TAXATION OF INTEREST ON DEBT OBLIGATIONS ISSUED BY STATE AND LOCAL GOVERNMENTS AND ON WITHHOLDING FEDERAL INCOME TAX ON INTEREST AND DIVIDEND INCOME

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-FOURTH CONGRESS

SECOND SESSION

JUNE 7, 1976

Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE
73-744 WASHINGTON : 1976

34
S361-34

COMMITTEE ON FINANCE

RUSSELL B. LONG, Louisiana, *Chairman*

HERMAN E. TALMADGE, Georgia
VANCE HARTKE, Indiana
ABRAHAM RIBICOFF, Connecticut
HARRY F. BYRD, JR., Virginia
GAYLORD NELSON, Wisconsin
WALTER F. MONDALE, Minnesota
MIKE GRAVEL, Alaska
LLOYD BENTSEN, Texas
WILLIAM D. HATHAWAY, Maine
FLOYD K. HASKELL, Colorado
CARL T. CURTIS, Nebraska
PAUL J. FANNIN, Arizona
CLIFFORD P. HANSEN, Wyoming
ROBERT DOLE, Kansas
BOB PACKWOOD, Oregon
WILLIAM V. ROTH, JR., Delaware
BILL BROCK, Tennessee

MICHAEL STERN, *Staff Director*
DONALD V. MOOREHEAD, *Chief Minority Counsel*

CONTENTS

ADMINISTRATION WITNESSES

Page

Alexander, Hon. Donald, Commissioner, Internal Revenue Service 6

Gerard, Robert A., Assistant Secretary of the Treasury for Capital Markets and Debt Management 7

Goldstein, William M., Deputy Assistant Secretary of the Treasury for Tax Policy 1

PUBLIC WITNESSES

American Bankers Association, Donald C. Miller, executive vice president Continental Illinois Bank & Trust Co., Chicago, Ill., and Bert C. Madden, senior vice president, Trust Co. of Georgia, Atlanta, Ga., accompanied by Charles F. Haywood, professor of economics, University of Kentucky 96

American Life Insurance Association, Lawrence R. Brown, Jr 147

Blum, Andre, director of administration, city of Madison, Madison, Wis., accompanied by Michael S. Zarin, chief, finance division, law department, Port Authority of New York and New Jersey, and Donald W. Beatty, executive director, Municipal Finance Officers Association 54

Brooks, Edwin, Jr., president, Security Federal Savings and Loan Association 141

Brown, Lawrence R., Jr., representing the American Life Insurance Association 147

Cohen, Edwin S., accompanied by Robert L. Augenblick, president of the Investment Company Institute 108

Hallahan, William J., on behalf of the National Savings and Loan League 137

Kennedy, Hon. Edward M., a U.S. Senator from the State of Massachusetts 84

Miller, Donald C., executive vice president, Continental Illinois Bank & Trust Co., Chicago, Ill., and Bert C. Madden, senior vice president, Trust Co. of Georgia, Atlanta, Ga., accompanied by Charles F. Haywood, professor of economics, University of Kentucky, for the American Bankers Association 96

Municipal Finance Officers Association, Andre Blum, director of administration, city of Madison, Madison, Wis., accompanied by Michael S. Zarin, chief, finance division, law department, Port Authority of New York and New Jersey, and Donald W. Beatty, executive director, Municipal Finance Officers Association 54

National Association of State Auditors, Controllers and Treasurers, Grady L. Patterson, president and State treasurer of South Carolina 74

National Governors' Conference Center for Policy Research and Analysis, John E. Petersen, director 40

National Savings and Loan League, William J. Hallahan 137

Patterson, Grady L., Jr., State treasurer of South Carolina and president of the National Association of State Auditors, Controllers and Treasurers 74

Petersen, John E., director, National Governors' Conference Center for Policy Research and Analysis 40

Securities Industry Association, Wallace O. Sellers, chairman, public finance division, and vice president, Merrill, Lynch, Pierce, Fenner & Smith, Inc., New York, accompanied by David G. Taylor, Continental Illinois Bank, Chicago, and vice chairman, public finance division; Gedale Horowitz, Solomon Bros., New York; William R. Hough, William R. Hough Co., St. Petersburg, Fla., and cochairman, Municipal Federal Legislation Committee 58

	Page
Security Federal Savings and Loan Association, Edwin Brooks, Jr., president	141
Sellers, Wallace O., vice president, Merrill, Lynch, Pierce, Fenner & Smith, Inc., and chairman, Public Finance Division, SIA, accompanied by David G. Taylor, Continental Illinois Bank, Chicago, and vice chairman, Public Finance Division, SIA, Gedale Horowitz, Solomon Bros., New York; William R. Hough, William R. Hough Co., St. Petersburg, Fla., and cochairman, Municipal Federal Legislation Committee, SIA	58

COMMUNICATIONS

American Bar Association, Section on Taxation, Sherwin P. Simmons, chairman	187
American Insurance Association, Walter D. Vinyard, Jr., counsel	226
Birchby, Kenneth L., chairman, Committee on Taxation, National Association of Mutual Savings Banks	157
Machinery and Allied Products Institute, Charles W. Stewart, president	153
National Association of Mutual Savings Banks, Kenneth L. Birchby, chairman, Committee on Taxation	157
National Fraternal Congress of America of Chicago, Ill., represented by Webster, Kilcullen & Chamberlain	151
Prudential Insurance Co. of America	156
Reese, Thomas J., legislative director, Taxation With Representation	160
Simmons, Sherwin P., chairman, Section on Taxation, American Bar Association	187
Stewart, Charles W. president, Machinery and Allied Products Institute	153
Stockholders of America, Inc., Margaret Cox Sullivan, president	151
Sullivan, Margaret Cox, president, Stockholders of America, Inc	151
Taxation With Representation, Thomas J. Reese, legislative director	160
Vinyard, Walter D., counsel, American Insurance Association	226

TAXATION OF INTEREST ON DEBT OBLIGATIONS ISSUED BY STATE AND LOCAL GOVERNMENTS AND ON WITHHOLDING FEDERAL INCOME TAX ON INTEREST AND DIVIDEND INCOME

MONDAY, JUNE 7, 1976

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

The committee met at 10 a.m., pursuant to notice, in room 2221, Dirksen Senate Office Building, Hon. Russell B. Long (chairman of the committee) presiding.

Present: Senators Long, Ribicoff, Byrd, Gravel, Haskell, Curtis, Hansen, Packwood, and Brock.

Senator RIBICOFF. The committee will be in order.

During the Finance Committee markup session on the tax revision bill, two suggestions had been made for major measures to raise revenues. One of these suggestions is that interest on debt obligations issued by State and local governments will be subject to Federal tax.

Under the second suggestion, Federal income tax would be withheld on interest and dividend income. Since both of these proposals may be pursued either in committee or on the Senate floor in connection with the tax revision bill, we are holding hearings on both these measures today. These are important proposals. We have a long witness list and would, therefore, remind each organization that it will be limited to 10 minutes for all oral presentations.

Our first witnesses will be the Honorable Robert A. Gerard, Assistant Secretary of the Treasury for Capital Markets and Debt Management; and the Honorable William M. Goldstein, Deputy Assistant Secretary for the Treasury for Tax Policy; and Commissioner Donald Alexander.

The CHAIRMAN. Senator Ribicoff, I want to thank you for opening this hearing. We also have a health subcommittee hearing going on, as you know, on a matter involving State sovereignty with regard to the medicaid program. I appreciate you opening this hearing and we will be pleased to hear from these witnesses. Thank you very much.

STATEMENT OF WILLIAM M. GOLDSTEIN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY

Mr. GOLDSTEIN. Mr. Gerard does not seem to be here yet. If it would not inconvenience you, I guess I would like to start off talking about withholding on dividends and interest problems.

Mr. Chairman and members of the Finance Committee, my name is William M. Goldstein, and I appear before you today with Donald C. Alexander, the Commissioner of the Internal Revenue Service. Your committee has requested the Treasury Department to testify on the subject of imposing a withholding tax on dividends and interest.

I shall speak first, then Commissioner Alexander. Since there is no specific proposal before your committee, our remarks are intended to present to you the general considerations regarding both such a tax and alternative methods of achieving the same result.

As we understand it, your interest in this subject derives in part from the Commissioner's recent testimony before the Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Committee on Government Operations. There he described the extent to which the Internal Revenue Service uses forms 1099, on which are reported the payment of many items of interest and dividends.

At present there is no complete program for matching these forms against taxpayers' income tax returns, and thus it is possible to have undetected nonreporting of interest and dividends.

Also, your committee is not unmindful of the potential impact on the budget that imposition of a withholding tax might produce, both by extracting payment of presently unreported dividends and interest, and by accelerating the payment of tax on items which honest and careful taxpayers would report in any event.

We in the Treasury share your concern over the possibility that significant amounts of dividends and interest are not being reported. While our present estimate of the magnitude of such nonreporting is subject to considerable error, there may be as much as $1 billion of dividends and $7 billion of interest on which tax is potentially due.

The amount due would be in the order of $1.5 billion. Some major sources of unreported income include U.S. bearer obligations and "E" bonds, bearer obligations such as certificates of deposit issued by banks and other corporations, and loan transactions between private parties.

Although these figures are, I repeat, speculative and must be viewed in context—in 1976, we estimate that $81 billion of dividends and interest will be reported, on which a tax of $18.5 billion will be paid—they are nevertheless most disturbing.

They represent a nontrivial amount of revenue owed the Government. More important, it is an outrage that numbers of taxpayers are in this manner failing to pay their fair share of tax. Such conduct diminishes public respect for the operation of the tax system and could indeed jeopardize our voluntary system of compliance.

In formulating an appropriate legislative and/or administrative response to this problem, we must not lose sight of other goals of the tax system. Any new proposal must be efficient in terms of the total costs imposed on taxpayers, on payers of dividends and interest, and on the Government.

It must be fair; that is, we must do our best to avoid imposing unreasonable burdens on any particular groups of involved parties. Finally, although I sometimes wonder whether we are ever successful in this regard, the system should be as simple as possible.

With regard to withholding tax on dividends and interest, the notions of efficiency, fairness, and simplicity are not idle abstractions. In 1942, 1950, 1951, and 1962, the House of Representatives passed tax

measures imposing a withholding tax on dividends and/or interest. Each time the Senate refused to accept such a tax, largely out of regard for the principles of efficiency, fairness, and simplicity, and no withholding tax was enacted.

The next portion of my statement, Mr. Chairman, deals with the historical background of the 1962 legislation, first as proposed by President Kennedy, then as modified by the House, and finally as ultimately criticized and reversed. The Senate, as you know, instead expanded the required system for recording, most significantly reducing from $600 to $10 the annual amount of interest which would require an information return on it.

In an effort to move along, I am going to skip through the historical presentation. At the time the proposal was for a flat rate of 20 percent withholding, and it was recognized that this would produce both under- and over-withholding.

The original proposal had in it a system of quarterly refunds for individuals with gross income of less than $5,000, or $10,000 in the case of a joint return, and also for tax-exempt organizations.

In the House, they added a provision for exemption certificates for individuals who could expect to pay no tax at all or who would certify they expected to pay no tax, and also for tax-exempt organizations. But even these were not complete.

They had exceptions within them, because it was not thought that in the case of certain types of securities there had to be withholding in all events.

So much for history, although I think the history itself and the considerations which caused this committee and the Senate to reject withholding are relevant and must be considered in context.

Our department and your committee today and in the ensuing months must now determine the relevance of this history in view of the substantial technological advances of the last 14 years and our increased sophistication both as to the practical limits of this technology, even after these advances have been made.

Before presenting to you our current thinking, I want to make clear what I say should not be taken as a definitive Treasury position. Because of our heavy commitment to work with you and your staff on the comprehensive tax reform legislation now before your committee and because of the short notice of your desire to hear testimony on withholding, we have by no means been able to devote to this subject the research and considered thinking it deserves.

The remarks which follow can thus be fairly characterized as tentative observations.

There are serious problems with exclusive reliance on matching information returns with taxpayers' income tax returns. If you desire, the Commissioner can explain these in greater detail. Briefly, there is first the substantial job of doing the matching.

Second, where a mismatch is detected, it is necessary to determine if the mismatch is justified or improper. For example, a person whose income is less than the sum of the personal exemptions to which he is entitled plus the low income allowance is not generally required to file a return.

Another situation involves a person who buys a bond between two interest payment dates; he will be shown on a form 1099 as having

been paid the full amount of the second of these interest payments, but only his allocable share of this amount is taxable to him as interest.

Third, even where an improper mismatch is discovered, it is still necessary actually to assess and collect the tax. In most cases, this would be a time-consuming and expensive process in relation to the amount of tax involved.

In contrast, withholding might prove to be a cost-efficient means of collecting tax on dividends and interest. One problem faced in 1962 would probably no longer be a problem—the furnishing to recipients of dividends and interest withholding receipts showing the gross amount paid and the amount withheld.

We believe that the technology exists to do this, even on a payment-by-payment basis, as well as on an annual basis with a revised form 1099, although we have not yet had the opportunity to fully explore the cost to payers of such a system.

These receipts would eliminate much confusion for recipients and would also potentially provide a way for the Service to verify the accuracy of the returns.

Withholding can also be expected to have its share of disadvantages. One relatively minor item would be its adverse impact on certain automatic investment arrangements such as bank certificates of deposit and mutual fund dividend reinvestment plans.

The income derived from such activities is, of course, taxable; but by paying the tax out of other funds, the individual can at present take advantage of the very low transaction costs involved when earnings are left in the hands of the business enterprise.

Of much greater concern is whether we can satisfactorily deal with the problem which ultimately defeated the 1962 legislation, overwithholding. It can be seen on the first table in the appendix, describing the 1973 individual income tax returns which reported dividend and/or interest income, that there were some 5 million returns which were nontaxable.

Obviously there were also many other individuals who received dividends and/or interest but who were not even required and had no need to file returns. Moreover, millions of additional individuals who received dividends and/or interest and who did owe tax had a much lower effective rate than 16⅔ percent or 20 percent.

Finally, of course, there are thousands of completely tax-exempt organizations with this type of income: Charities, pension plans, State governments, and so on.

The quarterly refund procedure in the 1962 House bill lacks appeal. If overwithholding is to be alleviated—and I remind you that the degree of hardship imposed is subject to debate—a broader program of exemption certificates might be the answer. However, the more expansive such a program becomes, covering not only tax-exempt organizations, but also individuals who expect to pay no tax, or who expect otherwise to pay enough estimated tax to avoid any civil penalties, et cetera, the more such a program raises the same type of enforcement problems as a system based upon matching.

There would have to be some type of policing; and once again, small improprieties will be relatively expensive to correct. Also, in order to make the program function properly, it may well be neces-

sary, in connection with implementing withholding, to update and revise our estimated tax system.

A third problem with withholding relates to bearer instruments, including those issued by the United States. It has been suggested that we have across-the-board withholding on them. It is likely that certain holders of those obligations, such as tax-exempt organizations, could avoid any complication merely by registering their securities.

However, for the majority of holders, withholding might adversely impact upon the usefulness and marketability of those important debt instruments.

I would now like to turn to an aspect of withholding which is of considerable, immediate interest to your committee, that is its revenue impact. Members of the Treasury staff, the Internal Revenue Service, and the Joint Committee staff have consulted with each other and produced estimates of the effect which a withholding system, if timely implemented, could have in fiscal year 1977 and subsequent years.

These estimates are included in the appendix to this statement. At this point, however, we do not believe that this system could be put in place in time to have any significant revenue impact in fiscal year 1977.

Before any withholding system can be implemented, Congress must determine the optimal combination of macthing and withholding—or, alternatively, adopt an even better solution which has not yet been explored. Even if we could, today, agree upon the broad outlines of a withholding system, you would have to draft legislation dealing with a myriad of technical dilemmas, some of which I previously mentioned and some of which are shown in the discussion of the 1962 legislation, some of which I dare say the other witnesses will tell you about in the course of the day.

I note that the 1962 House bill section on withholding was almost 50 pages long and was accompanied by a 30-page technical explanation.

Under any withholding system, all payers of dividends and interest would have to develop procedures for withholding, reporting, and remitting ~~the~~ money, and/or the information involved. In addition, it should be noted that many payers which do not now issue form 1099 and have no system for doing so would be required to address those problems for the first time.

There are additional problems if an exemption certificate procedure is adopted. How many of us have any idea of the names, much less the addresses, of the paying agents of our dividends and interest? The payers would have to assimilate the information on the exemption certificates, a fair portion of which is likely to be incorrect, and modify their withholding systems accordingly. We just do not see how all of these tasks could be carried out by the Government, the recipients and the payers in the next 6 months.

In conclusion, I want to repeat that we are concerned about the problem of nonreporting of dividends and interest, and we are determined to do something about it. Once the current legislative effort is concluded, we will carefully examine the various proposed solutions in terms of efficiency, fairness, simplicity, and cost to all concerned.

We would greatly appreciate the opportunity to come back to your committee with a comprehensive proposal on this important subject within a few months.

Thank you, Mr. Chairman.

The CHAIRMAN. I think we ought to hear next from Mr. Alexander, since he will address the same subject as Mr. Goldstein.

STATEMENT OF DONALD ALEXANDER, COMMISSIONER, INTERNAL REVENUE SERVICE

Mr. ALEXANDER. I don't have any formal statement or prepared statement.

On April 12 this year I testified before Chairman Rosenthal's subcommittee on the House side about our document matching program. I said then, and I would like to repeat this morning, that our document macthing program as it has been carried since 1962 and as it presumably will be carried out in the foreseeable future is no substitute for withholding on interest and dividends.

In 1962 when this committee did not accept the House provisions that Mr. Goldstein referred to, it stated its expectations that there would be a full document matching program, that we would match for the information returns given us with respect to interest and dividends with what taxpayers reported and that that program would be comparable in its effectiveness to withholding.

Well, we haven't done it, we are not doing it, and we are not about to do it.

We have asked for resources in the last 3 years to try to move toward a full-scale document matching program and then toward a 33½ percent document matching program, and we haven't received them and there is no likelihood that we will.

At the moment, we are matching or trying to match all documents submitted to us on magnetic tape, that is, information reported to us on magnetic tape that is good information, and about 10 percent of the paper documents. The universe is in excess of 400 million total reports. We are matching a total of less than 40 percent of that universe.

Now, also I said before Chairman Rosenthal that I didn't agree with the suggestion that there was about a $10 billion gap in income reporting, as was suggested by the press, and I used some of our taxpayer compliance measurement program results.

Off the top of my head, by using such results I computed a much, much smaller gap and much smaller gap than which Mr. Goldstein reported to you this morning. The gap is there, however; the problem is there.

Looking at it from the myopic standpoint of the persons in charge of trying to make this tax system work effectively and fairly, we think that withholding is the way to go. I am sure there are some problems. There are some problems of overwithholding, as there are problems with overwithholding on wages, and we attempt to solve these problems through having people who would be subject to overwithholding and pay taxes they don't owe at all or pay taxes greatly in excess of what they owe, file form W-4 or W-4E, as Mr. Goldstein pointed out.

We do have some enforcement problems with respect to these W-4's and with 4-E's, but these enforcement problems aren't nearly as serious as the problems we have with underreporting or failure to report interest and dividends.

Interest comes first. Interest comes first because of the bearer obligations to which Mr. Goldstein referred. We think that there should be withholding with respect to these obligations, again looking at it solely from the standpoint of tax administration and without regard to fiscal effects the effects on the capital markets and the like that are the responsibilities of others, such as Mr. Gerard.

We think there is a lot of tax evasion out there, and we don't think that bearer instruments of the United States Treasury or anybody else should be issued for the benefit of tax evaders or should be tax exempt by failure to report.

These problems, I am sure, others will address and point out their seriousness, but they apparently haven't deterred other countires in moving to withholding on interest and dividend. France, Germany, United Kingdom, Japan, Italy, the Netherlands, and Mexico, withhold on either or both interest and dividends.

The United Kingdom, for instance, has an integrated corporate tax, so it withholds on interest but doesn't withhold on dividends. So the problems of getting there from here, while substantial—I don't want to say they are not—are not so substantial as to prevent other countries from finding that they could get there from here.

Now, why is this better than providing us the money to try to have a full-scale document matching program? Well, let me give one reason why it is better. We have about a 10-percent or above 10-percent error rate in social security numbers on form 1099.

The error rate is only about 1½ percent on form W-2. There is a much greater incentive on the part of the taxpayer to play straight with his employer because not only is the employer reporting wages, also the employer is reporting tax withheld.

That same incentive would exist if there were a system of withholding on interest and dividends, and coping with this problem is very expensive for us. A full-scale document matching program might cost $140 million or so. We haven't been given that in 14 years, since 1962, and I have surely asked for it as had my predecessors. We have not been given this money and we are not about to be given it, Mr. Chairman, so you are not talking about two alternatives.

One of them is not there. That is all I have to say.

The CHAIRMAN. Thank you very much.

Now we will hear from Mr. Gerard. I would like to ask all three of you to remain available for questions as soon as we have heard Mr. Gerard's statement.

STATEMENT OF ROBERT A. GERARD, ASSISTANT SECRETARY OF THE TREASURY FOR CAPITAL MARKETS AND DEBT MANAGEMENT

Mr. GERARD. Good morning, Mr. Chairman and members of this distinguished committee, thank you for the opportunity to discuss with you whether the Federal Government should try to charge the current tax treatment of municipal bond interest, particularly by extending the minimum tax to such income.

The proposal to impose minimum tax on interest from municipal bonds derives from the general concern with tax equity. While the Treasury Department supports the objective of improving the equity

of the tax system, we are also concerned that taxing municipal bond interest payments will significantly increase the borrowing costs of State and local governments and, if interest on existing holdings is taxed, it will substantially reduce the value of these holdings.

For these reasons, Treasury is strongly opposed to such a proposal. We recommend, instead, that serious consideration be given to an alternative—the taxable bond option—which will contribute to tax equity and do so in a manner that will improve the structure of the municipal bond market.

While there are reasons for viewing the municipal bond market as a separate market, its essential characteristics are virtually identical to those found in every financial market—that is, the value of a municipal security is a direct function of the risks inherent in owning it and the return it provides.

What distinguishes the municipal bond market, of course, is that the return on municipal securities—the interest paid—is exempt from Federal taxation. Accordingly, the economic value of the interest payments on municipal bonds varies according to the tax circumstances of the holder.

In looking at the implications of extending the minimum tax to income from municipal securities it is vitally important that this value/return relationship be clearly understood. From a financial standpoint, an investor in the 50-percent bracket is indifferent as to whether he receives $50 of tax-exempt income or $100 of fully taxable income.

Accordingly, where the income on a bond is exempt from tax, the interest rate which must be offered to attract his investment in it need only be half as large. Any increase, however, in the taxes which must be paid by this investor has the effect of reducing the value of tax-exempt income relative to taxable income and therefore will increase, automatically, the amount of interest the issuer must offer in order to attract the investment.

The first and most serious concern we have about extending the minimum tax to municipal bond interest is that it would directly and substantially increase the cost of borrowing for State and local purposes. We must also take into account the potential impact of such tax in reducing the capital values of the more than $220 billion of municipal obligations held by the public.

This impact would be significant because these assets provide the means for carrying out important financial functions, such as the collateralization of deposits of public funds.

The response of the market to the adverse impact of the minimum tax on returns from municipal bonds would be to require higher yields on new issues in order to maintain the same net returns. Such higher yields would mean higher interest costs, and higher taxes at the State and local level to meet these costs.

To obtain some indication of how the preference tax might impact on borrowing costs, let us assume that the annual interest generated by new tax-exempt issues is somewhat more than $2.5 billion. If the minimum tax were extended to both individuals and corporate bondholders, virtually this entire amount would be added to the minimum tax base.

Even if the tax applied only to interest on bonds owned by individuals, perhaps $1 billion would be included in the base.

Individual investors are the purchasers of tax-exempt debt at the margin. Thus, even if the minimum tax were limited to individual investors, the effect of imposing the tax would be to increase the interest rates that State and local borrowers have to pay. The precise impact would depend on the particular structure of the minimum tax, including the tax rate and whether an exemption or an offset for regular taxes paid was allowed.

Even if the minimum tax increased overall municipal borrowing costs by only 5 percent, the interest burden on State and local governments could rise by some $125 million the first year.

This would increase by about the same amount each successive year for perhaps 10 years. Accordingly, by the 10th year, State and local governments would be bearing an additional annual interest burden of more than $1 billion solely as a result of the minimum tax.

Because the minimum tax proposals could have substantial impact of the municipal bond market, I want to take a few moments this morning to discuss more generally the state of this market.

The municipal bond market is basically sound and continues to provide an adequate mechanism for State and local government financing. Even in the face of widespread problems, the market as a whole performed very well in 1975, with a record of $29 billion in new long-term issues and an equally large amount of short-term debt. Table 1 shows that this was the culmination of a steady upward trend over the past 15 years.

There is, however, an artificial and unnecessary constraint on the efficient financing of State and local government, since potential lenders are presently limited to those who can profitably use tax-exempt income.

Thus, the largest borrowing sector in our capital markets after the Federal Government is restricted to a limited range of potential lenders. Some of the Nation's largest groupings of financial assets are effectively barred from the market.

The limitation on the class of potential lenders has two implications:

First, more so than other markets, the municipal market seems to be susceptible to cyclical variations.

Second, the market is vulnerable to long-term, basic changes in supply/demand patterns.

The cyclical variability of the municipal market is caused by the behavior of the major purchasers of State and local debt—commercial banks, fire and casualty insurance companies, and individual investors, including personal trusts.

As shown in table 2, commercial banks generally have been the most important purchasers. This means that the municipal market may be adversely affected during periods of credit stringency or strong demand for bank loans, or when the banking system's need for tax-exempt interest diminishes.

There is growing concern that because the need of commercial banks for tax-exempt interest has declined, they will on average be less interested in holding municipal bonds in the future.

Table 3 shows the ownership of municipal securities for selected periods since 1960. Commercial banks absorbed over 70 percent of the net new issues over the period from 1960 to 1970, when their share of the total municipal debt outstanding almost doubled.

Since 1970, however, they have absorbed only one-half of the net new issues, barely enough to keep their share of the total debt constant. Consequently, insofar as long-term development of the market is concerned, other sources of financing must be found if the overall demand for municipal securities is to be maintained.

Increased participation by individual investors typically will not fully offset the decrease in participation by commercial banks. In such circumstances, the total demand for State and local government debt tends to decline.

Second, the shape of the demand curve also changes, since individuals are willing to absorb larger amounts of municipal debt only at sharply increasing interest rates. The result, as shown in table 4, is a fluctuating relationship between taxable and tax-exempt interest rates.

The volume of municipal debt and the interest rates at which it can be sold are thus critically affected by the fact that the market responds not only to overall changes in credit supply and demand, but also to short run changes in the financial situation of a single group of institutional lenders.

At the same time that bank participation is diminishing, inflationary pressures have created sharply increased levels of demand for credit by municipalities. The impact of inflation is reflected in the higher cost of capital improvements which must be financed with tax-exempt bonds.

The long-range prospect for the municipal bond market is thus clouded by two interrelated elements: a static supply of credit to the market and a growing demand by municipalities for it.

A third related problem is that the cost of Federal tax exemption is substantially greater than the benefit to municipal borrowers.

To analyze this cost, we begin with the fact that, primarily due to market efficiency factors, the degree to which tax exemption reduces municipal interest costs varies with the maturity of the debt. Shorter term exempt securities enjoy a greater reduction in interest rates relative to taxable securities than do longer term bonds.

On average, tax-exempt rates are more than 50 percent below taxable rates for issues of a year or less, about 30 percent for intermediate issues, and about 20 percent for 30-year bonds. This represents the saving to municipal borrowers.

The tax cost of the exemption can be determined by reference to the marginal tax rate of the average investor. It has been estimated that the average marginal tax bracket of investors in tax-exempt bonds is over 40 percent. If all these investors purchased taxable rather than tax-exempt bonds, tax revenues would increase by over 40 percent of the interest that would be paid on such bonds.

This revenue cost is substantially greater than the benefit to State and local governments. For example, if $30 billion of long-term debt were issued at a tax-exempt interest rate of, say, 6.3 percent, as contrasted with a taxable rate of 9 percent, interest payments by State and local governments would be reduced by some $800 million in the first year.

If that interest had been taxable, however, and if purchasers of that debt had not investment alternatives except taxable bonds, the gain in Federal revenue would be $1.1 billion. The $300 million difference represents revenue losses which are not passed through the issuing governments.

There are other problems currently associated with the municipal bond market. For example, the Municipal Finance Officers Association and the Securities Industry Association have recommended repeal or substantial limitation of the pollution control exemption for private companies.

This recommendation warrants serious consideration as an additional method of improving the market for State and local securities. The large volume of such issues has had an adverse effect on interest rates for long-term municipal obligations, with which these private credits compete.

The proposal to extend the minimum tax to municipal bond interest involves an attempt to deal with the question of tax equity, not the structural problems of the municipal market. It is thus not surprising that such tax would simply exacerbate these critical problems.

Treasury believes that a preferable alternative is the taxable bond option, which can ameliorate the structural problems of the market while contributing in a meaningful way to increased tax equity.

The Treasury Department recommends that the committee consider—as an alternative to the minimum tax concept—the taxable bond option.

This proposal would give State and local governments the option of issuing either tax-exempt debt or taxable debt in return for a Federal subsidy payment. We have proposed a 30 percent subsidy limited to the first 12 percent of the interest payable on the taxable municipal bond.

We think that this is the right subsidy level to provide a needed "safety valve" for the municipal market, particularly in the long-term maturities. We would be concerned about the impact on the municipal market and the cost to the Federal Government of a subsidy figure in excess of the 30-percent level.

Treasury believes that the taxable bond option will increase the liquidity and improve the stability of the municipal bond market. It will deal with the problem of cyclical variations by freeing municipal issuers from their overdependence on the need of investors for tax-exempt income and the availability of credit from a particular class of lenders.

Under this option, new sources of long-term credit will become available to municipal lenders. Naturally, issuers will elect the taxable bond option only if their net interest costs can be reduced. Furthermore, to the extent part of the supply of new State and local issues shifts to the taxable market, those who continue to issue exempt bonds will also find that their interest costs are reduced.

The changes brought about by the taxable bond option will also have important implications for tax equity. To the extent that fewer bonds are issued in the tax-exempt market than would otherwise be the case, there will be less use of such bonds as a tax shelter.

Second, because the option will reduce interest rates on new tax-exempt bonds, those who continue to purchase tax-exempt securities

will receive a lesser amount of interest. Thus, high-bracket investors will no longer be able to command as much in the way of excess return from municipal bonds as they do today.

The taxable bond option therefore addresses both the structural problems of the municipal bond market and the tax equity issue.

The net cost of the taxable bond option will depend on the gross subsidy paid to municipal issuers of taxable securities, less the additional revenues generated by the higher volume of taxable issues.

While the increase in tax revenues will offset some of the gross subsidy costs, it is not reasonable to expect that, on balance, Treasury will make money from the plan. This is because the plan is an optional one, and State and local governments will only use it if there is a cost saving to be realized.

Therefore, the taxable bond option should not be advocated as a revenue raiser. It is fully justifiable because its benefits will be large relative to any net Federal costs.

In table 6, we show the cost components of a 30-percent interest subsidy and how those costs will vary over time. It should be noted here that the first-year costs are only a fraction of what the total longrun costs will be, since each successive year's issue of new debt will generate subsidy costs in addition to those of the previous years.

With a 30 percent subsidy, the gross subsidy costs are $39 million the first year and rise to $486 million per year by the 10th year. Offsetting these costs are Federal tax revenues of $405 million per year by the 10th year. Thus, the net annual cost grows from $7 million to $81 million over 10 years.

The table also indicates the benefits to State and local governments in terms of lower net interest expense. As a result of the plan, interest rates paid by State and local governments would decline by about 46 basis points in the over 15-year maturity range.

Therefore, over 10 years, these savings in annual interest payments grow from $69 million to $868 million. Thus, the ratio of State and local benefits to net Federal costs could exceed 10 to 1. I want to caution you that the precise costs and benefits will depend on market conditions which cannot be foreseen in advance.

However, while the figures shown in the table can only reflect the particular assumptions made, we believe them to be indicative of general market conditions which may be expected to prevail in the future.

An effective taxable bond option requires a relatively automatic procedure and certain safeguards. Thus, if a governmental until elects to issue federally taxable obligations and Treasury agrees to pay the subsidy, neither the election nor the subsidy could be revoked or adversely modified, even if the statute were later amended or repealed.

In most cases the subsidy agreement should be obtainable automatically through appropriate certification that certain general standards have been fulfilled. For example, the subsidy would be payable only if the instrument is marked to show clearly that all interest payments are subject to Federal tax.

The subsidy itself would be a fixed percentage of the issuer's net interest expense and could not be varied administratively. The subsidizable amount would be determined after deducting appropriate administrative costs. We anticipate Federal involvement in State and local financial decisions.

Administrative procedures for paying the subsidy would be simple. The subsidy payment would be made to the paying agent immediately before the interest is payable to the holder. The subsidy would not be released for payment to the holder unless and until the issuer paid its portion of the interest then due.

The payer would file an information return with the Internal Revenue Service reporting the payment of taxable interest, including the subsidy.

An issuer could elect the taxable bond option only for State or local obligations which would be exempt under the Internal Revenue Code but for the election. Certain municipal bonds otherwise eligible would not qualify, including:

Obligations as to which the United States provided other financial assistance, including agreements to guarantee the payment of principal or interest or to acquire the bonds; and

Obligations held by parties related to the issuer.

The first limitation is necessary to prevent additional Federal subsidies for certain transactions already subsidized by Federal agencies. The rule disqualifying obligations to be acquired by related parties is intended to prevent the issuance of bonds merely to obtain the Federal interest subsidy; for example, where two issuers swap their new obligations. We believe that, at a minimum, these two limitations are necessary.

The statute must be drafted carefully to prevent arbitrage—issuing obligations in one market for the purpose of investing the proceeds in a different market at a higher yield. Congress attempted to limit arbitrage in 1969 by providing that municipal bonds will be taxable if the proceeds are invested in securities producing a materially higher yield over the term of the bonds.

The artificially low yields so required has the undesirable, and doubtless unintended, effect of creating large windfall profits for underwriters, consultants and promoters. It has proved to be very difficult to remedy this situation administratively.

Based on this experience, we caution you that any taxable bond option should incorporate appropriate restrictions on arbitrage.

There are some who may advance the taxable bond option for the ultimate purpose of eliminating the tax-exempt bond market. This strategy would involve enacting a taxable bond option with a relatively high level of subsidy, attracting a large volume of new State and local issues into the taxable market through the subsidy and then, at some future date, pointing to the decline in interest and activity in the tax-exempt market as a justification for repealing the exemption entirely.

Needless to say, we strenuously oppose this approach, and in light of this, we are quite concerned about the appropriate level of the subsidy. At 40 percent or above, there is little doubt that this strategy would have a reasonable chance of success.

Additional support for the taxable bond option comes from those who believe that there should be a greater Federal subsidization of State and local borrowing. They are urging a form of revenue sharing, if you will, but revenue sharing tied to the amount the State or local government is willing to borrow, rather than based on broader

economic and demographic factors. Again, the percentage level of the subsidy is critical.

At the 30 percent level, we have suggested, there will be little in the way of new subsidies which must be paid for by Federal taxpayers; at 40 percent or more, the subsidy cost will be very substantial.

Moreover, because the subsidy level would be governed in this case by the desire to provide benefits substantially exceeding what the market now provides, it would have to be set at a level—40 percent or more—where the viability of the tax-exempt market would be threatened.

We view the taxable bond option from an entirely different perspective. As I have indicated, we are sensitive to the cyclical problems, as well as to the real possibility that a basic change in the supply/demand characteristic of the market is occurring.

We also cannot help but be cognizant of the concern that the current system, if left unchanged, does generate excessive benefits for certain taxpayers. Indeed, I doubt that we would be here today if this were not the case.

