In addition, the requirements are expensive, as they require a certain level of sophistication in accounting and tax concepts. It is doubtful whether many taxpayers will possess these capabilities, and even their tax advisors may have great difficulty coping with the provisions. Many of these records will have to be maintained for years, and in the case of a farm, possibly in perpetuity.

The proposal in the House bill to include depletion and intangible development cost as a tax preference item for allocation purposes and the Treasury Department's somewhat similar proposal to treat these as a limited tax preference should not be approved without full recognition of the tremendous complexity of determining the amounts. On oil and gas property, it would be necessary to set up complete records on each lease from the date of acquisition. These records would duplicate, in nature, present records. Tax returns for prior years would have to be analyzed to determine IDC expenses each year in many cases IDC would have to be analyzed in order to exclude dry hole costs. Cost depletion for each prior year would have to be computed. Where this is done on a unit or production basis, and there have been valid changes in estimated reserves, the problem grows.

It would be extremely time-consuming and costly to make these computations and to maintain lease records on the two bases.

The computed tax preference may well exceed in amount the tax preference on an economic basis. Thus, if the tax preference is computed for each separate property, presumably the computed tax preference would be the total of the tax preferences on the "good" leases while the losses or negative preferences on the poorer leases would be ignored. Marginal leases with high leasehold costs and leases with extensive reworking expenses in one or more years might well be on a cost-depletion basis, particularly if historical IDC is capitalized for computation purposes. This penalizes taxpayers subject to this provision.

4) Overlapping of provisions regarding farm losses

Section 211, essentially, does away with the ordinary loss-capital gain feature of wealthy taxpayers investing in farms. Many small taxpayers, with low incomes but farm losses in excess of $10,000 could be required to maintain books on two methods of accounting (cash and inventory). The maintenance of two sets of records will be burdensome where the small, active farmer is accidentally caught up in the provisions of Section 301. The main reason for the present farm accounting rules was to minimize recordkeeping by farmers. The extensive recapture provisions of Section 211 will protect the revenue from ordinary deductions creating capital gains. The further inclusion of farm losses as tax preferences unnecessarily complicates the law for all farmers.

CONCLUSION

The foregoing comments are not intended to indicate approval or disapproval of the remaining portions of the Act; instead, they are only indications of technical areas or unintended effects to unsuspecting taxpayers. This statement is submitted as part of a series of letters, each dealing with a particular area of the proposed legislation. It is intended that the comments and recommendations contained herein be made part of the record of testimony relative to the legislative changes contemplated for allocation of deductions and limit on tax preferences. We shall be pleased to discuss these matters further with you or the Committee, either in person or by telephone. Please call us collect at 312-346-6262 if necessary.

Very truly yours,

JOHN MENDENHALL,
Director of Taxes.

DAVIS POLK & WARDWELL,
New York, N.Y., September 2, 1969.

Senator RUSSELL B. LONG,
Chairman, Senate Finance Committee,
U.S. Senate,
Washington, D.C.

DEAR MR. CHAIRMAN: The proposed allocation of deductions (section 302 of H.R. 13270) is demonstrably wrong as applied to state and city income tax deductions.

To cite an obvious example, an individual who lives in New Jersey and works in New York City pays New York State and City income taxes on his earned income but not on his capital gains. Why, then, allocate part of his state and city taxes, wholly attributable to his earned income, to the so-called untaxed portion of his capital gains? If such person resides in New York City, only half of his gain is subject to the New York State tax (and only half of the appreciation since July 1, 1966 is included for the New York City income tax), so that in large measure the appropriate apportionment is taken care of automatically under existing law.

It is submitted that to the extent state and local income taxes do not tax so-called "tax preference amounts" (and to the extent they tax these "tax preference amounts" on the same proportionate basis as does the federal tax), the proposed allocation rules are totally inappropriate and merely have the effect of indirectly taxing citizens differently on tax preference income depending on the state and city in which they work and live. The proposal is particularly discriminatory against citizens in states which have an income tax system generally modeled on the federal tax structure.

The simplest solution is to exclude state and local income tax deductions from the allocation rules. A complex solution would provide for a separate formula for allocating only those deductions for state and local taxes imposed on preference amounts. An alternative would be to disallow state and local tax deductions to the extent attributable (at the taxpayers effective rate) to the tax preference amounts.

Sincerely yours,

DAVID A. LINDSAY.

NESSEN & CSAPLAR,
Boston, Mass., October 6, 1969.

SENATE FINANCE COMMITTEE,
New Senate Office Building,
Washington, D.C.

DEAR SIRS: This firm represents Lazard Freres and Co., 44 Wall Street, New York City in connection with certain aspects of H.R. 13270, The Tax Reform Act.

If certain limitations with respect to interest (Section 221) and the allocation of deductions (Section 302) are enacted many investments entered into in reliance upon existing tax laws will be materially devalued and some will be destroyed. We believe such a result is wrong and attach hereto a memorandum with supporting schedules dated September 30, 1969 that explains in detail the extent of potential devaluation of investments and the reasons therefor in the event the proposed sections become law.

We believe that tax reform can be achieved by enactment of the so-called Limit On Tax Preference provision (Section 301), but believe that the other limitations mentioned above are unnecessarily restrictive and in housing and commercial sectors will inevitably result in rental increases to consumers and if those are not forthcoming then a flight of capital to more secure investments. A memorandum in support of this proposition is attached entitled General Policy Statement on Tax Reform Bill.

Thank you for you attention to this position and to the supporting material. The undersigned is prepared to meet further with you and is available by telephone in the event there are any questions.

Respectfully submitted.

KINGSBURY BROWNE, Jr.

Enclosure.

MEMORANDUM—TAX REFORM ACT OF 1969

In my memoranda dated August 6 and September 8, 1969, I have attempted to describe the serious retroactive effect which the proposed Tax Reform Act of 1969 would have on existing equipment and real estate leasing transactions.

In recent weeks, however, after discussions with even my most knowledgeable and sophisticated clients, I have concluded that I have failed completely to bring home my point.

I shall again attempt to explain how drastic the proposals in the Tax Reform Act are, and this time I will use specific examples for illustration; but I am still not confident that I will be successful in convincing people of the substantial adverse effect on their economic position which would result from passage of the Act. In my judgment the only way to convince people of this is for each investor to analyze his own situation and the effect thereon of the proposals.

I therefore realize how brilliant a theory the tax reform advocates have devised to secure enactment of their proposals. That theory is simple: To propose legislation so complicated that not even the most sophisticated investor, let alone Congress, can understand the effect of the proposals, until the proposed legislation is enacted and the regulations thereunder are promulgated.

I will attempt to illustrate the retroactive effect of the allocation of deductions proposals on equipment leasing and real estate transactions by considering four types of leasing ventures:

(1) a conventional housing venture;
(2) a net lease of a post office with tax benefits;
(3) a net lease of a post office with a large cash flow; and
(4) an equipment lease transaction.

In this connection, I have assumed that proposed Section 221 of the House Bill, dealing with the disallowance of investment interest over $25,000 plus investment income, will not be passed. If that Section were passed, the effect on these transactions of the new law would be even worse for investors than is shown herein.

It should also be noted that the computations which are contained in this memorandum have been calculated and reviewed by leading accounting firms, and are computed in exactly the fashion that existing investments of this nature are marketed.

In each example I have used a hypothetical taxpayer with $15,000 adjusted gross income (other than from the particular transaction in question) and $50,000 of itemized deductions (other than those generated by such transaction). It has been suggested that my assumption of one-third deductions is excessive, but those who have reviewed their income tax returns to check this point have agreed that that percentage is realistic. Note that such a taxpayer living in New York City would have about $17,500 of state and local tax, and that the interest and taxes on his house or cooperative apartment, his charitable contributions and other allocable deductions usually would make up the remainder. However, as discussed below, I have also included in this memorandum calculations based upon the assumption that the taxpayer had deductions of 25% of this income.[1] Finally, we have assumed that the investor's effective Federal, state and local tax rate is 65% and that the capital gains rate is 25%.

1. *Conventional Housing Venture.*—Exhibit A shows the effect of the proposed law on a conventional housing project. In this example, the hypothetical taxpayer invested $100,000 in a $1,000,000 project, the remaining $900,000 provided by a 25-year 9% level payment borrowing, and the taxpayer sells out for $100,000 (plus assumption of debt) after 15 years, when the "lines cross" under the sum of the years digits method of depreciation. This Exhibit shows that under current law the above taxpayer would have a 16.75% rate of return on his investment, and under the House Bill the taxpayer would not only have no positive rate of return, but also would get back, over an extended period of time, only $89.137 of his $100.000 investment. The reasons for this are that under the House Bill the accelerated depreciation will constitute a tax preference which is turn will cause a portion of the taxpayer's itemized deductions to be disallowed and there is 100% recapture of the depreciation difference between straight line and accelerated depreciation.

The foregoing example assumes that the taxpayer recovers only his original $100,000 equity when he sells the property and that he does not realize a substantial amount of cash flow. This is admittedly conservative; favorable economic conditions would undoubtedly permit some conventional housing projects to be

[1] In addition, I have assumed that the taxpayer already has $10.000 of tax preferences before consideration of the leasing transaction. Thus the de minimis rule of $10.000 of allowable preferences can be ignored.

sold to taxpayers even under the House proposals because an investor might well believe that increased cash flow (from future increases in rentals) and additional resale value would outweigh the unfavorable tax consequences. However, there are hundreds of housing projects which have already been entered into and which were motivated at least in part by existing tax law. Those transactions would not have been entered into but for the tax incentives present in existing law and to remove the tax benefits afforded such existing transactions retroactively is completely inequitable.

On the other hand, I do not see how there will be any substantial construction of low and middle income housing by the private sector of our economy since, by and large, the only incentive for the private sector to get involved in this area is the tax incentive, which disappears if this Bill is enacted. The net consequences of this is that the percentage of public housing will have to increase, which most people in the housing area find undesirable.

The House Ways and Means Committee thought that it was stimulating housing construction when it decided to retain accelerated depreciation for such projects. However, because of the operation of the allocation of deductions section and the full recapture of depreciation section, the use of accelerated depreciation will be of little or no benefit in most cases. Indeed, Exhibit A-1 shows that the taxpayer would be significantly better off if he elected straight line rather than accelerated depreciation, since as shown therein the taxpayer would realize a 4.1% rate of return, rather than a negative rate of return.

It is obvious, however, that taxpayers at the very least would not invest in low income housing projects for the nominal rate of return allowable under straight line depreciation; in fact, it is probable that most marginal housing projects would not be entered into.

If Congress decides that the benefit to society from increased housing is not worth the tax revenues lost because of tax benefits afforded investors in such projects, it is certainly within its prerogative to remove such tax benefits. On the other hand, it is completely inequitable to apply these provisions retroactively to taxpayers who have previously made investments in such projects relying upon existing law. This is particularly true in low income housing projects. The only incentive that motivated investment in the low income housing field was the tax benefits, and to hit the investor over the head with a stick afer he has eaten the carrot is unjust.

2. *Net Lease of Post Office With Tax Benefits.*—Exhibit B shows the tax consequences of a net lease of a post office to the U.S. Government. In this example, the hypothetical taxpayer invested $150,000 in a $1,000,000 post office, the remaining portion of the project being financed by a 30-year level payment 9% mortgage. The post office is depreciated over 45 years and it is assumed that the taxpayer is able to sell the project for $150,000 (plus debt) when the lines cross under the sum of the years digits method of depreciation. The transaction yields 3% annual cash flow. Under current law, the taxpayer obtains a 11.54% rate of return. However, Exhibit B shows that, under the House Bill, even though the taxpayer realizes 3% cash flow, he realizes a negligible rate of return (0.32%) on his investment because of the adverse tax consequences.[2] In other words, after taking into account the adverse tax consequences, the taxpayer only got back $152,543 of his $150,000 investment, and that only over a long period of time.

The major reason for this is that the interest on the mortage is considered a personal itemized deduction, and is therefore allocable.[3] There is no question that the major adverse tax consequence of the proposed bill on net lease transactions in general is that such interest is treated as a personal itemized deduction subject to allocation. This means that every dollar of accelerated depreciation which a taxpayer claims, even depreciation on this very project, causes a portion of the interest on the transaction to be disallowed. Other than a positive decision that net leasing transactions should be outlawed altogether, there is no economic theory which justifies disallowing interest on a net leasing transaction where 100% of the rents are includible in income, since it is obvious that the source of the payment of such interest is the rents. If such a decision is to be made, it should not be made with respect to transactions previously consumated in reli-

[2] These illustrations assume that the tax on sale is funded through the use of 4% sinking fund. This is the usual manner of evaluating these transactions.

[3] The allocation of deductions for interest is not to be confused with the proposed disallowance of investment interest expense under Section 221 of the House Bill.

ance on existing law, and entered into prior to the time that Congress decided that net lease transactions should be outlawed.

Exhibit B, however, is unrealistic because it assumes that the taxpayer had no preferenecs other than the $10,000 de minimis amount and the accelerated depreciation in this transaction. However, such individuals, in addition to this transaction, undoubtedly have other preferences, such as capital gains.

Exhibit B also shows the effect on our hypothetical investor if $25,000 of capital gain is included in his $150,000 of adjusted gross income. Every dollar of capital gain will cause a portion of the interest on the net leasing transaction to be disallowed. This Exhibit shows that our hypothetical investor would under those circumstances only get back $83,039 of his $150,000 investment, and again, over a long period of time.

The Administration has proposed an amendment to the Bill which would somewhat alleviate the drastic consequences of the proposed legislation. This amendment would permit taxpayers to add to the tax basis of the leased property allocable deductions disallowed because of claiming accelerated depreciation thereon, but only for the purpose of computing gain on a subsequent sale. Although this section is somewhat helpful, it falls far short of protecting taxpayers who have previously entered into net lease transactions. The reasons for this are as follows:

1. Unless the amendment should specifically cover this point, the amount, if added to basis, would first reduce capital gain rather than ordinary income. Since the deductions that were disallowed were against ordinary income, the reduction in gain should reduce recapture (ordinary income) first and then capital gain.

2. The taxpayer cannot increase his tax basis for the purpose of computing depreciation. Since the disallowance of personal deductions economically reduces the amount of allowable depreciation, such a taxpayer should, for the purpose of computing further depreciation, only reduce basis by the difference between the accelerated depreciation claimed and the deductions disallowed.

3. Not all the interest disallowed in a net lease transaction can be added back to basis. The interest disallowed because of other preferences, such as capital gain, is not added back so as to reduce a future gain when the property is sold.

The limited effect of the Administration's basis proposal is illustrated by Exhibit B, which also shows that under that proposal, the taxpayer will get back only $104,625 of his original $150,000 investment, and that over a long period of time. It is obvious that no taxpayer would have entered into the transaction with the U.S. Government if he had any inkling that the tax law would be changed in such a drastic manner.

Exhibit B is also unrealistic in that it assumes that the taxpayer will be able to sell the project for $150,000 (plus debt) when the lines cross under the sum of the years digits method of depreciation. Actually, it would be most urlikely if the taxpayer could sell the property at that time for any substantial a nount more than the debt; *i.e.*, he would likely receive little cash to boot. The reason for this is that the tax position of any purchaser under the new legislation is so bad that he cannot afford to pay much more than the debt. If the taxpayer in Exhibit B sold the project for nothing more than the outstanding debt (or a nominal amount of cash to boot), not only would be not get back any portion of his original $150,000 investment, but also he would have to put up additional money to satisfy his tax liabilities.