We fear that this range of concerns could lead to measures which would impair the ability of State and local governments to finance their legitimate needs in a sound and responsible manner. I have testified at some length this morning on one such measure: the inclusion of tax-exempt interest in the minimum tax. Needless to say, a more troublesome prospect would be the attempt to deal with all of these concerns by eliminating the tax exemption entirely.

It is for these reasons, and these reasons alone, that we have proposed and support a taxable bond option at a 30-percent subsidy level. As I suggested a few moments ago, we believe that such an approach will, in effect, provide a safety valve for the tax-exempt market without either threatening the basic viability of the market or imposing substantial costs on Federal taxpayers.

Moreover, to the extent market efficiency is enhanced by this modest alternative, and we believe it will be, concerns about tax equity will be alleviated materially.

In short, we are convinced that the Nation would be best served at this point by responsible measures designed to maintain the traditional and proven method of financing State and local government. We strongly oppose radical change in either direction: inclusion of tax-exempt interest in the minimum tax, or the virtual elimination of the tax-exempt market through authorization of taxable bonds with a Federal interest subsidy of 40 percent or more.

If a change is warranted—and we believe it is—we urge the committee to consider providing a truly optional taxable bond; that is, one with a 30-percent subsidy.

Thank you, Mr. Chairman.

Senator RIBICOFF. In table 4, Mr. Goldstein, you indicated in 1977 that if you had a 20-percent withholding you would pick up $2.4 billion; in 1978 you would pick up $3.2 billion; in 1979, $2 billion.

What would be the administrative cost involved in the event there were this 20-percent withholding on interest and dividends? Mr. Alexander or yourself.

Mr. GOLDSTEIN. Let me make a few comments, and I think the Commissioner will want to as well.

First, as I stated in testimony, the most significant aspect of these figures is that this does assume you have got a system fully in place effective January 1, 1977, which as I indicated I am skeptical about.

Regardless of that, these figures are, we think, as good as we could do when the system goes into place. With regard to costs, essentially there are a couple of considerations which, I believe, are fairly obvious. The more elaborate system you devise for refund or exemption certificates or matching to see that even with this system that the information that is supplied and the money that is withheld is, in fact, correct—in other words, the more equity you try to provide—the more it is going to cost.

A second aspect of cost which is quite important is whose costs are we talking about? That can be allocated between the payors and the Federal Government depending to a large extent on how you design the system. It was recognized that the cost to the payors would be quite great, back in 1962, and in an attempt to offset that cost it was provided that withholding remittance would only be made quarterly.

In other words, whatever you paid out during the first quarter of 1977, let's say, you would accumulate the money and by April 30 you have to pay that over to the Federal Government.

Now, of course, if they would be able to hold onto that money for a period of time, it would be of considerable value to the payors, but it would reduce the value of the system to the Government.

The other aspect of cost is to the extent that the costs are deductible, as they would be, as a business expense of managing the system. If it is a private institution making the payments, in effect, the Federal Government becomes a 50-percent partner in that.

Now, there the general considerations pertaining to costs. In the footnote to the table we indicate that we have not built these costs in as offsets. As far as precise numbers, we don't have any very good numbers at this point. This is an example of the type of thing that remains to be developed.

Maybe the Commissioner has been able to get some handle on this.

Senator RIBICOFF. What is your guess, Mr. Alexander, do you have any indication of what it costs the countries that you mentioned before to have this system, what percentage of their collections go to administrative costs?

Mr. ALEXANDER. No, I don't have an idea of what it costs these particular countries. I am not sure they have that information. We can surely try to develop it. The question you raised has a number of facets.

First, what it would cost us to have the system itself without regard to efforts to match documents and take certain enforcement actions with respect to payors and recipients.

And we have roughly computed a cost of data processing to handle a system at about $3 million.

Senator RIBICOFF. $3 million?

Mr. ALEXANDER. $3 million.

Senator RIBICOFF. That is all?

Mr. ALEXANDER. No, that is not all. That is not all, at all. That is simply data processing costs that we have roughed out over the weekend, to cover only the data processing costs of this system that is being discussed this morning.

Next, we come to the question of matching documents under this system, because withholding isn't going to solve all of the problems that we have in the underreporting Mr. Goldstein mentioned.

It will take us a long way down the road. However, we have the facet that I mentioned earlier, the invalid social security number problem, which has been with us for 14 years and is still with us, where slightly over 10 percent of our social security numbers reported to us turn out to be wrong or missing on these 1099's we check out.

In fact, considerably over 10 percent in some situations. On the other hand, we only have a 1½-percent error rate on W-2's, and we are inclined to think the difference between 10 and 1½ is attributable to the fact that the W-2 reports two things, the 1099 reports only one.

It costs us a lot of money to try to cope with this problem of the missing or invalid SSN. I gave a figure of about $140 million for a full-scale document-matching program, which we have never had and which we have never been authorized to have.

We believe that with withholding we would have large front-end savings by reason of the fact that 10 percent plus is a lot bigger figure than 1½ percent, and we could have a document-matching program at whatever level we were authorized for considerably less money if you moved to withholding than if you don't have it.

Obviously, I am talking now not about the administrative costs of processing the paper, but about the enforcement costs of doing something with the paper. Another facet is checking to see whether people are meeting their responsibilities to withhold.

We have plans for what amounts to 1.6 percent, I believe, audit program coverage with respect to employment taxes. We would have a somewhat lesser problem with respect to payment by payors of dividends and interest.

Why? Because there is a very great incentive, thanks for the fact that employment taxes are so high, for employers to classify their employees as independent contractors, and this is a matter which I understand this committee has recently considered. We need new legislation on this issue.

That incentive is largely lacking when all we are talking about is a question of who gets the money, the Federal Government or the owner of the particular debt obligation or common stock.

We think that there would be less of a compliance problem with respect to payors. Insofar as forms W-4 and W-4E are concerned, we think that is the way to solve the problem of the elderly or young person who has some capital at work drawing interest or dividends but does not have much, if anything, in the way of a tax obligation.

We have a compliance problem now with respect to invalid or erroneous W-4's, the people who don't like to have taxes withheld from their wages. We cope with this in our regular compliance program.

If withholding can be applied to bearer instruments, we will have a new segment of our taxpayer population that we haven't had before to review, and we look forward to that review. But it is rather difficult for me to put a price on this because this might well involve a diversion of resources that we have now rather than the cost of new resources, Mr. Ribicoff.

Senator Ribicoff. One final question.

You are in favor of this withholding—and we are talking about billions of dollars here, even subtracting the administrative costs?

Mr. Alexander. I certainly am in favor of it, as I have testified this morning, and I testified before Chairman Rosenthal on April 12.

The problem that we see, particularly with respect to bearer instruments, is a major one in tax administration, and we think this is the way to solve the problem. We think that there will be some difficult practical questions with regard to people who may be overwithheld. We think there are various solutions to those questions.

We think the W-4 process that we now have can be modified to solve these problems. We might even provide that the W-4-E, which is a form for claiming exemption from wage withholding, should be modified not only to cover those that have no liability for tax on the interest and dividends but those whose liability for tax on interest and dividends can be reasonably expected to be only a small percentage of the tax which would otherwise be withheld.

There are various solutions to the practical problems that were described at great length in the 1962 Senate committee report.

Mr. RIBICOFF. Thank you, Mr. Chairman.

The CHAIRMAN. My impression is that the banks have been strenuously opposing this proposal, as well as savings and loan institutions, because they feel it would cost them money.

I address this to Mr. Goldstein. I wonder if we couldn't call upon the banks or the savings and loan institutions and work with the Treasury in such a fashion as to let them keep that money that they withhold in their banks for a limited period of time, perhaps 30 or 60 days. If it is worked out right, they would make enough money that way, since they would not be paying interest on the amount withheld, to where they would come out whole and it wouldn't cost them anything to cooperate and participate in this program. To the extent we don't collect the money, of course, it would remain in those institutions, and they would have the opportunity to use the money.

The concern of those institutions is a very poor excuse for failing to collect taxes.

Do you think that the thing could be handled in such a fashion that the banks might be less critical and less strong in opposition to this proposal, Mr. Goldstein?

Mr. GOLDSTEIN. Well, Mr. Chairman, that was the approach that was taken in 1962 in the House bill. As I indicated, they were permitted to retain the funds until 30 days after the end of the quarter in which the withholding took place.

As far as the banks' position, we know, notwithstanding the fact that was in the House bill, they vigorously and successfully opposed the withholding when it came over here to the Senate, but certainly that is an important consideration which I would think would affect their decision and their position.

I don't think this should be a windfall for the financial institutions. On the other hand, the burden has to fall on somebody if there is a cost involved, and the choices, I guess, are the financial institutions, the recipients, or the Government, and I think the payors will find a way to relieve themselves of the burden one way or the other.

It will either fall upon the Government through tax deductions, or otherwise, or they will, in effect, have less dividends and interest ultimately to pay.

But I agree with your thought, and I suspect that will find its way in. It is awfully hard to tell.

There will be some institutions that will make out well under such a system and probably——

Mr. ALEXANDER. They are already filing form 1099 so that cost is already there.

The CHAIRMAN. They are already providing the information?

Mr. ALEXANDER. Sure; and we figure we can adapt the form 1099 to put a place in for the amount withheld.

The CHAIRMAN. Senator Brock.

Senator BROCK. No questions.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. No questions.

The CHAIRMAN. Senator Haskell.

Senator HASKELL. Only to express surprise at the amount of revenue that the Service believes it will raise, assuming you are fairly confident of those figures, it sounds like something worth pursuing.

Mr. GOLDSTEIN. You were not here earlier. We are not completely confident of the figures. They are the best we could come up with under a lot of pressure. There is a substantial gap, as the Commissioner suggested in his testimony a couple of months ago, and as we find everytime we take a look at the figures.

You have to work backward from statistics of income and to see the actual reporting, and you find the gap. The gap may not be that big, but it is certainly there.

Senator HASKELL. Thank you very much.

The CHAIRMAN. One final question—Mr. Gerard might want to answer it. Maybe someone else might want to comment on it.

It occurs to me that an option other than taxing the municipal and State bonds might be simply to say that you would reduce the interest expense that someone is claiming by the amount of interest he has from State and municipal bonds.

What was your reaction to that, Mr. Gerard, that is, for tax purposes?

Mr. GERARD. Let me make sure I understand.

The CHAIRMAN. Let's put it this way: I am not as much worried about the fact that a person doesn't pay the tax on these bonds as I am about the fact that it is a fairly good tax avoidance device to buy the bonds by borrowing a lot of money and then deducting the interest expense. Let's say he borrows $1 million and he invests that in bonds that pay him 7 percent, while he is paying 9 percent interest on the loan. He might seem to be losing 20 percent on the transaction, but if he is in the 70-percent tax bracket that is a real sweet deal because he has taken no risk and he has made money on the differential in after-tax interest rates.

Now, there is something in the law to try to retard the use of that device, but it is not very effective. It could be extended to say that the interest expense that can be deducted will be reduced by the amount of interest a person receives from tax-exempt bonds.

What would your reaction to that be?

Mr. GERARD. As you point out, section 265 of the code does prohibit deductions of interest and other expenses for the purpose of generating tax-exempt income. I would have to defer to the Commissioner and to Mr. Goldstein as to whether that prohibition is effective.

The CHAIRMAN. What is your impression about that, Commissioner Alexander?

Mr. ALEXANDER. It doesn't work very well.

Section 265 says, if you borrow money to either purchase tax exempts or sort of carry them you don't get the interest deduction. As a matter of fact, it works rather awkwardly because somebody always has another reason, they say, for borrowing the money, and it is a fairly difficult provision to try to administer effectively.

The CHAIRMAN. All it takes is for a person to say he borrowed the money for some other purpose, I take it?

Mr. ALEXANDER. Sure. Well, we win some cases in court, but, Mr. Chairman, not enough.

The CHAIRMAN. Well, would it ease your burden if we said you will reduce the deduction by the amount of interest he has from tax-exempt securities?

Mr. ALEXANDER. Well, yes, but I am looking at it, again, from the standpoint of a green eyeshaded tax collector rather than from the big capital markets' picture.

The CHAIRMAN. You are looking at it from the point of view of the tax collector.

What is your reaction, Mr. Goldstein?

Mr. GOLDSTEIN. Well, two points. It has always been felt with respect to business indebtedness—if you happen to be a proprietor of a business where you borrow money to run your business, and you also happen to own municipal bonds as an investor—that it wouldn't be appropriate to reduce that type of interest or lose that type of interest deduction because you happened to own some municipals in contrast to an employee, let's say, who also owns some municipal bonds and didn't have any interest.

The same applies for home mortgage interest. That was always felt to be an exception, that there would be no reason you shouldn't be able to borrow money on a home mortgage and yet still own some municipal bonds. You might have to give some thought to exactly how you would tell.

Senator BROCK. Why don't you put a ceiling on it of $100,000.

Mr. GOLDSTEIN. You mean as to how much interest you could have if you also owned municipals? I think there are approaches that could be taken.

One further point. The principal owners of tax-exempt bonds in the country, as I am sure Mr. Gerard has the statistics, are the banks. The banks, of course, pay lots of interest and they have been excepted from the provision of 265, and I presume you don't have the bank situation in mind.

The CHAIRMAN. I wasn't thinking about the banks in asking the question.

Frankly, I am aware of people who borrow money in order to buy tax-exempts, and basically they do it for tax avoidance.

Mr. Alexander just got through reporting that he thinks his luck is very poor in court in proving that was their purpose. But if they borrowed it for that purpose, I take it it wouldn't be deductible anyhow?

Mr. GOLDSTEIN. That is the law right now.

The CHAIRMAN. It is my impression that a lot of these loans are being made for that purpose, and in doing so, the whole idea if they are

sued is to allege in court they didn't borrow it for that purpose, they borrowed it for some other purpose.

Mr. GERARD. In principle, Mr. Chairman, I agree that anything that would serve to strengthen and carry out the spirit of section 265 I would react positively to. However, in terms of the specific proposal, I think you run into the similar market impact and higher borrowing cost concerns that we have addressed with respect to the minimum tax.

You alleviate some of these concerns if you exempt commercial banks and other financial institutions, which are already exempted from 265, but I think we want to look more closely at the details of any such proposal before trying to assess the market impact.

The CHAIRMAN. It seems to me you ought to have some proposals of your own up here rather than talking about looking closely at our suggestions. It seems to me, if section 265 should be strengthened, you ought to have a proposal up here to strengthen section 265, or to find some way to do something about that situation.

Don't you know what is happening? People are borrowing money for the purpose of taking the interest deduction on the one hand and not paying tax on the bonds on the other hand, which is just exactly what 265 is supposed to include.

Don't you know that?

Mr. GERARD. I must say that, in a rather particular context; namely, holders of New York City bonds, I have heard that that has been the case, at least in a number of situations, yes, sir.

The CHAIRMAN. I wish you would send us your suggestions along that line.

Now, do you have any suggestions, Mr. Commissioner, or anything further to add about this? You are the tax collector.

What can you suggest to us along that line?

Mr. ALEXANDER. All we do is collect.

The CHAIRMAN. You just got through giving your independent views about the withholding on interest and dividends.

Mr. ALEXANDER. I sure did.

The CHAIRMAN. What is your thought about this section 265?

Mr. ALEXANDER. It doesn't work very well, Mr. Chairman. It needs tightening up. You suggested a sort of automatic matching and Mr. Goldstein brought out the fact that presumably that would not apply to banks, which, of course, is fine. The automatic matching would be an easy thing to administer and would solve the enforcement problem, not entirely, but go a long way toward solving it.

The CHAIRMAN. Will you send us a suggestion as to how the automatic matching could be done? Has that been suggested yet?

Mr. ALEXANDER. You mentioned it this morning, an automatic offset. You just mentioned it.

The CHAIRMAN. I threw the idea out, and now I am trying to see how it could be done.

Mr. ALEXANDER. It would be pretty arbitrary, but you say for every dollar of tax-exempt interest you lose a dollar of deductible interest provided you are subject to 265, excluding banks, and that would make it a lot easier than the problem we have now, where we are trying to decide whether the debt was incurred in order to carry municipal bonds.

This has administrative and policy aspects. I can speak solely from the administrative aspect; the Internal Revenue Service does not have the responsibility, nor can it arrogate to itself the responsibility to speak from a policy standpoint.

The CHAIRMAN. Thank you very much.

Senator BROCK. Can any of you tell me why the banks' share of the municipal bond market has gone from 25 to 50 percent in the last 15 years?

Mr. GERARD. I can only speculate at this point. I prefer to give that to you for the record.

Senator BROCK. Well, let me ask you this: are the banks allowed to take tax-exempt bonds to the discount window?

Mr. GERARD. They are allowed to as a theoretical matter, but they rarely, if ever, do.

Senator BROCK. But wasn't that a new procedure within the last few years?

Mr. GERARD. Theoretically you can discount anything the Fed will let you discount.

Senator BROCK. We have expanded the definition of discountable instruments in the last few years.

Let me ask you an alternative question. Would the fact that banks are not covered under § 265 have anything to do with it?

Mr. GERARD. No, I don't think they ever were covered under 265. I think it is also noteworthy that one of the concerns we have about the market is that the banks' role has changed significantly. In the 1960's they were purchasing virtually all net new issues. In other words, the increase in bank holdings net over the course of a year was equivalent to the new issues in the market. In the last couple of years, the banks' relative participation has been declining.

I think the figures for 1975 will show virtually no net new increase

Senator BROCK. If you could elaborate on that for the record, I would like to see it.

Mr. GERARD. I would be pleased to.

[The information referred above follows:]

COMMERCIAL BANKS IN THE STATE AND LOCAL GOVERNMENT SECURITIES MARKET

The attached table shows that the commercial bank share of net purchases of state and local government securities has varied widely from year to year, generally in response to the tighter or easier money conditions accompanying the business cycle. Yet the table also shows a substantial increase in the commercial bank share of outstanding securities held during the 1960's and early 1970's.

The initial impetus for heavier commercial bank purchases of municipal securities came in the early 1960's after the regulatory ceilings on time and savings deposits were raised to competitive levels successively each year from 1962 through 1966. Bank purchases were also spurred by the innovation of the C/D (large certificates of deposit of $100,000 or more). C/D's were introduced in 1960 in response to the sluggish growth of demand deposits and to the fact that commercial banks were losing ground relative to other savings institutions, viz., savings and loan associations and mutual savings banks. C/D's outstanding grew quickly to over $20 billion by 1967.

The commercial banks were thus enabled to compete for time and savings deposits, thereby adding to their sources of funds. In fact, the funds available to them were in excess of their traditional outlets, that is, the demands for business and consumer credit emanating from the economy. As a result, they invested heavily in municipal securities and in real estate mortgage loans as well.

By the late 1960's, however, the large money market banks had begun to enter foreign markets increasingly and embarked on leasing and other operations. These operations provided other sources of shelter, and interest in municipal securities at the money market banks, and gradually some others, began to wane. This was evident during the early 1970's, when the commercial bank share of net purchases of municipal securities declined from 90-95 percent in 1968-70 (excluding the tight money year of 1969), to 30-40 percent in 1973-74.

The precipitous drop in 1975 to an 11 percent share of net purchases is probably related to higher than average loan losses, realized or prospective, and the tax effect thereof. Nevertheless, in the future, the interest of commercial banks as a group in the municipal securities market will probbaly be substantially less than in the 1960-72 period, particulraly with respect to the money market banks.

COMMERCIAL BANKS IN THE STATE AND LOCAL GOVERNMENT SECURITIES MARKET

[Amounts in billions of dollars]

	State and local government securities (outstanding)			Net purchases of State and local government securities		
	Total	Commercial banks	Percent of commercial banks total	Total	Commercial banks	Percent of commercial banks total
1945	$14.8	$4.2	28.3			
1946	14.9	4.6	31.1	$0.1	$0.4	630.8
1947	16.3	5.5	33.9	1.4	.9	63.2
1948	19.5	5.9	32.0	2.2	.4	18.0
1949	21.0	6.8	32.3	2.6	.9	34.8
1950	24.4	8.4	34.5	3.3	1.6	47.9
1951	26.6	9.5	35.8	2.2	1.1	50.3
1952	30.2	10.5	34.7	3.7	1.0	27.4
1953	34.5	11.2	32.4	4.3	.7	15.4
1954	40.6	12.9	31.8	6.1	1.8	29.0
1955	45.9	13.1	28.6	5.3	.2	3.7
1956	49.5	13.1	26.4	3.6	-.1	-1.6
1957	53.7	14.1	26.2	4.2	1.0	23.9
1958	59.2	16.7	28.2	5.5	2.6	47.1
1959	65.5	17.1	26.1	6.3	.4	6.5
1960	70.8	17.7	25.0	5.3	.6	11.5
1961	75.9	20.5	27.0	5.1	2.8	54.7
1962	81.2	26.2	32.2	5.4	5.7	106.2
1963	86.9	30.1	34.6	5.7	3.9	68.9
1964	92.9	33.7	36.2	6.0	3.6	59.5
1965	100.3	38.9	38.8	7.3	5.2	71.2
1966	105.9	41.2	38.9	5.6	2.3	41.1
1967	113.7	50.3	44.3	7.8	9.1	116.7
1968	123.2	58.9	47.8	9.5	8.6	90.5
1969	133.1	59.5	44.7	9.9	.2	2.0
1970	144.4	70.2	48.6	11.2	10.7	95.5
1971	162.0	82.8	51.1	17.6	12.6	71.6
1972	176.3	90.0	51.0	14.4	7.2	50.0
1973	190.0	95.7	50.3	13.7	5.7	41.6
1974	207.4	101.3	48.8	17.4	5.5	31.6
1975	222.8	103.0	46.2	15.4	1.7	11.0

Source: Federal Reserve flow of funds.

Chairman LONG. Thank you very much, gentlemen.

Mr. GERARD. Thank you.

[The prepared statements of Messrs. Gerard and Goldstein and information referred to above by Mr. Gerard follow:]

STATEMENT BY HON. WILLIAM M. GOLDSTEIN, DEPUTY ASSISTANT SECRETARY FOR TAX POLICY

Mr. Chairman and Members of the Finance Committee, my name is William M. Goldstein, and I appear before you today with Donald C. Alexander, the Commissioner of the Internal Revenue Service. Your Committee has requested the Treasury Department to testify on the subject of imposing a withholding tax on dividends and interests, I shall speak first, then Commissioner Alexander. Since there is no specific proposal before your Committee, our remarks are

intended to present to you the general considerations regarding both such a tax and alternative methods of achieving the same result.

As we understand it, your interest in this subject derives in part from the Commissioner's recent testimony before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations. There he described the extent to which the Internal Revenue Service uses Forms 1099, on which are reported the payment of many items of interest and dividends. At present there is no complete program for matching these forms against taxpayers' income tax returns, and thus it is possible to have undetected nonreporting of interest and dividends.

Also, your Committee is not unmindful of the potential impact on the budget that imposition of a withholding tax might produce, both by extracting payment of presently unreported dividends and interest and by accelerating the payment of tax on items which honest and careful taxpayers would report in any event.

We in the Treasury share your concern over the possibility that significant amounts of dividends and interest are not being reported. While our present estimate of the magnitude of such nonreporting is subject to considerable error, there may be as much as $1 billion of dividends and $7 billion of interest on which tax is potentially due. The amount due would be in the order of $1.5 billion. Some major sources of unreported income include U.S. bearer obligations and "E" bonds, bearer obligations such as certificates of deposit issued by banks and other corporations, and loan transactions between private parties. Although these figures are, I repeat, speculative, and must be viewed in context—in 1976 we estimate that $81 billion of dividends and interest will be reported, on which a tax of $18.5 billion will be paid—they are nevertheless most disturbing. They represent a nontrivial amount of revenue owed the Government. More important, it is an outrage that numbers of taxpayers are in this manner failing to pay their fair share of tax. Such conduct diminishes public respect for the operation of the tax system and could indeed jeopardize our voluntary system of compliance.

In formulating an appropriate legislative and/or administrative response to this problem, we must not lose sight of other goals of the tax system. Any new proposal must be efficient in terms of the total costs imposed on taxpayers, on payors of dividends and interest, and on the Government. It must be fair; that is, we must do our best to avoid imposing unreasonable burdens on any particular groups of involved parties. Finally, although I sometimes wonder whether we are ever successful in this regard, the system should be as simple as possible.

With regard to withholding tax on dividends and interest, the notions of efficiency, fairness, and simplicity are not idle abstractions. In 1942, 1950, 1951, and 1962, the House of Representatives passed tax measures imposing a withholding tax on dividends and/or interest. Each time the Senate refused to accept such a tax, largely out of regard for the principles of efficiency, fairness, and simplicity, and no withholding tax was enacted.

I believe it is worthwhile for me to describe in some detail what transpired in 1962, despite subsequent changes in the substantive tax laws and, more important, the impressive technological advances in computing and processing equipment since that time. By and large the debate generated by the 1962 proposal highlights the issues which pertain to any withholding scheme and, in addition, shows their complex and far-reaching nature.

By way of background, I note that in 1962, prior to the legislation ultimately enacted, corporations were required to file information returns reporting payments of dividends of $10 or more; all persons engaged in a trade or business were required similarly to report interest payments of $600 or more. The practical scope of the requirement to report interest was limited by the large floor: at the going rate of 4 percent annual interest, it took principal of $15,000 in a single account to produce $600 of interest. This amount exceeded, for example, the ceiling on the federally insured portion of savings accounts.

In 1961, President Kennedy proposed a plan to require withholding at 20 percent on dividends and interest. It was to apply to most dividends payable in cash or in kind with a few exceptions, such as stock dividends or stock rights, distributions in connection with reorganizations, and dividends paid to other members of an affiliated group of corporations which filed a consolidated return. The interest subject to withholding included amounts paid with respect to deposits at banks and thrift institutions; amounts paid on bonds, debentures, notes, or certificates issued by corporations with interest coupons or in registered form; and amounts paid on U.S. obligations. Excluded were such items as inter-

est paid by individuals; interest paid on U.S. or corporate discount obligations issued for 1 year or less; and interest paid on open accounts, notes, and mortgages.

To lessen the burden on payors, the plan required withholding even where the receipient was not taxable on the item paid—for example, tax-exempt organizations or persons with no taxable income. Also, payors were not required to furnish a statement of the gross amount of the payment, the portion withheld, and the portion actually paid. Statements were not thought necessary because a recipient, provided he properly identified an item as subject or not to withholding, could always be sure that it represented 80 percent of the gross amount due him. To compute the gross amount, or to "gross-up", he had only to increase the amount received by 25 percent.

It was recognized that this system, while administratively simple for payors and the Treasury, would rarely result in withholding precisely the amount of tax ultimately due; by using the flat rate of 20 percent, it would inevitably produce under- and overwithholding. Obviously overwithholding imposes a degree of hardship on the recipient by depriving him of the use of the overwithheld money until he can claim a refund of tax. To minimize this effect, the Treasury plan would have permitted the filing of quarterly refund claims; in addition, tax-exempt organizations were to be allowed to offset the withholding tax against the amounts they would otherwise be required to pay the Government by reason of wage withholding on their employees.

I should point out here that reasonable people can differ as to the harshness of overwithholding. On the one hand, persons with dividends and interest necessarily own capital, and usually some of that capital is held in a fairly liquid form, such as a savings account. Also, many such persons have income from other sources. Therefore, cash flow is not typically a problem, and the only detriment is the foregone interest on the overwithheld funds. On the other hand, in some situations the recipient does not have ready access to funds to replace the overwithheld amounts until they are refunded to him. Also, particularly in the case of tax-exempt organizations and nontaxable individuals, the lost use of the overwithheld funds represents, in the long run, a significant levy. In addition, some recipients, through confusion over the system or lack of information will fail to avail themselves of the opportunity to file proper refund claims.

The House Ways and Means Committee generally followed the President's recommendations as to the definition of dividends and interest subject to withholding and the quarterly refund procedure. Illustrative of the minor technical changes made, the Committee excluded school savings programs from withholding. However, the Committee struck a decidedly different balance between simplicity and fairness with respect to the problem of overwithholding. The Committee provided that all individuals under 18, those individuals over 18 who expected to have no tax liability, and tax-exempt organizations could file exemption certificates relieving them of withholding in certain cases. For individuals, the certificates applied to dividends and to most interest except interest on corporate indebtedness and U.S. obligations. For tax-exempt organizations, the certificates operated only with respect to interest on deposits in banks and thrift institutions and to interest on noninterest-bearing U.S. discount obligations. To compensate payors for the cost of compliance, the Committee provided that remittance of withheld funds was to be made quarterly, on the last day of the month immediately following the end of each calendar quarter; this gave payors the use of the funds withheld for a considerably longer period than would have been the case in the absence of withholding.

The Committee's rationale for the restrictions placed on the scope of exemption certificates was in part based upon the assumption that the market price of a bond subject to withholding which was traded between interest payment dates would reflect the fact that part of the interest would be withheld. That is, the buyer and seller could compute and take into account the allocation of the withheld amount in much the same manner as they took account of the accrued interest. This system would, however, break down if the seller was subject to withholding and the buyer was not; the tax-exempt buyer would pay a price for the bond that was reduced by the accrued amount to be withheld, but this amount would never in fact be withheld. A similar problem would arise in the case of stock transferred after the record date but before the payment date.

Consequently, the Committee attempted to curtail the use of exemption certificates as to marketable securities, although admittedly it did not do this in a completely consistent manner.

The Ways and Means Committee's approach became section 19 of the House bill which passed in 1962 and was referred to this Committee. It was apparent that the compromise among efficiency, fairness, and simplicity was unsatisfactory. An analysis by the staff of the Joint Committee outlined the problems. On the one hand, exemption certificates were not available to any persons with tax liability, even if it was very small; and the quarterly refund procedure, which was available, promised to be slow, complicated, and in certain situations not sufficiently generous. On the other hand, the exemption certificates were difficult for payors to process properly; and both the certificates and the refund procedure would have created serious administrative problems for the Internal Revenue Service, especially as to policing. It was noted in particular that those persons who are not inclined to report dividends and interest would likely be inclined to treat themselves to undeserved exemption certificates.

The bottom line in 1962 was that your Committee rejected withholding entirely, opting instead for making the informational reporting system more rigorous. Much optimism was expressed regarding the benefits of the new automatic data processing equipment which the Service was just beginning to install and experiment with. The Senate, by a wide margin, agreed with your Committee's approach and the expanded reporting system was ultimately enacted into law.

So much for history per se. Our Department and your Committee must now determine the relevance of this history in view of the substantial technological advances of the last fourteen years and our increased sophistication as to the practical limits of this technology even after these advances.

Before presenting to you our current thinking, I want to make clear that what I say should not be taken as the Treasury's definitive position. Because of our heavy commitment to working with you and your staff on the comprehensive tax reform legislation now before your Committee and because of the short notice of your desire to hear testimony on withholding, we have by no means been able to devote to this subject the research and considered thinking it deserves. The remarks which follow can thus be fairly characterized as tentative observations.

There are serious problems with exclusive reliance on matching information returns with taxpayers' income tax returns. If you desire, the Commissioner can explain these in greater detail. Briefly, there is first the substantial job of doing the matching. Second, where a mismatch is detected, it is necessary to determine if the mismatch is justified or improper. For example, a person whose income is less than the sum of the personal exemptions to which he is entitled plus the low income allowance is not generally required to file a return. Another situation involves a person who buys a bond between two interest payment dates; he will be shown on a Form 1099 as having been paid the full amount of the second of these interest payments, but only his allocable share of this amount is taxable to him as interest. Third, even where an improper mismatch is discovered, it is still necessary actually to assess and collect the tax. In most cases, this would be a time-consuming and expensive process in relation to the amount of tax involved.

In contrast, withholding might prove to be a cost-efficient means of collecting tax on dividends and interest. One problem faced in 1962 would probably no longer be a problem—the furnishing to recipients of dividends and interest withholding receipts showing the gross amount paid and the amount withheld. We believe that the technology exists to do this, even on a payment-by-payment basis, as well as on an annual basis with a revised Form 1099, although we have not yet had the opportunity to fully explore the cost to payors of such a system. These receipts would eliminate much confusion for recipients and also would potentially provide a way for the Service to verify the accuracy of returns.

Withholding can also be expected to have its share of disadvantages. One relatively minor item would be its adverse impact on certain automatic investment arrangements such as bank certificates of deposit and mutual fund dividend reinvestment plans. The income derived from such activities is of course taxable; but by paying the tax out of other funds, the individual can at present

take advantage of the very low transaction costs involved when earnings are left in the hands of the business enterprise.

Of much greater concern is whether we can satisfactorily deal with the problem which ultimately defeated the 1962 legislation, overwithholding. It can be seen on the first table in the Appendix, describing the 1973 individual income tax returns which reported dividend and/or interest income, that there were some 5 million such returns which were nontaxable. Obviously there were also many other individuals who received dividends and/or interest but who were not even required and had no need to file returns. Moreover, millions of additional individuals who received dividends and/or interest and who did owe tax had a much lower effective rate than 16⅔ or 20 percent. Finally, of course, there are thousands of completely tax-exempt organizations with this type of income: charities; pension plans; state governments; and so on.

The quarterly refund procedure in the 1962 House bill lacks appeal. If overwithholding is to be alleviated—and I remind you that the degree of hardship imposed is subject to debate—a broader program of exemption certificates might be the answer. However, the more expansive such a program becomes, covering not only tax-exempt organizations, but also individuals who expect to pay no tax, who expect to pay only a minimal tax, or who expect otherwise to pay enough estimated tax to avoid any civil penalties, etc., the more such a program raises the same type of enforcement problems as a system based upon matching. There would have to be some type of policing; and once again, small improprieties will be relatively expensive to correct. Also, in order to make the program function properly, it may well be necessary, in connection with implementing withholding, to update and revise our estimated tax system.

A third problem with withholding relates to bearer instruments, including those issued by the United States. It has been suggested that we have across-the-board withholding on them. It is likely that certain holders of those obligations, such as tax-exempt organizations, could avoid any complication merely by registering their securities. However, for the majority of holders, withholding might adversely impact upon the usefulness and marketability of those important debt instruments.

I would now like to turn to an aspect of withholding which is of considerable, immediate interest to your Committee, that is its revenue impact. Members of the Treasury staff, the Internal Revenue Service, and the Joint Committee staff have consulted with each other and produced estimates of the effect which a withholding system, if timely implemented, could have in fiscal 1977 and subsequent years. These estimates are included in the Appendix to this statement. At this point, however, we do not believe that this system could be put in place in time to have any significant revenue impact in fiscal 1977.

Before any withholding system can be implemented, Congress must determine the optimal combination of matching and withholding—or, alternatively, adopt an even better solution which has not yet been explored. Even if we could, today, agree upon the broad outlines of a withholding system, you would have to draft legislation dealing with a myriad of technical dilemmas. I note that the 1962 House bill section on withholding was almost 50 pages long and was accompanied by a 30-page technical explanation.

Under any withholding system, all payors of dividends and interest would have to develop procedures for withholding, reporting, and remitting the money and/or the information involved. In addition, it should be noted that many payors which do not now issue Form 1099 and have no system for doing so would be required to address those problems for the first time.

If the withholding system is to include an exemption procedure, the Service would have to design, print, and distribute forms. Recipients of dividends and interest would have to obtain the forms, learn how to fill them out, and send them to payors. How many of us have any idea of the names, much less the addresses, of the paying agents of our dividends and interest? The payors would have to assimilate the information on the exemption certificates, a fair proportion of which is likely to be incorrect, and modify their withholding systems ac-

cordingly. We just do not see how all of these tasks could be carried out by the Government, the recipienst, and the payors in the next six months.

In conclusion, I want to repeat that we are concerned about the problem of nonreporting of dividends and interest, and we are determined to do something about it. Once the current legislative effort is concluded, we will carefully examine the various proposed solutions in terms of efficiency, fairness, simplicity, and cost to all concerned. We would greatly appreciate the opportunity to come back to your Committee with a comprehensive proposal on this important subject within a few months.

TABLE 1.—TABULATION OF ALL INDIVIDUAL RETURNS WITH DIVIDEND AND/OR INTEREST INCOME, 1973

Total dividend and interest income	Tax liabilities			Withholding		
	Amount (millions)	Returns	Average	Amount (millions)	Returns	Average
0 to $100	$17,888	12,136,262	$1,474	$21,335	13,382,647	$1,594
$100 to $1,000	28,441	13,788,151	2,063	28,574	13,497,931	2,117
$1,000 to $10,000	22,904	7,478,138	3,063	13,889	4,781,047	2,905
$10,000 and over	11,068	768,470	14,402	2,077	278,429	7,461
Total	80,301	34,171,020	2,350	65,875	31,940,053	2,062
	Estimated payments			Overpayments		
	Amount (millions)	Returns	Average	Amount (millions)	Returns	Average
0 to $100	$933	657,346	$1,419	$5,156	12,265,398	$420
$100 to $1,000	3,101	1,644,306	1,886	5,194	11,232,51[illegible]	462
$1,000 to $10,000	7,185	3,339,289	2,152	2,155	3,409,304	632
$10,000 and over	6,957	713,784	9,746	894	277,982	3,215
Total	18,176	6,354,726	2,860	13,398	27,185,194	493
	Balance due			Total tax on dividends and interest		
	Amount (millions)	Returns	Average	Amount (millions)	Returns	Average
0 to $100	$1,123	1,764,235	$637	$91	11,689,012	$8
$100 to $1,000	2,654	3,808,063	697	1,057	13,738,077	77
$1,000 to $10,000	4,384	4,419,402	992	4,581	7,477,598	613
$10,000 and over	2,674	503,081	5,315	6,164	767,825	8,028
Total	10,835	10,492,981	1,033	11,893	33,672,511	353
	Dividends less than or equal to excludable amount			Dividends and interest		
	Amount (millions)	Returns	Average	Amount (millions)	Returns	Average
0 to $100	$34	1,266,808	$27	$540	13,245,498	$36
$100 to $1,000	152	2,357,845	65	5,894	15,707,470	375
$1,000 to $10,000	58	874,223	67	25,266	8,582,598	2,944
$10,000 and over	1	14,348	165	20,202	790,019	25,572
Total	246	5,413,224	54	51,902	39,325,585	1,320

Total dividend and interest income	Average taxpayer rate of tax on dividends and interest (percent)	Average rate of tax on all dividends and interest (percent)
0 to $100	16.5	16.9
$100 to $1,000	17.7	17.9
$1,000 to $10,000	17.6	18.1
$10,000 and over	26.9	30.5
All tax returns	17.4	22.9

TABLE 2.—TABULATION OF RETURNS WITH AT LEAST 1 INDIVIDUAL OVER 65 WITH DIVIDEND AND/OR INTEREST INCOME, 1973

Total dividend and interest income	Tax liability			Withholding		
	Amount (millions)	Returns	Average	Amount (millions)	Returns	Average
0 to $100	$194	240,632	$805	$246	324,286	$759
$100 to $1,000	922	1,112,524	828	844	1,062,609	794
$1,000 to $10,000	3,688	2,744,080	1,344	1,282	931,045	1,377
$10,000 and over	4,752	452,647	10,499	409	92,240	4,436
Total	9,556	4,549,882	2,100	2,781	2,410,180	1,154
	Estimated payments			Overpayments		
	Amount (millions)	Returns	Average	Amount (millions)	Returns	Average
0 to $100	$30	46,063	$658	$88	318,724	$275
$100 to $1,000	205	239,321	856	276	1,035,747	266
$1,000 to $10,000	1,875	1,548,790	1,211	350	1,032,456	339
$10,000 and over	3,622	439,237	8,247	372	158,843	2,340
Total	5,733	2,273,412	2,522	1,086	2,545,771	426
	Balance due			Total tax on dividends and interest		
	Amount (millions)	Returns	Average	Amount (millions)	Returns	Average
0 to $100	$21	78,143	$275	$2	226,335	$8
$100 to $1,000	217	479,833	453	86	1,112,524	77
$1,000 to $10,000	992	1,884,156	527	1,450	2,744,062	529
$10,000 and over	1,024	299,612	3,419	3,197	452,614	7,063
Total	2,256	2,741,744	823	4,735	4,535,535	1,044
	Dividends less than or equal to excludable amount			Dividends and interest		
	Amount (millions)	Returns	Average	Amount (millions)	Returns	Average
0 to $100	$1	43,506	$28	$21	460,102	$45
$100 to $1,000	11	187,644	60	891	1,883,534	473
$1,000 to $10,000	21	318,227	67	12,021	3,502,972	3,432
$10,000 and over	0	6,686	56	11,306	463,719	24,382
Total	34	556,063	62	24,238	6,310,327	3,841
	Average taxpayer rate of tax on dividends and interest (percent)			Average rate of tax on all dividends and interest (percent)		
0 to $100	8.5			9.5		
$100 to $1,000	9.5			9.7		
$1,000 to $10,000	10.9			12.1		
$10,000 and over	23.1			28.3		
All tax returns	11.2			19.5		

TABLE 3.—*Summary of characteristics of tax returns with dividend and/or interest income, 1973*

Average rate of tax on interest and dividends for an average taxpayer (percent)	17.4
Average rate of tax paid on all dividends and interest (percent)	22.9
Percentage of returns with dividends and interest which owe no tax (percent)	13.1
Average amount of dividends and interest	$1,320
Average tax on interest and dividends of all taxpayers with interest and dividends	$302
Average tax on interest and dividends of all taxpayers with dividends and interest who have some tax liability	$353
Percent of interest and dividends reported on returns with at least one over-65 exemption (percent)	46.7

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

TABLE 4.—ROUGH ESTIMATES OF REVENUE GAINS

WITHHOLDING PAYMENTS ON INTEREST AND DIVIDENDS (INDIVIDUALS ONLY)[1]

	Evaders	Change in timing[2,3]	No tax liability[2,4]	Total
At 20 percent withholding rate:				
Fiscal 1977	0.7	1.3	0.4	2.4
Fiscal 1978	1.4	1.4	.4	3.2
Fiscal 1979	1.5	.4	.1	2.0
At 16⅔ percent withholding rate:				
Fiscal 1977	.6	1.1	.2	1.9
Fiscal 1978	1.1	1.2	.2	2.5
Fiscal 1979	1.2	.3	.1	1.6

[1] Estimates assume that withholding becomes effective Jan. 1, 1977. Estimates exclude increased costs of administration for government and decreased revenues from deductions of administrative costs for business.
[2] To the extent that tax returns with interest and dividends are on average currently overwithheld, revenue gains from "change in timing" and taxation of those with "no tax liability" represent an increase in net overwithholding. Revenue gains in these categories do not result in net gains in tax collected over time.
[3] For fiscal 1980 and later years, the revenues effect from change in timing could become negative as taxpayers decrease other withholding and estimated payments to compensate for withholding on interest and dividends.
[4] Allows individuals who show proof of zero or negligible tax liability to request exemption from the withholding rate.

73-744—76——3

TABLE 5.—ALL RETURNS: SOURCES OF INCOME, DEDUCTIONS, AND TAX ITEMS BY SIZE OF ADJUSTED GROSS INCOME

[All figures are estimates based on samples—money amounts are in thousands of dollars]

Size of adjusted gross income	Sales of capital assets				Sales of property other than capital assets net gain less loss		Dividends in adjusted gross income	
	Net gain		Net loss					
	Number of returns	Amount	Number of returns	Amount	Number of returns	Amount	Number of returns	Amount
All returns, total	5,393,912	15,167,029	2,737,674	1,970,987	921,495	447,969	8,904,013	21,478,346
No adjusted gross income	97,791	658,243	20,940	23,358	63,153	−109,947	48,694	203,373
$1 under $1,000	75,052	62,958	26,848	20,170	20,045	−4,903	149,196	54,928
$1,000 under $2,000	127,863	98,452	29,183	18,570	18,597	−5,799	184,391	65,101
$2,000 under $3,000	231,077	204,834	44,651	31,085	30,763	−5,546	345,459	216,932
$3,000 under $4,000	206,670	203,645	73,676	64,596	25,321	−30,458	380,033	320,511
$4,000 under $5,000	230,155	229,891	66,280	58,454	37,107	−273	409,258	374,053
$5,000 under $6,000	251,742	279,290	66,173	59,246	33,400	−2,921	320,750	297,347
$6,000 under $7,000	207,148	257,390	68,106	41,204	25,041	4,852	336,861	435,815
$7,000 under $8,000	189,415	249,578	79,856	59,896	24,561	4,309	335,885	365,335
$8,000 under $9,000	188,780	258,330	89,652	56,275	38,480	1,505	356,863	452,552
$9,000 under $10,000	208,514	293,887	82,888	57,273	47,184	15,317	326,003	382,691
$10,000 under $11,000	157,473	242,079	90,260	63,439	35,265	23,378	284,958	356,099
$11,000 under $12,000	195,320	265,526	79,156	49,797	34,521	3,560	277,948	330,314
$12,000 under $13,000	165,919	263,860	90,976	58,693	40,773	12,474	276,326	311,378
$13,000 under $14,000	181,905	355,979	74,830	46,533	28,535	1,408	276,627	328,712
$14,000 under $15,000	176,394	245,359	83,682	56,162	22,363	4,438	248,927	286,622
$15,000 under $20,000	757,206	1,298,302	425,628	281,240	109,230	36,241	1,235,640	1,516,057
$20,000 under $25,000	557,652	1,088,943	339,989	229,880	75,640	74,943	942,262	1,545,450
$20,600 under $30,000	366,471	890,131	245.362	169,829	56,708	78,259	625,042	1,409,766
$30,000 under $50,000	510,815	2,167,636	409,207	315,898	88,611	138,700	961,751	3,099,002
$60,000 under $100,000	236,921	2,020,742	196,457	161,762	48,205	102,381	448,041	3,601,428
$100,000 under $200,000	56,671	1,350,072	44,374	38,897	13,717	38,800	105,645	2,426,312
$200,000 under $500,000	14,149	1,019,319	8,550	7,671	3,407	31,170	23,487	1,741,935
$500,000 under $1,000,000	2,066	509,112	865	796	600	18,447	2,948	658,443
$1,000,000 or more	743	673,471	285	263	268	17,634	1,018	698,190
Taxable returns, total	4,585,689	13,705,389	2,547,964	1,806,305	689,209	552,746	8,008,554	20,429,585

No adjusted gross income	2,004	178,322	26	26	835	5,263	1,270	44,587
$1 under $1,000 $1,000 under $2,000	11,000	16,009	---	---	---	---	13,091	2,665
$2,000 under $3,000	79,058	42,807	16,863	10,838	5,211	−2,207	160,531	101,788
$3,000 under $4,000	106,600	92,577	38,742	30,795	9,199	−16,345	269,046	226,805
$4,000 under $5,000	146,580	134,548	54,731	38,620	15,811	12,064	319,574	284,394
$5,000 under $6,000	189,952	194,519	57,812	51,505	15,596	−2,046	286,585	264,251
$6,000 under $7,000	177,609	212,103	60,507	35,462	17,156	3,729	308,215	406,655
$7,000 under $8,000	178,795	224,727	76,990	57,852	20,092	2,036	320,977	346,904
$8,000 under $9,000	169,903	199,498	87,238	54,546	29,679	1,572	346,036	437,113
$9,000 under $10,000	197,317	283,129	79,892	55,864	41,349	13,344	313,661	361,158
$10,000 under $11,000	146,540	223,227	86,672	61,387	29,881	13,494	277,874	332,727
$11,000 under $12,000	188,507	250,016	78,325	49,340	31,755	1,720	274,616	325,772
$12,000 under $13,000	161,050	244,210	89,591	57,545	37,399	10,014	274,778	308,852
$13,000 under $14,000	176,239	307,989	74,675	46,428	26,744	−2,078	272,184	295,280
$14,000 under $15,000	173,862	238,461	83,601	56,084	20,814	3,263	247,559	276,429
$15,000 under $20,000	745,359	1,249,837	423,318	279,435	105,007	24,990	1,227,532	1,476,140
$20,000 under $25,000	553,843	1,070,747	339,330	229,515	74,090	72,464	937,772	1,528,469
$25,000 under $30,000	363,460	869,670	244,034	169,601	55,767	75,563	621,331	1,357,877
$30,000 under $50,000	508,869	2,139,002	405,980	313,153	87,072	134,668	957,095	3,061,183
$50,000 under $100,000	235,917	1,997,905	195,787	161,102	47,877	102,288	446,460	3,549,178
$100,000 under $200,000	56,362	1,338,789	44,175	38,516	13,542	37,780	105,111	2,392,060
$200,000 under $500,000	14,057	1,016,026	8,499	7,622	3,362	28,161	23,322	1,716,034
$500,000 under $1,000,000	2,053	507,800	859	790	587	16,458	2,921	647,563
$1,000,000 or more	743	673,417	285	263	264	16,051	1,013	685,702
Total nontaxable returns	808,223	1,481,640	189,910	164,678	232,286	−104,780	825,459	1,048,760
All returns summary:								
Returns under $5,000	958,608	1,458,023	261,578	216,231	194,986	156,925	1,517,031	1,234,898
Returns $5,000 under $10,000	1,045,599	1,338,475	386,675	273,894	168,666	23,062	1,676,362	1,933,740
Returns $10,000 under $15,000	877,011	1,372,803	418,904	274,625	161,457	45,257	1,364,786	1,613,124
Returns $15,000 or more	2,502,694	11,017,728	1,670,717	1,206,235	396,386	536,574	4,345,834	16,696,581

TABLE 5.—ALL RETURNS: SOURCES OF INCOME, DEDUCTIONS, AND TAX ITEMS BY SIZE OF ADJUSTED GROSS INCOME—Continued

[All figures are estimates based on samples—money amounts are in thousands of dollars]

Size of adjusted gross income	Interest received		Pensions and annuities in adjusted gross income		Rent				Royalty net income less loss	
					Net income		Net loss			
	Number of returns	Amount	Number of returns	Amount	Number of returns	Amount	Number of returns	Amount	Number of returns	Amount
All returns, total	40,276,726	40,394,151	4,716,433	17,102,233	3,804,256	9,039,192	2,845,243	4,146,092	581,701	1,714,619
No adjusted gross income	229,313	367,068	19,411	65,039	45,072	100,260	57,021	440,421	11,903	−63,062
$1 under $1,000	1,045,228	210,916	50,339	114,956	50,144	37,255	40,722	44,749	8,023	1,533
$1,000 under $2,000	1,554,798	510,116	129,891	151,611	122,656	101,685	47,731	46,279	8,917	3,998
$2,000 under $3,000	1,734,241	988,982	266,897	448,352	170,415	173,569	75,373	114,307	17,354	19,391
$3,000 under $4,000	1,813,438	1,581,922	459,924	990,478	189,810	208,771	103,056	121,332	15,838	14,204
$4,000 under $5,000	1,831,037	1,802,953	447,188	1,088,919	197,039	276,041	87,047	85,500	20,922	15,769
$5,000 under $6,000	1,751,704	1,768,126	372,965	1,151,626	167,086	268,538	68,219	94,594	11,971	19,608
$6,000 under $7,000	1,727,081	1,769,005	387,234	1,291,656	159,381	244,778	89,023	89,464	16,513	15,544
$7,000 under $8,000	1,582,302	1,559,082	292,469	1,142,184	134,166	163,619	97,553	85,539	26,904	52,402
$8,000 under $9,000	1,656,696	1,384,599	219,444	898,771	151,073	229,679	112,636	116,872	12,603	18,212
$9,000 under $10,000	1,775,649	1,652,527	271,318	1,031,854	163,218	235,785	109,545	93,982	20,971	16,822
$10,000 under $11,000	1,580,046	1,224,108	162,220	694,418	159,598	230,493	121,932	120,396	16,648	54,541
$11,000 under $13,000	1,698,934	1,259,490	199,556	870,698	137,655	237,187	164,037	174,246	23,001	27,553
$12,000 under $13,000	1,672,978	1,242,974	143,178	643,958	150,720	206,164	117,974	102,086	20,781	33,745
$13,000 under $14,000	1,760,616	1,126,537	129,588	619,791	147,741	189,838	122,770	134,205	21,536	7,895
$14,000 under $15,000	1,623,278	1,079,921	124,826	537,773	137,479	183,436	124,854	114,746	8,136	26,680
$15,000 under $20,000	6,677,817	4,839,240	457,569	2,044,434	543,792	975,421	502,753	565,533	72,595	188,779
$20,000 under $25,000	3,826,509	3,430,994	266,474	1,434,714	339,526	746,789	326,666	372,588	58,526	120,049
$25,000 under $30,000	1,921,980	2,579,161	118,022	626,862	187,975	542,142	162,036	251,202	44,364	111,268
$30,000 under $50,000	1,972,255	4,492,847	140,291	788,866	267,706	1,150,014	203,138	425,691	83,047	286,490
$50,000 under $100,000	660,743	3,180,813	43,602	323,316	139,487	958,774	87,020	338,475	42,151	244,252
$100,000 under $200,000	129,728	1,368,561	10,784	99,186	33,991	410,261	19,067	132,006	13,649	200,943
$200,000 under $500,000	26,149	619,550	2,689	35,757	7,254	131,080	4,199	55,713	4,404	173,891
$500,000 under $1,000,000	3,198	188,714	394	5,472	903	25,365	644	17,511	683	59,869
$1,000,000 or more	1,108	145,945	120	2,142	369	12,248	227	8,656	251	64,252
Taxable returns, total	35,520,695	37,031,436	3,923,000	15,460,928	3,228,881	7,282,454	2,494,700	3,271,166	519,184	1,729,050

No adjusted gross income	2,028	51,412	160	725	494	7,158	432	24,144	480	6,668
$1 under $1,000										
$1,000 under $2,000	26,966	18,521								
$2,000 under $3,000	971,801	370,067	66,646	125,230	33,777	26,461	16,748	30,575	4,442	3,933
$3,000 under $4,000	1,335,523	1,056,980	269,331	596,387	111,410	124,263	49,775	49,297	10,373	9,515
$4,000 under $5,000	1,536,077	1,372,088	321,081	780,432	136,192	188,122	54,586	47,696	14,393	13,911
$5,000 under $6,000	1,623,786	1,597,219	343,230	1,029,951	141,416	231,937	48,882	50,070	9,141	12,364
$6,000 under $7,000	1,644,506	1,665,010	371,668	1,227,417	147,675	224,260	73,933	63,738	15,338	11,734
$7,000 under $8,000	1,535,715	1,504,426	285,345	1,117,385	121,128	147,243	93,773	78,490	26,030	51,319
$8,000 under $9,000	1,614,097	1,333,525	209,039	880,816	144,577	219,387	107.592	106,439	12,257	17,812
$9,000 under $10,000	1,748,449	1,601,622	268,506	1,024,805	158,352	231,162	106,203	85,864	20,756	16,238
$10,000 under $11,000	1,557,493	1,183,204	160,014	680,456	156,179	219,196	118,933	112,378	16,030	52,934
$11,000 under $12,000	1,689,811	1,242,498	197,568	865,049	135,273	229,965	162,775	169,649	22,273	26,444
$12,000 under $13,000	1,663,646	1,224,692	141,052	628,018	149,123	195,963	117,375	101,576	20,781	33,746
$13,000 under $14,000	1,769,372	1,105,889	129,284	618,549	145,443	185,608	121,841	129,956	21,460	11,789
$14,000 under $15,000	1,616,642	1,053,717	123,689	530,300	135,148	180,272	124,765	114,034	8,057	26,842
$15,000 under $20,000	6,660,625	4,816,227	456,326	2,043,045	540,008	961,456	499,611	555,368	71,124	179,611
$20,000 under $25,000	3,818,307	3,397,507	266,286	1,434,271	337,369	739,623	325,160	355,912	58,464	120,202
$25,000 under $30,000	1,917,380	2,558,565	116,766	625,953	187,770	540,318	161,847	246,395	44,237	110,639
$30,000 under $50,000	1,963,109	4,446,884	139,748	787,797	265,496	1,102,918	199,904	412,878	82,811	283,695
$50,000 under $100,000	658,617	3,148,211	43,315	322,374	138,951	955,279	86,447	329,012	41,775	244,960
$100,000 under $200,000	129,177	1,349,188	10,767	98,777	33,787	405,556	18,879	127,843	13,557	198,494
$200,000 under $500,000	25,976	604,452	2,662	35,527	7,193	129,107	4,149	53,750	4,364	173,130
$500,000 under $1,000,000	3,169	183,917	394	5,472	885	24,498	639	17,397	671	58,897
$1,000,000 or more	1,103	143,069	120	2,142	367	12,221	226	8,510	251	64,252
Total nontaxable returns	4,756,031	3,362,716	783,433	1,041,209	575,375	756,741	350,543	874,925	62,517	−14,431
All returns summary:										
Returns under $5,000	8,208,055	5,461,958	1,373,650	2,859,355	775,136	897,582	410,950	852,588	82,957	−8,166
Returns $5,000 under $10,000	8,493,332	8,153,339	1,543,430	5,516,090	774,924	1,142,401	476,976	480,451	88,962	122,587
Returns $10,000 under $15,000	8,355,852	5,933,030	759,408	3,366,038	733,193	1,047,119	651,567	645,678	90,102	150,415
Returns $15,000 or more	15,219,487	20,845,826	1,039,945	5,360,749	1,521,003	4,952,094	1,305,750	2,167,375	339,680	1,449,783

TABLE 6.—ADULT SHAREOWNERS BY HOUSEHOLD INCOME

	Individual shareowners			
	Mid-1975		Mid-1976	
	Number	Percent of total	Number	Percent of total
Under $5,000	780,000	3.3	2,389,000	8.5
$5,000 to $7,999	1,279,000	5.5	2,857,000	10.1
$8,000 to $9,999	1,357,000	5.8	2,923,000	10.3
$10,000 to $14,999	4,552,000	19.5	8,346,000	29.5
$15,000 to $24,999	8,778,000	37.5	7,670,000	27.1
$25,000 and over	6,642,000	28.4	4,114,000	14.5
Subtotal	23,388,000	100.0	28,299,000	100.0
Minors	1,818,000		2,221,000	
Not classified by income	64,000		330,000	
Total	25,270,000		30,850,000	

Source: New York Stock Exchange.

STATEMENT OF HON. ROBERT A. GERARD, ASSISTANT SECRETARY OF THE TREASURY FOR CAPITAL MARKETS AND DEBT MANAGEMENT

Mr. Chairman and Members of this distinguished Committee, thank you for the opportunity to discuss with you whether the federal government should try to change the current tax treatment of municipal bond interest, particularly by extending the minimum tax to such income.

The proposal to impose minimum tax on interest from municipal bonds derives from the general concern with tax equity. While the Treasury Department supports the objective of improving the equity of the tax system, we are also concerned that taxing municipal bond interest payments will significantly increase the borrowing costs of state and local governments and, if interest on existing holdings is taxed, it will substantially reduce the value of these holdings. For these reasons, Treasury is strongly opposed to such a proposal. We recommend, instead, that serious consideration be given to an alternative—the taxable bond option—which will contribute to tax equity and do so in a manner that will improve the structure of the municipal bond market.

IMPLICATIONS OF EXTENDING THE MINIMUM TAX

While there are reasons for viewing the municipal bond market as a separate market, its essential characteristics are virtually identical to those found in every financial market—that is, the value of a municipal security is a direct function of the risks inherent in owning it and the return it provides. What distinguishes the municipal bond market, of course, is that the return on municipal securities—the interest paid—is exempt from federal taxation. Accordingly, the economic value of the interest payments on municipal bonds varies according to the tax circumstances of the holder.

In looking at the implications of extending the minimum tax to income from municipal securities it is vitally important that this value/return relationship be clearly understood. From a financial standpoint, an investor in the 50-percent bracket is indifferent as to whether he receives $50 of tax-exempt income or $100 of fully taxable income. Accordingly, where the income on a bond is exempt from tax, the interest rate which must be offered to attract his investment in it need only be half as large. Any increase, however, in the taxes which must be paid by this investor has the effect of reducing the value of tax-exempt income relative to taxable income and therefore will increase, automatically, the amount of interest the issuer must offer in order to attract the investment.

The first and most serious concern we have about extending the minimum tax to municipal bond interest is that it would directly and substantially increase the cost of borrowing for state and local purposes. We must also take into account the potential impact of such tax in reducing the capital values of the more than $220 billion of municipal obligations held by the public. This impact would be significant because these assets provide the means for carrying out important financial functions, such as the collateralization of deposits of public funds.

The response of the market to the adverse impact of the minimum tax on returns from municipal bonds would be to require higher yields on new issues in order to maintain the same net returns. Such higher yields would mean higher interest costs, and higher taxes at the state and local level to meet these costs.

To obtain some indication of how the preference tax might impact on borrowing costs, let us assume that the annual interest generated by new tax-exempt issues is somewhat more than $2.5 billion. If the minimum tax were extended to both individuals and corporate bondholders, virtually this entire amount would be added to the minimum tax base. Even if the tax applied only to interest on bonds owned by individuals, perhaps $1 billion annually would be included in the base.

Individual investors are the purchasers of tax-exempt debt at the margin. Thus, even if the minimum tax were limited to individual investors, the effect of imposing the tax would be to increase the interest rates that state and local borrowers have to pay. The precise impact would depend on the particular structure of the minimum tax, including the tax rate and whether an exemption or an offset for regular taxes paid was allowed. Even if the minimum tax increased overall municipal borrowing costs by only 5 percent, the interest burden on state and local governments could rise by some $125 million the first year. This would increase by about the same amount each successive year for perhaps 10 years. Accordingly, by the tenth year, state and local governments would be bearing an additional annual interest burden of more than $1 billion solely as a result of the minimum tax.

THE MUNICIPAL BOND MARKET TODAY

Because the minimum tax proposals could have substantial impact on the municipal bond market, I want to take a few moments this morning to discuss more generally the state of this market.

The municipal bond market is basically sound and continues to provide an adequate mechanism for state and local government financing. Even in the face of widespread problems, the market as a whole performed very well in 1975, with a record $29 billion in new long-term issues and an equally large amount of short-term debt. Table 1 shows that this was the culmination of a steady upward trend over the past 15 years.

There is, however, an artificial and unnecessary constraint on the efficient financing of state and local government, since potential lenders are presently limited to those who can profitably use tax-exempt income. Thus, the largest borrowing sector in our capital markets after the federal government is restricted to a limited range of potential lenders. Some of the nation's largest groupings of financial assets are effectively barred from the market.

The limitation on the class of potential lenders has two implications:

First, more so than other markets, the municipal market seems to be susceptible to cyclical variations;

Second, the market is vulnerable to long-term, basic changes in supply/demand patterns.

The cyclical variability of the municipal market is caused by the behavior of the major purchasers of state and local debt—commercial banks, fire and casualty insurance companies, and individual investors, including personal trusts. As shown in Table 2, commercial banks generally have been the most important purchasers. This means that the municipal market may be adversely affected during periods of credit stringency or strong demand for bank loans, or when the banking system's need for tax-exempt interest diminishes.

There is growing concern that because the need of commercial banks for tax-exempt interest has declined, they will on average be less interested in holding municipal bonds in the future. Table 3 shows the ownership of municipal securities for selected periods since 1960. Commercial banks absorbed over 70 percent of the net new issues over the period from 1960 to 1970, when their share of the total municipal debt outstanding almost doubled. Since 1970, however, they have absorbed only one-half of the net new issues, barely enough to keep their share of the total debt market constant. Consequently, insofar as long-term development of the market is concerned, other sources of financing must be found if the overall demand for municipal securities is to be maintained.

Increased participation by individual investors typically will not fully offset the decrease in participation by commercial banks. In such circumstances, the total demand for state and local government debt tends to decline. Secondly, the shape of the demand curve also changes, since individuals are willing to absorb larger amounts of municipal debt only at sharply increasing interest

rates. The result, as shown in Table 4, is a fluctuating relationship between taxable and tax-exempt interest rates.

The volume of municipal debt and the interest rates at which it can be sold are thus critically affected by the fact that the market responds not only to overall changes in credit supply and demand, but also to short run changes in the financial situation of a single group of institutional lenders.

At the same time that bank participation is diminishing, inflationary pressures have created sharply increased levels of demand for credit by municipalities. The impact of inflation is reflected in the higher cost of capital improvements which must be financed with tax-exempt bonds.

The long-range prospect for the municipal bond market is thus clouded by two interrelated elements: a static supply of credit to the market and a growing demand by municipalities for it.

A third related problem is that the cost of federal tax exemption is substantially greater than the benefit to municipal borrowers.

To analyze this cost, we begin with the fact that, primarily due to market efficiency factors, the degree to which tax exemption reduces municipal interest costs varies with the maturity of the debt. Shorter-term exempt securities enjoy a greater reduction in interest rates relative to taxable securities than do longer-term bonds. On average, tax-exempt rates are more than 50 percent below taxable rates for issues of a year or less, about 30 percent for intermediate issues, and about 20 percent for 30 year bonds. This represents the saving to municipal borrowers.

The tax cost of the exemption can be determined by reference to the marginal tax rate of the average investor. It has been estimated that the average marginal tax bracket of investors in tax-exempt bonds is over 40 percent. If all these investors purchased taxable rather than tax-exempt bonds, tax revenues would increase by over 40 percent of the interest that would be paid on such bonds. This revenue cost is substantially greater than the benefit to state and local governments. For example, if $30 billion of long-term debt were issued at a tax-exempt interest rate of, say, 6.3 percent, as contrasted with a taxable rate of 9 percent, interest payments by state and local governments would be reduced by some $800 million in the first year. If that interest had been taxable, however, and if purchasers of that debt had no investment alternatives except taxable bonds, the gain in federal revenue would be $1.1 billion. The $300 million difference represents revenue losses which are not passed through to issuing governments.

There are other problems currently associated with the municipal bond market. For example, the Municipal Finance Officers Association and the Securities Industry Association have recommended repeal or substantial limitation of the pollution control exemption for private companies. This recommendation warrants serious consideration as an additional method of improving the market for state and local securities. The large volume of such issues has had an adverse effect on interest rates for longer-term municipal obligations, with which these private credits compete.

The proposal to extend the minimum tax to municipal bond interest involves an attempt to deal with the question of tax equity, not the structural problems of the municipal market. It is thus not surprising that such tax would simply exacerbate these critical problems. Treasury believes that a preferable alternative is the taxable bond option, which can ameliorate the structural problems of the market while contributing in a meaningful way to increased tax equity.

THE TAXABLE BOND OPTION

The Treasury Department recommends that the Committee consider—as an alternative to the minimum tax concept—the taxable bond option.

This proposal would give state and local governments the option of issuing either tax-exempt debt or taxable debt in return for a federal subsidy payment. We have proposed a 30 percent subsidy limited to the first 12 percent of the interest payable on the taxable municipal bond. We think that this is the right subsidy level to provide a needed "safety valve" for the municipal market, particularly in the longer-term maturities. We would be concerned about the impact on the municipal market and the cost to the federal government of a subsidy figure in excess of the 30 percent level.

Treasury believes that the taxable bond option will increase the liquidity and improve the stability of the municipal bond market. It will deal with the problem of cyclical variations by freeing municipal issuers from their overdependence on the need of investors for tax-exempt income and the availability of credit from a particular class of lenders. Under this option, new sources of long-

term credit will become available to municipal issuers. Naturally, issuers will elect the taxable bond option only if their net interest costs can be reduced. Furthermore, to the extent part of the supply of new state and local issues shifts to the taxable market, those who continue to issue exempt bonds will also find their interest costs are reduced.

The changes brought about by the taxable bond option will also have important implications for tax equity. To the extent that fewer bonds are issued in the tax-exempt market than would otherwise be the case, there will be less use of such bonds as a tax shelter. Secondly, because the option will reduce interest rates on new tax-exempt bonds, those who continue to purchase tax-exempt securities will receive a lesser amount of interest. Thus, high-bracket investors will no longer be able to command as much in the way of excess return from municipal bonds as they do today.

The taxable bond option therefore addresses both the structural problems of the municipal bond market and the tax equity issue.

REVENUE AND COST OF TAXABLE BOND OPTION

The net cost of the taxable bond option will depend on the gross subsidy paid to municipal issuers of taxable securities, less the additional revenues generated by the higher volume of taxable issues.

While the increase in tax revenues will offset some of the gross subsidy costs, it is not reasonable to expect that, on balance, Treasury will make money from the plan. This is because the plan is an optional one, and state and local governments will only use it if there is a cost saving to be realized. Therefore, the taxable bond option should not be advocated as a revenue raiser. It is fully justifiable because its benefits will be large relative to any net federal costs.

In Table 6, we show the cost components of a 30 percent interest subsidy and how those costs will vary over time. It should be noted here that the first-year costs are only a fraction of what the total long-run costs will be, since each successive year's issue of new debt will generate subsidy costs in addition to those of the previous years. With a 30 percent subsidy, the gross subsidy costs are $39 million the first year and rise to $486 million per year by the tenth year. Offsetting these costs are federal tax revenues of $32 million the first year and $405 million per year by the tenth year. Thus, the net annual cost grows from $7 million to $81 million over 10 years.

The table also indicates the benefits to state and local governments in terms of lower net interest expense. As a result of the plan, interest rates paid by state and local governments would decline by about 46 basis points in the over 15-year maturity range. Therefore, over 10 years, these savings in annual interest payments grow from $69 million to $868 million. Thus, the ratio of state and local benefits to net federal costs could exceed ten to one. I want to caution you that the precise costs and benefits will depend on market conditions which cannot be foreseen in advance. However, while the figures shown in the table can only reflect the particular assumptions made, we believe them to be indicative of general market conditions which may be expected to prevail in the future.

RECOMMENDED PROCEDURES FOR THE TAXABLE BOND OPTION

An effective taxable bond option requires a relatively automatic procedure and certain safeguards. Thus, if a governmental unit elects to issue federally taxable obligations and Treasury agrees to pay the subsidy, neither the election nor the subsidy could be revoked or adversely modified, even if the statute were later amended or repealed. In most cases the subsidy agreement should be obtainable automatically through appropriate certification that certain general standards have been fulfilled. For example, the subsidy would be payable only if the instrument is marked to show clearly that all interest payments are subject to federal tax. The subsidy itself would be a fixed percentage of the issuer's net interest expense and could not be varied administratively. The subsidizable amount would be determined after deducting appropriate administrative costs. We anticipate that such costs will be minimal because there will be no federal involvement in state and local financial decisions.

Administrative procedures for paying the subsidy would be simple. The subsidy payment would be made to the paying agent immediately before the interest is payable to the holder. The subsidy would not be released for payment to the holder unless and until the issuer paid its portion of the interest then due. The payor would file an information return with the Internal Revenue Service reporting the payment of taxable interest, including the subsidy.

An issuer could elect the taxable bond option only for state or local obligations which would be exempt under the Internal Revenue Code, but for the election. Certain municipal bonds otherwise eligible would not qualify, including:

Obligations as to which the United States provided other financial assistance, including agreements to guarantee the payment of principal or interest or to acquire the bonds; and

Obligations held by parties related to the issuer.

The first limitation is necessary to prevent additional federal subsidies for certain transactions already subsidized by federal agencies. The rule disqualifying obligations to be acquired by related parties is intended to prevent the issuance of bonds merely to obtain the federal interest subsidy—for example, where two issuers swap their new obligations. We believe that, at a minimum, these two limitations are necessary.

The statute must be drafted carefully to prevent arbitrage—issuing obligations in one market for the purpose of investing the proceeds in a different market at a higher yield. Congress attempted to limit arbitrage in 1969 by providing that municipal bonds will be taxable if the proceeds are invested in securities producing a materially higher yield over the term of the bonds. The artificially low yields so required has the undesirable, and doubtless unintended, effect of creating large windfall profits for underwriters, consultants and promoters. It has proved to be very difficult to remedy this situation administratively. Based on this experience, we caution you that any taxable bond option should incorporate appropriate restrictions on arbitrage.