3. *Net Lease of Post Office with Large Cash Flow.*—There can be no better illustration of the disastrous effect of the proposed Bill on taxpayers who have entered into leasing transactions than the case of a taxpayer who entered into such a transaction without expecting or obtaining any tax losses. Exhibit C shows the drastic effects on such a transaction. In this example, it is assumed that a taxpayer invests $50,000 in a $250,000 post office, borrowing $200,000 on a 30-year 9% level payment basis. The investment yields the taxpayer $3,500 or 7% cash flow. The taxpayer depreciates the property over 45 shares on a straight line basis. For purposes of simplicity, it is assumed that the taxpayer claims the standard deduction. The taxpayer has adjusted gross income of $150,000, $50,000 of which is long-term capital gain. The post office is sold after 19 years for $50,000 (plus debt). Exhibit C shows that under current law the taxpayer in this example would have a 7% pre-tax rate of return on his investment, or 5% after-tax. Under the House Bill, however, he would not have any positive rate of return and indeed would only receive back $43,443 of his $50,000 investment. Although it may seem that the factual situation in Exhibit C is extreme, it should be noted that there are hundreds of situations where property has been leased

primarily to obtain cash flow rather than tax benefits; investors in such non-tax motivated transactions would be severely hurt if this law were enacted.

4. *Equipment Leasing Transaction.*—Exhibit D shows the substantial adverse effects of the proposed legislation on equipment leasing transactions. In this Exhibit, it is assumed that our hypothetical taxpayer invested $49,500 in railroad equipment costing $300,000. The balance was financed on a 15-year 9% level payment basis. It is assumed that the investor realizes 2.04% cash flow and that he sells the equipment for $45,000, at the end of 15 years. Under current law such an investor would realize a 12.97% rate of return. However, if the House Bill is passed, the investor would only get back $42,911 out of his original $49,500 investment; that is, he would have a negative rate of return on his investment even though he realized a 2.04% positive economic rate of return. The situation is even worse if it is assumed that the investor includes a $25,000 capital gain in his $150,000 adjusted gross income. In that case he only gets back $29,318 of his original $49,500 investment, and even that is returned over a period of years. Even under the Administration proposal to add disallowed deductions back to basis, the investor would have a negative rate of return, since he would get back only $46,086 of his $49,500 investment.

From the foregoing examples, it is clear that what causes such leasing transactions to become uneconomical under the new law is the combination of the facts that (1) accelerated depreciation requires a portion of the taxpayer's allocable deductions to be disalowed and (2) the interest payments in the transactions are treated as personal allocable deductions which in part will be disallowed.

Billions of dollars of equipment and real estate have been financed by the net lease route. These investments will, as a practical matter, be largely wiped out if the House Bill is enacted in its current form. Each investor is urged to review his personal situation to convince himself that the examples used in this memorandum are typical of the adverse consequences of the proposed legislation. Although it is submitted that the 33% rate of itemized deductions utilized in this memorandum is reasonable for taxpayers who enter into net leasing transactions, Exhibit E shows that taxpayers who have only 25% of itemized deductions will discover that such transactions are also uneconomical under the proposed legislation.

It might be arguable whether leasing transactions should be outlawed, but there should be no question that punitive action should not be taken with respect to transactions which were consummated or committed to in reliance on existing law. Accordingly, the following amendments (in the order of their importance) should be made to the House Bill:[6]

(1) interest in all leasing transactions, and in any event, interest in leasing transactions consummated or committed to prior to July 25, 1969, should not constitute an allocable expense;

(2) accelerated depreciation in transactions consummated or committed to prior to July 25, 1969, should not be considered a tax preference for purposes of allocation of deductions; and

(3) depreciation taken after July 24, 1969, on real property in such transactions should be subject to the current recapture rules of Section 1250 of the Internal Revenue Code.

General Policy Statement on Tax Reform Bill Together With Supporting Memoranda

The investment banking industry is deeply concerned with certain provisions of H.R. 13270 as they pertain to investment in areas such as low-cost housing, urban renewal, railroad and airline modernization and other real and personal property development.

Over the last decade, investment bankers have played an important role in the manufacture, construction and leasing of real and personal property, in the development of commercial real estate and moderate and low-income housing, and in bringing together manufacturers, developers, investors, institutional lenders and lessees. Through their efforts, in part, it is estimated that real and personal property having an initial cost in excess of $20,000,000,000 has been manufactured or constructed and leased. It is well accepted that tax considera-

[6] As indicated above this memorandum assumes that Section 221 of the House Bill (dealing with disallowance of investment interest) will not be passed. Furthermore, no consideration has been given to certain other proposals, such as the inclusion of interest during construction as a tax preference.

tions play a significant role in investment in such property, and it is unlikely that the record of the 1960's will be matched in the 1970's, if H.R. 13270 is enacted in its present form. By eliminating the benefits presently provided by the Internal Revenue Code, the incentives to investors investing in areas such as low-cost housing, urban renewal, railroad and airline modernization and other real and personal property development will be severely curtailed notwithstanding that much remains to be done in these areas. Indeed, it is no exaggeration to state that most of our major cities must be rebuilt.

It has been said that in the area of tax considerations, abuse of tax policy has occurred and, obviously, this is true. However, certain aspects, described below, of H.R. 13270 are excessive and not only would prohibit needed investment in real and personal property transactions, but also would devalue investments already made in reliance upon existing tax laws. Elimination of those aspects of H.R. 13270 which are excessive will not permit the abuses of tax policy to continue, since other provisions of H.R. 13270 (such as the provision relating to limitation on tax preferences) deal directly and adequately with them.

The aspects of H.R. 13270 which are objectionable are as follows:

1. The proposed limitation on interest expense deductions (Section 221) will seriously curtail the sound development of essential real estate projects and the modernization of plant and equipment (i) by materially reducing net lease transactions, and (ii) by materially reducing the ability of individual investors to join together in partnership for the purpose of investing in such projects and modernization.

2. The proposed allocation of deductions provision (Section 302) will disallow, in part, among other deductions, those otherwise allowable in respect of charitable contributions, state and local taxes, medical expenses and certain interest expenses. Such disallowance of deductions will be in proportion to accelerated depreciation and other so-called "perferences" (including, in the case of the Administration proposal, net construction expenses), and will thereby depress the value of present investments in equipment and real estate and render such investments made in the future impossible of evaluation.

3. The proposed effective date provisions in the bill, will, if enacted, devalue existing investments in personal and real property, a retroactive result we consider unfair, and bound to destroy confidence in any future tax incentive measures.

In addition to the foregoing objections, the proposals to extend to real estate certain stringent recapture rules and to reduce allowable rates of accelerated depreciation (Sections 521(a) and 521(b)), will result in a reduction of yields to investors on their present investments in real estate. Similarly, such proposals will deter future investments in real estate, unless reduced yields are maintained through a significant increase in rentals payable by lessees of the real estate.

The attached memoranda discuss, in detail, the aspects of H.R. 13270 described in paragraphs 1 and 2 above and illustrate the serious extent to which the provisions of H.R. 13270 will reduce investment incentives, thereby requiring either a significant increase in rents (and other charges payable by lessees and other users of real and personal property), at the consumer's ultimate expense, or a flight of capital to investments in which lower yields are justified by greater security. If the aspects of H.R. 13270 discussed in paragraphs 1 and 2 above are enacted into law, there will be significant reductions in the yields to taxpayers investing in real estate and equipment transactions, including typical federally assisted low-income housing projects, railroad net leasing transactions for the replacement of rolling stock and real estate net leased to the Post Office Department. These reductions in yields will be even greater in the real estate area, if there is enacted into law the proposals to extend the recapture rules, referred to above, to real estate and to reduce allowable rates of depreciation. These reductions in yields will, no doubt, insure the necessity of further governmental intervention in the housing area.

It is obvious that, under existing tax laws, the private sector of our economy has brought about essential development and modernization of housing and real estate generally and in plant and equipment. While development and modernization must continue, if H.R. 13270 is enacted in its present form, the private sector will not be willing to continue its high level of investment in these areas. If such level of investment is not maintained, pressures for governmental subsidies and special incentives will build. Such subsidies and special incentives should, and can be, avoided, particularly when other adequate and acceptable proposals in H.R. 13270 deal with existing tax abuses.