TREASURY PERSPECTIVE ON THE TAXABLE BOND OPTION

There are some who may advance the taxable bond option for the ultimate purpose of eliminating the tax-exempt bond market. This strategy would involve enacting a taxable bond option with a relatively high level of subsidy, attracting a large volume of new state and local issues into the taxable market through the subsidy and then, at some future date, pointing to the decline in interest and activity in the tax-exempt market as a justification for repealing the exemption entirely. Needless to say, we strenuously oppose this approach, and in light of this, we are quite concerned about the appropriate level of the subsidy. At 40 percent or above, there is little doubt that this strategy would have a reasonable chance of success.

Additional support for the taxable bond option comes from those who believe that there should be greater federal subsidization of state and local borrowing. They are urging a form of revenue sharing, if you will, but revenue sharing tied to the amount the state or local government is willing to borrow, rather than based on broader economic and demographic factors. Again, the percentage level of the subsidy is critical. At the 30-percent level we have suggested, there will be little in the way of new subsidies which must be paid for by federal taxpayers; at 40 percent or more, the subsidy cost will be very substantial. Moreover, because the subsidy level would be governed in this case by the desire to provide benefits substantially exceeding what the market now provides, it would have to be set at a level—e.g., 40 percent or more—where the viability of the tax-exempt market would be threatened.

We view the taxable bond option from an entirely different perspective. As I have indicated, we are sensitive to the cyclical problems, as well as to the real possibility that a basic change in the supply/demand characteristics of the market is occurring. We also canont help but be cognizant of the concern that the current system, if left unchanged, does generate excessive benefits for ceratin taxpayers. Indeed, I doubt that we would be here today if this were not the case.

We fear that this range of concerns could lead to measures which would impair the ability of state and local governments to finance their legitimate needs in a sound and responsible manner. I have testified at some length this morning on one such measure: the inclusion of tax-exempt interest in the minimum tax. Needless to say, a more troublesome prospect would be the attempt to deal with all of these concerns by eliminating the tax exemption entirely.

It is for these reasons, and these reasons alone, that we have proposed and support a taxable bond option at a 30-percent subsidy level. As I suggested a few moments ago, we believe that such an approach will, in effect, provide a safety valve for the tax-exempt market without either threatening the basic viability of the market or imposing substantial costs on federal taxpayers. Moreover, to the extent market efficiency is enhanced by this modest alternative, and we believe it will be, concerns about tax equity will be alleviated materially.

In short, we are convinced that the nation would be best served at this point by responsible measures designed to maintain the traditional and proven method

of financing state and local government. We strongly oppose radical change in either direction: inclusion of tax-exempt interest in the minimum tax, or the virtual elimination of the tax-exempt market through authorization of taxable bonds with a federal interest subsidy of 40 percent or more. If a change is warranted, and we believe it is, we urge the Committee to consider providing a truly optional table bond—that is, one with a 30-percent subsidy.

TABLE 1.—*Volume of gross new issues of long-term municipal bonds by year*

Year	Gross issues (millions of dollars)
1960	7,229
1961	8,359
1962	8,558
1963	10,107
1964	10,544
1965	11,084
1966	11,089
1967	14,288
1968	16,374
1969	11,460
1970	17,762
1971	24,370
1972	22,941
1973	22,953
1974	22,824
1975	29,224

Source: Bond Buyer, Jan. 15, 1976.

TABLE 2.—OWNERSHIP OF MUNICIPAL SECURITIES, YEAR-END OUTSTANDINGS, SELECTED YEARS

[Dollar amounts in billions]

Year	Total	Households		Commercial banks		Nonlife insurance		All other	
		Amount	Percent of total	Amount	Percent of total	Amount	Percent of total	Amount	Percent of total
1960	$70.8	$30.8	43.5	$17.7	25.0	$8.1	11.4	$14.2	20.1
1965	100.3	36.4	36.3	38.9	38.8	11.3	11.3	13.7	13.7
1970	144.5	45.6	31.6	70.2	48.6	17.8	12.3	10.9	7.6
1974	204.1	60.3	29.6	100.3	49.2	30.7	15.1	12.8	6.3

Source: Federal Reserve Board, flow of funds data.

TABLE 3.—NET CHANGE IN OWNERSHIP OF MUNICIPAL SECURITIES, SEASONALLY ADJUSTED ANNUAL RATES

[Dollar amounts in billions]

Year	Total		Individuals		Commercial banks		Fire and casualty insurance companies		All other	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
1960	$5.3	100	$3.5	66.0	$0.6	11.3	$0.8	15.1	$0.4	7.6
1961	5.1	100	1.2	23.5	2.8	54.9	1.0	19.6	.1	2.0
1962	5.4	100	−1.0	−18.5	5.7	105.6	.8	14.8	−.1	−1.9
1963	5.7	100	1.0	17.6	3.9	68.4	.7	12.3	.1	1.8
1964	6.0	100	2.6	43.3	3.6	60.0	.4	6.7	−.6	−10.0
1965	7.3	100	1.7	23.3	5.2	71.2	.4	5.5	0	....
1966	5.6	100	3.6	64.3	2.3	41.1	1.3	23.2	−1.6	−28.6
1967	7.8	100	−2.2	−28.2	9.1	116.7	1.4	18.0	−.5	−6.4
1958	9.5	100	−.7	−7.4	8.6	90.5	1.0	10.5	.6	6.3
1969	9.9	100	9.6	96.9	.2	2.0	1.2	12.1	−1.1	−11.1
1970	11.2	100	−.8	−7.2	10.7	95.5	1.5	13.4	−.2	−1.8
1971	17.6	100	−.2	−1.1	12.6	71.6	3.9	22.2	1.3	7.4
1972	14.4	100	1.0	7.0	7.2	50.0	4.8	33.3	1.4	9.7
1973	13.7	100	4.3	31.4	5.7	41.6	3.9	28.5	−.2	−1.5
1974	17.4	100	10.0	57.5	5.5	31.6	1.8	10.4	.1	.6
1975 [1]	16.2	100	10.0	61.7	2.4	14.8	2.2	13.6	1.6	9.8

[1] 1st 3 quarters annualized.

Source: Federal Reserve Board, flow of funds data.

TABLE 4.—TAX-EXEMPT AND TAXABLE INTEREST RATES AND RATIO OF THE 2

[In percent]

Year	Tax-exempt interest rate (Bond Buyer 20)	Taxable interest rate (Moody's corporate new issue)	Ratio
1960	3.54	4.82	73.5
1961	3.45	4.70	71.6
1962	3.17	4.46	71.1
1963	3.16	4.41	71.7
1964	3.22	4.54	70.9
1965	3.25	4.71	69.0
1966	3.81	5.59	68.2
1967	3.92	5.91	66.3
1968	4.42	6.70	66.0
1969	5.66	7.97	71.0
1970	6.36	8.85	71.9
1971	5.52	7.74	73.9
1972	5.25	7.47	70.3
1973	5.22	7.88	66.3
1974	6.09	9.08	67.1
1975	7.06	9.42	75.0

TABLE 5.—TAX-EXEMPT BORROWING

[Dollar amounts in millions]

Year	Gross long-term tax-exempt borrowing	Pollution control	Other industrial development bonds	Total non-governmental	Percent of market
1971	$24,370	$93	$220	$313	1.3
1972	22,941	594	471	1,065	4.6
1973	22,953	1,750	270	2,020	8.8
1974	22,824	2,140	337	2,477	10.9
1975	29,224	2,508	398	2,906	9.9

Source: Bond Buyer.

TABLE 6.—ANNUAL COSTS AND BENEFITS OF TAXABLE MUNICIPAL BOND PLAN WITH 30 PERCENT SUBSIDY

[In millions of dollars]

Year	1	2	3	4	5	10
Gross subsidy cost	39	79	122	166	213	486
Revenues generated	32	66	102	139	178	405
Net subsidy cost	7	13	20	27	35	81
Reduction in State and local interest costs	69	141	218	297	381	868

The CHAIRMAN. Next we will call on Mr. John E. Petersen, director of the National Governors Conference Center for Policy Research and Analysis.

Is Mr. Petersen here?

Mr. PETERSEN. Yes, I am here, Senator.

The CHAIRMAN. All right, sir.

STATEMENT OF JOHN E. PETERSEN, DIRECTOR, NATIONAL GOVERNORS CONFERENCE CENTER FOR POLICY RESEARCH AND ANALYSIS, WASHINGTON, D.C.

Mr. PETERSEN. Mr. Chairman, I am John Petersen, director of the Center of Policy Research and Analysis of the National Governors Conference. The NGC has a policy in opposition to the taxa-

tion of the interest income from State and local obligations, and testified to that effect in 1969 when inclusion of such income in the minimum tax was proposed. That policy position has not been reviewed for purposes of these hearings, but I have no reason to believe that it would be altered.

State governments and local governments and their agencies and authorities have approximately $225 billion in debt outstanding. Because of the importance of tax exemption to the financing of both State and local governments, I am appearing to discuss why Governors, as well as other State and local officials, believe that removal of that exemption is not a desirable policy. My comments will focus on the taxation of such income through the application of the Federal minimum tax.

Inclusion of municipal bond interest income in the Federal minimum income tax base would be a peculiarly costly form of tax revision, the Federal revenue and equity consequences of which are miniscule in comparison to the increased burden it would place on State and local governmental borrowers.

When the national tax system is viewed as a whole—incuding Federal and State and local taxes and charges—and when the impact of increased borrowing costs of governments are set beside the foreseeable revenues from such a tax, the most probable outcome is that the effect of the change would be to lessen the progressivity of the system and to increase the burdens of the lower and middle income groups.

This contrary result occurs because the interest paid on State and local borrowings would go up once it became subject to taxes. This, in turn, means that taxes, fees, and user charges must go up to meet the increased cost of borrowing. Examination of the relative progressivity of the Federal and State and local tax systems shows that the latter is less progressive, and in the case of the sales and local property tax, is frequently regressive. Thus, the bulk of the money raised to pay for a minimum tax will be generated by those parts of the national revenue system that are relatively more dependent upon those in the lower income brackets.

Estimates of the yields of a minimum income tax on municipals are hypothetical. In 1969, it was thought that such a tax might yield $35 million after 10 years. Even after allowing for expansion through inflation, this is a small amount in comparison to the estimated more than $11 billion in interest payments that State and local governments now pay.

But unfortunately, the actual taxes paid probably would have no relationship to the amount borrowing costs would rise. This is so because not only would the added taxload on investors have to be compensated for by increased interest payments, the latter would have to be raised to compensate investors for the increased risk of future tax changes and the uncertainty as to their effects on the market.

Congress would, in effect, be announcing that henceforward the extent of tax exemption on the obligations of State and local governments is subject to legislative change. For a security that depends for about 25 to 30 percent of its present value on tax exemption, this is frightening, especially when one contemplates making a 20- or 30-year investment.

Thus, any investor buying a tax-exempt bond would not only discount the customary risks of changes of creditworthiness, prices, interest rates, and tax shelter requirements, he would also have to discount for the added risk that the bonds he owned might become taxable.

This added risk factor is not confined to individuals. Institutions that acquire municipal securities must also discount for the impact of such risk on the future complexion of the secondary market into which they may have to enter for liquidity.

I go on to discuss in my statement some of the possible changes on interest rates, and I believe these outdistance by a considerable measure the revenues from the Federal minimum income tax. I think the estimates are similar to those you received from the Treasury.

Aside from the market effects required to compensate investors for both increased taxpayments—small—and added risks of tax liability—large—there are other problems to consider in the imposition of a minimum tax. There is the potential of litigation over the right of Congress to levy such a tax on municipal bond interest.

Regardless of the outcome of such a confrontation, the impacts of the municipal bond market would be disastrous, at least until the question was resolved.

In addition, drawing a bead on individual investors in municipal bonds seems particularly poorly timed when the market has had to rely so heavily on them recently. With a lack of institutional interest and many worries over default and bankruptcy, the reliance on individuals has been of critical importance. It has already required high rates of interest to induce these investors into municipal bonds, and uncertainty over future tax status would serve to magnify these costs.

The minimum tax proposal involves yet other equity problems of its own. If the interest on bonds sold prior to date of enactment were to be included, those investors that hold them will be taxed on bonds which they originally purchased at lower rates of interest on the understanding that they were tax exempt. More important, even were they not to pay the tax directly, investors in such bonds would suffer a loss in capital value because of the tax's depressing influence on security prices.

On both scores, investors would have legitimate complaints about inequities. On the other hand, if the tax were to apply only to the income on bonds sold after enactment, the holders of the old bonds would be given a capital gain because these securities would continue to possess complex tax exemption which the new bonds would not.

In summary, the implications of inclusion of municipal bond interest income in the Federal income tax are fraught with inequities and cost effects that would outweigh any marginal benefits that might be achieved in snagging a few individuals who pay no taxes. In fact, any investor who owns municipals and has no taxable income is not acting rationally. This is because until an investor is in a 30- to 40-percent marginal tax bracket, he would be better off buying taxable securities of like quality in order to maximize aftertax income.

The minimum tax does nothing to improve the efficiency or the absorptive capacity of the municipal bond market and actually works

against both by constricting the demand for debt and adding to the risk in that market.

The Governors Conference is aware of other proposals, such as the taxable bond option, that are directed to broadening the demand for State and local obligations. Such proposals, we believe, cannot be considered on their own merits when they are coupled with the taxation of existing tax-exempt securities; it is not an acceptable trade-off.

The Governors Conference has adopted criteria concerning Federal credit assistance to State and local governments, and has examined the issue. There is not, at this time, consensus on whether a taxable bond option meets those criteria.

But I do ask that there be included in the record a recent analysis of the taxable bond legislation prepared by the staff of the National Governors Conference, which I have given to the recorder.

Thank you very much. I would be pleased to answer any questions you might have.

The CHAIRMAN. Senator Brock.

Senator BROCK. Mr. Petersen, I am very sympathetic to what you say. Perhaps I could ask you a question a little more philosophical in tone.

I had some members of a local union down in Chattanooga come up and visit with me, longtime friends of mine, and they were asking me what we were going to do with the fact that a couple hundred people in this country had over $100,000 in income and didn't pay any tax, and I wonder if you could tell me how we can get to that problem, if we don't deal with it in some fashion like this?

Mr. PETERSEN. Senator, I can only speak from the standpoint of municipal bonds, in particular, and I think that in many ways this exemption does pose a peculiar problem for the committee. In examining the effect, as I discussed in my testimony, this is one instance where inclusion of this particular form of income in the tax base would increase costs for government, the other half of the federal system, the State and local governments. In effect, I submit that individuals that buy tax-exempt securities, by accepting a lower rate of return, have paid some tax.

Now, is that enough tax or not, is a question of efficiency. I am not prepared to argue that today.

Senator BROCK. Well, it is not just a matter of paying taxes or not just paying taxes but to whom the taxes are paid, and you are correct in the essence of your statement that they are not paying the tax, but they are not paying the tax to the—they are paying a hidden tax to the State and local governments, but they are not paying tax to the Federal Government.

Mr. PETERSEN. Senator, when I give a charitable contribution which helps me forego tax, I am not paying the contribution to the Federal Government, but I am giving it to a recognized social purpose which will reduce my tax burden.

Senator BROCK. I understand; I am not trying to argue with you. You are a very bright guy, and I want you to tell me how to solve this problem.

Mr. PETERSEN. My reach doesn't go beyond my grasp, Senator.

Senator BROCK. Let's leave the impossible question for a moment, then.

I don't know if you heard the Treasury presentation——

Mr. PETERSEN. Yes.

Senator BROCK [continuing]. But if we, instead of having taxation on municipal bonds, or even applicability of minimum taxation—but if we were to consider the option as proposed by the Treasury, wouldn't that fit within most of your areas of concern? Wouldn't that still offer State and local governments an alternative mechanism that would, rather than destabilize, would enhance the marketability of these particular securities?

Mr. PETERSEN. Senator, again, I have presented an analysis that the National Governors' Conference has done, and to be entirely candid with you, we do not have unanimity as to the desirability of a taxable bond option. That being understood, I do think that many would argue that with a properly designed option, there are many benefits from such a market-broadening device.

In particular, there are the lowering of the interest costs, relatively, for State and local governments and stabilizing the rates. That, incidentally, would have many of the same impacts on the amount of tax avoidance as a minimum tax, by actually reducing the amount of surplus going to the highest marginal tax bracket payers. Those are economic arguments.

Setting forth the counterarguments are those who are fearful the subsidy could lead to possible Federal domination and regulation in the State and local securities market. This is a point which Treasury itself has addressed saying, "this is a valid argument, so we are keeping the rate of subsidy low."

I know that subsequent witnesses will be talking about some of the details and mechanics of the taxable bond option.

Senator BROCK. Thank you.

The CHAIRMAN. Senator Packwood.

Senator PACKWOOD. Is it your position that, if we were to tax municipal bonds at the going tax rate, the additional interest that the local governments would have to pay would be greater than the revenue that the Federal Treasury would derive?

Mr. PETERSEN. I think that my remarks were aimed specifically at the minimum tax. In terms of looking at the entire markets, say, where you were to withdraw section 103——

Senator PACKWOOD. No, no minimum income tax, the argument made is on the other side, that the Federal Government would get more revenue than would be the increased interest cost for local governments, and we can rebate the difference to local governments and still come out with a surplus.

Mr. PETERSEN. You are talking about a taxable bond option now?

Senator PACKWOOD. I am talking about eliminating the taxable bond option.

Mr. PETERSEN. We don't have a taxable bond option yet to eliminate.

Senator PACKWOOD. Let me rephrase the question. Forget the taxable bond issue.

If we were to simply levy a tax on municipal bonds at the same rate all other taxes are levied, is it your position that the increased interest paid by local governments would be more than the increases in revenue to be derived by the Federal Treasury?

Mr. PETERSEN. That would be such a drastic change, Senator, I am not prepared to give you a direct answer on that.

I would say, if you were to make it apply on all new bond issues, the initial impact on the market would be catastrophic; it would call for considerable change and friction cost. I am not in a position to give you a flat answer. After a period of time it might balance out.

Senator PACKWOOD. Then, I would suggest—I don't know if the issue is going to come up seriously to be offered in this committee or on the floor. Those on the other side from your position are making the very firm statement that the gain to the Treasury will be greater than the increased interest to local governments and will use the gain to rebate the cost to local governments and keep the difference. And they are setting hard facts and statistics allegedly proving that, and you are going to be in a weak position if your defense on the other side is, "Well, we are not sure."

I have no other questions.

The CHAIRMAN. Senator Hansen.

Sentor HANSEN. Mr. Petersen, I think that I can discern an increasing reluctance on the part of subdivisions of government and municipal government and county government to participate to the extent they have in the past in Federal grant-in-aid programs and all that sort of thing, and they do it for a number of reasons, one of which is the fact that oftentimes there is a written-in requirement that they have to comply with the Davis-Bacon Act.

I noted that the House general revenue sharing bill this year would further impose that costly law upon governments throughout the United States, that if they used any Federal revenue sharing funds for the funding of a project that the Davis-Bacon Act would apply. They are becoming frustrated, local officials are, with the increasingly high amount of redtape and requirements that they have to go through.

I know in my State of Wyoming you would be amazed at the HEW requirements that were put in to make certain that there was no discrimination in the practices that were being employed by the University of Wyoming to use some of the federally funded grants that they were receiving from HEW.

Now, with that growing reluctance, or at least as I discern it to be a growing reluctance, does it make sense to you to discourage local units of government from bonding to raise the dough, to tax themselves to raise the dough for specific purposes and to, on the other hand I suspect, make or require that the governments have to turn to the Federal Government for various kinds of funding?

Mr. PETERSEN. Well, State and local governments, despite the occasional difficulties in categorical assistance, have shown a mighty appetite for borrowing in what often are difficult market conditions. A record was set last year in terms of the total bond volume despite the New York difficulties, and so I don't think such assistance has

abated their willingness to go to the market and pledge their own security and taxes in the future to pay for needed improvements.

Senator HANSEN. I was misunderstood if I implied that there was that tendency. I think what you are saying is precisely what I was trying to say, that there is an increasing willingness of State and local governments to go into the market and to borrow the money so they don't have some bureaucrat in Washington telling them how they have to spend it all or the kind of laws they have to comply with.

That is what I meant to say.

Mr. PETERSEN. Certainly that is desirable, to cut out as much as possible the bureaucracy problems and the redtape problems, and so forth. That is one of the advantages to the existing market mechanism—it does present an opportunity to borrow at a lower cost of capital, in any conditions, and, of course, it is used for this purpose. Many times you have to convince the voters in the referendum to go along with you but it has been a tremendous source of capital to the State and local governments, and one without strings.

Senator HANSEN. Well, my next question then I guess would be this: Carrying on with the concern that was expressed by Senator Brock, how do we explain to people in the United States, to our constituents, that there are some 244 people with incomes in excess of $200,000 last year who paid no tax? All I can say is that insofar as tax exempt municipal and State bonds contributed to that situation, I am willing to try to defend them by saying that it is the best bargain that America ever had.

There has been a lot of talk about Mrs. Dodge, and how much money she received. I have been a school board member and a county commissioner. We are just darn lucky there have been people like Mrs. Dodge around. If she had wanted to go into the market with some people to manage her investment portfolio, I have no doubt that she could have died worth twice as much as she did when she died. I am willing to take the flak to explain to people that there may be many other places where we should tighten up.

I think the Chairman has pointed out the importance of closing loopholes where you go out and borrow money and can deduct the interest on it and then buy tax exempt municipal bonds. I am not for encouraging that sort of thing at all, I am for discouraging it. But I don't go so far as to say people who don't have to borrow the money and who have money to invest should be denied the simplicity of buying these bonds.

While it is interesting to speculate on the point Senator Brock made about the banks, increasing the amount of money they invest in these bonds, one thing that can be said about it, prior to the experience that New York City had exhibited for all of America to view was that it was up to then a pretty safe investment and some of their investments have not been all that good.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Haskell.

Senator HASKELL. Thank you, Mr. Chairman.

Mr. Petersen, I think I probably agree with your view concerning the dislocating effects of putting municipal interest under the minimum tax. I would like to see if we are talking about the same thing concerning the so-called option on bonds.

You stated that you submitted a staff paper. I am talking about something that operates perspectively only—that is, for new issues, not existing issues—that has a Federal subsidy of somewhere around 40 percent of the interest rate.

Now, based upon those two things, it is my understanding that there would be a net increase in revenue to the Treasury if they were made taxable. What are your views on this?

Mr. PETERSEN. Were you to make the bonds taxable that elected to use the taxable option taxable?

Senator HASKELL. That is correct.

Mr. PETERSEN. It is my personal feeling, not representing any way, shape, or form the National Governors Conference——

Senator HASKELL. Just Mr. Petersen.

Mr. PETERSEN. No, I don't think it would. You might possibly break even, but I would say Treasury takes a small loss. I think most of the analyses that have been done both by Treasury and others would tend to indicate that there would be a small net Treasury cost.

Senator BROCK. Treasury comes out with a break even at 30 percent, or almost break even.

Senator HASKELL. They come up with a breakeven point at 30 percent. Anyway, what I am talking about is that we are getting close to a wash situation.

Now, this would solve problems. which I agree are real national psychological problems in dealing with the Internal Revenue Service.

I have one other question I would like to ask you, Mr. Petersen. The municipal market in past years has itself been necessary to increase interest rates and it seems to me it has been necessary to increase interest rates beyond the normal curve and I have heard it suggested that it is a function of an increasing supply. And I have also heard it suggested it might be a good idea to reduce the number of things you could have municipal bonds for.

For example, these industrial development bonds really are not used for municipal purposes. I wonder if you had any comments on that situation?

Mr. PETERSEN. Yes, sir, I do. I think that you would find upon examination that a considerable amount of growth in tax exempt securities has occurred in nontraditional uses and, in particular, the pollution control bond. That is a form of tax exempt security sold under section 103 for the benefit of corporations that are putting in pollution control equipment. Also, there is continuing the use of the industrial revenue bond.

Here again I am speaking strictly as a technician and not representing policy, but I believe most of the market analysts and students would say these have increased interest costs.

The supply of bonds, of course, always has to be considered in relationship to the demand for them. The point was made earlier of the impacts of shifting of bank participation. This has been a critical factor. The bank appetite for municipal bonds has diminished somewhat over the last couple of years. They have found other ways to get tax shelter and so we have had to adjust the market to other investors.

Senator HASKELL. The use of that very phrase indicates what we are dealing with here.

Mr. PETERSEN. Yes.

Senator HASKELL. The fact that that phrase came out. If that was in somebody else's testimony it would have been a Freudian slip, however, I do not feel it was in your case. This is very significant.

Thank you. Go ahead, sir.

Mr. PETERSEN. I think we have to call them what they are.

Senator HASKELL. Call a spade a spade.

Mr. PETERSEN. That is right.

That is the first step in making a good analysis of the situation. I know you will have subsequent suggestions in terms of how to diminish the supply of tax exempt securities, either by restricting the use to which they can be put or by diverting some of that supply into the taxable securities market.

Senator HASKELL. Thank you very much, Mr. Petersen.

The CHAIRMAN. Senator Gravel.

Senator GRAVEL. No questions.

Senator RIBICOFF. Let me ask you about the one matter I raised with Treasury. You might just write this down in front of you so you can look at these figures.

I am just looking at some of these various years of interest rates in the Treasury statement just to give you a rough calculation. Let's assume that a person owned $100,000 of bonds and he is drawing 6 percent interest on them. That is tax exempt.

Now, that person then proceeds to borrow $100,000 in order that he can continue to own those bonds. So he then has a $9,000 interest expense which, if he were in a 70-percent bracket, would be worth $6,300 for a deduction.

Now that transaction would be a loss transaction of $3,000 but he has a gain against taxes of $6,300. That works out to the fact that the man has engaged in a loss transaction of $3,000 which works out to an overall profit of $3,300 at the expense of Uncle Sam.

In effect, the United States has lost $6,300 which makes it possible for that man to continue a loss situation.

Now, minus that tax loss, that man would sell those bonds and pay off what he owes. We have section 263, which is intended to strike at that type situation and you heard the Commissioner of IRS testify that is a very ineffective section, very difficult to enforce, because it relies upon the intent when the man bought the bonds or the intent in carrying it.

Now, what would your reaction to that be? Suppose we simply said that you simply have to reduce your interest expense by the amount of interest that you have got from the tax exempt securities?

Mr. PETERSEN. Well, I have to make an off-the-top estimation——

The CHAIRMAN. Let's understand this. If the States needed it I would be glad to vote for it. The House has already suggested it. They suggested a 35-percent Federal subsidy to the States that chose to issue taxable bonds. The purpose is to broaden the market for States. I favor that.

This would affect in some respects the taxation and the marketability of these stocks, if we exempted these lending institutions which are the prime purchasers of these bonds, leave them out and say if you want to issue taxable securities the Federal Government would subsidize them to the extent of 35 percent—what would your reaction to that be, to that type of approach?

Mr. PETERSEN. Well, my reaction would be as an individual that the economics are there, if indeed the program can be designed to make it a free going option. On the other hand, as I pointed out, Senator, the National Governors Conference does not have a consensus position on the desirability of any particular proposal. But, I do think the Treasury and others will testify that were it to operate in the way people believe it could operate, then it would be a useful alternative, and certainly one that would be preferable to the minimum income tax and other devices which would increase the cost of borrowing.

I am intrigued by your example and wish I could be helpful in terms of setting parameters. It is a fact that people who are violating this law present an enforcement problem because clearly this kind of behavior is currently against the law.

The CHAIRMAN. Well, if Uncle Sam is willing, and I would favor it, to do his part toward helping the States to find their funds at a low interest rate, it seems to me the States ought to be willing to cooperate in an arrangement or at least to acquiesce to a tightening up on section 265 so a person can't engage in a loss transaction where he makes money by losing money. Uncle Sam has to pick up the tab for it. It seems to me that that type of tax avoidance is difficult for anyone to defend and I don't detect you defending it.

If we protected the interest rate for the States by simply saying you get a 35-percent subsidy, whatever would be fair, it seems to me the State should not object to closing out that loophole.

Mr. PETERSEN. All I can say is that borrowing for the purpose of buying tax exempt bonds and then taking the interest deduction—unless you are a bank—is against the law. I am sure no governors are going to stand here and tell you that they are in favor of breaking the law.

The CHAIRMAN. That gets down to what my old criminal law professor told me with regard to a lot of things, it is not what you do but the way you do it. People are doing this all the time and they are getting away with it and the Collector of Internal Revenue says his win record is very poor because we haven't given him a very good law to enforce. I wondered what your reaction would be if we take care of that problem, but protect the States' borrowing capacity?

Mr. PETERSEN. I think that no one could argue that there shouldn't be better enforcement of the law that stands. If that means subsequent or additional changes in the law, that is a matter of analysis.

I think it is always important when dealing with this market, since I am here representing this market, not to make the cure worse than the disease. This is a problem we have with the minimum income tax proposition.

The CHAIRMAN. Thank you very much.

Mr. PETERSEN. Thank you.

[The prepared statement of Mr. Petersen and attachment follow:]

STATEMENT OF JOHN E. PETERSEN, DIRECTOR, CENTER FOR POLICY RESEARCH AND ANALYSIS NATIONAL GOVERNORS' CONFERENCE

I am John Petersen, Director of the Center of Policy Research and Analysis of the National Governors' Conference. The NGC has a policy in opposition to the taxation of the interest income from state and local obligations and testified to that effect in 1969 when inclusion of such income in the minimum tax was pro-

posed. That policy position has not been reviewed for purposes of these hearings, but I have no reason to believe that it would be altered.

State governments and local governments and their agencies and authorities have approximately $225 billion in debt outstanding. Because of the importance of tax exemption to the financing of both state and local government, I am appearing to discuss why Governors, as well as other state and local officials, believe that removal of that exemption is not a desirable policy. My comments will focus on the taxation of such income through the application of the Federal minimum tax.

Inclusion of municipal bond interest income in the Federal minimum income tax base would be a peculiarly costly form of tax revision, the Federal revenue and equity consequences of which are miniscule in comparison to the increased burden it would place on state and local governmental borrowers. When the national tax system is viewed as a whole—including Federal and state and local taxes and charges—and when the impact of increased borrowing costs to governments are set beside the foreseeable revenues from such a tax, the most probable outcome is that the effect of the change would be to lessen the progressivity of the system and to increase the burdens of the lower- and middle-income groups.

This contrary result occurs because the interest paid on state and local borrowings would go up once it became subject to taxes. This, in turn, means that taxes, fees, and user charges must go up to meet the increased cost of borrowing. Examination of the relative progressivity of the Federal and state and local tax systems shows that the latter is less progressive and in the case of the sales and local property tax is frequently regressive. Thus, the bulk of the money raised to pay for a minimum tax will be generated by those parts of the national revenue system that are relatively more dependent upon those in the lower income brackets.

Estimates of the yields of a minimum income tax on municipals are hypothetical. In 1969 it was thought that such a tax might yield $35 million after 10 years. Even after allowing for expansion through inflation, this is a small amount in comparison to the estimated more than $11 billion in interest payments that state and local governments now pay. But, unfortunately, the actual taxes paid probably would have no relationship to the amount borrowing costs would rise. This is so because not only would the added tax load on investors have to be compensated for by increased interest payments, the latter would have to be raised to compensate investors for the increased risk of future tax changes and the uncertainty as to their effects on the market. Congress would, in effect, be announcing that henceforth the extent of tax exemption on the obligations of state and local governments is subject to legislative change. For a security that depends for about 25 to 30 per cent of its present value on tax exemption, this is frightening, especially when one contemplates making a 20 or 30-year investment. Thus, any investor buying a tax-exempt bond would not only discount the customary risks of changes of creditworthiness, prices, interest rates, and tax shelter requirements, he would also have to discount for the added risk that the bonds he owned might become taxable.

This added risk factor is not confined to individuals. Institutions that acquire municipal securities must also discount for the impact of such risk on the future complexion of the secondary market into which they may have to enter for liquidity.

Any *a priori* estimates of these effects on interest rates must be judgmental, but it is certain they would take place and, in my opinion, would far out-distance the revenues from a minimum tax. For example, with $30 billion in annual bond sales, a modest ¼ per cent (25 basis points) increase lasting one year would mean an average increase in interest costs of $75 million a year throughout the life of the bonds sold that year, or a total of about $1 billion extra until they all mature. (Were that effect to be lasting, you can see how the amounts cumulate: at the end of 10 years, assuming no growth in bond sales, you would have annual added interest costs of $500 to $600 million.) When one contemplates that the added cost is absorbed by local property taxes, various charges and fees, state sales and income taxes, then the cure easily becomes much worse than the disease.

Aside from the market effects required to compensate investors for both increased tax payments (small) and added risks of tax liability (large), there are other problems to consider in the imposition of a minimum tax. There is the potential of litigation over the right of Congress to levy such a tax on

municipal bond interest. Regardless of the outcome of such a confrontation, the impacts of the municipal bond market would be disastrous, at least until the questions were resolved. In addition, drawing a bead on individual investors in municipal bonds seems particularly poorly timed when the market has had to rely so heavily on them recently. With a lack of institutional interest and many worries over default and bankruptcy, the reliance on individuals has been of critical importance. It has already required high rates of interest to induce these investors into municipal bonds and uncertainty over future tax status would serve to magnify these costs.

The minimum tax proposal involves yet other equity problems of its own. If the interest on bonds sold prior to date of enactment were to be included, those investors that hold them will be taxed on bonds which they originally purchased at lower rates of interest on the understanding that they were tax-exempt. More important, even were they not to pay the tax directly, investors in such bonds would suffer a loss in capital value because of the tax's depressing influence on security prices. On both scores, investors would have legitimate complaints about inequities. On the other hand, if the tax were to apply only to the income on bonds sold after enactment, the holders of the old bonds would be given a capital gain because these securities would continue to possess complete tax exemption which the new bonds would not.

In summary, the implications of inclusion of municipal bond interest income in the Federal income tax are fraught with inequities and cost effects that would outweigh any marginal benefits that might be achieved in snagging a few individuals who pay no taxes. In fact, any investor who owns municipals and has no taxable income is not acting rationally. This is because until an investor is in a 30 to 40 percent marginal tax bracket, he would be better off buying taxable securities of like quality in order to maximize after-tax income.

The minimum tax does nothing to improve the efficiency or the absorptive capacity of the municipal bond market and actually works against both by constricting the demand for debt and adding to the risk in that market.

The Governors Conference is aware of other proposals, such as the taxable bond option, that are directed to broadening the demand for state and local obligations. Such proposals, we believe, cannot be considered on their own merits when they are coupled with the taxation of existing tax-exempt securities: it is not an acceptable trade-off.

The Governors Conference has adopted criteria concerning Federal credit assistance to state and local governments and has examined the issue. There is not, at this time, consensus on whether a taxable bond option meets those criteria.

Taxable Bond Option

Latest developments

A bill entitling state and local governments to a federal subsidy of 35 percent on the interest they pay if they issue taxable bonds was approved by the House Ways and Means Committee on March 30 by a 20 to 16 vote. The bill (H.R. 12774), introduced by Reps. Ullman (Ore.) and Conable (N.Y.), is expected to go to the Rules Committee within two weeks and to the House floor soon thereafter.

Background

Under the bill, a state or local government could choose between traditional tax-exempt bonds and the taxable option, depending on market conditions and a comparison of interest yields, after putting the bonds out to bid.

The bill assumes that a taxable issue would be marketed according to the same regulations governing a tax-exempt issue. A government wishing to issue a taxable bond would notify the U.S. Treasury Department and submit an opinion by bond counsel that the issue is eligible for the federal-subsidy. After certification, the Treasury would pay the issuing government 35 percent of the effective interest yield, over the life of the issue and corresponding to the issuer's schedule of payments to bond holders.

The bill clearly eliminates the need for any federal agency review or administration and does not interfere in the usual process of issuing bonds.

Analysis

The bill raises a number of issues regarding market expansion and stability, reduced borrowing costs, inequity and inefficiency in tax-exempt borrowing, continuance of the tax exemption and permanence of the federal subsidy.

Proponents argue that the taxable bond option would expand the market for state and local debt since tax-exempt institutions such as pension funds, foundations, universities and mutual savings banks which do not purchase tax-exempts would find subsidized taxable bonds attractive. These new investors would diversify the market for state and local bonds, thereby easing the cyclical instability of demand in the market.

Another argument in favor of the proposal is that it will reduce the current glut of tax-exempt offerings in the market. As some jurisdictions opt for taxable bonds, the supply of tax-exempts will decrease. Investors seeking tax exemption will then have to buy them at a lower yield, thus reducing state and local borrowing costs.

Both supporters and opponents agree that States and localities are likely to save some costs through reduced interest rates for tax-exempts if the bill is enacted, but opponents argue that the savings would be at the expense of the Treasury, the average taxpayer and private borrowers.

Opponents say that the entry of state and local governments into the private capital market will increase competition for funds and force interest rates up for everyone except state and local governments.

INEQUITY AND INEFFICIENCY

The inequities and inefficiencies inherent in tax exemption arise from the fact that tax-exempt bonds are a shelter from federal taxation for wealthy individuals, institutions and corporations. The shelter effect is seen as inequitable because it reduces the progressivity of the federal tax system, and inefficient because each $1 of state and local interest savings costs the U.S. Treasury $1.50 in uncollected income taxes.

Proponents argue that the total supply of tax-exempts will decrease as jurisdictions choose the taxable option, thereby allowing fewer wealthy individuals, institutions and corporations to escape taxation. Also, if the U.S. Treasury is going to subsidize state and local borrowing, the taxable option is more efficient. At a 35 percent subsidy, $1 of interest savings is projected to cost the Treasury only about 13 cents.

Opponents argue that inequities will continue to exist since with the 35 percent subsidy only about $3.1 billion in borrowing will shift to the taxable market. This is about 9 percent of total tax-exempt borrowing in 1975. There will still be nearly $27 billion on tax-exempts issued annually.

They also argue that most of the new purchasers of taxable bonds would be public pension funds which are already exempt from the federal taxation. The net effect on the over-all equity of the tax system would be minimal.

Opponents point out that the amount the Treasury pays out in subsidies would be greater than the amount of new taxes collected. The difference would be shared by all federal taxpayers. Also, under the current system, the cost to the Treasury is on paper only, i.e., a loss of uncollected taxes. The taxable bond option would require federal cash outlays.

CONTINUANCE AND PERMANENCE

Traditionally, state and local governments have been skeptical about the taxable bond option, mainly because they have seen it as the first step toward eliminating tax-exemption altogether. The argument suggests that once a subsidized taxable option is in place, the pressures against elimination of tax-exemption would be reduced since Congress could point to the option as a continuing source of low-cost state and local borrowing.

However, there is no iron-clad way to ensure that tax-exemption will survive future attacks in any case. Tax reform proposals surface in every Congress and elimination of tax-exempt bonds is usually a key element.

State and local governments are also concerned about the permanence of the subsidy. It is often granted that the subsidy level could suddenly be reduced for future bond issues. For this reason, many supporters say the option must have a permanent appropriation to fund subsidy payments.

H.R. 12774 does not provide a permanent appropriation because of procedural difficulties. House rules create a point of order against bills which contain both an authorization and an appropriation. Efforts to avoid this problem would have embroiled the bill in a major procedural fight in the Rules Committee and on the floor.

However, the House committee did include language in the bill making the subsidy an entitlement. This creates a legally enforceable claim against the federal government, but would still require annual Appropriations Committee action.

The report accompanying H.R. 12774 states:

The assurance given by this entitlement is that if no funds are appropriated, state and local governments have the right to sue the United States in court to obtain the necessary funds under the entitlement. Thus, annual appropriations of the funds would become virtually automatic.

The report says that any congressional decision to withhold subsidies for taxable bonds already issued "would be a breach of faith on the part of the Congress and Congress has not acted this way in the past. More importantly, entitlement programs impose legal obligations on the federal government which can be enforced in the federal court of claims."

From a practical point of view, the entitlement language creates a federal obligation very nearly the same as a permanent appropriation.

Action needed

The National Governors' Conference has generally been cautious about the taxable bond option. However, some Governors are now looking at the proposal more favorably, particularly in view of soaring interest rates for state and local bonds.

Current NGC policy (B.-2) states:

The last several years have witnessed a growing number of bills introduced in Congress which would shift state and local borrowing from the tax-exempt to the taxable market. In most of those cases, federal line agencies would act as intermediaries between state and local governments and the public in marketing municipal bonds. Regarding further congressional action in this area, the Conference recommends the following criteria:

(A) Use of any federal credit assistance programs by state and local governments should be entirely voluntary.

(B) Such assistance should be free of federal interference and intervention in matters of state and local concern.

(C) Such assistance should be simple, dependable and free of delay.

(D) Such assistance should not be viewed as an alternative to federal grant assistance where the latter is appropriate and necessary.

The Conference reasserts that any proposal should not in any way impair the access of state and local governments to the tax-exempt market or infringe upon these governments' independence in debt financing or repeal or limit the exemption of state and local government bond interest from federal taxation.

H.R. 12774 meets the NGC criteria with one important exception; its lack of a permanent appropriation.

Debate on the House floor is expected to be vigorous and passage of the taxable bond option may largely turn on what Congressmen hear from the Governors, who are urged to review their position on the issue and transmit their views to their congressional delegations.

The CHAIRMAN. There is a vote going on in the Senate.

We will recess here for 15 minutes, then I will call the next witness.

[Brief recess.]

The CHAIRMAN. Next we will call Mr. Andre Blum, director of administration, city of Madison, Wis., accompanied by Mr. Michael Zarin, chief of the finance division, law department of the Port Authority of New York and New Jersey; also Donald W. Beatty, executive director, Municipal Finance Officers Association.

STATEMENT OF ANDRE BLUM, DIRECTOR OF ADMINISTRATION, CITY OF MADISON, WIS., ACCOMPANIED BY MICHAEL S. ZARIN, CHIEF, FINANCE DIVISION LAW DEPARTMENT, PORT AUTHORITY OF NEW YORK AND NEW JERSEY, AND DONALD W. BEATTY, EXECUTIVE DIRECTOR, MUNICIPAL FINANCE OFFICERS ASSOCIATION

Mr. BLUM. My name is Andre Blum, director of administration for the city of Madison, Wis. and a member of the Municipal Finance Officers Association Committee on Governmental Debt Administration. With me are Michael S. Zarin, chief, finance division, law department and the Port Authority of New York and New Jersey and also a member of the Committee on Governmental Debt Administration of the MFOA, and Donald W. Beatty, executive director of MFOA. The Municipal Finance Officers Association of the United States and Canada represents 5,500 members who are Federal, State, and local government financial officials, appointive or elective, and public finance specialists.

I will direct my testimony to the considerations before us today concerning proposals that would affect the present tax-exempt market for municipal securities. These issues are a taxable bond option, and imposition of a minimum tax on the currently tax-exempt interest from municipal bonds.

The MFOA cannot support either of the current proposals on a taxable bond option—S. 3211, Senator Kennedy's bill, or H.R. 12774, the bill reported by the House Ways and Means Committee—as they now stand. However, at its annual conference in San Francisco, May 2–6, the MFOA membership adopted a resolution, a copy of which is attached as appendix A, which accepts the concept of a taxable bond option provided it meets the following criteria:

It must retain the ease of borrowing and there must be freedom from procedural uncertainties and delay.

Any exercise of an option shall be as to an individual issue of bonds and shall not preclude future issuance on a tax-exempt basis.

The Federal interest portion shall be fully guaranteed and beyond question as to the continuing fulfillment of the Federal Government's pledge;

Any such option should be restricted to governmentally owned and operated facilities and their activities.

These four criteria, MFOA feels, would strengthen the present system of tax-exemption of interest on municipal bonds and maintain the attributes of the present market which are outlined in the association's long-standing policy. Essentially these attributes are: (1) Unquestionable constitutionality, (2) freedom from Federal controls, (3) savings in interest costs, (4) freedom from the uncertainties of recurrent annual Federal appropriation processes, (5) retention of viable competitive private marketing channels and (6) expedition in borrowing, free from the delay of Federal clearance.

At this point, it is only fair to say that although the resolution was accepted by a majority of the MFOA membership, there still remains a basic disagreement over whether or not a taxable bond option could be consistent with the preservation of the tax-exempt market. That

debate—and both sides are well represented in our group—has both its economic and political dimensions.

Despite the difficulties in the application of our criteria, we do think they accurately reflect what should be targets (or constraints) for Federal policy in the area. For unless an alternative such as the taxable bond option can be shown to be congenial with such criteria, then the path of policy is clearly one leading to opposition.

With this perspective in mind, the MFOA is pledged to working with Congress as well as other interested groups to perfect taxable bond option legislation.

In spite of our mixed emotions on the taxable bond option issue, the association is sensitive to the need to broaden and make more efficient the market for the debt of all borrowers. To that effect, the MFOA membership also adopted a resolution (a copy of which is attached as appendix "B") calling for Congress to amend the Internal Revenue Code to permit the pass through of tax-exempt interest income to the shareholders of regulated investment companies (mutual funds).

Our position on the retention of tax-exemption for traditional governmental purposes is unequivocal: We oppose any changes in the existing law that would deny its use or diminish its value for legitimate State and local governmental purposes. These changes would include a minimum tax on the interest of municipal securities and the repeal of tax-exemption in its entirety.

We have also been asked by the National League of Cities and the National Association of Counties to inform you that their policy positions are in concert with ours.

Therefore, I believe that the issues involved in a taxable bond option or other alternatives can be much more clearly drawn if such market-assisting proposals are not combined with measures to tax, directly or indirectly, the interest income on conventional municipal bonds. This combination occurred in the tax reform package the House passed in 1969; to proffer a trade of a taxable bond option for the taxation of the tax-exempt bond was hardly to offer an appealing alternative. I can assure the committee that were such an "alternative" to be placed before issuers again the reaction would be instant and widespread. I strongly urge that the committee keep the optional concept a meaningful one and not attach to it tax changes that either would erode its value or undermine the value of tax-exemption. Surely not a worse time could be found to propose to tax traditional tax-exempt securities and to add to the already heavy burdens and uncertainties of State and local finance.

In closing, I will read the resolution on taxable bond options adopted in 1976 conference of the MFOA in May which best summarizes our position:

Whereas the Municipal Finance Officers Association both has defended and sought to strengthen the present system of tax-exemption of interest on municipal bonds, the attributes of which are contained in its policy of May 28, 1969, which required:

1. Conformity to the Constitution, preserving the Federal system by protecting State and local governments from Federal compulsion.

2. Freedom from Federal controls of policy decisions which are properly the sole province of State and local governments.

3. A saving in the cost of borrowing—without which the present urban crisis would become more aggravated by requiring increased property, sales and other local taxes, and a reduction in essential services.

4. Freedom from the uncertainties of the recurrent annual Federal appropriation process to obtain state and municipal capital needs or any portion of their interest costs.

5. Protection of and freedom of access to viable capital markets of their own choice without reliance on a dominant Federal financial institution.

6. Expedition in their borrowing, free of the delay of Federal clearances which can make them miss their optimum interest market timing and can force them into increased capital costs as construction costs continue to rise. And

Whereas the Association has fought in ways that are consistent with the above policy to assist in the resolution of the fiscal dilemma of many governmental borrowers and to moderate the strains that occur from time to time in the market for their obligations: Now, therefore be it

Resolved that the Municipal Finance Officers Association believes that the present proposed legislation to provide for a taxable bond option for state and local government issuers in its current form does not conform with the above stated longstanding policy and is not in the best interests of state and local governments until it is modified to ensure that the benefits to state and local government are compatible with those inherent in the tax-exemption of municipal bonds. In particular, any taxable bond option legislation should contain the following features:

1. Ease of borrowing must be retained and there must be freedom from procedural uncertainties and delay.

2. Any exercise of an option shall be as to an individual issue of bonds and not preclude future issuance on a tax-exempt basis.

3. The Federal interest portion shall be fully guaranteed and beyond question as to the continuing fulfillment of the Federal government's pledge.

4. Any such option should be restricted to governmentally owned and operated facilities and their activities.

The MFOA Executive Board, through its Governmental Debt Administration Committee, is authorized and directed to work with interested groups in perfecting legislation and is to report back to the membership its progress in implementing this policy and to recommend further policy as may be appropriate.

This ends my testimony. We will be happy to answer any questions you may have.

[An additional resolution follows:]

RESOLUTION ON PERMITTING MUTUAL FUND INVESTMENT IN MUNICIPAL SECURITIES

Whereas the MFOA supports efforts to broaden the municipal bond market by promoting greater investment interest in and competition for municipal securities as a means to lowering borrowing costs and stablizing the flow of credit to state and local borrowers, and

Whereas mutual funds and other regulated investment companies under the Internal Revenue Code are not permitted to pass through tax-exempt interest income to their shareholders and this treatment is inconsistent with prevailing theory of mutual fund taxation which is to place such shareholders in the same position as if they owned the securities directly, and

Whereas the present liability to pass through tax-exempt income unfairly denies investors that prefer to use this investment medium certain advantages of convenient investment techniques, diversification, and professional management when it comes to investment in tax-exempt securities, and

Whereas the consequent inability of state and local governmental borrowers to enjoy the advantages of investment by mutual funds in tax-exempt securities unfairly and unnecessarily restricts the demand for such securities: Now, therefore, be it

Resolved that the MFOA supports such amendments to the Internal Revenue Code as may be required to permit the pass through of the municipal bond interest exemption to shareholders of regulated investment companies.

Chairman LONG. Senator Haskell.

Senator HASKELL. Thank you, Mr. Chairman.

Your conditions seem reasonable, however, I am just curious about one of them. I think you stated that one condition would be that the option would be restricted to financing governmental functions.

Mr. BLUM. Yes.

Senator HASKELL. Why that? I just do not understand what you are saying.

Mr. BLUM. Well, we were thinking primarily of pollution control bonds and the industrial revenue bonds which we feel perhaps are to some degree eroding the market by glutting and we do not favor the option on that type of debt.

Senator HASKELL. Thank you.

The CHAIRMAN. As I understand it, the House bill as reported by the Ways and Means Committee would provide a 35-percent interest subsidy. The Federal Government would apparently pay 35 percent of the interest yielded on obligations.

Do you support that?

Mr. BLUM. We were supporting the original version of 40 percent and since the Treasury recommended 30, I suppose we would prefer 30 to 35.

The CHAIRMAN. The House came in with 35 percent, which I guess was a compromise between the 30 suggested and the 40 that you asked for.

Now, I was looking over the list of ratios and it looked to me like 35 would be more than necessary to take care of the average situation. In the average situation, State interest rates seemed to be 70 percent of the Federal interest rate, at least maybe it was 70 percent of the interest rate of good corporate bonds.

So not trying to judge the question, maybe it ought to be 40 percent rather than 35. But if we gave you that, would your people be willing to go along with the proposal that where a person borrows money and then proceeds to purchase tax-exempt bonds, we simply reduce his interest deduction by the amount of interest income he has from tax-exempt securities?

Mr. BLUM. I think that if the concerns we have with the existing legislation were met, I am sure the 35 percent would not be a factor we would be quibbling about.

Responding to your question of matching the taxable bond option with some other type of legislation that would have the effect of meeting the concern that you have expressed, that those who borrow money to invest in tax-free, I am not sure that these two pieces of legislation should be combined. I think there are two problems that we are facing and the effect I think of doing what you suggest would be to use the State and local governments to resolve a problem which at least in the first instance is a Federal Government problem.

What I mean by that is that if we have a taxable bond option, without any other legislation, and the way we propose it would be a true option.

If we combined with that some legislation that would have the effect of forcing people out of the tax-exempt market because they would not be able to do something that they are presently allowed to do, that would have the effect of minimizing the availability of the

tax-exempt market and to a considerable degree removing the real option from State and local government because they would not be able to market tax-exempt bonds with the freedom that they presently have.

I think the real solution to the problem you suggest is either a tightening of the existing legislation or some modification in the legislation which continues to deal with it in the context that it presently exists, which is that here is a situation that we want to resolve and let's take care of it for those who are going beyond what they are allowed to do, rather than bringing into it all of the State and local government borrowers. Use them as the solution to this rather restricted problem.

The CHAIRMAN. Well, if we tighten up section 265 the way I have suggested, where you won't look to the intent, but simply to the fact that the person had interest income from tax exempts and he had interest expense, and you simply reduce the interest expense by the interest income without looking at the intent, we would be closing off an activity a lot of high-bracketed taxpayers have engaged in, and that would probably hurt the sale of your bonds.

I would fully expect that to be the case. You would have quite a few people selling their bonds now, high-bracketed individuals, and if you are going to do it I would want to protect an alternate market so it would protect the interest rate of those bonds.

Now, you know a tax exempt security is not all that good a buy for a fellow who is in the 30-percent tax bracket. If he is in a 70-percent tax bracket it is a very good buy. That is a concern that we are thinking about.

Thank you very much.

The CHAIRMAN. Next we will call Mr. Wallace O. Sellers, vice president, Merrill Lynch, Pierce, Fenner & Smith, Inc., New York, and chairman of the Public Finance Division of Securities Industry Association.

STATEMENT OF WALLACE O. SELLERS, VICE PRESIDENT, MERRILL LYNCH, PIERCE, FENNER & SMITH, INC., NEW YORK, AND CHAIRMAN, PUBLIC FINANCE DIVISION, SIA ACCOMPANIED BY DAVID G. TAYLOR, CONTINENTAL ILLINOIS BANK, CHICAGO, AND VICE CHAIRMAN, PUBLIC FINANCE DIVISION, SIA; GEDALE HOROWITZ, SALOMON BROS., NEW YORK; WILLIAM R. HOUGH, WILLIAM R. HOUGH CO., ST. PETERSBURG, FLA., AND COCHAIRMAN, MUNICIPAL FEDERAL LEGISLATION COMMITTEE, SIA

Mr. SELLERS. Mr. Chairman, I am Wallace O. Sellers, vice president of Merrill Lynch, Pierce, Fenner & Smith, Inc., New York. I am appearing today as the chairman of the Public Finance Division of the Securities Industry Association. With me are the division vice chairman, Mr. David G. Taylor, executive vice president, Continental Illinois National Bank and Trust Co. of Chicago, and Cochairman of SIA's Municipal Federal Legislation Committee, Mr. Gedale Horowitz, partner, Solomon Brothers, New York, and Mr.. William R. Hough, partner, William R. Hough & Co., St. Petersburg, Fla.

In our appearance today we represent the Public Finance Division of the Securities Industry Association whose 650 member firms and banks underwrite and deal in all types of securities, including those of State and local governments, corporations and the Federal Government and its agencies.

We appreciate this opportunity to work with the Committee in improving the municipal securities market as an efficient mechanism to finance the borrowing needs of State and local governments. Our aim today is to appraise the market impact and costs associated with the inclusion of the interest from State and local government bonds as a tax preference item under a minimum income tax. We will also discuss the proposal to give State and local governments the option of issuing either tax exempt securities or taxable securities.

The State and local government securities market, commonly called the municipal securities market, represents approximately 15.7 percent of the net new funds raised each year in the U.S. capital markets.

The tax exempt security developed through constitutional interpretation under the doctrine of reciprocal immunity as a protection of the State and local government's independence of action. Through it State and local governments have raised massive amounts of funds to provide services and facilities for the public good. The tax exempt security has served that purpose well.

The Securities Industry Association strongly opposes either the elimination of the tax exemption or the inclusion of tax exempt interest income as a tax preference under the minimum income tax. Either proposal would have a disastrous impact on the municipal securities market and on the ability of State and local governments to raise capital. The Securities Industry Association opposes either proposal for the following five reasons:

1. The buyer of tax exempt securities already pays a substantial hidden tax.

Critics of tax exemption for municipal securities often cite examples of people with large portfolios of tax-exempt securities who pay no taxes on their interest income. That is true, as far as it goes; however, what the critics fail to point out is that the yield on tax-exempt securities is substantially below that on taxable securities of equivalent risk. By accepting this lower rate of return, it can be said that the municipal investor is in effect prepaying taxes rather than avoiding them.

2. The inclusion of tax-exempt interest in a minimum income tax will increase State and local government borrowing costs.

An investor who buys tax-exempt securities must discount not only interest rate risk, credit risk and price risk, he must also discount his expected tax bracket to determine the advantage of tax-exempt income in the future. If you remove the only certainty—that the interest will not be taxed—the investor has no basis on which to calculate what his tax liability will be. Faced with increased uncertainty the investor will demand a higher yield to compensate for the greater risk. This uncertainty will be magnified in the longer end of the municipal securities market. The ratio of tax-exempt interest rates to taxable rates in the long-term market is already much higher than in the shorter maturities. Any tampering with tax exemption will further hurt long-term borrowers.

3. The cost benefit calculus of applying the minimum tax to tax-exempt income would be extemely unfavorable.

There is no way that the Treasury can come anywhere close to gaining sufficient revenue to cover even the threshold costs involved in a minimum income tax. More important, in our estimation, these increased borrowing costs to State and local governments would need to be met by the State and local tax systems that are already overburdened. Furthermore, State and local tax systems are generally regressive in that they throw a heavier burden on the lower income individual. The added tax burden would therefore fall to a large extent on low-income individuals. We doubt that many would consider this an improvement in equity.

Unless the markets were to be totally oblivious to the fact that bonds formerly free of tax are now subject to taxation, there is no conceivable way that Treasury gains in revenue taxation will even approach the higher costs that must be borne by State and local governments.

4. The imposition of a minimum tax would have an unfavorable impact on investor confidence in the municipal securities market.

Any action which would place a tax of any size on the interest paid by State and local government securities would surely be subject to a court test. Investor uncertainty as to the future status of tax exemption which would exist during this extended litigation period would necessarily push tax-exempt yields closer to taxable yields and make it even more difficult for certain State and local government issuers to get financing.

5. The imposition of a tax on State and local government securities would cause a major reduction in the market value of the outstanding stock of municipal securities.

When interest rates on municipal securities rise the market price falls. Consequently, the rise in municipal interest rates brought on by the imposition of a minimum tax will be translated in the marketplace into a reduction in the value of outstanding municipal securities.

Any taxation of municipal securities income not only offends what many believe to be constitutional principles but also will involve an increase in State and local borrowing costs that will surely exceed any Federal revenue gain. We cannot in good conscience endorse such an attempt to make government more expensive or to undermine established principles in the conduct of government.

There are a number of proposals to broaden the market for State and local government securities. We too are concerned with the ability of municipal borrowers to have ready access to the capital markets at reasonable costs. We are ready and willing to work with the committee in developing approaches to improve the workings of the municipal securities market. However, at this time we cannot support completely the current proposals for a taxable bond option with a Federal subsidy. The securities industry fears that this program may be designed in a manner that, rather than creating a true option for municipal issuers may substitute one market—the tax-exempt market, which has proved effective, with another—the untried taxable. Furthermore, a taxable bond option would only affect the price of credit and have little, if any, impact on access to credit markets where it has been denied because of fiscal mismanagement or loss of investor confidence.

Accordingly, those issuers who find it difficult to market their secu-

rities because of their inherent risk will continue to find credit markets difficult to access even with a taxable bond option in place.

We believe that other mechanisms should be tried before the taxable bond option is put in place. Congress can act to increase the efficiency of the tax-exempt market by returning the market to the exclusive use of State and local government issuers. If in fact it is the aim of the Congress to improve the market, the Congress can act to eliminate provisions that enable private companies to borrow in the tax-exempt market by means of industrial development and pollution control bonds.

We believe that if the Congress acts to reduce the demands on the municipal securities market, the taxable bond option may be unnecessary. Our concerns regarding the taxable bond option legislation, H.R. 12774, which was reported by the House Ways and Means Committee, are summarized in our written statement.

Given the problems with the proposed taxable bond option and our belief that the Congress should first reduce the supply of tax exempt securities by eliminating the use of tax exemption for financing of facilities owned by private organizations organized for profit we would urge that this committee carefully restudy the need for a taxable bond option.

A special subcommittee of our association spent nearly a year examining how a taxable bond option could be structured to insure that it would be workable. The committee developed statutory language which we presented 3 years ago to the staff of the Joint Committee on Internal Revenue Taxation. We would be pleased to resubmit that material.

We want to thank the committee for the opportunity to discuss the municipal securities market with you.

[The prepared statement of Mr. Sellers and the material referred to follows:]

STATEMENT OF THE PUBLIC FINANCE DIVISION OF THE SECURITIES INDUSTRY ASSOCIATION

Mr. Chairman, I am Wallace O. Sellers, Vice President of Merrill Lynch, Pierce, Fenner and Smith Incorporated, New York. I am appearing today as the Chairman of the Public Finance Division of the Securities Industry Association. With me are the Division Vice Chairman, Mr. David G. Taylor, Executive Vice President, Continental Illinois National Bank and Trust Company of Chicago, and the Co-Chairman of SIA's Municipal Federal Legislation Committee, Mr. Gedale Horowitz, Partner, Salomon Brothers, New York, and Mr. William R. Hough, Partner, William R. Hough & Company, St. Petersburg, Florida. In our appearance today we represent the Public Finance Division of the Securities Industry Association whose 650 member firms underwrite and deal in all types of securities, including those of state and local governments, corporations and the federal government and its agencies.

We appreciate this opportunity to work with the Committee in improving the municipal securities market as an efficient mechanism to finance the borrowing needs of state and local governments. Our aim today is to appraise the market impact and costs associated with the inclusion of the interest from state and local government bonds as a tax preference item under a minimum income tax. We will also discuss the proposal to give state and local governments the option of issuing either tax exempt securities or taxable securities. Under the taxable bond option the federal government would pay a portion of the taxable interest rate associated with taxable state and local government debt securities.

THE MUNICIPAL SECURITIES MARKET

The state and local government securities market, commonly called the municipal securities market, represents approximately 15.7% of the net new funds raised each year in the United States capital markets.

The U.S. municipal securities market has more issuers, more issues outstanding and is more complex than any other securities market in the world. By the end of 1975, for example, there were 78,268 separate issuers of municipal securities, (there were only 33,465 issuers of corporate securities) and 1,381,062 separate serial maturities of municipal issues outstanding (there were only 64,486 different corporate issues outstanding).

In recent years, the volume of new issues in the municipal securities market has grown rapidly, from $36 billion in 1970 (including $18 billion in long-term issues and $18 billion in short-term notes) to $60.6 billion in 1975 ($30.7 billion in long-term and $29.9 billion in short-term), a compound annual growth rate of over 10%. Funds from long-term issues have been used to finance educational facilities, hospitals, transportation facilities, public housing, public utilities, and facilities for public services such as fire, police and santation. In 1975, for example, 23.8% of the long-term financing was used for utilities and conservation, 15.3% for education, and 14.3% for social welfare projects such as public housing and hospitals. General obligation bonds comprised 52.4% of all long-term new municipal issues in 1975. The balance were revenue bonds of various types. (See Table 1.)

The tax-exempt security developed through constitutional interpretation under the doctrine of reciprocal immunity as a protection of the state and local government's independence of action. Through it state and local governments have raised massive amounts of funds to provide services and facilities for the public good. The tax-exempt security has served that purpose well. With massive growth in Federal income taxation, it has also become valuable in terms of interest cost saving. On average and in the main, it has maintained this interest saving at 30 to 35% for long-term issues, and at higher percentages for medium-term bonds and short-term notes. (See Table 2.)

The Securities Industry Association strongly opposes either the elimination of tax exemption or the inclusion of tax-exempt interest income as a tax preference under the minimum income tax. As outlined above, the municipal securities market has performed reasonably well as a mechanism for raising funds for state and local governments. The elimination of tax exemption or the imposition of a minimum tax would have an adverse impact on the ability of state and local governments to raise funds in the capital markets. The Securities Industry Association, opposes either proposal for the following 5 reasons.

1. *The buyer of tax-exempt securities already pays a substantial hidden tax*

Critics of tax exemption for municipal securities often cite examples of people with large portfolios of tax-exempt securities who pay no taxes on their interest income. That is true, as far as it goes, however, what the critics fail to point out is that the yield on tax-exempt securities is substantially below that on taxable securities of equivalent risk. By accepting this lower rate of return, it can be said that the municipal investor is in effect prepaying taxes rather than avoiding them.

This can be easily demonstrated by comparing yields on taxable and tax-exempt securities. Based upon yield averages for the year 1975, for example, an investor could have purchased an Aa corporate bond yielding an average og 9.59%. The purchaser of an equivalent tax-exempt security, however, would have received a tax-exempt yield of only 6.48%. Therefore, a million dollars invested in taxable securities would have given the investor an income of $94,000 a year and he would have paid taxes on it. The amount of taxes would depend upon the investor's marginal tax rate. A million dollars invested in tax-exempt securities, however, would bring in only $64,800. The $30,100 which the investor in tax-exempts relinquished, represents in effect, a prepayment of taxes or the "hidden" tax equivalent paid by the tax-exempt securities buyer. For the year 1975 this "hidden" tax equivalent averaged approximately 25.5% for long maturities.

This "hidden" tax equivalent was larger for intermediate maturities averaging 35.4% in 1975, and for short-term notes averaging 47%. Consequently, the purchaser of tax-exempt securities does indeed pay a substantial tax equivalent.

2. The inclusion of tax exempt interest in a minimum income tax will increase State and local government borrowing costs

An investor who buys tax exempt securities must discount not only interest rate risk, credit risk and price risk, he must also discount his expected tax bracket to determine the advantage of tax exempt income in the future. If you remove the only certainty—that the interest will not be taxed—the investor has no basis on which to calculate what his tax liability will be. Faced with increased uncertainty the investor will demand a higher yield to compensate for the greater risk. This uncertainty will be magnified in the longer end of the municipal securities market. The ratio of tax exempt interest rates to taxable rates in the long-term market is already much higher than in the shorter maturities. Any tampering with tax exemption will further hurt long-term borrowers.

Schedule A provides a hypothetical example of the impact of a minimum income tax on an individual buyer of tax exempt securities. While the example is an abstraction from the real life workings of a minimum income tax it does illustrate that tax exempt interest rates would rise substantially under the assumption that a 20% minimum income tax rate is imposed on an individual buyer. Both the Senate and the House versions of the minimum income tax have lower rates than 20%.

3. The cost benefit calculus of applying the minimum tax to tax exempt income would be extremely unfavorable

In testifying on the application of the minimum income tax to municipal bond income back in 1969, former Treasury Assistant Secretary Edwin Cohen estimated that the effect of imposition of a minimum income tax on tax exempt interest would be—after 10 years—to increase Treasury tax collections by $35 million.[1] At the same time, in 1969, we saw an impact on the municipal bond market of the suggestions to tax such income that amounted to ½ per cent higher yields on state and local obligations.[2]

If a minimum tax were to be seriously contemplated again—not even enacted, just reported by this Committee—it is predictable that tax-exempt rates would again rise disproportionately. If the effect were the same as in 1969, then increase in interest costs in 1975 for state and local governments would have been approximately $300 million for notes and bonds sold that year. Even were the impact only 1/10th as great as that observed in 1969, say it amounted to only 5/100's of one percent or 5 basis points, the total cost impact would be 2 or 3 times as great as the revenue gain that was envisaged by Mr Cohen, once the higher interest cost had made its impact on the outstanding stock of bonds.[3]

In short, there is no way that the Treasury can come anywhere close to gaining sufficient revenue to cover even the threshold costs involved in a minimum income tax. More important, in our estimation, these increased borrowing costs to state and local governments would need to be met by the state and local tax systems that are already over burdened. Furthermore, state and local tax systems are generally regressive in that they throw a heavier burden on the lower income individual. The added tax burden would therefore fall to a large extent on low income individuals. We doubt that many would consider this an improvement in equity.

Unless the markets were to be totally oblivious to the fact that bonds formerly free of tax are now subject to taxation, there is no conceivable way that Treasury gains in revenue taxation will even approach the higher costs that must be borne by state and local governments.

4. The imposition of a minimum tax would have an unfavorable impact on investor confidence in the municipal securities market

Over the past two years there have already been a number of events that have reduced investor confidence in the municipal securities market. These included the financial problems of New York City, the abrogation of contracts and covenants and legislation altering the municipal bankruptcy laws. Any action which would place a tax of any size on the interest paid by state and local government securities would surely be subject to a court test. Investor

---

[1] Edwin Cohen before Senate Finance Committee (September 4, 1969).

[2] Testimony of Mayor Louie Welch of Houston, Texas before Senate Finance Committee (September 23, 1969).

[3] This assumes an increase of .0005 in the annual interest cost on $222.9 billion of bonds outstanding, or $111.4 million, compared to the $35 million in tax receipts after a 10-year phasing in of the minimum tax.

uncertainty as to the future status of tax-exemption which would exist during this extended litigation period would necessarily push tax exempt yields closer to taxable yields and make it even more difficult for certain state and local government issuers to get financing. In short it would create an unfavorable environment for state and local borrowing.

b. The imposition of a tax on State and local government securities would cause a major reduction in the market value of the outstanding stock of municipal securities

When interest rates on municipal securities rise the market price falls. Consequently, the rise in municipal interest rates brought on by the imposition of a minimum tax will be translated in the market place into a reduction in the value of outstanding municipal securities. Since the outstanding par value of state and local government securities at the end of 1975 exceeded $222 billion, a reduction in value of just 1% could exceed $2.2 billion.

The bulk of these securities are held by individuals and commercial banks. A reduction in market value could have a substantial impact on bank balance sheets which in turn has implications for the capital position of the banking system. In addition the reduction of individual wealth seems to us to be arbitrary and inequitable.

Any taxation of municipal securities income not only offends what many believe to be constitutional principles but also will involve an increase in state and local borrowing costs that will surely exceed any federal revenue gain. We cannot in good conscience endorse such an attempt to make government more expensive or to undermine established principles in the conduct of government.

TAXABLE BOND OPTION

There are a number of proposals to broaden the market for state and local government securities. We too are concerned with the ability of municipal borrowers to have ready access to the capital markets at reasonable costs. We are ready and willing to work with the Committee in developing approaches to improve the workings of the municipal securities market. However, at this time we cannot support the current proposals for a taxable bond option with a federal subsidy. The securities industry believes that this program is designed in a manner that, rather than creating a true option for municipal issuers merely substitutes one market—the tax exempt market, which has proved effective—with another—the untried taxable. Furthermore, a taxable bond option would only affect the price of credit and have little, if any, impact on access to credit markets where it has been denied because of fiscal mismanagement or loss of investor confidence. Accordingly, those issuers who find it difficult to market their securities because of their inherent risk will continue to find credit markets difficult to access even with a taxable bond option in place.

We believe that other mechanisms should be tried before the taxable bond option is put in place. This Committee can act to increase the efficiency of the tax exempt market by returning the market to the exclusive use state and local government issuers. If in fact, it is the aim of the Committee to improve the market, the Committee can act to eliminate provisions that enable private companies to borrow in the tax exempt market by means of industrial development and pollution control bonds.

Although the Revenue and Expenditure Control Act of 1968 and the Tax Reform Act of 1969 cut back on industrial development bonds by imposing a $5,000,000 limit on such issues, bonds issued for air or water pollution control facilities were made exempt from the limit. Environmental legislation has encouraged the use of pollution control bonds to enable private companies to comply with clean air and water standards. The publicity reported volume of pollution control financing has grown from $93.3 million in 1970 to $2.2 billion in 1975. These data are for reported volume. Most market experts believe that a large portion of the pollution control financing is unreported.

Although interest and principal for pollution control securities come from the issuing corporation and not from state and local governments, some analysts believe that these securities have had a number of negative effects on the municipal securities markets. Their availability has drawn some important institutional and individual investors away from conventional tax-exempt financing. This reduces access to the market for some governmental issuers, particularly those with medium grade credit standings. An allied effect is the upward pressure that the volume of pollution control financing places on tax exempt interest rates in

general. According to some reliable analysts,[4] a $1 billion increase in the annual volume of pollution control bonds drives up rates on all tax exempt bonds anywhere from 5 to 20 basis points (one-hundredth of a percentage point) at the 20 year maturity range.