MEMORANDUM

Limitations of Interest Deductions Application of Provision

Section 221 of H.R. 13270, the pending tax reform bill, amends Sections 163 and 1202 of the Internal Revenue Code by limiting the deduction of interest expense paid or incurred on indebtedness incurred or continued to purchase or carry property held for investment.

The bill provides that the allowable deduction for "investment interest" in the case of taxpayers other than corporations shall not exceed the sum of:

A. $25,000 ($12,500 in the case of a separate return by a married individual),

B. The taxpayer's investment income, and

C. An amount equal to the amount by which the net long-term capital gain exceeds the net short-term capital loss for the taxable year.

Investment interest disallowed in any year can be carried over and applied against investment income and the amount referred to in paragraph C above in succeeding taxable years.

OBJECTIONS

We believe that Section 221 of H.R. 13270 is discriminatory, lacking in fairness and would restrict and discourage needed investment in real and personal property, for the following reasons:

1. This Section discriminates against non-corporate taxpayers. For example, it would not apply to corporations.

2. This Section effectively prevents the use of the partnership form by individuals in order to invest in real and personal property. Individuals would be allowed to deduct investment interest of up to $25,000 against other income. However, if a group of individuals formed a partnership or syndicate for investment, then, as members of a "partnership," the $25,000 deduction against other income would have to be divided among them.

3. This Section favors wealthy investors with substantial investment income to the disadvantage of moderate investors with earned income.

4. This Section will drastically reduce the rate of return to individual investors in net leasing arrangements.

5. In future transactions this Section could result in costly and inefficient operations at the expense of the operator, user or tenant of leased property.

DISCUSSION

1. This Section discriminates against individual taxpayers and in favor of corporate taxpayers (in particular, commercial banking institutions), since corporations are not subject to the limitations contained in this Section. As a result, this Section will have the effect of encouraging commercial banks to invest equity capital in net lease equipment transactions, with the further result that capital that could be made available by commercial banks for short-term loans will be diminished. This should not be encouraged, since commercial banks are the primary and the traditional source of short-term moneys. To the extent that this provision favors commercial banks, as discussed above, it would also favor equipment lease transactions, as opposed to real estate transactions, since banks are, for the most part, limited by statute to the making of equity investments in equipment and are not allowed to invest equity capital in real estate.

2. Since this Section treats partnerships the same as individuals, in that the investment interest which can be deducted against other income to the extent of $25,000 must be divided among all of the partners in a venture, the most effective means for developing real estate and modernizing plant and equipment will be effectively curtailed. Typically, in the development of a housing project, a commercial real estate development or the leasing of substantial amounts of personal property, a group of individuals joining together will acquire the equity interest in the property to be leased. If the $25,000 limitation with respect to other income is to apply at the partnership level, and is thus to be allocated among a group of individual partners, it is expected that such persons simply will not enter into such transactions.

3. Individuals, or a partnership of individuals, with moderate investment income in combination with earned income would be deprived of the tax benefits from the type of investments discussed herein. Nevertheless, wealthy individuals with substantial investment income would not be so curtailed, since they could effectively insulate this income from taxation by incurring investment interest and would not be concerned with the provisions limiting the deduction of such investment interest against earned income.

4. Enactment of this Section can significantly reduce the rates of return on investments made by taxpayers both in the 50% and 65% brackets. This is an undesirable result, since it must follow that rents and the attendant consumer costs will be increased or there will be a flight of equity to capital to investments, the yield on which is commensurate with the risks involved.

5. Customarily, in the type of transactions discussed herein, investors lease property to a lessee on a "net lease" basis; that is, the lessee assumes the obligations to pay all expenses pertaining to the property, such as utility costs, property taxes and maintenance costs. The rent payable to the investors is net of all of these items, and out of such rent, the investors pay interest on the indebtedness incurred by the investors in order to purchase the property and amortization of the principal of such indebtedness. It has been found that such net lease arrangements are, as a matter of sound business judgment, well-suited to the needs of investors, lessees and institutional lenders, since, in most cases, lessees are more efficient than investors in controlling such expenses, and institutional lenders have more security by reason of lessees being responsible for such expenses. As a result, economies can usually be achieved by making lessees responsible for these expenses, including lower financing costs (i.e., interest rates). Since Section 221 will severely curtail investment in net lease transactions, it can be expected that there will be substantial increases in rents payable by lessees, which will ultimately be borne by the consumer, whether the consumer be the operator of the property, the user of the equipment, or the tenant in a housing project.

Allocation of Deductions, Application of Provision

Section 302 of H.R. 13270 will require an individual to allocate his personal deductions between taxable income and tax-free and tax-preference items.

The personal deductions which will have to be allocated include interest expense and state and local taxes unless, in each case, they constitute trade or business expenses, theft and casualty losses, charitable contributions and medical expenses.

The tax preference items taken into account are:

(1) Tax-exempt interest on state and local bonds issued after July 12, 1969,

(2) The excluded one-half of long-term capital gains,

(3) Appreciation in property contributed for charitable purposes.

(4) Excess of accelerated over straight-line depreciation claimed on real property,

(5) Excess farm losses, and

(6) 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.

The Administration would modify the above rules as follows:

(1) All interest on state and local bonds would be included as a tax-preference item,

(2) The appreciation in property contributed to charity would be eliminated as a tax-preference item,

(3) Accelerated depreciation in excess of straightline depreciation on personal property taken by a lessor of property subject to a net lease would be added as a tax-preference item,

(4) Net expenses incurred during the period of construction of improvements on real property would be added as a tax-preference item, and

(5) Rapid amortization of rehabilitation expenditures for low-cost housing would be added as a tax-preference item.

OBJECTIONS

The stated purpose of Section 302 of H.R. 13270 is to require taxpayers to allocate personal deductions between taxable and non-taxable income. Those expenses allocable to non-taxable income will not be deductible. We believe that the bill clearly exceeds this stated purpose and is objectionable for the following reasons:

(1) So-called investment interest is not a personal expense,

(2) Accelerated depreciation is not a non-taxed item or an item that escapes taxation, and

(3) Construction expense represents a cash outlay and is in no sense a tax preference.

DISCUSSION

The result of enacting the provisions referred to above will be to devalue existing investments and make it uneconomical for individuals to invest in further projects involving real and personal property. Substantial reductions in yields, resulting from the enactment of Section 302, to taxpayers can be expected in real estate and equipment transactions, including (i) federally assisted low-income housing projects (FHA 236), (ii) railroad net leasing transactions for the replacement of rolling stock and (iii) real estate net leased to the Federal Government.

Consistent with its purpose, this Section provides that interest or taxes paid or incurred in the conduct of a trade or business are excepted from the expenses subject to allocation, since they are clearly attributable to taxable income incurred to produce such income, and are not personal expenses. However, the bill also provides, in effect, that this exception will not apply to interest paid in a rental transaction, unless the business deductions thereof equal or exceed 15% of the rental income and the taxpayer has no guaranty of income or against loss. The result, therefore, is that interest paid in a so-called net lease transaction will be subject to allocation and partial disallowance under Section 302 of the bill. This result is unreasonable in that such interest is paid out of taxable rental income in excess of such interest, is incurred to produce such rental and is clearly not a personal expense.

Under the proposed Section 302, allowable deductions will be subject to allocation and partial disallowance, if the taxpayer has tax preferences, including accelerated depreciation (and under the Administration proposal, net construction expenses). The theory of the allocation of deductions is that certain types of income (e.g., appreciation in gifts of property to charity, the excluded portion of capital gains and tax-exempt interest) which are exempt from taxation could be utilized to pay a portion of the taxpayer's itemized deductions. To include accelerated depreciation as an item resulting in allocation of certain allowable deductions is objectionable in that depreciation is not an item of income that escapes taxation, but, rather, is actually an item of expense, which itself has been deferred from the time at which it arose, and even in the case where the depreciation taken proves to be too great, that amount is subject to tax at a future date upon sale of the property. This latter point will be particularly true if Section 1250 of the Internal Revenue Code is amended so as to cause 100% of the difference between accelerated and straight-line depreciation to be subject to recapture pursuant to the Administration proposal.