Some analysts also feel that if left alone the volume of this type of financing will continue to grow rapidly throughout the remainder of this decade. A recent study estimated that annual volume could easily reach $6 billion by 1980.

We believe that if the Committee acts to reduce the demands on the municipal securities market, the taxable bond option may be unnecessary. Furthermore, we cannot endorse the taxable bond option legislation, H.R. 12774, which was reported by the House Ways and Means Committee at this time for the following reasons:

1. We are concerned that the addition of municipal securities to the taxable market will place upward pressure on taxable interest rates, and as a result, increase the borrowing costs of both Federal government and its agencies, as well as private borrowers.

2. A taxable bond option does not address the problems of excess supply created by financing done for the ultimate benefit of privately owned businesses. Indeed, H.R. 12774 provides for a taxable bond option on pollution control issues.

3. Because of restrictions placed on various types of issues, H.R. 12774 discriminates against various types of issues and will lead to classification and administrative problems and will result in the need for federal clearance. Such clearance could cause issuers to miss their optimum market timing and force them into increased borrowing costs. Procedural delays will also lead to uncertainty regarding to eligibility for the subsidy. There is no assurance that the Treasury will not ask for more data or more restrictions as to what qualifies as a tax exempt security. The option must be freely and generally available on a completely voluntary basis. We believe that state and local issuers who are now eligible to sell a tax exempt issue should have the option of selling a taxable bond. If the taxable bond option is to increase the efficiency of tax exemption for those that can sell tax exempt securities in any event, it appears senseless to discriminate among types of issues.

4. The subsidy must be permanent. The current proposal provides for the subsidy to be subject to an annual federal appropriation process. Any delay or other problems during the appropriation period would severely damage the existing markets for outstanding taxable municipal securities.

5. There seems to be no reason to limit the taxable bond option only to competitive issues as the present proposal does. As Table 3 illustrates negotiated issues comprise a large and growing proportion of the new issue market.

6. The current proposal does not address the Constitutional problem of reciprocal tax immunity. It can be assumed that any tampering with tax exemption will be subject to a lengthy court test which could severely restrict state and local government borrowing.

7. There is no assurance that the level of the subsidy will remain at a specified level. Obviously the higher the subsidy level is set the more attractive will be the taxable securities market for state and local government issuers. We feel a maximum subsidy level of 33⅓% should be set permanently.

Given the problems with the proposed taxable bond option and our belief that the Congress should first reduce the supply of tax exempt securities by eliminating the use of tax exemption for financing of facilities owned by private organizations organized for profit we would urge that this Committee carefully restudy the need for a taxable bond option.

The tax exempt securities market does produce an interest cost saving to the issuers. Some claim that this saving is less than the tax revenue loss to the Treasury, and thus speak of an "inefficient subsidy." Generally these critics have underestimated the interest cost saving. Furthermore, the tax revenue can only be an estimated figure based on assumed tax brackets of assumed investors in assumed taxable municipals, plus assumptions about the investment shifting among types of investors.

"Efficiency" can also be looked at in another way—efficiency in terms of providing the funds needed for state and local capital projects. It can safely be said that in no other country in the world can local governments borrow so readily with so little confusion and red tape, and with such dispatch.

---

[4] "The Tax Exempt Pollution Control Bond," John E. Petersen.

The investor in tax-exempt municipal securities, by accepting much lower yields has paid a substantial hidden tax equivalent, in an amount far larger than any proposed minimum income tax. The inclusion of tax-exempt interest in the base of a minimum income tax, by tampering with the basic structure of tax exemption, would do great harm to the tax-exempt market and substantially increase the borrowing costs of state and local governments.

The tax-exempt municipal securities market has proved itself a valuable part of our financial structure and has importantly increased the aggregate flow of funds into the bond and credit markets. It has given a strong and sustaining performance in the face of very heavy volume. It has provided state and local governments with ready and independent access to capital funds, and should be maintained as the main source of state and local financing.

We want to thank the Committee for the opportunity to discuss the municipal securities market with you. The gentlemen accompanying me and I will be happy to answer any questions which members of the Committee may have.

TABLE 1.—STATE AND LOCAL GOVERNMENT DEBT CHARACTERISTICS, SELECTED YEARS 1960 TO 1976

[In billions of dollars]

	1960	1970	1974	1975	1976 (1st quarter)
Total long term	6.81	18.19	24.32	30.65	8.34
Total short term	4.01	17.81	29.54	29.89	5.03
General obligation	4.36	11.85	13.57	16.05	4.50
Revenue	2.07	6.10	10.21	14.61	3.74
Utility	1.79	4.59	6.53	3.13	1.15
Special tax	.08	.34	.46	4.16	.76
Rental	.19	1.17	3.22	5.66	1.10
Purpose:					
Education	2.28	5.03	4.73	4.68	1.20
Transportation	1.31	3.17	1.71	2.21	.68
Utilities and conservation	1.30	3.47	5.64	7.26	1.83
Social welfare	.60	1.47	4.45	4.40	1.56
Public housing	.43	.13	1.69	.65	.91
Hospitals	NA	NA	.78	1.96	.35
Other	.17	1.30	1.98	1.79	.30
Industrial revenue	.04	.11	.50	.46	.56
Pollution control			1.71	2.22	.29
Others (general purpose)	1.53	4.20	6.50	9.86	2.61
New capital	7.06	18.00	23.51	29.60	8.03
Refunding	.05	.11	.73	1.01	.31
Total	7.11	18.11	24.24	30.65	8.34

Source: Securities Industry Association.

TABLE 2.—TAX EXEMPT/TAXABLE YIELD RATIO ANNUAL AVERAGES

	Short term	Long term	
		Aaa	Baa
1965	NA	74.4	73.3
1966	NA	71.5	74.3
1967	NA	67.9	69.0
1968	NA	68.0	70.3
1969	NA	77.5	77.7
1970	NA	76.1	74.1
1971	NA	70.6	68.8
1972	NA	69.9	68.6
1973	50.5	64.4	66.6
1974	50.3	65.5	68.7
1975	53.1	65.4	73.3
1st quarter 1976	49.8	70.6	74.8

TABLE 3.—STATE AND LOCAL GOVERNMENT BONDS SOLD BY TYPE OF OFFERING

[In billions of dollars]

	1970	1971	1972	1973	1974	1975	1976 (1st quarter)
Negotiated	3.0	4.4	5.6	6.7	7.1	10.5	3.6
Percent of total sales	16.5	17.6	23.6	27.9	29.2	34.2	43.4
Competitive	15.0	19.1	17.9	17.1	17.0	19.5	4.7
Percent of total sales	82.4	79.6	75.5	71.2	70.0	63.5	56.6

Source: Securities Industry Association.

TABLE 4.—LONG-TERM DEBT SOLD BY TYPE OF ISSUER, 1960 TO 1975

[In billions of dollars]

	1960	1970	1972	1974	1975
State	1.00	4.17	4.99	4.79	7.42
Local general government	2.54	6.21	7.25	8.66	8.36
School district	1.35	2.13	1.92	2.16	2.44
Special district	.66	1.16	1.51	1.27	1.57
Statutory authority	1.30	4.39	8.01	7.37	10.91
Total	6.85	18.08	23.69	24.69	30.64

TABLE 5.—ANNUAL CHANGES IN HOLDINGS OF MUNICIPAL BONDS 1960–75

[In billions of dollars]

Year	Commercial banks	Fire and casualty insurance companies	Households	Other	Total change
1960	0.7	0.8	3.5	3.0	5.3
1961	2.8	1.0	1.2	1.0	5.1
1962	5.7	.8	−1.0	−.1	5.4
1963	3.9	.7	1.0	.1	5.7
1964	3.6	.4	2.6	−.6	6.0
1965	5.2	.4	1.7	0	7.3
1966	2.3	1.3	3.6	−1.6	5.6
1967	9.1	1.4	−2.2	−1.5	7.8
1968	8.6	1.0	−.8	.7	9.5
1969	.2	1.2	9.6	−1.1	9.9
1970	10.7	1.5	−.8	−.1	11.3
1971	12.6	3.9	−.2	1.3	17.6
1972	7.2	4.8	1.0	1.4	14.4
1973	5.7	3.9	4.3	−.2	13.7
1974	5.5	1.8	10.0	.1	17.4
1975	1.7	2.1	7.0	4.6	15.4

TABLE 6.—OWNERSHIP OF STATE AND LOCAL SECURITIES

[In billions of dollars]

	1950		1960		1970		1975	
	Amount	Percent of total	Amount	Percent of total	Amount	Percent of total	Amount	Percent of total
Banks	8.2	32.6	17.7	25.0	70.2	48.0	102.8	46.1
Individuals	10.0	39.6	30.8	43.5	47.4	32.5	67.5	30.3
Fire and casualty insurance	1.1	4.4	8.1	11.5	17.8	12.2	34.3	15.4
Others	5.9	23.4	14.2	20.0	10.8	7.3	18.2	8.2
Total	25.2	100.0	70.8	100.0	146.2	100.0	222.8	100.0

SCHEDULE A

Without minimum tax:[1]

Taxable investment:		Tax-exempt investment
$30,000	Ordinary income	$30,000
$10,000	Deductions	10,000
$20,000	Income before investment income and taxes	20,000
$ 4,000	(at 10 percent) Investment income ($40,000 investment at 6.8 percent)	2,720
$24,000	Taxable income	20,000
$ 5,660	Taxes	4,380
$18,340	After tax income	18,180

With minimum tax (20 percent):[2]

Taxable investment:		Tax-exempt investment
$30,000	Ordinary income	$30,000
$10,000	Deductions	10,000
$20,000	Income before investment income and taxes	20,000
$ 4,000	(at 10 percent) Investment income ($40,000 investment at 6.8 percent)	2,720
$24,000	Taxable income	22,720
$ 5,660	(regular) Taxes at 20 percent of total	4,540
$18,340	After tax income	18,180

In order to induce this investor (who had bought municipals previously) the yield on municipals would have to rise to 7.31 percent.

Taxable investment:		Tax-exempt investment
$20,000	Ordinary income	$30,000
$10,000	Deductions	10,000
$20,000	Income before investment income and taxes	20,000
$ 4,000	(at 10 percent) Investment income ($40,000 investment at 7.31 percent)	2,925
$24,000	Taxable income	22,925
$ 5,660	(regular) Taxes at 20 percent of total	4,585
$18,340	After tax income	18,340

SEC. 1. [Preamble and policy statement to be furnished by S.I.A. Subcommittee on Taxable Municipal Securities.]

SEC. 2. INTEREST SUBSIDY PAYMENTS.

(a) UNITED STATES TO MAKE INTEREST SUBSIDY PAYMENTS.—The Secretary shall pay 30 percent of the interest payable on any issue of taxable municipal obligations if the provisions of this section shall have been satisfied.

(b) TAXABLE MUNICIPAL OBLIGATIONS.—For purposes of this section "taxable municipal obligations" means any obligation—

(1) with respect to which an election pursuant to subsection (f) of this section has been made and which would, but for such election, be an obligation described in section 103(a)(1) of the Internal Revenue Code of 1954, as amended, and

(2) in connection with the issuance, sale and delivery of which the conditions specified in subsections (e) and (g) of this section shall have been timely satisfied.

(c) SECRETARY.—For purposes of this section "Secretary" means the Secretary of the Treasury or his delegate.

(d) INTEREST.—For the purposes of this section "interest" means the amount of interest payable on any obligation as stated by the terms of such obligation, regardless of by whom paid, and includes—

(1) to the extent payable in accordance with the terms of such obligation, interest on any interest not available for payment to the holder of such obligation at the due date therefor as a result of—

(A) the default by the issuer of such obligation in the making of the interest payment required to be paid by it, or

---

[1] Investor is indifferent between investments.
[2] Investor will not buy municipal at 6.8 percent.

(B) the application of the provisions of subsection (k), and

(2) any amounts at any time payable as interest on such obligation in accordance with the terms thereof, without regard to the stated maturity of such obligation.

(e) CONDITIONS TO INTEREST SUBSIDY.—The Secretary shall make the payments provided for under subsection (a) on any issue of taxable municipal obligations if—

(1) not more than 30 nor less than 12 calendar days prior to the date of sale by the issuer of such taxable municipal obligations the issuer shall have filed with the Secretary a written notice setting forth—

(A) the identity of such issuer,

(B) a description of the proposed application of the proceeds anticipated to be realized by such issuer from the sale of such issue of obligations,

(C) the proposed date of sale of such obligations,

(D) the anticipated maximum annual interest to be payable on such obligations, and

(E) the anticipated maximum principal amount of such obligations,

(2) on or before two business days prior to the date specified in paragraph (1)(C) of subsection (e) of this section, the Secretary shall not have filed with the issuer written objection to the sale of such obligations which shall not prior to the actual date of sale have been withdrawn by the Secretary, and

(3) at the time of the payment for and delivery of such obligations counsel shall be of the opinion that such obligations are taxable municipal obligations within the meaning of subsection (b) of this section.

(f) ELECTION OF TAXABILITY OF INTEREST.—The issuer of any obligation which, with the making of an election that such obligation be treated as an obligation not described in section 103(a)(1) of the Internal Revenue Code of 1954, as amended, would constitute a taxable municipal obligation shall be deemed to have made such election if—

(1) the conditions provided in subsection (e) shall have been timely satisfied, and

(2) the instrument evidencing such obligation—

(A) clearly evidences in the title and in the text of the terms of such obligation that interest on such obligation is taxable, and

(B) contains a statement to the effect that the issuer has elected to issue a taxable municipal obligation under the provisions of this section.

(g) MANNER OF ISSUANCE AND SALE OF TAXABLE MUNICIPAL OBLIGATIONS.—The time and manner of the issuance and sale of any taxable municipal obligation and the terms and conditions of such obligation shall be governed by the legislation creating such issuer or under or pursuant to which it exists or pursuant to which such obligation or the authority to issue such obligation is created or exists.

(h) ISSUANCE OF OBLIGATIONS CONCLUSIVE.—Timely satisfaction of the conditions provided in subsections (e), (f) and (g) of this section shall, with respect to the holder of any taxable municipal obligation, be conclusive evidence of the eligibility of such obligation for the benefits of this section; and the validity and enforceability of the obligation of the Secretary to make payments under this section with respect to interest on such obligation shall be absolute and incontestable for any reason: *Provided* that the provisions of this subsection shall not affect any rights the Secretary may have against the issuer of such obligation.

(i) EVIDENCE OF OBLIGATION OF UNITED STATES.—The obligation of the Secretary to make payments pursuant to this section with respect to any taxable municipal obligation—

(1) shall be evidenced either by a coupon attached to and issued with the instrument evidencing such taxable municipal obligation or in the text of the instrument evidencing such obligation—

(A) in such a manner as shall clearly set forth that the obligation of the issuer to pay 70% of the interest payable on such taxable municipal obligation and the obligation of the Secretary to pay 30% of such interest are separate and several, and

(B) in such manner that, if such obligation is evidenced by coupons attached to the instrument evidencing such taxable municipal obligation, each such coupon shall represent a single and indivisible instru-

ment and no instrument or coupon purporting to evidence the obligation of the Secretary to make payments pursuant to subsection (a) of this section shall be separately detachable, and

(2) shall, with respect to the holder of any taxable municipal obligation, be valid and enforceable, in accordance with the provisions of this section, without—

(A) the making, issuance or publication of any determination, ruling or waiver by the Secretary or any other agent, representative or delegate of the United States or on behalf of the Secretary or the United States or any agency or instrumentality of the United States, or

(B) the endorsement of such obligation or interest coupons on such obligation by or on behalf of the Secretary or the United States or any agency or instrumentality of the United States.

(j) MANNER OF PAYMENT BY SECRETARY.—Amounts required by subsection (a) of this section to be paid by the Secretary shall be paid by the Secretary directly to the trustee, paying agent or other person performing similar functions for such taxable municipal obligations, as provided in the instrument creating such obligations, and shall be segregated and held in trust by such trustee, paying agent or other person for the benefit of the holders of such taxable municipal obligations, and shall not be commingled with any other funds of the issuer or of such trustee, paying agent or other person, and the Secretary shall not have any obligation to make any payment to any other person and shall not have any liability to the holder of such taxable municipal obligations other than to make payments to the trustee, paying agent or other person performing similar functions therefor; provided, however, that payment to such trustee, paying agent or other person shall discharge the obligation of the Secretary to make payments pursuant to subsection (a) of this section only to the extent that such amounts are paid over to the holders of such taxable municipal obligations.

(k) TIME OF PAYMENT.—Payment of interest on any taxable municipal obligations pursuant to subsection (a) shall be made by the Secretary in Federal funds at or prior to the time at which the interest payment on such obligation is required in the instrument creating such obligation, except that if the issuer shall default in the payment of any interest required to be paid by it, any payment made by the Secretary pursuant to subsection (a) on account of interest with respect to which the issuer is in default shall be returned to the Secretary and payment required to be made pursuant to subsection (a) with respect to the defaulted interest payment shall be made by the Secretary at such time as the issuer shall have paid the entire amount required to be paid by it with respect to such interest payment.

(l) ADJUSTMENTS ON ACCOUNT OF CERTAIN SALES OF TAXABLE MUNICIPAL OBLIGATIONS.—In the event that the net proceeds realized by the issuer from the sale of any issue of taxable municipal obligations by the issuer, not including any accrued interest thereon, are in excess of the stated principal amount of such issue of obligations, or in the event that there is any accrued interest on such obligations paid to the issuer at the time of the delivery of such issue, the issuer of such obligations shall, at the time of payment for and delivery of such obligations, pay to either the United States, or at the option of the issuer, the person to whom, pursuant to subsection (j) of this section, the Secretary is to make the payments required by subsection (a) of this section an amount equal to 30 percent of the sum of—

(1) the amount, if any, by which the net proceeds realized by the issuer on the sale of such issue, not including any accrued interest thereon, exceeds the stated principal amount of such obligations, and

(2) the amount of any accrued interest on such obligations paid to the issuer at the time of the delivery of such issue.

Any amount so paid the issuer under this subsection to the person to whom, pursuant to subsection (j) of this section, the Secretary is to make the payments required by subsection (a) of this section shall be deemed to have been a payment by the Secretary pursuant to subsection (j) of this section at the time of such payment and delivery and shall be treated in accordance with the provisions of subsection (j).

(m) REPORTS TO THE SECRETARY.—

(1) Within 30 days after payment for and delivery of any issue of taxable municipal obligations, the issuer shall file with the Secretary a written notice setting forth—

(A) the identity of such issuer,

(B) the time and manner of the issue and sale of such obligations,

(C) the date of the payment for and delivery of such obligations,

(D) the principal amount of such obligations,

(E) the net proceeds, excluding accrued interest, realized by such issuer from the sale of such obligations and the amount of accrued interest on such obligations paid to the issuer at the time of the delivery of such issue,

(F) the amount and time of payment of each installment of interest on such obligations, and the person to whom, pursuant to subsection (j) of this section the Secretary is to make the payment required by subsection (a) of this section.

(2) Not more than 30 nor less than 10 calendar days prior to the redemption by the issuer of any taxable notices required to be published or sent to with the Secretary copies of any notices required to be published or sent to the holders of such obligations as a condition to or in connection with such redemption and a written notice setting forth—

(A) the date of such redemption,

(B) the principal amount of such obligations then to be redeemed,

(C) the amount and time of payment of interest to be paid on such obligations then to be redeemed, and

(D) the amount and time of payment of each installment of interest on such obligations due after the date of such redemption.

(3) The failure of the issuer of any taxable municipal obligation to file any notice required by paragraphs (1) or (2) of this subsection (m) shall not affect the validity or enforceability of such taxable municipal obligation, or the validity of the election pursuant to subsection (f) of this section with respect to such taxable municipal obligation, or the validity or enforceability of the obligation of the Secretary to make payments under this section with respect to interest of such obligation: *Provided*, that the provisions of this subsection shall not affect any rights the Secretary may have against the issuer of such obligation.

(n) Return of Payments Under Certain Circumstances.—

(1) In the event that interest paid by the issuer pursuant to the instrument creating any taxable municipal obligation and then remaining unclaimed, shall in accordance with the provisions of such instrument, be returned to such issuer, there shall be returned to the Secretary the payment made by the Secretary pursuant to subsection (a) of this section with respect to the interest so returned to the issuer, provided that the Secretary shall be required to pay to the person to whom, pursuant to subsection (j) of this section, the Secretary is required to make the payments required by subsection (a) of this section any amounts returned to the Secretary pursuant to this subsection (n) which are subsequently claimed on such taxable municipal obligation.

(2) In the event that interest paid by the issuer pursuant to the instrument creating any taxable municipal obligation and then remaining unclaimed shall, in accordance with provisions of applicable law, escheat to any State, the payment made by the Secretary pursuant to subsection (a) of this section with respect to the interest so escheating to such State shall—

(A) be retained by the Secretary if such payment by the Secretary shall, prior to the time of such escheat, have been returned to the Secretary pursuant to paragraph (1) of this subsection (n), and

(B) be returned to the Secretary if such payment by the Secretary shall not, prior to the time of such escheat, have been returned to the Secretary pursuant to paragraph (1) of this subsection (n):

Provided, that the Secretary shall be required to pay to such State any amounts retained by the Secretary pursuant to paragraph (2)(A) of this subsection (n) or returned to the Secretary pursuant to paragraph (2)(B) of this subsection (n) which, prior to the time that such escheat shall have become unconditional, such State is required under applicable law to pay over to a claimant on such taxable municipal obligation.

Sec. 3. Pernament Annual Appropriations.

Section 3689 of the Revised Statutes (31 U.S.C. 711) is amended by inserting after

"(2) *Interest on Public Debt.* For payment of interest on the public debt, under the several Acts authorizing the same."

the following:

"(2a) *Payments with respect to taxable municipal obligations.* For payments pursuant to Section 2(a) of the Taxable Municipal Bond Act of 1973."

SEC. 4. PROVISIONS RELATING TO FEDERAL FINANCING BANK.

The obligation of the Secretary of the Treasury pursuant to Section 2(a) of this Act to make payments of interest on taxable municipal obligations (as defined in section 2(b) of this Act) shall not be deemed to constitute a "guarantee" (as defined in section 3(3) of the Federal Financing Bank Act of 1973) for any purpose of the Federal Financing Bank Act of 1973.

SEC. 5. AMENDMENT RELATING TO TAXATION OF INTEREST ON CERTAIN GOVERNMENTAL OBLIGATIONS.

(a) ELECTION TO ISSUE TAXABLE MUNICIPAL OBLIGATIONS.—Section 103 of the Internal Revenue Code of 1954, as amended (relating to interest on certain governmental obligations), is amended by redesignating subsection (e) as subsection (f) and by inserting after subsection (d) the following new subsection:

"(e) TAXABLE MUNICIPAL OBLIGATIONS.—

"(1) SUBSECTION (a)(1) NOT TO APPLY.—Any taxable municipal obligation shall be treated as an obligation not described in subsection (a)(1).

"(2) TAXABLE MUNICIPAL OBLIGATIONS.—For purposes of this subsection "taxable municipal obligation" means any obligation—

"(A) with respect to which an election pursuant to section 2(f) of the Taxable Municipal Bond Act of 1973 has been made, and

"(B) in connection with the issuance, sale and delivery of which the conditions specified in sections 2(e) and 2(g) of the Taxable Municipal Bond Act of 1973 shall have been timely satisfied."

(b) CONFORMING AMENDMENTS OF OTHER LEGISLATION.—

(1) AMENDMENT OF PUERTO RICAN FEDERAL RELATIONS ACT.—Section 3 of the Puerto Rican Federal Relations Act, as amended, is amended by adding at the end thereof a new paragraph as follows:

"The exemption from taxation accorded by this section shall not apply to interest on any bond or other obligation which constitutes a taxable municipal obligation as defined in Section 103(e)(2) of the Internal Revenue Code of 1954, as amended, of the United States."

(2) AMENDMENT OF REVISED ORGANIC ACT OF THE VIRGIN ISLANDS.—Section 8(b) of the Revised Organic Act of 1954, as amended, of the Territory of the Virgin Islands is amended by adding at the end thereof a new paragraph as follows:

"(iii) The exemption from taxation accorded by paragraphs (i) and (ii) of this subsection (b) with respect to bonds or other obligations issued under paragraphs (i) or (ii) shall not apply to interest on any such bond or other obligation which constitutes a taxable municipal obligation as defined in Section 103(e)(2) of the Internal Revenue Code of 1954, as amended, of the United States."

(3) AMENDMENT OF ORGANIC ACT OF GUAM.—Section 1423a of the Organic Act of Guam, as amended, is amended by adding at the end thereof a new sentence as follows:

"The exemption from taxation accorded by this section shall not apply to interest on any bond or other obligation which constitutes a taxable municipal obligation as defined in Section 103(e)(2) of the Internal Revenue Code of 1954, as amended, of the United States."

SEC. 6. AMENDMENT RELATING TO TAXATION OF INTEREST SUBSIDY PAYMENTS IN CERTAIN CASES.

Subtitle D of the Internal Revenue Code of 1954, as amended (relating to miscellaneous excise taxes), is amended by inserting after Chapter 42 (relating to private foundations) the following chapter:

"CHAPTER 43—USERS OF CERTAIN FACILITIES

"SEC. 4960. EXCISE TAX BASED ON RELATED INTEREST SUBSIDY INCOME.—

"(a) IMPOSITION OF TAX.—There is hereby imposed on each disqualified holder of taxable municipal obligations a tax equal to 100 percent of the related interest subsidy income of such holder for the taxable year.

"(b) DISQUALIFIED HOLDER DEFINED.—For purposes of subsection (a) a disqualified holder of taxable municipal obligations is a person who is, or a related person (as defined in section 103(c)(6)(C)) of a person who is—

(1) a holder of industrial development bonds (as defined in section 103(c)) which constitute taxable municipal obligations (as defined in section 103(e)) issued as part of an issue substantially all of the proceeds of which were used—

(A) to provide facilities referred to in paragraph 4 of section 103(c), or

(B) for the acquisition or development of land as the site for an industrial park, as defined in paragraph (5) of section 103(c), or

(C) for the acquisition, construction, reconstruction or improvement of land or property of a character subject to the allowance for depreciation, referred to in paragraph (6) of section 103(c) and

(2) a substantial user (as that term is used in paragraph (7) of section 103(c)) of facilities referred to in paragraph (1) of this subsection (b).

"(c) RELATED INTEREST SUBSIDY INCOME DEFINED.—For purposes of subsection (a) related interest subsidy income means the gross amount of income from payments pursuant to section (2)(a) of the Taxable Municipal Bond Act of 1973 of interest on taxable municipal obligations (as defined in section 103(e)) described in paragraph (1) of subsection (b)."

SEC. 7. AMENDMENTS OF SECURITIES ACTS RELATING TO TAXABLE MUNICIPAL OBLIGATIONS.

(a) AMENDMENT OF SECURITIES ACT OF 1933.—Section 3(a)(2) of the Securities Act of 1933 (15 U.S.C. 77c(a)(2)) is amended by amending the fourth clause of the first sentence of said section 3(a)(2), which reads as follows:

"or any security which is an industrial development bond (as defined in section 103(c)(2) of the Internal Revenue Code of 1954) the interest on which is excludable from gross income under section 103(a)(1) of such Code if, by reason of the application of paragraph (4) or (6) of section 103(c) of such Code (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security;"

to read as follows:

"or any security which is an industrial development bond (as defined in section 103(c)(2) of the Internal Revenue Code of 1954) the interest on which either is excludable from gross income under section 103(a)(1) of such Code if, by reason of the application of paragraph (4) or (6) of section 103(c) of such Code (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security, or would be so excludable from gross income if such security were not a taxable municipal obligation (as defined in section 103(e)(2) of such Code;"

(b) AMENDMENT OF SECURITIES EXCHANGE ACT OF 1934.—Section 3(a)(12) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(12)) is amended by amending the fourth clause of said section 3(a)(12), which reads as follows:

"or any security which is an industrial development bond (as defined in section 103(c)(2) of the Internal Revenue Code of 1954) the interest of which is excludable from gross income under section 103(a)(1) of such Code if, by reason of the application of paragraph (4) or (6) of section 103(c) of such Code (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security;"

to read as follows:

"or any security which is an industrial development bond (as defined in section 103(c)(2) of the Internal Revenue Code of 1954) the interest on which either is excludable from gross income under section 103(a)(1) of such Code if, by reason of the application of paragraph (4) or (6) of section 103(c) of such Code (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security, or would be so excludable from gross income if such security were not a taxable municipal obligation (as defined in section 103(e)(2) of such Code);"

(c) AMENDMENT TO TRUST INDENTURE ACT OF 1939.—Section 304(a)(4) of the Trust Indenture Act of 1939 (15 U.S.C. 77ddd(a)(4)) is amended by adding at the end thereof a new paragraph as follows:

"(C) any security exempted from the provisions of the Securities Act of 1933, as amended, by paragraph (2) of subsection 3(a) thereof, as amended by section 7(a) of the Taxable Municipal Bond Act of 1973;"

(d) AMENDMENT OF INVESTMENT COMPANY ACT OF 1940.—Section 2(a)(16) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(16)) is amended by inserting before the period at the end of said section the following proviso:

": *Provided*, that no security shall be deemed to be a Government security solely by reason of (A) being a taxable municipal obligation (as defined in section 103(e)(2) of the Internal Revenue Code of 1954) or (B) payments of interest on such taxable municipal obligation by the Secretary of the Treasury pursuant to section 2(a) of the Taxable Municipal Bond Act of 1973"

SEC. 8. EFFECTIVE DATE.

This Act shall become effective ____________, 197 .

SEC. 9. SHORT TITLE.

This Act may be cited as the Taxable Municipal Bond Act of 1973.

The CHAIRMAN. Senator Haskell.

Senator HASKELL. I don't have any questions. Thank you, Mr. Chairman.

The CHAIRMAN. I have no questions. Thank you very much.

Now we will stand in recess until 2 o'clock.

[Whereupon, at 12:30 p.m. the committee was recessed, to reconvene at 2 p.m. the same day.]

AFTERNOON SESSION

The Senate Committee on Finance reconvened at 2 p.m., pursuant to the noon recess, Hon. Russell B. Long (chairman of the committee), presiding.

The CHAIRMAN. Next we will call Mr. Grady L. Patterson, State Treasurer of South Carolina, president of the National Association of State Auditors, Comptrollers and Treasurers.

We are pleased to have you with us, Mr. Patterson.

STATEMENT OF GRADY L. PATTERSON, JR., STATE TREASURER OF SOUTH CAROLINA AND PRESIDENT OF THE NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS, AND TREASURERS

Mr. PATTERSON. Thank you very much, Mr. Chairman.

Mr. Chairman, shall I proceed?

The CHAIRMAN. Yes.

Mr. PATTERSON. First I want to express my appreciation to this committee for an opportunity to be heard in opposition to suggestions that alter, modify, or destroy the tax-exempt status of interest earned on State and municipal bonds.

I am appearing on behalf of the National Association of State Auditors, Comptrollers, and Treasurers; the State of South Carolina; the Municipal Association of South Carolina and the Association of Counties. We are grateful for an opportunity to express to you our profound opposition to these detrimental proposals.

Let me say in the beginning that this committee has considered such proposals several times in the past and has always rejected them. It was through the wise and sound judgment of this committee that such proposals were deleted from the Tax Reform Act of 1969. Your

logic and reasoning were sound then, and such logic and reasoning are equally valid today.

Without question, a taxable bond would substantially increase the taxes of almost every taxpayer in the Nation. Such a proposal would do significant and irreparable damage to the taxpayers of this country and the market for public securities. There is no way to make a security taxable that was formerly tax exempt without increasing the cost to the taxpayers. The so-called subsidy to be provided by the Federal Government will, of course, be derived from tax dollars. Thus the taxpayers either at the State level or the Federal level end up paying the bill.

Because so many continue to ignore, either through oversight or design, the legal basis for the tax exemption of State and municipal bonds, I think it appropriate to set forth and restate the legal basis for the tax exemption of the interest earned on State and municipal bonds.

In the interest of time, Mr. Chairman, I would summarize by saying that there is no question about the constitutional basis for the tax exemption. I have also searched the record surrounding the passage of the 16th amendment which deals quite extensively with what the Congress meant when the 16th amendment was adopted and what some of your distinguished predecessors thought about tax exemption, and I have that in my statement, so I will just read one portion which the Chief Justice in the famous *McCulloch* v. *Maryland* case, I think, stated beautifully:

> * * * The exemption from taxation has been sustained on a principle which so entirely pervades the Constitution, is so intermixed with the materials which compose it, so interwoven with its web, so blended with its texture as to be incapable of being separated from it without rendering it to shreds.

Thus the constitutional basis for tax exemption of interest earned on State and municipal bonds is expressed in a long line of U.S. Supreme Court decisions and is crystal clear.

Moreover, the meaning and intent of the purpose of the 16th amendment, which I have just alluded to, were not directed at tax exemption. The evil to be remedied by the 16th amendment was the adverse effect of the *Pollock* decision which I am sure the chairman is familiar with.

Proponents say a taxable municipal bond with a Federal subsidy is "designed to broaden and stabilize the municipal capital market." This is sheer folly. These securities would be competing in the marketplace with all other taxable securities now being sold. Consequently, municipals would have no preference and would not be attractive over other taxable issues competing for the investment dollar. In fact, smaller unknown issues would fare worse under those conditions, because an investor would not want to invest in little known, or lesser known, water district or sewer district securities when his money could be put in a well-known corporate or utility issue. Additionally, interest by individual investors would dry up, thereby virtually eliminating the market, for municipals.

In my judgment the idea of making municipals taxable and expanding the market would have the exact reverse effect on these securities.

Testimony before the Committee on Ways and Means on January 21, 22, and 23, 1976, showed rather clearly that issuers with bad credit supported the taxable bond option with a Federal subsidy while issuers

with good credit opposed the idea. The conclusion is that bad credit issues are looking to the Federal Government to salvage their long pattern of excessive debt and fiscal irresponsibility.

Where is there any proof or showing that purchasers of municipal bonds would probably buy high risk bad credit taxable bonds simply because the Federal Government would pay 30 to 40 percent of the interest costs? I say there is none. It goes to creditworthiness.

Purchasers would still necessarily look to the issuers of such high risk securities for the payment of principal and 60 to 70 percent of the interest cost. Consequently, the argument that such securities would sell better is fallacious, in my judgment, and the product of pie-in-the-sky dreamers.

Those issuers who manage their fiscal affairs properly, keep their financial houses in order, and live within their means and maintain excellent credit have no problem selling their securities at attractive rates of interest.

I want to cite two examples in South Carolina, with your permission. We went to the market on January 21 with a $30 million bond issue and we got five bids and the lowest bid was 4.82 percent annual interest cost.

We went to the market again on April 6 with about a $14 million bond issue. We had six bids on that issue and the lowest bid was 4.39 percent. So there is proof positive.

As you well know, South Carolina enjoys a triple-A credit rating. There is proof positive if you keep your financial house in order and live within your means you have no trouble selling your bonds.

So why should the Congress tamper with a marketing system that has worked so well for decades and inject a proposal of admitted questionable validity?

Another main objection to the alternative tax proposals is the Federal Government's getting involved in our business. You hear that all the time, I am sure.

There is no question that any Federal participation will produce untold detail, forms, and restrictions on the marketing of our securities. We can judge the future on what has happened in the past to prove this point. One of the most recent examples of this fact is the proposed rules and regulations dealing with arbitrage bonds.

If you would bear with me 1 minute I want to show you, Mr. Chairman, what I am talking about.

There is a law that deals with arbitrage bonds. It is one sheet of paper. There are the rules and regulations that the bureaucrats have added to it. It is 49 pages of very small print. That is one example of what happens when the Federal Government gets involved in our business.

Another example is the subsidy which deals with the grants to schools and institutions of higher learning, and it is a HUD program which is 11774, talking about the same thing, and it has got 7 pages of instructions, 12 pages of applications, and 69 pages of more instructions. That is what I am talking about and you are certainly aware of the revenue sharing law which is very limited, no strings attached, and I just got stacks of material that deals with that which I won't take the time to show you.

What I am saying, the Congress enacts a very simple law and by the time the Federal Government, the bureaucrats, finish with it it is totally foreign to the spirit and intent the Congress had in mind when they enacted the law.

The CHAIRMAN. What do you have for revenue sharing? I see you have a bunch of volumes——

Mr. PATTERSON. These are some of the regulations, payment entitlement under local fiscal assistance act, and general revenue sharing research utilization project. It goes on and on, Mr. Chairman. That is what I am talking about.

So I think this is proof positive of what would happen to an optional taxable bond because once the Federal Government gets its fingers in the act the sovereignty is compromised and control follows. There is no question, the sovereignty is sacrificed and the contol follows.

I think this is proof positive of what would happen if the Federal Government got into this business.

The plain and direct fact of the matter is that the simple optional taxable bond idea as the proponents would have you believe, would end up as a great morass of forms, guidelines, priority determinations and other redtape for the States to meet. It simply is not in the cards to run a simple Federal program. Moeover, the Congress will never approve a blank check to be drawn on the U.S. Treasury and signed at will by the several States. Anyone concluding to the contrary is a pipe dreamer engaged in sheer fantasy.

I am confident that this committee is aware of the many fundamental questions that will be raised with respect to the terms of this specific piece of legislation.

As I understand it, there is no specific piece of legislation before this committee, Mr. Chairman. Supporters of the legislation apparently assume that a program will be developed which would be automatic, irrevocable, fully optional with the issuer, and free of regulations, policies and procedures which would delay the issuance of the taxable securities at a time deemed advantageous or necessary for State and local governments or which would prevent the issuance of all types of securities now issued by State and local governments for the various purposes for which such securities may be issued under local law. I say that is not possible.

In my judgment, these are very naive and glib assumptions, and it is highly unrealistic to expect those conditions to be met; for those familiar with the legislative process know that the legislation that is finally passed, more often than not, bears little or no relationship to what started through the legislative mill.

This proposal may sound simple at the outset, and on a voluntary basis only; however, it would be only a few years until the same proponents would be back here before this committee proposing that optional taxable State and municipal bonds be made mandatory.

They are already talking about higher percentage rates. They start out talking about 30, 35 percent. They are talking about 40, 45, and 50 percent. And once you get the foot in the door they will be back here hollering for more and more subsidy, and that is going to destroy the tax-exempt market and going to destroy tax-exempt securities for State and local governments.

Another overriding objection to such a proposal would be the threat of repeal of a taxable bond arrangement, or interest subsidy. There would be no way to prevent a subsequent Congress from repealing a subsidy established by a former Congress. Moreover, if the subsidy payouts should far exceed the expectations of Congress, it could and probably would place a limit on the amount of the subsidy to be paid out. This would then bring on delays in issuing our securities, as well as priority determinations by the Federal Government. Which States and municipalities or political subdivisions would get the limited payout?

Any proposal that will alter, modify or destroy the tax-exempt status of State and municipal bonds, including an optional taxable bond with a Federal subsidy, will be met immediately with court action. This will cause more uncertainty in the bond market for the several years it will take the U.S. Supreme Court to decide the issue.

The minimum tax proposal as it applies to the individual taxpayers has a single, a 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 are 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 instantly severe.

Tax exemption is not something someone dreamed up or plucked from the sky, and it is not a Federal subsidy as Mr. Reuss and Mr. Kennedy think. The principle is interwoven into the very fabric of the U.S. Constitution. It is as basic as the right to vote, equal protection, due process and all the other constitutional guarantees.

Why should we honor all the other constitutional guarantees and do all of this carrying on with trying to eliminate this constitutional guarantee. It doesn't make any sense to me.

The CHAIRMAN. I will have to ask you to end your oral presentation at this point. I have read your statement, and you made a very fine statement. I wish we could have had more of the members here to hear you. I will try to see to it that they do and that your statement will receive all the consideration it deserves. I feel you have made a very fine statement on behalf of yourself and all State officers that have a similar responsibility.

Mr. PATTERSON. If I could just respond to Senator Brock's question about the 244, Mr. Chairman. Would you indulge me for that?

I think the answer to that question, Mr. Chairman, is that why should we penalize and jeopardize the taxpayers, all the taxpayers in this country to require 244 people to pay additional taxes. If you do away with the tax exemption, you are going to raise the taxes of all the taxpayers. I think that is the answer to it.

A further answer is there is no showing on the record that 9 of those 244 persons escaped tax liability by virtue of owning tax-exempt bonds.

Thank you, sir.

[The prepared statement of Mr. Patterson follows:]

STATEMENT BY GRADY L. PATTERSON, JR., STATE TREASURER OF SOUTH CAROLINA

Mr. Chairman and members of the committee, first I want to express my appreciation to this Committee for an opportunity to be heard in opposition to suggestions that alter, modify or destroy the tax-exempt status of interest earned on state and municipal bonds.

I am appearing on behalf of the National Association of State Auditors, Comptrollers and Treasurers; the State of South Carolina; the Municipal Association of South Carolina and the Association of Counties. We are grateful for an opportunity to express to you our profound opposition to these detrimental proposals.

Let me say in the beginning that this Committee has considered such proposals several times in the past and has always rejected them. It was through the wise and sound judgment of this Committee that such proposals were deleted from the Tax Reform Act of 1969. Your logic and reasoning were sound then, and such logic and reasoning are equally valid today.

Without question, a taxable bond would substantially increase the taxes of almost every taxpayer in the nation. Such a proposal would do significant and irreparable damage to the taxpayers of this country and the market for public securities. There is no way to make a security taxable that was formerly tax exempt without increasing the cost to the taxpayers. The so-called subsidy to be provided by the Federal Government will, of course, be derived from tax dollars. Thus, the taxpayers either at the state level or the federal level end up paying the bill.

Because so many continue to ignore, either through oversight or design, the legal basis for the tax exemption of state and municipal bonds, I think it appropriate to set forth and restate the legal basis for the tax exemption of the interest earned on state and municipal bonds.

LEGAL AND CONSTITUTIONAL BASIS FOR TAX EXEMPTION

The Supreme Court of the United States has spoken to the issue on many occasions. In an early case, *Mercantile Bank* v. *City of New York*, *7 Sup. Ct. 826*, (1887), in which it said:

> Bonds issued by the State of New York, or under its authority by its public municipal bodies, are means for carrying on the work of the government and are not taxable, even by the United States, and it is not a part of the policy of the government which issues them to subject them to taxation for its own purposes.

Some have argued that the 16th Amendment included authority for the Congress to tax state and municipal bonds.

The text of the 16th Amendment to the United States Constitution is as follows:

> 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.

The Amendment became effective in 1913.

In perhaps the first decision of the United States Supreme Court taking cognizance of its ratification, *Brushaber* v. *Union P. R. Co., 36 Sup. Ct. 239*, (1915), Chief Justice White for a unanimous Court held:

> 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 a consideration of the source when the income was derived.

The Chief Justice goes on to point out that the obvious intention of the Amendment was to do away with the principle upon which the case of *Pollock* v. *Farmers' Loan & Trust Co., 15 Sup. Ct. 674*, (1895), was decided.

The Pollock case was twice argued in the Supreme Court, and on the principal questions it was decided by a five to four majority. In substance, the majority held that despite the unquestioned right of Congress to levy taxes on income when such income tax was levied upon rents, it was judicially a direct tax upon the real estate from whence the rents were derived. Accordingly, since Congress was prohibited from levying direct taxes by the provisions of Article I, Section 2, Clause 3, unless they be apportioned among the states according to population, such tax was unconstitutional.

When one first reads the 16th Amendment and notes the language permitting the Congress to tax "income from whatever source derived," one's first impression would be that this was intended to permit Congress to tax income from municipal bonds. One has to read further to see that the significant portion of the Amendment is that which permitted this taxation without apportionment among the several states and without regard to any census or enumeration.

Pollock has held that the tax on rent from real property was, in effect, a tax upon the property itself. It was accordingly necessary in order to overcome Pollock to say in so many words that Congress might tax the income from real estate notwithstanding that it was a direct tax upon real estate. This, and this alone, was the thrust of the 16th Amendment, for it had been unanimously conceded that to tax the income on state bonds was, in effect, an act of taxation by Congress on the states themselves—something that could not be done without destroying the Federal System.

HISTORICAL BACKGROUND SURROUNDING THE BASIS OF THE 16TH AMENDMENT

The record surrounding the passage of the 16th Amendment reveals conclusively the intent *not* to include power or authority for the Federal Government to tax state or municipal securities.

In April 1910, Senator Norris Brown from Nebraska had this to say concerning the question "Shall the Income Tax Amendment be Ratified?":

> Recently, the question has been raised by those who are opposed to the ratification of the amendment that with the amendment ratified the powers of the States will in some way be impaired and their strength and vitality, in some way not specified, destroyed. The objection is not sound. The amendment in no way changes the existing relation between the State and the Federal Government. Whether the amendment is ratified or not, the rights of the State as a State and those of the Federal Government in their relation to each other will remain the same. Each sovereignty is now wholly independent of the other in the exercise of certain governmental functions, and the proposed amendment neither adds to nor takes away from the independence now enjoyed by each. . . .

Earlier, Senator Joseph W. Bailey, Texas, made the following observation:

> I have also responded to the unanimous decision of the Supreme Court of the United States that Congress has no power to levy a tax upon the incomes derived from state, county and municipal securities, and I have specifically exempted them. I regarded it as unfortunate when the old act was passed that they were then included. I thought it certain, then, that the court would decide—and I think that the court ought to have decided—that part of the old act unconstitutional.
>
> In the early days of the Republic that court, in a decision, announced by its most illustrious member, declared that States, counties and municipalities could not levy a tax upon Federal obligations holding that to permit it would be equivalent to a permission for the States to lay a tax upon the operations and instrumentalities of the Federal Government. I have always believed that decision wise and just; and if it is, then it necessarily follows that its reasoning applies equal force against a federal tax upon the operations or instrumentalities of the States and their subdivisions.
>
> But even if I doubted that, I would have conformed the amendment to what was the unanimous judgement of the court. (*Congressional Report*, Vol. 44, Part 2, 61st Congress, 1st Session.)

Senator Borah of Idaho is on record as follows:

> I say, therefore, that already Congress is given absolute power; and if the reasoning of the distinguished governor [Hughes, New York] were correct, the language being full and complete, conveying all power, we could tax state bonds and municipal securities and state salaries at the present time.
>
> But there is another controlling reason why we cannot do so, which reason is omitted in the message and which is not affected by this amendment in any manner. The first time the question arose as to power of one sovereignty was in the case of *McCulloch* v. *Maryland*. In that case, as all lawyers well remember, there was an attempt on the part of the State of Maryland to tax the stock of the United States Bank. The United States Bank having been organized as an instrumentality of the National Government to carry out certain functions of granted power, it was held that it was not a taxable article. In that case, Chief Justice Marshall considered this question and gave

as the basis upon which has been built the entire structure of law which prevents one nationality from taxing the instrumentalities and means of another.

In the first place, it was admitted by the Chief Justice that there was no provision of the Constitution which controlled the subject-matter. It was stated by the Chief Justice that there was neither any limitation nor grant of power of the National Government being complete, the inhibition had to be found somewhere other than that of the taxing clause itself. He said in *McCulloch* v. *Maryland* (4 Wheat.):

> There is no express provision [of the Constitution] for that case, but the claim—

That is, the exemption from taxation—

> has been sustained on a principle which so entirely pervades the Constitution, is so intermixed with the materials which compose it, so interwoven with its web, so blended with its texture as to be incapable of being separated from it without rendering it to shreds. (*Congressional Record*, February 10, 1910, p. 1696.)

Thus, the Constitutional basis for tax exemption of interest earned on state and municipal bonds as expressed in a long line of U. S. Supreme Court decisions is crystal clear. Moreover, the meaning, intent and purpose of the 16th Amendment were not directed at tax exemption. The evil to be remedied by the 16th Amendment was the adverse effect of the Pollock decision. Beyond any doubt, it (16th Amendment) did not grant Congress any new authority or power to tax state and municipal bonds. The myth about what the 16th Amendment means with respect to state and municipal bonds should be dispelled and forever laid to rest.

PROPOSAL WOULD NOT BROADEN THE MARKET

Proponents say a taxable municipal bond with a federal subsidy is "designed to broaden and stabilize the municipal capital market." This is sheer folly. These securities would be competing in the marketplace with all other taxable securities now being sold. Consequently, municipals would have no preference and would not be attractive over other taxable issues competing for the investment dollar. In fact, smaller unknown issues would fare worse under these conditions, because an investor would not want to invest in little known, or lesser known, water district or sewer district securities when his money could be put in a well-known corporate or utility issue. Additionally, interest by individual investors would dry up, thereby virtually eliminating the market for municipals.

In my judgment, the idea of making municipals taxable and expanding the market would have the exact reverse effect on these securities.

Testimony before the Committee on Way sand Means on January 21, 22, and 23, 1976, showed rather clearly that issuers with bad credit supported the taxable bond option with a federal subsidy while issuers with good credit opposed the idea. The conclusion is that bad credit issuers are looking to the Federal Government to salvage their long pattern of excessive debt and fiscal irresponsibility. Where is there any proof or showing that purchasers of municipal bonds would probably buy high risk bad credit taxable bonds simply because the Federal Government would pay 30 to 40 percent of the interest cost? I say there is none.

Purchasers would still necessarily look to the issuers of such high risk securities for the payment of principal and 60 to 70 percent of the interest cost. Consequently, the argument that such securities would sell better is fallacious, and the product of pie-in-the-sky dreamers.

Those issuers who manage their fiscal affairs properly, keep their financial houses in order, and live within their means and maintain excellent credit have no problem selling their securities at attractive rates of interest.

So, why should the Congress tamper with a marketing system that has worked so well for decades and inject a proposal of admitted questionable validity?

Another main objection to the alternative tax proposals is the Federal Government's getting involved in our business. There is no question that any federal participation will produce untold detail, forms and restrictions on the marketing of our securities. We can judge the future on what has happened in the past to prove this point. One of the most recent examples of this fact is the proposed rules and regulations dealing with arbitrage bonds. As this Committee knows, the Tax Reform Act of 1969 contained certain relatively simple provisions relating to arbitrage bonds. I show you a copy of the proposed regulations

from the Treasury Department which were proposed on November 7, 1970; June 1, 1972; May 3, 1973; and again in December 1975, which deals with this matter. (Other examples in point are the proposed regulations by the Treasury Department on Fiscal Assistance to State and Local Governments, dated February 22, 1973, and the HUD regulations dealing with interest subsidies on loans to institutions of higher learning.)

It is obvious to a casual reader that these proposed regulations go far beyond the spirit and intent of the law enacted by the Congress. They are punitive in nature on their face and are clear and convincing proof of what would happen to a taxable bond arrangement once it goes to the federal bureaucrats to interpret.

If for no other reason, this is sufficient evidence to prove the objection to allowing the Federal Government into our business of financing schools, roads, mental institutions and other public projects.

The plain and direct fact of the matter is that the simple optional taxable bond idea as the proponents would have you believe, would end up as a great morass of forms, guidelines, priority determinations and other red tape for the states to meet. It simply is not in the cards to run a simple federal program. Moreover, the Congress will never approve a blank check to be drawn on the U.S. Treasury and signed at will by the several states. Anyone concluding to the contrary is a pipe dreamer engaged in sheer fantasy.

I am confident that this Committee is aware of the many fundamental questions that will be raised with respect to the terms of this specific piece of legislation. Supporters of the legislation apparently assume that a program will be developed which would be automatic, irrevocable, fully optional with the issuer, and free of regulations, policies and procedures which would delay the issuance of the taxable securities at a time deemed advantageous or necessary for state and local governments or which would prevent the issuance of all types of securities now issued by state and local governments for the various purposes for which such securities may be issued under local law. In my judgment, these are very naive and glib assumptions, and it is highly unrealistic to expect these conditions to be met; for those familiar with the legislative process know that the legislation that is finally passed, more often than not, bears little or no relationship to what started through the legislative mill.

This proposal may sound simple at the outset, and on a voluntary basis only; however, it would be only a few years until the same proponents would be back here before this Committee proposing that the optional taxable state and municipal bonds be made mandatory.

Another overriding objection to such a proposal would be the threat of repeal of a taxable bond arrangement, or interest subsidy. There would be no way to prevent a subsequent Congress from repealing a subsidy established by a former Congress. Moreover, if the subsidy payouts should far exceed the expectations of Congress, it (Congress) could and probably would place a limit on the amount of the subsidy to be paid out. This would then bring on delays in issuing our securities, as well as priority determinations by the Federal Government. Which states and municipalities or political subdivisions would get the limited payout?

Any proposal that will alter, modify or destroy the tax-exempt status of state and municipal bonds, including an optional taxable bond with a federal subsidy, will be met immediately with court action. This will cause more uncertainty in the bond market for the several years it will take the U.S. Supreme Court to decide the issue.

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 are 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 instantly severe.

Tax exemption is not something someone dreamed up or plucked from the sky, and it is not a federal subsidy as Mr. Reuss and Mr. Kennedy think. The principle is interwoven into the very fabric of the U.S. Constitution. It is as basic as the right to vote, equal protection, due process and all the other

constitutional guarantees. Any optional or voluntary taxable bond arrangement would do violence to this constitutional principle. The very heart of the issue is sovereignty and separation of powers. It cannot be mandatorily taken away by Congress; neither can it be optionally or voluntarily bartered away in the form of a federal subsidy.

Would anyone suggest that the Federal Government pay citizens not to exercise their constitutional right to vote? Of course not! Yet, we see a Congressman and a United States Senator suggesting that the Federal Government pay (in the form of a federal subsidy) states, municipalities and political subdivisions not to exercise their constitutional right to issue tax-exempt bonds. Such suggestions are against public policy and against the public and national interest.

FLUCTUATIONS ARE NORMAL IN BOND MARKETS

Of course, the municipal bond market comes under stress during periods of economic shifts and swings the same as most other markets. The stock market fluctuates widely during economic cycles, but there is no hue and cry to dismantle the system for marketing stocks. Interest rates have been on a roller coaster over the past two years, but there is no clamor to overhaul the money markets. This is what makes a market in any item or product and what free enterprise is all about. The point is markets fluctuate, but this is no cause to cast the systems aside and destroy them under emotions of the moment.

It is a fact that banks have reduced their buying of municipals because of commitments in tanker and REIT paper. I consider this as a passing interlude, and when banks get beyond the REIT and tanker problems they will return to the municipal market. Historically, the record shows that commercial banks continually commit an increasing percentage of their total assets to obligations of state and political subdivision securities.

TAXABLE MUNICIPAL BOND WILL NOT CURE LOOSE FISCAL POLICY

A taxable muncipal bond will not cure loose fiscal policy and excessive debt and fiscal irresponsibility. Voters across the land expressed themselves clearly and convincingly in rejecting additional bond issues a few weeks ago. There is a mood across this country of retrenchment and a return to fiscal sanity at all levels of government. People are sick and tired of deficit spending, excessive debt and loose fiscal policy. I am confident that a great majority of citizens throughout this country reject any plan that transfers control of their financing from the local level of government to Washington, where the track record for fiscal responsibility is woefully lacking.

I reject appeals by a very few to destroy a principle that has served our citizens so well since the founding of this Republic. We have a free and open municipal bond marketing system which is working very well and has worked for nearly 200 years for states, municipalities and political subdivisions that exercise fiscal discipline and keep their financial houses in order, I do not believe that the great majority of people are willing to exchange a known valid working system for an unknown, theoretical proposal that will do violence to the "harmonious proportions" of the United States Constitution "rending it to shreds", and sacrificing the independence of the states and political subdivisions.

CONCLUSION

In conclusion, we urge this Committee and the Congress not to tamper with the present mechanism of our tax-exempt financing. We urge you not to destroy our tax-exempt market in the emotional fall out of the New York City debacle. The guise of a simple optional taxable bond with a 30 to 40 percent subsidy will mushroom into a federal monster that will destroy our present public securities marketing procedures. It will destroy the tax exemption of state and municipal bonds.

We have said it before, and we say it again, most people come here and appear before your Committee wanting something. We do not want a thing. We just want to be left alone.

We respectfully urge this Committee to reject all proposals relating to tampering with the tax-exempt status of interest earned on state, municipal

and political subdivision bonds and to put an end to this detrimental proposal once and for all.

The CHAIRMAN. We had told Senator Kennedy we had time to get to him right after Mr. Patterson, so I am calling Senator Kennedy at this point.

STATEMENT OF HON. EDWARD M. KENNEDY, A U.S. SENATOR FROM THE STATE OF MASSACHUSETTS

Senator KENNEDY. I thank the Chair very much. I will try and abide by the time limitation.

If I may, Mr. Chairman, I will submit a more complete statement in support of my position.

First of all, I want to commend you, Mr. Chairman, and the members of this committee for having this hearing today on the question of taxable municipal bonds and also on the question of withholding on interest and dividends. My testimony is limited to the question of the taxable municipal bonds. I hope the other issue can also be addressed. I understand it is enormously complex. You are very familiar with it, and I understand you received testimony on it this morning.

The area that I am concerned about, Mr. Chairman, is how we are going to permit the major cities of this country to develop new capital in the future in a way that is sound economically and sound financially. We must create new capital opportunities with a minimum impact in terms of expenditures or commitments of the Federal Government. It can be done with a minimum of a Federal intervention, presence, and bureaucracy. That is why I think the idea of the taxable bond option, working through the Treasury Department, is satisfactory and valuable and worthwhile. It will also have the effect of giving assurances to cities and municipalities and States of a continuing ongoing basic entitlement over a period of years as they plan for the future.

I know there are a number of proposals before the Congress to consider different ways of trying to help and assist the municipalities. Those ideas have been before the Congress for a long period of time. You have the urban development bank concept, which is strongly supported by a good friend of mine and a distinguished urban expert from Massachusetts, Prof. Charles Haar. I have reviewed that very carefully. I think there are a number of features to it which commend it.

There is the concept of a Marshall plan for the cities which would require an additional Federal presence and revenues.

But it seems to me that the taxable municipal-bond concept is the most practical idea to pursue for the immediate future. It meets the objectives of continuity, continuation, and certainty. It requires only minimum Federal bureaucracy. It has the great advantage of allowing an enormous increase in the amount of new capital for a very small investment of Federal revenues.

You are familiar with the fact that of every dollar lost to the Treasury under tax-free municipal bonds, only 67¢ goes to States or cities. Under the TBO, there would be $7 in State and local savings for every dollar of Federal revenues.

Mr. Chairman, I am aware of the testimony that was presented to the committee by the Treasury Department, indicating that those that support this idea are trying to undermine the tax-exempt bond. I want to refute that. I certainly, as one who is a strong supporter of it, deny any such intention. I support it because in my State as in so many other areas of the Northeast and other parts of the country there is an absolutely critical urban capital shortage. The TBO offers the best opportunity to deal with that.

I know you are aware of the history of the TBO. It is an idea which has been around for a long time. I am very hopeful that even given the press of business of this committee that we can see action on this proposal now, because such action is overdue.

You are aware of the TBO legislation in the House. It has been reported out of the Ways and Means Committee. In my conversations with the chairman, I have received a very positive response from the chairman of the Ways and Means Committee if the Senate were to take action in this area. I think it is an issue whose time is due. I know the concerns that have been expressed by some, but I do think that this is an extremely effective way of dealing with the problem.

An important issue, Mr. Chairman, is the level of the subsidy. I know the Treasury has talked about a figure of 30 percent. Others have gone as high as 50 percent. I would hope that the commitee would accept a figure of 40 percent as the appropriate cost.

I have submitted in my statement some tables on the costs long run implications of the TBO at various subsidy costs. I think it would be unwise to pass a 30 percent subsidy. It would be unrealistic and ineffective. I think it would be creating false hopes, false promises. I think 40 percent would offer a real opportunity, with a very modest commitment of resources, to achieve a desirable and worthwhile public policy.

In my statement, I review some of the reasons why the TBO complements existing tax free municipal bonds. I also review the problems and the enormous difficulties of municipalities in creating new resources and in marketing existing bonds.

Mr. Chairman, the two most important issues before the country are the restoration of the economy and the effort to make the cities livable places. In my travels around my own State, this is a problem not only for the major cities but also for smaller communities and towns. I think the TBO offers a useful way of beginning to meet their needs and I am hopeful that the committee can take favorable action on it.

I would ask consent to be able to submit my more detailed testimony which goes through these points.

The CHAIRMAN. That additional information will be included in the record.

Senator Byrd.

Senator BYRD. Senator Kennedy, on the table on page 3, I am not sure whether I understand correctly, the cost at 40 percent you put at $5 billion. Over what period of time was that?

Senator KENNEDY. I have two different talks. The one at the bottom of the page shows the net costs at various percentages. For the 1st year and the 10th year, when the program would be at equilib-

rium. I have taken the 30, 35, 40, and 45 percent levels of the subsidy and indicated the cost of the program. That is what those figures are trying to represent. The table at the top of the page shows how many taxable bonds would be issued at each level of the subsidy. At 40 percent, the cost in the 10th year would be $568 million. The first year at 40 percent would be only $45 million. And about 17 percent of all the bonds issued would be taxable bonds. The other 83 percent would continue to be issued as tax free bonds.

The 40 percent is what I recommend as the subsidy level.

Senator BYRD. That would be the annual cost?

Senator KENNEDY. The first year would be $45 million at 40 percent, the 10th year $568 million.

Senator BYRD. I see. Now,——

Senator KENNEDY. The cost table also shows the savings to State and local governments. The effect would be a 7-fold saving. Seven times the Federal cost would be saved by cities and municipalities. For every Federal dollar spent, $7 in benefits results to State and local governments. The leverage is high.

Senator BYRD. This proposal would give——

Senator KENNEDY. That would be the bottom figure. The $3.547 billion figure is the savings to the States and cities because of the reduction in borrowing costs.

Senator BYRD. Your proposal would give the localities the option of issuing tax exempt bonds or going this route?

Senator KENNEDY. Exactly, Senator.

Senator BYRD. And you estimate that 17 percent of the $30 billion would shift to the taxable bond market?

Senator KENNEDY. That is correct.

Senator BYRD. I assume the figures——

Senator KENNEDY. These are Treasury figures actually..

Senator BYRD. But I assume that they are based on 17 percent?

Senator KENNEDY. That is right, Senator.

Senator BYRD. There is a lot of merit to it. On the other hand, it doesn't get away, as I see it, from the possibility of individuals using tax exempts to avoid paying any income taxes.

Senator KENNEDY. No; it doesn't, Senator. As I mentioned earlier I would be opposed given the extraordinary burden that cities and municipalities are under at this time, to changing that situation.

Senator BYRD. That is what this committee was faced with about 7 years ago, every Governor came here and government came down, most of the mayors urging that no change be made.

Senator KENNEDY. I agree. The choice the committee might make is to take this new opportunity for creation of new municipal capital. I develop it more completely in the testimony. A 30-percent subsidy level would be a false hope and promise; 50 percent might go too far; 40 percent would be just right. The Governors and mayors had reservations about this concept in 1969. Now there is quite a different attitude. Certainly the mayors that I have talked to recognize their critical problem. The advantage of the TBO is that we are not creat-

ing a new Federal agency or bureaucracy to interfere with decisions in local communities. We can provide substantial help without doing that.

Senator BYRD. The question of tax exempts presents a dilemma. If we are to eliminate the total opportunity for an individual to utilize tax exempts to escape taxes then we get into an area that every locality would strongly oppose.

Senator KENNEDY. Yes.

Senator BYRD. Your proposal goes part of the way but doesn't eliminate the basic problem, does it?

Senator KENNEDY. Well, Senator, I would say it doesn't even go part of the way on the issue of eliminating the exemption for tax exempts. What we are attempting to do is recognize that 88 percent of the benefits of tax exempts go to those in the top 1.2 percent of the income brackets and, therefore, there is a very limited market for the tax exempts. With the taxable municipal bonds, you can broaden the market to include other individuals and institutions that see this is a useful, worthwhile, and valuable investment. It won't solve the tax-exempt bond question so far as tax equity is concerned, but it is an important step in helping cities obtain capital.

Senator BYRD. Yes; I think that is very important.

Senator KENNEDY. But it is meant to be a companion to the existing tax-exempt bond.

Senator BYRD. I think this has a lot of appeal, it certainly does to me. But it does not plug that loophole everyone is trying to find a way to plug. No one seems to have come up with a way to plug it.

Senator KENNEDY. Well, Senator, as one who has talked about plugging loopholes, I think the critical problems of the communities, the cities of this Nation, are very important, too. If we take away the tax-free bond, the impact on cities and towns could be catastrophic. This way, we can offer to the cities and towns new capital opportunities in a way that provides the minimum Federal presence and the greatest protection, at a very low and reasonable cost.

Senator BYRD. I think what you say about the needs of the localities is absolutely correct, and that being the case we are in the position where we almost have to sacrifice what you might call tax justice in order to make it possible for those localities to borrow money on reasonable terms.

I was a little surprised at the 17 percent. I would have thought perhaps a larger share of that $30 billion would utilize this method, but the best thinking——

Senator KENNEDY. That is the Treasury estimate. This is a very modest approach to a major problem, but I do think it would have an important useful impact on the cities.

Senator BYRD. Thank you.

The CHAIRMAN. Senator, the preceding witness, Mr. Grady Patterson, State Treasurer of South Carolina, put in the record some of his authorities, and I am sure he could marshal others, contending that the Federal Government doesn't have the authority constitutionally

to tax the interest on State and municipal bonds. Some in the Treasury who would know would welcome the opportunity to test that in court, but thus far Congress has not seen fit to offer them that opportunity.

What is your opinion about that? Have you researched that point also?

Senator KENNEDY. Well, yes. First of all, I agree with you that it would be challenged. Unquestionably, it would be decided by the Supreme Court, but I think the Court would sustain the power of Congress to take such action. There is a very strong and compelling case in terms of the constitutionality of such action.

The issue had been studied by the Justice Department as far back as 1942, they believed that such a tax would be constitutional. I would like to include in the record a Justice Department opinion in 1942, taking this position.

[The letter follows:]

DEPARTMENT OF JUSTICE,
Washington, April 14, 1942.

Hon. RANDOLPH E. PAUL,
Tax Adviser to the Secretary of the Treasury,
Washington, D.C.

DEAR MR. PAUL: On June 24, 1938, Hon. James W. Morris, Assistant Attorney General in charge of the Tax Division of the Department of Justice, transmitted to the Honorable Herman Oliphant, General Counsel of the Treasury Department a comprehensive study of the constitutional aspects of the taxation of Government bondholders and employees. Copies of this study were also made available to the appropriate congressional committees.

You have requested our opinion on the constitutionality of the proposal by your Department to subject to Federal income tax the interest received hereafter on outstanding and future issues of State and municipal bonds, with special emphasis on legal developments subsequent to the publication of our study. We are pleased to comply with your request and submit the following views.

In our earlier study we expressed the following conclusion:

"It is believed that there can no longer be found in the decisions of the Supreme Court any rule of continuing authority which would raise a constitutional prohibition against applying the Federal income tax to State bondholders, officers, and employees."

You are no doubt aware that since that time the decisions of the Supreme Court on the question of constitutional tax immunity have all served to reinforce and confirm that conclusion. The trend toward a limitation of such immunity, which had developed when we published our study in 1938, has continued without interruption to the present date.

We are, of course, no longer concerned with the power of the Federal Government to tax the income of State officers and employees. The decision of the Supreme Court in *Graves* v. *N.Y. ex rel. O'Keefe* (306 U.S. 466), and the enactment of the Public Salary Tax Act of 1939, have removed that problem from the field of controversy. Taxation by both State and Federal Governments of the salaries of public employees is now an accepted incident of our fiscal system. The only remaining question is whether the income received from State and municipal obligations may be subjected to Federal taxation. In our view, the answer is as clear and certain as the solution of any legal problem can ever be prior to a final determination of the precise issue by the Supreme Court. It is our considered opinion that the Congress does have the power to tax income.

It is, of course, true that the Supreme Court concluded in *Pollock* v. *Farmers' Loan & Trust Co.* (157 U.S. 429, 158 U.S. 601), that a Federal tax could not validly be imposed upon income derived from municipal obligations. That decision was based upon the theory that a tax on income was a tax upon the source from which the income was derived. Thus, a tax on the income from municipal

bonds was the equivalent of a tax upon the bonds themselves, and, therefore, an unconstitutional burden upon the power to borrow. However, this reasoning has been completely discredited in later opinions of the Supreme Court. With the destruction of the premise of the *Pollock case*, its conclusion must also fall.

"The theory, which once won a qualified approval, that a tax on income is legally or economically a tax on its source, is no longer tenable * * *," said the Supreme Court in March 1939, in *Graves* v. *N.Y. ex rel. O'Keefe* (306 U.S. 480). Less than a year earlier in *Helvering* v. *Gerhardt* (304 U.S. 405), the Court had sustained a Federal tax upon the salaries received by employees of the Port of New York Authority. The claimed immunity, if allowed, would in the Court's opinion (p. 424) have imposed "to an inadmissable extent a restriction upon the taxing power which the Constitution has granted to the Federal Government." The imposition of a State tax upon the salary of a Federal employee was similarly held in the *O'Keefe case* not to place an unconstitutional burden upon the employing sovereign. *Collector* v. *Day* (11 Wall. 113), another landmark decision like the *Pollock case*, was thus overruled. The express denial in the *O'Keefe case* that a tax on income was the equivalent of a tax upon the source represented no new though but was rather a reiteration of a principle which had been applied in the Court's prior decision in *New York ex rel. Cohn* v. *Graves* (300 U.S. 308), and in *Hale* v. *State Board* (302 U.S. 95). There, too, it had been recognized that "income is not necessarily clothed with the tax immunity enjoyed by its source."

The opponents of the pending proposal urge that it would produce an unconstitutional "interference" with State governments. Translated into practical terms, the interference complained of is merely the increased cost of future public borrowing which might be occasioned by the tax. It is significant that this increased cost involves no discriminatory burden. Rather, it represents the effect of placing income from private and public sources upon the same plane of equality. The absence of any element of discrimination would be helpful in sustaining the constitutionality of the proposed tax.

Until the Supreme Court handed down its decision in *Alabama* v. *King & Boozer* on November 10, 1941 (314 U.S. 1), there was room for the view that, despite the decisions affecting public employees, a constitutional immunity from taxation might possibly be accorded to Government bondholders. Mr. Justice Stone had stated in the *O'Keefe* opinion, p. 480, that there was no basis "for the assumption that any * * * tangible or certain economic burden is imposed on the government concerned as would justify" a decision that the tax upon the employee's salary was invalid. On the other hand, it is no doubt true that the issuing government would bear a part of the economic burden of an income tax imposed upon the bondholder. Nevertheless, this Department did not attach to the statement of Mr. Justice Stone the significance urged for it by those who have opposed the legislation now suggested. The recent decision in *Alabama* v. *King & Boozer* confirms our view. It is now clearly established that the validity of a tax upon bond interest will not be affected by the increased likelihood that the economic burden will in some measure be passed on to the Government.

The question in the *Alabama case* was whether an Alabama sales tax, which was to be collected from the buyer, was unconstitutional in its application to purchases made by a contractor engaged by the United States under a cost-plus-a-fixed-fee contract. It was quite clear, of course, that the entire burden of the tax would be borne by the Government. In fact, the Government had agreed with the contractor that State taxes, if valid, would constitute part of the cost of the project and would be assumed and borne by the Government. Hence there was no uncertainty as to the economic effect of the tax as in the earlier case of *James* v. *Dravo Contracting Co.* (302 U.S. 134), which involved a lump sum contract. The Supreme Court nevertheless sustained the State exaction. In the course of its opinion the Court made the following observation (pp. 8–9):

"So far as such a nondiscriminatory State tax upon the contractor enters into the cost of the materials to the Government, that is but a normal incident of the organization within the same territory of two independent taxing sovereignties. The asserted right of the one to be free of taxation by the other does not spell immunity from paying the added costs, attributable to the taxation of

those who turnish supplies to the Government and who have been granted no tax immunity."