To include net deductible construction expenses as an item resulting in allocation of other deductions is objectionable in that the payment by a taxpayer, in cash, of construction expenses results in a net outflow of cash, and therefore, no actual sheltering of other income.

In addition, we object to this provision insofar as it would result in a disallowance of interest expense incurred in net lease arrangements for the reasons that it discriminates against individuals and in favor of corporations, drastically reduces the ability to do sound net lease transactions and renders the valuation of past and future investments impossible.

Therefore, this provision should be amended so as to eliminate interest expense incurred in a net lease transaction as an item subject to allocation. In addition, this provision should also be amended so as to eliminate accelerated depreciation and, should not be amended to include net construction expense, as items requiring the allocation of otherwise allowable deductions.

EXHIBIT A

	I.—Present law	II.—Proposed law
(1) Original investment	$100,000	$100,000
(2) Total net benefits or (detriments)	216,671	89,137
(3) (2) minus (1)	116,671	−10,863
(4) Rate of return (percent)	16.75	[1]

[1] Negative.

Schedule A-1

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	Total	Present Value	Rate of Return
I. Present Law																		
Annual Benefits and (Detriments)*	$ 24,880	$ 23,386	$ 21,926	$ 20,385	$ 18,787	$ 17,117	$ 15,368	$ 13,533	$ 11,604	$ 9,578	$ 7,432	$ 5,165	$ 2,769	$ 228	$ 24,611	$ 216,672	$	
Benefits deposited in Sinking Fund	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—		
Detriments paid from Sinking Fund	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—		
Net Benefit (Detriments)	24,880	23,386	21,926	20,385	18,787	17,117	15,368	13,533	11,604	9,578	7,432	5,165	2,769	228	24,611	216,672		16.73%
II. Proposed Law																		
Annual Benefits and (Detriments)*	19,078	18,018	16,876	15,682	14,389	13,051	11,602	10,102	8,486	6,762	4,922	2,995	849	(1,407)	(68,211)	73,174		
Benefits deposited in Sinking Fund						7,957	11,602	10,102	8,486	6,762	4,922	2,995	849			53,675	30,978	
Detriments paid from Sinking Fund														(1,407)	(68,211)	(69,618)	(30,978)	
Net Benefit (Detriments)	19,078	18,018	16,876	15,672	14,389	5,094	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-	89,137		

* Annual Benefits or (detriments) represent 65% of the decrease or (increase) in taxable income per schedule A-2 plus cash flow per schedule A-2.

Schedule [illegible]

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	If Basis is Adjusted for Disallowed Deductions
Investment																
Rental Income	$91,686	$91,686	$91,686	$91,686	$91,686	$91,686	$91,686	$91,686	$91,686	$91,686	$91,686	$91,686	$91,686	$91,686	$91,686	$91,686
Interest Expense	81,061	80,064	79,042	77,763	76,687	75,337	73,866	72,041	70,433	68,548	66,471	64,267	61,739	59,049	56,117	56,117
Depreciation	48,780	47,601	46,361	45,284	43,902	42,683	41,463	40,464	39,085	37,865	36,645	35,366	34,206	32,987	32,707	31,707
Net Profit or (Loss)	(38,155)	(35,979)	(33,717)	(31,361)	(28,903)	(26,334)	(23,643)	(20,819)	(17,832)	(14,727)	(11,430)	(7,947)	(4,259)	(350)	(3,881)	(3,801)
Other Gross Income	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000
Profit on Sale of Leased Property															299,355	219,266
Adjusted Gross Income (AGI)	111,845	114,021	116,283	118,639	121,097	123,666	126,357	129,181	132,168	135,273	138,570	142,053	145,741	149,650	445,474	365,465
Personal Deductions	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000
Taxable Income (present law)(A)	61,845	64,021	66,283	68,639	71,097	73,666	76,357	79,181	82,168	85,273	88,570	92,053	95,741	99,650	395,474	315,465
Disallowed Deductions (no Capital Gains)	8,764	8,259	7,753	7,252	6,751	6,255	5,764	5,277	4,797	4,324	3,858	3,400	2,952	2,515	2,089	2,089
Taxable Income (proposed law)(B)	70,609	72,280	74,036	75,890	77,848	79,921	82,121	84,458	86,965	89,597	92,428	95,453	98,693	102,165	397,563	317,554
Disallowed Deductions (if taxpayer has $25,000 Capital Gain in AGI)																
(a) Deductions Disallowed Because of Accelerated Depreciation																
(b) Interest Disallowed Because of Capital Gain																
(c) Other Deductions Disallowed Because of Capital Gain																
Total Disallowed																
Taxable Income of Capital Gains Taxpayer (proposed law)(C)																
Taxable Income Without Leasing Investment (present law)(D)	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Increase or (Decrease) in Taxable Income from Leasing Transaction																
I Present Law (A-D)	(38,155)	(35,979)	(33,717)	(31,361)	(28,903)	(26,334)	(23,643)	(20,819)	(17,832)	(14,727)	(11,430)	(7,947)	(4,259)	(350)	295,474	215,465
II Proposed Law (B-D)	(29,391)	(27,720)	(25,964)	(24,110)	(22,152)	(20,079)	(17,879)	(15,542)	(13,035)	(10,403)	(7,572)	(4,547)	(1,307)	2,165	297,563	217,554
III Proposed Law (Capital Gains Taxpayer)																
(1) Overall (C-D)																
Less (2) Deductions Disallowed Unrelated to Leasing Transaction (d)																
Net Increase or (Decrease)																
Cash Flow from Investment																

Exhibit A-1

	1	2	3	4	5	6	7	8	9	10	11	Total	Rate of Return
I. Investment													
Rental Income	$ 91,446	$ 91,446	$ 91,446	$ 91,446	$ 91,446	$ 91,446	$ 91,446	$ 91,446	$ 91,446	$ 91,446	$ 91,446		
Interest Expense	81,000	79,864	78,821	77,685	76,447	75,097	73,625	72,022	70,273	68,348	66,271		
Depreciation	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000	25,000		
Net Profit or (Loss)	(14,554)	(13,418)	(12,375)	(11,239)	(10,001)	(8,651)	(7,179)	(5,576)	(3,827)	(1,902)	175		
Other Gross Income	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000		
Profit on Sale of Leased Property											88,387		
Adjusted Gross Income (AGI)	135,446	136,582	137,625	138,761	139,999	141,349	142,821	144,424	146,173	148,098	238,562		
Personal Deductions	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000		
Taxable Income (present Law)(A)	85,446	86,582	87,625	88,761	89,999	91,349	92,821	94,424	96,173	98,098	188,562		
Taxable Income Without Leasing Investment (present Law)(B)	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000		
Increase or (Decrease) in Taxable Income from Leasing Transaction (A-B)	(14,554)	(13,418)	(12,375)	(11,239)	(10,001)	(8,651)	(7,179)	(5,576)	(3,827)	(1,902)	88,562		
II. Rate of Return Calculation													
Annual Benefits and (Detriments)*	9,393	8,722	8,044	7,305	6,500	5,623	4,667	3,624	2,488	1,236	77,797	$135,362	
Benefits deposited in Sinking Fund	-	-	-	-	-	-	-	-	-	-	-		
Detriments paid from Sinking Fund	-	-	-	-	-	-	-	-	-	-			
Net Benefits (Detriments)	9,393	8,722	8,044	7,305	6,500	5,623	4,667	3,624	2,488	1,236	77,797	135,362	4.26

* Annual Benefits or (Detriments) represent 65% of the decrease or (increase) in taxable income per Item I.

EXHIBIT B

	I	II	III	IV
	Present Law	Proposed Law	Proposed Law (Capital Gains Taxpayer)	Proposed Law (Capital Gains Taxpayer, with basis adjustment)
(1) Original Investment	$150,000	$150,000	$150,000	$150,000
(2) Total Net Benefits or (Detriments)	$332,625	$152,543	$ 83,039	$104,628
(3) (2) minus (1)	$182,625	$ 2,543	- $ 66,961	$ 45,372
(4) Rate of Return	11.54%	0.32%	Negative	Negative

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	Total	Present Value at 6%	Rate of Return
I. Present Law																						
Annual Benefits and (Detriments)*	$26,089	$25,085	$24,008	$22,934	$21,861	$20,732	$20,540	$18,305	$17,082	$15,639	$14,387	$12,742	$11,366	$ 9,581	$7,740	$5,876	$3,893	$1,785	$58,472	$332,485	—	
Benefits deposited in Sinking Fund																				—	—	
Detriments paid from Sinking Fund																				—	—	
Net Benefit (Detriment)	26,089	25,085	24,008	22,934	21,861	20,732	20,540	18,305	17,082	15,639	14,387	12,742	11,366	9,581	7,740	5,876	3,893	1,785	58,472	332,485	—	21.9%
II. Proposed Law																						
Annual Benefits and (Detriments)*	17,882	17,892	16,898	16,087	15,336	14,602	13,827	12,581	12,084	11,326	10,096	8,989	7,796	6,511	5,383	3,483	2,000	841	(49,395)	142,999	—	
Benefits deposited in Sinking Fund											(5,308)	(8,989)	(7,796)	(6,511)	(5,383)	(3,483)	(2,000)	(841)		(40,631)	23,634	
Detriments paid from Sinking Fund																			49,395	49,395	23,634	
Net Benefit (Detriment)	17,882	17,892	16,898	16,087	15,336	14,602	13,827	12,581	12,084	11,326	4,788	0	0	0	0	0	0	0	0	152,563		0.38%
III. Proposed Law (if Taxpayer has $ 75,000 Capital Gain in AMT)																						
Annual Benefits and (Detriments)*	13,544	12,939	12,344	11,694	11,020	10,287	9,520	8,704	7,836	6,911	5,984	4,867	3,734	2,536	1,207	(882)	(1,780)	(3,361)	(50,642)	67,132	—	
Benefits deposited in Sinking Fund								(7,082)	(7,836)	(6,911)	(5,984)	(4,867)	(3,734)	(2,536)	(1,207)					(40,157)	26,795	
Detriments paid from Sinking Fund																882	1,780	3,361	50,642	56,665	26,795	
Net Benefit (Detriment)	13,544	12,939	12,344	11,694	11,020	10,287	9,520	1,622												82,970	—	—
IV. Proposed Law (if Taxpayer has $75,000 Capital Gain) (with Administration Basis adjustment)																						
Annual Benefits and (Detriments)*	13,544	12,979	12,344	11,694	11,020	10,287	9,520	8,704	7,836	6,911	5,984	4,867	3,734	2,536	1,207	(882)	(1,780)	(3,361)	(18,466)	99,308	—	
Benefits deposited in Sinking Fund										(180)	(5,984)	(4,867)	(3,734)	(2,536)	(1,207)					(18,508)	11,463	
Detriments paid from Sinking Fund																882	1,780	3,361	18,466	24,489	11,463	
Net Benefit (Detriment)	13,544	12,979	12,344	11,694	11,020	10,287	9,520	8,704	7,836	6,731										104,659	—	—

* Annual Benefits or (detriments) represent 67% of the decrease or (increase) in taxable income per schedule B-2 plus cash flow per schedule B-2.

Schedule B-2

	1	2	3	4	5	6	7	8	9	10
Investment	$86,692	$86,692	$86,692	$86,692	$86,692	$86,692	$86,692	$86,692	$86,692	$86,692
Rental Income	76,305	75,757	75,158	74,503	73,788	73,005	72,150	71,215	70,194	69,079
Interest Expense	43,478	42,512	41,546	40,580	39,614	38,647	37,681	36,715	35,749	34,783
Depreciation										
Net Profit or (Loss)	(33,091)	(32,777)	(30,012)	(28,391)	(26,720)	(24,960)	(23,139)	(21,238)	(19,251)	(17,168)
Other Gross Income	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000
Profit on Sale of Leased Property										
Adjusted Gross Income (AGI)	116,909	118,423	119,988	121,609	123,290	125,040	126,861	128,762	130,749	132,832
Personal Deductions	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000
Taxable Income (present Law)(A)	66,909	68,423	69,988	71,609	73,290	75,040	76,861	78,762	80,749	82,832
Disallowed Deductions (Capital Gains)	12,518	11,897	11,277	10,657	10,038	9,420	8,805	8,191	7,581	6,974
Additional Gain from Recapture										
Taxable Income (proposed Law)(B)	79,427	80,320	81,265	82,266	83,328	84,460	85,666	86,955	88,330	89,806
Disallowed Deductions (if taxpayer has no Capital Gain in AGI)										
(a) Deductions Disallowed Because of Accelerated Depreciation	11,212	10,654	10,099	9,5[illegible]	8,998	8,456	7,886	7,333	6,789	6,247
(b) Interest Disallowed Because of Capital Gain	7,965	7,909	7,846	7,77[illegible]	7,702	7,622	7,532	7,4[illegible]	7,389	7,2[illegible]
(c) Other Deductions Disallowed	5,220	5,220	5,220	5,220	5,220	5,220	5,220	5,220	5,220	5,220
(d) Recapture of Capital Gain Deductions Disallowed from Sale Gain										
Total Disallowed	24,397	23,783	23,165	22,5[illegible]	21,943	21,278	20,637	19,990	19,338	18,678
Additional Gain from Recapture										
Taxable Income of Capital Gains Taxpayer (proposed Law)(C)	92,306	92,206	93,153	94,1[illegible]	95,205	96,318	97,498	98,752	100,087	101,510
Taxable Income Without Leasing Investment (present Law)(D)	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Increase or (Decrease) in Taxable Income from Leasing Transaction										
1) Present Law (A-D)	(33,091)	(31,577)	(30,012)	(28,391)	(26,720)	(24,960)	(23,139)	(21,238)	(19,251)	(17,168)
2) Proposed Law (B-D)	(20,573)	(19,600)	(18,735)	(17,734)	(16,672)	(15,540)	(14,334)	(13,047)	(11,670)	(10,194)
3) Proposed Law (Capital Gains Taxpayer)										
(1) Overall (C-D)	(8,694)	(7,794)	(6,847)	(5,840)	(4,797)	(3,682)	(2,502)	(1,248)	87	1,510
(2) Deductions Disallowed Unrelated to Leasing Transaction (c)	5,220	5,220	5,220	5,220	5,220	5,220	5,220	5,220	5,220	5,220
Net Increase or (Decrease)	(13,914)	(13,014)	(12,067)	(11,0[illegible])	(10,017)	(8,902)	(7,722)	(6,468)	(5,133)	(3,710)
Cash Invested in Investment	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500

	11	12	13	14	15	16	17	18	19	19 If Basis is Adjusted for Disallowed Deductions
Investment	$86,692	$86,692	$85,692	86,697	$86,692	$86,692	$86,692	$86,692	$86,692	$86,692
Rental Income	67,856	66,522	65,063	43,465	61,726	59,881	57,730	55,462	52,976	52,976
Interest Expense	33,816	32,850	31,884	30,918	29,952	28,986	28,019	27,053	26,057	26,077
Depreciation										
Net Profit or (Loss)	(14,980)	(12,600)	(10,295)	(7,695)	(4,986)	(2,115)	935	4,177	7,661	7,661
Other Gross Income	150,000	150,000	150,000	20,300	150,000	150,000	150,000	150,000	150,000	150,000
Profit on Sale of Leased Property									190,487	190,487
Adjusted Gross Income (AGI)	135,020	137,320	139,745	142,305	145,014	147,885	150,935	154,177	348,148	348,148
Personal Deductions	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000
Taxable Income (present Law)(A)	85,020	87,320	89,745	[illegible]	95,014	97,885	100,935	104,177	298,148	298,148
Disallowed Deductions (Capital Gains)	6,371	5,774	5,184	4,6[illegible]	4,086	3,463	2,912	2,375	12,970	1,909
Additional Gain from Recapture									119,386	98,908
Taxable Income (proposed Law)(B)	91,391	93,094	94,929	96,9[illegible]	[illegible]	101,348	103,847	106,552	430,444	332,965
Disallowed Deductions (if taxpayer has no Capital Gain in AGI)										
(a) Deductions Disallowed Because of Accelerated Depreciation	5,705	5,171	4,643	4,1[illegible]	[illegible]	3,101	2,607	2,127	637	707
(b) Interest Disallowed Because of Capital Gain	7,084	6,944	6,791	6,6[illegible]	[illegible]	6,465	6,088	5,750	2,134	2,692
(c) Other Deductions Disallowed	5,220	5,220	5,220	5,220	[illegible]	5,220	5,220	5,220	2,015	2,492
(d) Recapture of Capital Gain Deductions Disallowed from Sale Gain									11,810	2,404
Total Disallowed	18,009	17,335	16,654	[illegible]	[illegible]	14,966	14,207	13,137	16,596	8,323
Additional Gain from Recapture									119,386	[illegible]
Taxable Income of Capital Gains Taxpayer (proposed Law)(C)	103,029	104,655	106,399	[illegible]	[illegible]	112,451	114,790	117,314	434,070	366,342
Taxable Income Without Leasing Investment (present Law)(D)	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Increase or (Decrease) in Taxable Income from Leasing Transaction										
1) Present Law (A-D)	(14,980)	(12,600)	(10,295)	(7,695)	(4,906)	(2,115)	935	4,177	198,148	198,148
2) Proposed Law (B-D)	(8,609)	(6,906)	(5,071)	(3,095)	[illegible]560)	1,348	3,847	6,552	330,444	232,965
3) Proposed Law (Capital Gains Taxpayer)										
(1) Overall (C-D)	3,029	4,655	6,399	[illegible],272	[illegible]	12,451	14,790	17,314	334,070	266,342
(2) Deductions Disallowed Unrelated to Leasing Transaction (c)	5,220	5,220	5,220	5,220	5,220	5,220	5,220	5,220	2,015	2,492
Net Increase or (Decrease)	(2,191)	(565)	1,179	3,052	565	7,231	9,570	12,094	332,055	268,833
Cash Invested in Investment	4,500	4,500	4,500	4,500	4,500	4,500	4,500	4,500	154,500	154,500

EXHIBIT C

		I	II	III
		Present Law	Proposed Law	Proposed Law (Capital Gains Taxpayer)
(1)	Original Investment	$ 50,000	$ 50,000	$ 50,000
(2)	Total Net Benefits or Detriments)	$ 89,164	$ 89,164	$ 43,443
(3)	(2) minus (1)	$ 39,164	$ 39,164	- $ 6,557
(4)	Rate of Return	5.07%	5.07%	Negative

Schedule C-1

		1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	Total	Present Value at 4%	Rate
I. Present Law																							
Annual Benefits and (Detriments)*		$ 3,936	$ 3,852	$ 3,760	$ 3,661	$ 3,551	$ 3,432	$ 3,301	$ 3,158	$ 3,002	$ 2,831	2,644	$ 2,440	$ 2,217	$ 1,973	$ 1,707	$ 1,415	$ 1,097	$ 749	$40,439	$89,164		
Benefits deposited in Sinking Fund		—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—		
Detriments paid from Sinking Fund		—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—		
Net Benefit (Detriments)		3,936	3,852	3,760	3,661	3,551	3,432	3,301	3,158	3,002	2,831	2,644	2,440	2,217	1,973	1,707	1,415	1,097	749	40,439	89,164		5.07%
II. Proposed Law																							
Annual Benefits and (Detriments)*	Same as Item I																						
Benefits deposited in Sinking Fund																							
Detriments paid from Sinking Fund																							
Net Benefit (Detriments)																							
III. Proposed Law (if Taxpayer has $ 50,000 Capital Gain in ASH)																							
Annual Benefits and (Detriments)*		1,251	2,437	1,115	1,040	954	863	762	650	551	400	296	99	(73)	(260)	(465)	(	(1,385)	(1,203)	37,831			
Benefits deposited in Sinking Fund							(197)	(762)	(650)	(551)	(400)	(296)	(99)										
Detriments paid from Sinking Fund														(73)	(260)	(465)	((	(1,385)	(1,203)				
Net Benefit (Detriments)		1,251	2,437	1,115	1,040	954	666													37,831	43,443		
IV. Proposed Law (if Taxpayer has $,000 Capital Gain) (with Administration Basis adjustment)	Not Applicable																						
Annual Benefits and (Detriments)*																							
Benefits deposited in Sinking Fund																							
Detriments paid from Sinking Fund																							
Net Benefit (Detriments)																							

* Annual Benefits or (detriments) represent 65% of the decrease or (increase) in taxable income per schedule C-2 plus cash flow per schedule C -2.

Schedule C-2

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19
Investment																			
Rental Income	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,839	$ 22,[illegible]
Interest Expense	17,954	17,845	17,684	17,550	17,362	17,177	16,976	16,756	16,516	16,253	15,966	15,652	15,309	14,934	14,544	14,076	13,586	13,050	[illegible]
Depreciation	5,556	5,556	5,556	5,556	5,556	5,556	5,556	5,556	5,556	5,556	5,556	5,556	5,556	5,556	5,556	5,556	5,556	5,556	[illegible]
Net Profit or (Loss)	(671)	(562)	(401)	(267)	(79)	106	307	527	767	1,030	1,317	1,631	1,974	2,349	2,739	3,207	3,697	4,233	4,818
Other Gross Income	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000
Profit on Sale of Leased Property	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	30,780
Adjusted Gross Income (AGI)	150,000	150,000	150,000	150,000	150,000	150,000	150,006	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	189,720
Personal Deductions	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Taxable Income (present law)(A)	149,329	149,438	149,599	149,733	149,921	150,106	150,307	150,527	150,767	151,030	151,317	151,631	151,974	152,349	152,739	153,207	153,697	154,233	154,538
Disallowed Deductions (no Capital Gains)	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Taxable Income (proposed law)(B)	149,329	149,438	149,599	149,733	149,921	150,106	150,307	150,527	150,767	151,030	151,317	151,631	151,974	152,349	152,739	153,207	153,697	154,233	154,538
Disallowed Deductions (If taxpayer has $ 70,000 Capital Gain in AGI)																			
(a) Deductions Disallowed Because of Accelerated Depreciation	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
(b) Interest Disallowed Because of Capital Gain	4,131	4,122	4,069	4,053	3,995	3,952	3,906	3,859	3,801	3,740	3,674	3,602	3,523	3,436	3,362	3,239	3,726	3,003	4,935
(c) Other Deductions Disallowed Because of Capital Gain	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Total Disallowed	4,131	4,122	4,069	4,053	3,995	3,952	3,906	3,859	3,801	3,740	3,674	3,602	3,523	3,436	3,362	3,239	3,726	3,003	4,935
Taxable Income of Capital Gains Taxpayer (proposed law)(C)	153,460	153,560	153,668	153,786	153,916	154,058	154,213	154,386	154,568	154,770	154,991	155,233	155,497	155,785	156,101	156,446	157,423	157,236	159,473
Taxable Income Without Leasing Investment (present law)(D)	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000
Increase or (Decrease) in Taxable Income from Leasing Transaction																			
I Present Law (A-D)	(671)	(562)	(401)	(267)	(79)	106	307	527	767	1,030	1,317	1,631	1,974	2,349	2,739	3,207	3,697	4,233	4,818
II Proposed Law (B-D)	(671)	(562)	(401)	(267)	(79)	106	307	527	767	1,030	1,317	1,631	1,974	2,349	2,739	3,207	3,697	4,233	4,538
III Proposed Law (Capital Gains Taxpayer)																			
(1) Overall (C-D)	3,460	3,560	3,668	3,786	3,916	4,058	4,213	4,386	4,568	4,770	4,991	5,233	5,497	5,785	6,101	6,446	7,423	7,236	9,473
Less (2) Deductions Disallowed Unrelated to Leasing Transaction (c)	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—	—
Net Increase or (Decrease)	3,460	3,560	3,668	3,786	3,916	4,058	4,213	4,386	4,568	4,770	4,991	5,233	5,497	5,785	6,101	6,446	7,423	7,236	9,473
Cash Flow from Investment	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500	3,500

EXHIBIT D

		I	II	III	IV
		Present Law	Proposed Law	Proposed Law (Capital Gains Taxpayer)	Proposed Law (Capital Gains Taxpayer, with basis adjustment)
(1)	Original Investment	$ 49,500	$ 49,500	$ 49,500	$ 49,500
(2)	Total Net Benefits or (Detriments)	$ 62,480	$ 42,911	$ 29,318	$ 46,086
(3)	(2) minus (1)	$ 12,920	-$ 6,589	- $ 20,172	- $ 3,414
(4)	Rate of Return	12.97%	Negative	Negative	Negative

Schedule D-1

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	Total	Present Value at 6%	Rate of Return
I. Present Law																						
Annual Benefits and (Detriments)*	$19,270	$17,143	$14,970	$12,745	$10,467	$8,187	$5,722	$3,245	$690	($1,951)	($4,686)	($7,228)	($10,469)	($13,539)	($984)							
Benefits deposited in Sinking Fund				(1,648)	(10,467)	(8,187)	(5,722)	(3,245)	(690)											$33,428	--	
Detriments paid from Sinking Fund										1,951	4,686	7,228	10,469	13,539	984					(29,899)	23,885	
Net Benefit (Detriments)	19,270	17,143	14,970	11,097																39,151	23,885	
II. Proposed Law																				62,480	--	12.97%
Annual Benefits and (Detriments)*	$24,182	$18,848	$11,427	$9,940	$8,383	$6,707	$5,054	$3,845	$690	($1,951)	($4,686)	($7,522)	($10,469)	($13,539)	($984)							
Benefits deposited in Sinking Fund				(5,456)	(8,383)	(6,707)	(5,054)	(3,845)	(690)											$33,365		
Detriments paid from Sinking Fund										1,951	4,686	7,522	10,469	13,539	984					(29,605)	23,885	
Net Benefit (Detriments)	24,182	18,848	11,427	4,484																39,151	23,885	
III. Proposed Law (if Taxpayer has $ 25,000 Capital Gain in AGI)																				42,911		
Annual Benefits and (Detriments)*	$12,918	$11,327	$10,087	$8,591	$7,033	$5,408	$3,707	$1,922	($492)	($2,986)	($5,564)	($8,235)	($11,008)	($13,894)	($1,113)							
Benefits deposited in Sinking Fund			(5,214)	(8,591)	(7,033)	(5,408)	(3,707)	(1,922)												$27,901		
Detriments paid from Sinking Fund									492	2,986	5,564	8,235	11,008	13,894	1,113					(32,873)	26,576	
Net Benefit (Detriments)	12,918	11,327	4,873																	43,892	26,576	
IV. Proposed Law (if Taxpayer has $ 25,000 Capital Gain) (with Administration Basis adjustment)																				29,318		
Annual Benefits and (Detriments)*	$12,918	$11,327	$10,087	$8,591	$7,033	$5,408	$3,707	$1,922	($492)	($2,986)	($5,564)	($8,235)	($11,008)	($13,894)	$16,078)							
Benefits deposited in Sinking Fund			(4,524)	8,591	(7,033)	(5,408)	(3,707)	(1,922)												$35,098		
Detriments paid from Sinking Fund									492	2,986	5,564	8,235	11,008	13,894						32,185	25,954	
Net Benefit (Detriments)	12,918	11,327	5,563																	40,179	25,954	
															16,078					46,086		

* Annual Benefits or (detriments) represent 65% of the decrease or (increase) in taxable income per schedule D-2 plus cash flow per schedule D-2.

Schedule D-7

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	a/ If Basis Is Adjusted for Disallowed Deductions
Investment																
Rental Income	$31,769	$31,769	$31,769	$31,769	$31,769	$31,769	$31,769	$31,769	$31,769	$31,769	$31,769	$31,769	$31,769	$31,769	$31,769	$31,769
Interest Expense	22,360	21,587	20,744	19,822	18,816	17,717	16,517	15,206	13,775	12,212	10,505	8,642	6,607	4,384	1,970	1,970
Depreciation	37,500	35,000	32,500	30,000	27,500	25,000	22,500	20,000	17,500	15,000	12,500	10,000	7,500	5,000	2,500	2,500
Net Profit or (Loss)	(28,091)	(24,818)	(21,475)	(18,053)	(14,547)	(10,948)	(7,248)	(3,437)	494	4,557	8,764	13,127	17,662	22,385	27,299	27,299
Other Gross Income	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000	150,000
Profit on Sale of Leased Property															45,000	45,000
Adjusted Gross Income (AGI)	121,909	125,182	128,525	131,947	135,453	139,052	142,752	146,563	150,494	154,557	158,764	163,127	167,662	172,385	222,299	222,299
Personal Deductions	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000	50,000
Taxable Income (present Law)(A)	71,909	75,182	78,525	81,947	85,453	89,052	92,752	96,563	100,494	104,557	108,764	113,127	117,662	122,385	172,299	172,299
Disallowed Deductions (no Capital Gains)	7,828	6,638	5,466	4,316	3,190	2,092	1,028	-	-	-	-	-	-	-	-	(30,559)
Taxable Income (proposed Law)(B)	79,737	81,820	83,991	86,263	88,643	91,144	93,780	96,563	100,494	104,557	108,764	113,127	117,662	122,385	172,299	141,740
Disallowed Deductions (if taxpayer has $25,000 Capital Gain in AGI)																
(a) Deductions Disallowed Because of Accelerated Depreciation	6,780	5,730	4,735	3,738	2,753	1,813	890									(26,469)
(b) Interest Disallowed Because of Capital Gain	2,993	2,809	2,777	2,653	2,529	2,371	2,211	2,035	1,819	1,592	1,352	1,098	829	546	198	221
(c) Other Deductions Disallowed Because of Capital Gain	6,693	6,693	6,693	6,693	6,693	6,693	6,693	6,693	6,605	6,518	6,434	6,353	6,273	6,210	5,013	5,610
Total Disallowed	16,466	15,232	14,204	13,084	11,975	10,877	9,794	8,728	8,424	8,110	7,786	7,451	7,102	6,755	5,212	5,831
Taxable Income of Capital Gains Taxpayer (proposed Law)(C)	88,375	90,414	92,729	95,031	97,428	99,929	102,546	105,291	108,918	112,667	116,550	120,578	124,764	129,140	177,511	151,661
Taxable Income Without Leasing Investment (present Law)(D)	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000	100,000
Increase or (Decrease) in Taxable Income from Leasing Transaction																
I Present Law (A-D)	(28,091)	(24,818)	(21,475)	(18,053)	(14,547)	(10,948)	(7,248)	(3,437)	494	4,557	8,764	13,127	17,662	22,385	72,299	72,299
II Proposed Law (B-D)	(20,263)	(18,180)	(16,009)	(13,737)	(11,357)	(8,856)	(6,220)	(3,437)	494	4,557	8,764	13,127	17,662	22,385	72,299	41,740
III Proposed Law (Capital Gains Taxpayer)																
(1) Overall (C-D)	(11,625)	(9,586)	(7,271)	(4,969)	(2,572)	(71)	2,546	5,291	8,918	12,667	16,550	20,578	24,764	29,140	77,511	51,661
Less (2) Deductions Disallowed Unrelated to Leasing Transaction (c)	6,693	6,693	6,693	6,693	6,693	6,693	6,693	6,693	6,605	6,518	6,434	6,353	6,273	6,210	5,013	5,610
Net Increase or (Decrease)	(18,318)	(16,279)	(13,964)	(11,662)	(9,265)	(6,764)	(4,147)	(1,402)	2,313	6,149	10,116	14,225	18,491	22,930	72,498	46,051
Cash Flow from Investment	1,011	1,011	1,011	1,011	1,011	1,011	1,011	1,011	1,011	1,011	1,011	1,011	1,011	1,011	46,011	46,011