Thus, the Supreme Court finally laid to rest the theory that an economic burden in terms of incerased governmental costs invalidates a tax. The earlier opinions in *Panhandle Oil Co.* v. *Knox* (277 U.S. 218), and *Graves* v. *Texas Co.* (298 U.S. 393), were held untenable so far as they supported the contrary conclusion.

A decision which supports State taxation of Federal cost-plus-a-fixed-fee contractors would operate at least equally to sustain a Federal tax imposed upon State bondholders. Both relationships rest upon contract; one involves the furnishing of supplies and services, the other money. The tax in each instance would increase the cost of governmental operations: In the case of the State tax on the Federal contractor, to the full extent of the tax extracted; in the case of the State bondholders, to some extent which is difficult of precise ascertainment. Paraphrasing the language of the Supreme Court in the *Alabama case*, we may therefore conclude that so far as a nondiscriminatory Federal income tax upon a holder of a State obligation enters into the cost of borrowing, that is but a normal incident of the organization within the same territory of two independent taxing sovereigns.

What has been said thus far as to the power of the Federal Government to impose a tax upon income received from State obligations applies with equal force to all interest hereafter received whether upon future issues or upon outstanding obligations. No constitutional question as to the validity of a retroactive tax is involved. See *United States* v. *Hudson* (299 U.S. 498), and cases cited therein. The proposed tax reaches only future income, and is therefore entirely prospective in operation. It possesses the same constitutional validity as the income tax imposed by the Public Salary Tax Act of 1939, upon the income received after 1938 by all Federal judges, irrespective of the date of their appointment to office.

The assumption, which was formerly prevalent that interest received upon State securities was immune from Federal taxation, is analogous to the assumption of many years standing that under *Evans* v. *Gore* (253 U.S. 245), an income tax upon the salaries of Federal judges would be unconstitutional as a diminution of their compensation. The salaries of some Federal judges were made subject to the income-tax laws by the Revenue Act of 1932, which required that all compensation received by judges taking office after June 6, 1932, the effective date of the act, be included in gross income. Judges who had taken office prior to June 6, 1932, were thus given a statutory tax immunity. In the case of the bondholder, express statutory exemption was included in the act of October 3, 1913, and this provision was repeated in later acts. With the realization that tax immunity of judges who had taken office prior to June 6, 1932, was not a constitutional requirement, the Congress, by the Public Salary Tax Act of 1939, took the final step to remove it. The present proposal to tax future income of all State securities is therefore consistent with the procedure and objective of the Public Salary Tax Act of 1939. A further illustration of the application of the income-tax to future income arising out of transactions which were closed before the particular taxing provision was adopted may be found in *Burnet* v. *Wells* (289 U.S. 670). The grantor of an irrevocable trust was there held constitutionally taxable upon the trust income although the trust had been created before the enactment of the statute imposing the tax.

There is no constitutional basis for contending that income hereafter received upon outstanding State bonds must be free from Federal taxation because the obligations were issued and purchased on that implied or expressed understanding. The Federal Government was not a party to such contracts and the power of the Congress to enact a revenue measure is not fettered by any agreement between individuals or between an individual and a State. There are many illustrations of this proposition. Thus, in *Louisville & Nashville R. R.* v. *Mottley* (219 U.S. 467), an act of Congress which prohibited the enforcement of certain contracts for transportation was upheld, although applied to a preexisting contract. In *New York* v. *United States* (257 U.S. 591), an order of the Interstate Commerce Commission which increased an intrastate railroad rate was upheld even though the State charter had provided that a lesser rate should be charged by the company. See also *Norman* v. *B. & O. R. Co.* (294 U.S. 240).

It accordingly appears that no objection on constitutional grounds can be successfully raised against the proposal to tax the income hereafter received upon outstanding State obligations. Indeed, the assistant secretary of the Conference on State Defense has admitted that if Federal taxation of income arising out of future issues of State bonds is constitutional, "there remains no constitutional bar to Federal taxation of the income received from the bonds now outstanding." (Tax Immunity and the Revenue Bond, by Daniel B. Goldberg, a printed memorandum distributed by the Conference on State Defense, March 1940.)

The Department's study of 1938, referred to above, reached a second and alternative conclusion that irrespective of the weakened vitality of the *Pollock case* and *Collector* v. *Day*, there is sound basis for a construction of the sixteenth amendment which would remove the immunity of the State bondholder and officer. We there examined at length the history of the ratification of the amendment and presented as exhibits the evidence which would support that conclusion. Accordingly, we refrain from entering into that phase of the problem in detail. One brief observation, however, seems appropriate.

At the hearings last month before the Committee on Ways and Means of the House of Representatives, reference was made to the fears expressed in 1910 by then Governor Hughes, of New York, that the proposed sixteenth amendment would authorize the taxation of interest received from State and municipal obligations. Reference was also made to the subsequent assurances of Senator Root and Senator Borah leading to the conclusion that the amendment was adopted by the legislatures of all the States with the views of the latter two in mind. The statements of Governor Hughes and of Senators Root and Borah, and of many others, were gathered and commented upon in our study. It is significant that a large number of public officials (some agreeing and others disagreeing with the construction placed upon the amendment by Governor Hughes) urged that if the Hughes construction was correct, it furnished an additional ground for the adoption of the amendment. Among these was Frederick M. Davenport, to whom Senator Root's letter had been addressed, and Senator Brown, of Nebraska, who was the father of the joint resolution submitting the amendment to the States. It is also significant that the New York Legislature rejected the amendment in 1910 after the message of Governor Hughes, but ratified it subsequently under the administration of Gov. John A. Dix, who vigorously championed the broadest interpretation of the amendment.

The foregoing and an abundance of similar evidence permitted the conclusion to be reached in our study that the preponderant understanding of the States at the time of the ratification of the sixteenth amendment was that its adoption would in all probability carry with it the power to tax the income from State and municipal bonds.

We should like to reiterate, however, that the constitutionality of the proposed legislation does not depend exclusively upon the acceptance of our construction of the sixteenth amendment; namely, that the words "from whatever source derived" mean exactly what they say, and as so interpreted clearly embrace income from Government securities. With full confidence, the validity of our conclusion may rest upon the basic proposition previously discussed that no implied constitutional immunity from Federal taxation attaches to interest received from State and municipal obligations.

Very truly yours,

SAMUEL O. CLARK, Jr.,
Assistant Attorney General.

The CHAIRMAN. Well, I have heard argument on both sides of it, but so long as we do not attempt to tax the interest on these State and municipal bonds then would you agree that there is no way you could insist on complete tax uniformity between citizens?

Senator KENNEDY. I agree, but I think the consequences of moving to uniformity in this area might be too harmful to State and local governments.

The CHAIRMAN. Thank you for your statement.

Senator KENNEDY. Thank you.

[The prepared statement of Senator Kennedy follows:]

TESTIMONY OF SENATOR EDWARD M. KENNEDY

Mr. Chairman, it is a privilege to appear before the Finance Committee today. I am well aware of the heavy workload on the Committee at this time, as the Committee completes its work on the omnibus House-passed tax reduction bill.

I take it as an auspicious sign, therefore, that in light of the already crowded schedule, the Committee has scheduled these hearings at this time to include the important topic of taxable bond options for state and local governments. It is this subject that I wish to address today.

My own view, Mr. Chairman, is that adoption of the taxable bond option is a wise and practical course of action that Congress should now take in dealing with the sensitive and complex topics of state and local financing and the tax exemption for interest on state and local bonds.

Unquestionably, the tax exemption feature has become a tax avoidance device for many wealthy persons. By now, it is a well-known fact that 244 individuals with adjusted gross incomes over $200,000 in 1974 paid no tax. Even that figure is an understatement. Tax exempt interest is not included in adjusted gross income. It is not even required to be reported. Individuals with large amounts of income derived entirely from this source lie outside the IRS figures on tax avoiders.

Other data indicate the magnitude of the problem. The Congressional Budget Office and the Joint Tax Committee estimate that the tax preference in current law for interest on state and local bonds will cost the Treasury approximately $5 billion in lost revenues in fiscal year 1977, derived as follows:

TAX EXPENDITURES

[In millions of dollars]

	Individuals	Corporations	Total
General purpose bonds	1,390	3,150	4,540
Industrial development bonds	85	165	250
Pollution control bonds	75	170	245
Total	1,550	3,485	5,035

These tax expenditures operate as massive federal subsidies for wealth individuals and corporations. But, unlike many other tax preferences, this loophole is also a lifeline for state and local governments, because the tax subsidy enables them to market their bonds at lower interest rates.

Closing this loophole, therefore—either by taxing the interest directly or by including it as an item of tax preference in the minimum tax—could cause serious repercussions for state and local governments, who would have to pay even higher interest rates on future bonds than they are already paying now. As a result, hard-pressed State and local governments would face the Hobson's choice of foregoing needed bond issues or cutting back expenditures in other areas in order to pay the higher interest rates.

In addition, although I am convinced that Congress has the constitutional power to tax the interest on state and local bonds, it is likely that legislation imposing such a tax would be the subject of lengthy litigation over the issue.

By contrast, the taxable bond option is an extremely attractive solution that avoids the undesirable consequences of imposing a regular tax or minimum tax on tax-free bonds, while offering a far more efficient form of federal interest subsidy to state and local governments.

The proposal I favor is incorporated in S. 3211, which I introduced last March and which is now pending before this Committee. Companion legislation introduced by Congressman Al Ullman and Henry Reuss was approved by the Ways and Means Committee in April and is now awaiting action by the full House. S. 3211 is essentially identical to the Ways and Means Committee Bill, H.R. 12774, except that I favor a higher federal subsidy than is contained in the House Committee bill.

S. 3211, would authorize the federal government to pay 40%—35% in the Ways and Means Bill and 30% in the version favored by the Administration—of the interest on State or local bond issues, in cases where the state or local government agrees to make interest payments on the bonds taxable to those who pur-

chase them. However, the interest subsidy will not be available for industrial development bonds or pollution control bonds.

The proposal will not in any way impair the tax exemption option available to State and local governments. Any jurisdiction may continue to issue tax exempt bonds. But the bill will encourage these jurisdictions to use the taxable bonds alternative, as a way of obtaining substantial new federal assistance at a far lower net cost to the Federal Treasury, and at lower net interest rates to themselves than they would have to pay on tax exempt bonds.

The proposal is also designed to minimize as much as possible the instinctive hostile reaction that arises in some quarters against federal intrusion into the tradition preserve of state and local financing. The bill accomplishes this goal in three ways:

—The Federal subsidy will be automatic. The subsidy will be available, without federal strings, conditions or other federal oversight, to all jurisdictions that choose the alternative of issuing taxable bonds.

—In addition, the subsidy will be funded by a so-called permanent entitlement, which means that the federal funds for the subsidy will be a binding legal obligation of the federal government. In this way, the subsidy funds will be insulated as much as possible from the vagaries and delays and uncertainties of the annual appropriations process in Congress. The entitlement method of funding is the same method used for Social Security payments, and is a necessary guarantee to States and cities that the program will be funded and carried forward in good faith by the Federal Government.

—The subsidy will be set at a level low enough to guarantee that it will not disrupt the existing tax exempt bond market, which will continue to be available for all jurisdictions that wish to use it.

My strong preference is for a 40% level of the subsidy, as the proper balance between adequately encouraging use of the taxable bond alternative and avoiding disruption of the existing tax exempt market.

The following table, adapted from the Ways and Means Committee Report, indicates the effect on the estimated $30 billion in annual issues of State and local bonds, at varying levels of subsidy:

[Dollar amounts in millions]

Subsidy level	Amount of taxable bonds issued				Amount of tax exempt bonds issued	
	Short term	Long term	Total	Percent	Total	Percent
30 percent		$1.4	$1.4	5	$28.6	95
35 percent	$0.2	2.9	3.1	10	26.9	90
40 percent	.5	4.5	5.0	17	25.0	83
45 percent	1.0	6.2	7.2	24	22.8	76
50 percent	14.5	13.7	28.2	94	1.8	6

These figures make a convincing case for at least a 40% subsidy level. At this level, only about $5 billion, or 17% of the $30 billion of annual state and local government offerings, would shift over to the taxable bond market.

Even at a 45% subsidy level, only about a quarter of the offerings would shift to the taxable alternative. Even at this level, there would be no real threat to the existing tax exempt market, since the vast majority of offerings would still be made through the tax exempt route.

It is only when the 45% subsidy level is exceeded and the 50% level is approached that serious effects begin to be felt on the tax exempt market. My hope, therefore, is that Congress will see fit to adopt the 40% level as the most appropriate compromise for the subsidy.

These data offer virtually no justification for the Administration's support of a 30% level for the subsidy. At this level, only 5% of the offerings would choose the taxable alternative, and the miniscule resulting use of the subsidy would prevent it from becoming an efficient source of new capital formation for state and local governments. In effect, Congress would be adopting the concept in theory, but would be denying it in practice.

Moreover, as the following table indicates, the 30% subsidy level would mean an extremely low "net" Treasury cost, defined as the gross cost of the subsidy to the Treasury, less the revenues generated for the Treasury from taxes on the

73-744—76——7

interest on the taxable bonds. For a 30% subsidy, the net cost would only be $7 million in the first full year of the program, and only $81 million by the tenth year, when the program would be operating at "equilibrium." The low cost emphasizes the negligible role the Administration envisions for the new program.

FEDERAL COSTS AND STATE-LOCAL BENEFITS OF TAXABLE MUNICIPAL BONDS AT VARIOUS SUBSIDY LEVELS

[In millions of dollars]

Year	30 percent		35 percent		40 percent		45 percent		45 percent	
	1st	10th	1st	10th	1st	10th	1st	10th	1st	10th
Gross subsidy cost	39	486	99	1,240	181	2,272	290	3,653	1,174	14,766
Revenues generated	32	405	77	975	135	1,704	210	2,638	1,026	12,908
Net subsidy cost	17	81	21	266	45	568	81	1,015	148	1,858
Reduction in State and local interest cost	69	868	157	1,972	282	3,547	407	5,122	533	6,698

In fact, at all subsidy levels—30% to 50%—the net Treasury cost is remarkably low, considering the leverage effect that can be achieved in the form of reduction of State and local borrowing costs. At the 40% level, the net cost of the program would be only $45 million in the first year, rising to $568 million in the tenth year. In return, state and local governments would receive benefits of $282 million in lower interest costs in the first year, and over $3.5 billion in the tenth year.

For every dollar the Treasury spends, the TBO produces seven dollars in benefits for state and local governments. So far as efficiency is concerned in the expenditure of federal funds I know of no present federal program that achieves this extraordinary 7-1 efficiency ratio. If efficiency is our guide in our use of federal funds, the TBO should have been enacted long ago.

In terms of this cost benefit analysis, the 50% subsidy is also extremely attractive—apart from the sensitive issue of its disruptive effect on the tax exempt market. At a 50% level, the Treasury would be spending $1.8 billion in the tenth year of the program to provide $6.7 billion in benefits to state and local governments.

This is an interesting "might have been"—if, in years gone by, Congress had adopted this sort of subsidy for state and local bonds, and if Congress had set the subsidy at 50%, then the program today would be providing $6.7 billion in savings to state and local governments, at a cost to the federal Treasury of $1.8 billion.

In other words, at less than one third the cost of the current revenue sharing program, we could be giving state and local governments even more benefits than they now receive under revenue sharing. That fact should be food for thought for governors and mayors and municipal finance officers, as they balance their philosophical desire to retain the existing tax exempt market against their practical need for capital formation and realistic forms of federal aid that Washington can afford.

In addition, the remarkable efficiency of the TBO stands in sharp contrast to the glaring inefficiency of the existing subsidy to state and local bonds. Through the current tax exemption Congress is now providing an annual $5 billion tax subsidy to state and local governments—but only $3.3 billion of the subsidy actually reaches its destination: $1.6 billion is siphoned off in the form of tax benefits for the wealthy private citizens, commercial banks and insurance companies who have been the principal purchasers of tax exempt bonds. In other words, it costs the federal government $1.00 to provide 67¢ worth of benefits to state and local governments.

By contrast, as the above figures indicate, the taxable bond alternative with a 40 percent subsidy offers much higher efficiency in the expenditure of scarce federal funds. For each federal dollar spent, seven dollars of benefits flow through to state and local governments. Thus, the shift to the alternative gives much more bang to the federal buck—ten times more bang, in fact, than the existing wasteful subsidy for tax exempt bonds.

Further, Mr. Chairman, I object very strenuously to the subtle innuendo in the Treasury testimony this morning, suggesting that some who favor a 40% tax

subsidy are doing so with the ulterior motive of eliminating the tax exempt bond market in the future.

I completely disavow any such purpose myself, and I know of no one else who favors such a strategy.

The figures I have cited demonstrate no significant danger that such a strategy could even get off the ground at any of the subsidy levels now under serious consideration—30 percent, 35 percent, or 40 percent.

The real issue is whether, in order for Congress to win the confidence of state and local governments, we shall be forced to enact a subsidy level so low that the program will be ineffective, and perhaps crippled, from the outset.

In trying to win this confidence, I do not feel that constructive debate is helped at all by scare talk, straw men, red herrings and other similar tactics the Treasury trots out when it wants to get its way on matters of taxation. Such tactics shed no light on the issue. They only inflame debate and make it more difficult for Congress to act responsibly.

Finally, in addition to the question of efficiency, there are a number of other important economic and tax policy considerations that strongly support the taxable bond alternative.

It will broaden the existing market for state and local bonds. An important part of the current crisis over state and local financing is that the current municipal bond market is too narrow to absorb the rapidly increasing levels of state and local obligations at reasonable rates of interest. Annual long term municipal borrowing has climbed from $10 billion in 1964 to nearly $30 billion today. At the same time, the development of more attractive investments and tax shelters in other areas has diverted traditional investors, especially banks, from the municipal market. And, of course, for institutions that are already tax exempt, municipal bonds have no attraction at all, since the institutions obviously prefer the higher returns available in the taxable bond market. The taxable bond option will make municipal bonds attractive to many investors now foreclosed to state and local governments, especially pension funds, charities, universities, and other tax exempt institutions.

The availability of the taxable bond will exert a beneficial counter cyclical effect, by shielding state and local governments from the squeeze traditionally felt in periods of tight money. During such periods, tax exempt interest rates tend to rise faster than taxable bond rates. Under the 40% taxable bond option, jurisdictions will be encouraged to use the taxable bonds whenever the interest rate gap between tax exempt and taxable bonds is less than 40 percent.

Use of the taxable bond option will reduce the flagrant inequity of the current subsidy for tax exempt bonds. According to estimates of the Joint Tax Committee, 88 percent of the current tax benefits for individuals go to the richest 1.2 percent of the population, those with incomes over $50,000 a year. By encouraging state and local governments to issue taxable bonds, the option would help to cutback these inequitable tax expenditures.

The option will improve the access of state and local governments to the long term bond market. Because of the commercial banks' preference for short term obligations, many municipalities have recently been forced to finance long term projects through a series of one year, bond anticipation notes. As a result, the jurisdictions find themselves in perennial jeopardy of default each time its short term notes come up for renewal. The taxable bond alternative will help state and local governments to tap the long term taxable market, thereby reducing their dependence on unstable short term obligations, lowering the risk of default, and reducing the risk premium incorporated in today's high municipal interest rates.

In closing, I would emphasize that the taxable bond option is neither new nor the special preserve of any political party. It was initially proposed by Democratic administrations in the 1960's. Its high water mark so far was its incorporation in the House version of the Tax Reform Act of 1969. Although it was dropped from the final act, it was subsequently endorsed by both the Nixon and Ford Administrations.

In the intervening years, the strong array of forces that opposed and successfully defeated the option in 1969 has greatly diminished. The financial crisis of New York City has sensitized all of us in Congress and around the country to the serious fiscal problems of the nation's cities. There is now broad support for the TBO from governors and mayors in every section of the country.

We cannot afford to miss the opportunity we now have. I hope that the Committee will act favorably on the option, and that you will give serious consideration to making the proposal a committee amendment to H.R. 10612, now about to reach the Senate floor.

Senator LONG. Next we will call representatives of the American Bankers Association, Mr. Donald C. Miller, Mr. Bert C. Madden, and Mr. Charles F. Haywood. I will ask that they be appropriately identified for the record as indicated by the list of witnesses.

STATEMENT OF DONALD C. MILLER, EXECUTIVE VICE PRESIDENT, CONTINENTAL ILLINOIS BANK & TRUST CO., CHICAGO, ILL., AND BERT C. MADDEN, SENIOR VICE PRESIDENT, TRUST CO. OF GEORGIA, ATLANTA, GA., ACCOMPANIED BY CHARLES F. HAYWOOD, PROFESSOR OF ECONOMICS, UNIVERSITY OF KENTUCKY, LEXINGTON, KY., FOR THE AMERICAN BANKERS ASSOCIATION

Mr. MILLER. I am Donald C. Miller, executive vice president of Continental National Bank & Trust Co. of Chicago. I am accompanied by Bert C. Madden, senior vice president, Trust Co. of Georgia, Atlanta, Ga., Charles F. Haywood, professor of economics, University of Kentucky, Lexington, Ky. and consultant to the American Bankers Association, and John F. Rolph, tax counsel, American Bankers Association.

Mr. MILLER. Mr. Chairman, this completes our statement on State and local obligations. Mr. Haywood will continue with testimony on the question of withholding on dividends and interest.

Mr. HAYWOOD. I am Charles Haywood, professor of economics at the University of Kentucky, and I serve as a consultant to the American Bankers Association.

My purpose in being here today is to submit a statement on behalf of the American Bankers Association, on the subject of withholding of Federal income taxes on interest and dividend income paid to U.S. citizens. That statement will be supplied to you and I will comment very briefly on it.

The consideration of withholding on interest and dividend income is hardly new. It received extensive consideration in 1962 and several times since then. Looking back to 1962 the issues today are the same as they were in 1962 except that the information reporting system that was put in place by the 1962 legislation has proved to be very successful in promoting compliance with the tax reporting requirements.

The paper we are submitting here for the ABA makes four points.

(1) We think that the need has not been demonstrated for replacing the information reporting system with a tax withholding system, or for adding a withholding system.

(2) That withholding would be burdensome and inequitable for certain classes of taxpayers for whom there would be overwithholding, including various taxpayers who in the end would not in fact have to pay tax on the interest or dividend income.

(3) That the costs of shifting from the present information reporting system to a withholding system would impose very significant costs upon the commercial banks, savings and loan associations, mutual savings banks, credit unions, and other institutions which make interest payments to individuals.

In addition, to the extent that a law or regulation might try to reduce some of the inequity of just a flat withholding requirement by setting up various kinds of exemption categories, the cost of administering an exemption system would fall upon the private sector, upon

the banks, and the thrift institutions, and that could be a very, very large cost in this particular situation.

(4) The last point made in the paper is that we think shifting to withholding at the present time would have an adverse effect on our economy in this period of economic recovery.

Now, let me go back and comment just very briefly on the first point about whether a need for withholding has been demonstrated. This morning, Deputy Assistant Secretary Goldstein's statement provided us with an interesting contribution on the question of just what amount of interest and dividend income is not being reported for tax purposes.

He estimated in his statement that there is about $1 billion of underreporting of income on dividends. His estimate seems to be consistent with what Commissioner Alexander said in April in testimony before the House, ~~where he said~~ that in the case of dividends, the most recent information is that withholding is about 96.5 percent effective. Applying that percentage, it comes out to be about $1 billion of underreporting on dividend income.

However, the estimate in Secretary Goldstein's paper of $7 billion of underreporting on interest payments cannot be reconciled with the statement that Commissioner Alexander made in April. With respect to reporting of interest income on information returns filed by financial institutions, Commissioner Alexander stated that about 97.6 percent of all interest required to be reported is, in fact, correctly reported by taxpayers.

We have about a $6 billion discrepancy here. This appears to be where most of the alleged improvement in revenue would have to come from; that is, the $6 billion discrepancy between Commissioner Alexander's figures and the figures presented by Secretary Goldstein this morning. I think there should be very serious effort made to reconcile that discrepancy and to put it in the record as to just where that $6 billion comes from.

One may assume that the $6 billion of underreported interest income may be based on some estimate of underreporting of interest income that lies outside the scope of the present information-reporting system, and that there is significant interest income that is not covered by the present reporting system. If this assumption is correct, it seems that the problem is not within the present reporting system to be corrected by substituting a withholding system, but that the present information-reporting system is not extensive enough.

Thank you, sir.

The CHAIRMAN. Thank you very much, gentlemen.

I had wondered if it might have more appeal to the banks if this burden on them to withhold were offset by permitting them to keep that money in the bank a little while longer and let them make some interest on the money.

What reaction do you people have to that suggestion?

Mr. HAYWOOD. Mr. Chairman, several considerations. One is that Reserve requirements would have to be taken into account in figuring what the cost in income relationship would be. In other words, at the present time, the funds that you are referring to would be held in a savings or time account which has a much lower Reserve requirement than the Treasury's tax and loan account. Any increase in income that might result from shifting money from an interest-bearing

account into a non-interest-bearing Treasury tax and loan account would be offset, I think, in significant part by the higher Reserve requirements that banks must maintain on those Treasury tax and loan accounts.

In addition, banks must, of course, pledge securities as collateral for the Treasury tax and loan accounts, and a larger amount of money in the Treasury tax and loan account means you have to put up more collateral, and that would also reduce some of the income.

We have not had a chance to look at that in any detail, but those are two considerations that immediately come to mind that would mitigate any benefits.

The CHAIRMAN. Senator Byrd.

Senator BYRD [presiding]. Do you gentleman have anything further to add?

Mr. HAYWOOD. We appreciate the opportunity to be here, Senator.

Senator BYRD. We thank you for your testimony.

I might say it is a pretty bad way to legislate with an important hearing like this going on and the Senate voting simultaneously on equally important antitrust legislation.

Mr. HAYWOOD. We have, of course, submitted our statements for the record, and we would be glad to amplify upon those and respond to any questions in writing you or Chairman Long might wish to put to us.

Senator BYRD. Thank you very much.

[The preferred statements of Messrs. Miller and Haywood follow:]

STATEMENT OF DONALD C. MILLER ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

I am Donald C. Miller, Executive Vice President of Continental Illinois National Bank and Trust Company of Chicago. I am accompanied by Bert C. Madden, Senior Vice President of the Trust Company of Georgia in Atlanta. We appreciate this opportunity to testify on behalf of the American Bankers Association on tax proposals which would have a profound impact on the market for State and municipal securities and would have some effect on other capital markets. (I) These proposals include:

1. Repeal of the exemption for interest on state and local obligations from Federal income tax.
2. Treating tax exempt interest as a tax preference item subject to the minimum tax, either at the present 10 percent rate or at an increased rate.
3. The option to issue taxable state and local obligations.
4. A combination of the taxable option and the minimum tax on tax-exempt interest.

While the effect of proposals such as these would vary considerably, all but one would have strong adverse effects on the market for State and local obligations. Outright repeal (Proposal 1) would have the greatest impact, while the optional issuance of taxable municipal bonds (Proposal 3) would have the least effect. The impact of Proposals 2 and 4 would depend on the percentage of minimum tax on tax-exempt income, the extent of exclusions from the minimum tax, and the classes of investors to which the tax would apply.

REPEAL OF THE EXEMPTION FROM FEDERAL INCOME TAX

The American Bankers Association is strongly opposed to the outright repeal of tax-exemption. Aside from the possible constitutional question that might be raised, outright repeal would undoubtedly increase the cost of financing state and local debt by more than one-third. This is demonstrated by the data on Table 1 (attached), which shows that the 1965–75 average ratio of municipal issue yields to comparable corporate yields is about 71 percent. If the interest on municipal bonds becomes federally taxable, yields on municipals would be equal to corporate bond yields. Thus, an increase of about 40 percent would be required for municipal long-term yields to rise to the level of corporate rates. Eventually, yields on municipal issues would be slightly less than on corporates

because municipals would probably continue to be exempt from state and local taxation in the state of issuance.

Moreover, municipal obligations maturing in 10 years or less represent a large, although not a major, part of the total amount issued. The ratios of yields on these shorter municipal issues to corporate yields is substantially lower than the ratios shown on Table 1. Therefore, the cost to state and local borrowers of eliminating tax-exemption would be relatively more in the short- and intermediate-term issues than is indicated by the ratios for long-term issues.

In addition, if tax-exemption is eliminated, the volume of municipal issues, nearly $31 billion in 1975 (see Table 3), would almost certainly increase interest rates on all taxable issues. The total volume of taxable issues of the Federal government, Federal Agencies and non-financial corporations amounted to about $130 billion in 1975. The $31 billion in municipal obligations issued in 1975 would have increased that total by nearly 25 percent.

More importantly, total elimination of tax exemption for municipal bonds would require the development of a completely new market for the entire volume of municipal issuances. Present holders of municipal bonds would turn to other investment outlets. As indicated on Table 4, banks are already reducing their acquisition of municipals. In fact, bank holdings of municipal bonds as a percentage of total assets, which had reached a peak of nearly 13 percent in 1971, are now down to about 10½ percent which is roughly the level of 10 years ago. Other corporate investors, mainly non-life insurance companies, would also stop buying municipal bonds.

Large individual investors are also likely to lose interest in municipals. They would probably turn to other tax havens or higher yielding investments, or to equities. Thus, new classes of investors, i.e., pension funds, charitable and other tax-exempt organizations, lightly-taxed life insurance companies, smaller individual investors, etc., would be the most likely prospective investors in the new taxable issues. At the outset, these investors would require higher yields to be attracted away from their existing investment patterns.

APPLICATION OF THE MINIMUM TAX

The banking industry also strongly opposes treating tax-exempt interest as a tax preference item subject to the minimum tax. The imposition of such a tax—at a rate of 10 to 15 percent, or at any higher level—would have a very large impact on the market for municipal bonds.

A similar proposal was made in 1969 by Chairman Mills of the House Ways & Means Committee. The impact of the 1969 proposals is reflected in Table 2 which shows monthly yields on long-term municipal and corporate bonds between December 1968 and July 1970. It should be noted that ratios of municipal to corporate yields increased abruptly during the mid-months of 1969, reaching a high of 84 percent by yearend, about 14 percentage points from the 70 percent ratio at the end of 1968 (see the right hand section of Table 2). Moreover, this was not a period of great stress for municipalities, as is the case today.

Also noteworthy is the fact that 1969 was a year of extreme monetary tightness during which all market yields soared to peaks unprecedented at the time.

The fact that *long-term* municipal yields grew rapidly in relation to corporate rates should not be strongly attributable to bank withdrawal from the municipal market during 1969, since most bank holdings of municipals are in the maturity area of less than ten years. This is indicated in Table 5 which shows that nearly three-quarters of all bank-held municipal bonds are in maturities under ten years. Even the largest banks hold about two-thirds of the municipal bonds in the maturity area of less than ten years.

The impact of a minimum tax on the municipal bond market will depend on the extent of the tax and on the classes of investors to which it is applied. If applied only to individuals, the effect will, of course, be mitigated by the fact that individuals (households) as shown in Table 6 currently hold only $72 billion or 32 percent of the total $224 billion of municipal bonds outstanding.

Most of the $72 billion is held by large individual investors and in long-term issues. A minimum tax on tax-exempt interest could drive these investors out of the market, or to the extent that they continued to buy tax-exempt issues, they would want to be compensated for a substantial part of the minimum tax by increased yields. Thus, long-term municipal yields might rise by perhaps 50 basis points (hundredths of one percentage point).

However, if corporations, including banks, are also subject to the minimum tax, the effect would be much more drastic. Short- and intermediate-term municipal yields would tend to rise to compensate for most of the impact of the tax. Banks

hold over $102 billion of municipal bonds amounting to about 45 percent of municipal obligations outstanding. In addition, non-life insurance companies hold another $34 billion in municipals, generally scattered throughout the outstanding maturity spectrum. Together these two classes of investors own over 60 percent of all municipal bonds outstanding.

The tax on banks and non-life insurance companies might be quite large, depending on the percentage of tax and the amount of tax preference income excludable. In the case of banks, under present tax rules, more than 60 percent of the $4.5 billion in tax-exempt income in 1974 (see Table 5) would have been subject to the minimum tax. Under those circumstances, the present municipal bond market would be virtually extinguished. Banks would stop buying municipals and yields would rise almost as much as if tax-exemption were eliminated altogether.

THE TAXABLE MUNICIPAL OPTION

The American Bankers Association is not opposed to the concept of optional taxable municipal bonds. We approve the purposes of this proposal, despite misgivings as to its possible effects. We believe, however, that adoption of the taxable municipal bond concept will unquestionably have a significant impact on the present market for state and local obligations.

Proponents of the proposal believe that, with an appropriate subsidy percentage, the market for municipal bonds would be substantially expanded. As indicated in the discussion on the outright repeal of tax-exemption, taxable municipal issues *may* prove attractive to most tax-exempt investors, and to lightly taxed life insurance companies, as well as to mutual funds, foundations, trust accounts and, in some degree, to lower income individuals.

Equally important, the mere issuance of taxable municipal bonds would not interfere with free market forces. Experienced intermediaries now in the market would underwrite and distribute taxable municipal bonds as is the case with tax-exempt bonds.

However, a new market for taxable municipal obligations with issues attractive to the new investor groups, would have to be developed. Since taxable municipal bonds would be new and untried market instruments, new investors would have to be attracted by high investment yields.

At this time of recovery from the severest recession since World War II and in the light of current financing problems confronting state and local governments, we would question whether the passage of legislation which might have a disruptive effect on our capital markets is appropriate now.

Many potential problems would be faced. For example, the percentage of subsidy would require extremely careful determination. Too large a percentage would shift all municipals into the taxable option where they would compete with other taxable issues producing an upward impact on taxable bond rates. Too small a percentage would be ignored by most municipal borrowers.

We make the following recommendations on the taxable option: (1) the subsidy should not be considered a partial guarantee; (2) the Treasury should not be permitted to pick and choose among prospective state and local issuers; (3) the subsidy should be subject only to legislative and not to administrative change; (4) self-dealing, such as with a state or local government pension fund, should not be permitted; and (5) only a market test of the required rate of interest should be permitted.

Finally, there is great concern by some that the option to issue taxable municipals might open the door to the complete elimination of tax-exemption. We would urge the Congress to reaffirm the fact that repeal of tax-exemption is not intended.

COMBINATION OF THE OPTIONAL TAXABLE MUNICIPAL AND THE MINIMUM TAX

We strongly oppose a combination of the optional taxable municipal bond and the minimum tax. As indicated in the discussion of Proposal 2 above, a minimum tax of any significant percentage and with a relatively small taxes paid exclusion provision, even if applied only to individuals, would have a sharp impact on intermediate and long-term municipal yields. A far greater impact would result if corporations were also made subject to the tax.

Under this combined approach, if the subsidy to state and local issuers for using the taxable option would be 30 percent of the interest cost, as recommended by the Treasury, virtually all municipal financing would be driven into the taxable option. The end result would be much the same as the repeal of tax-exemption.

CONCLUSION

Of the four proposals discussed, the option to issue taxable state and local obligations will have the least adverse effect on the market for state and local obligations, and the economy in general. Conversely, the repeal of the historic exemption from Federal income taxation for interest on state and local obligations would have the most drastic impact. Any application of the minimum tax would greatly impact the market in varying degrees, depending upon the rate of tax, the permissible exclusions, and the classes of investors to which the tax preference would apply.

In the final analysis, other than a taxable option, any change in the tax exemption accorded to state and local obligations would have a widespread effect on the municipal securities market and the ability of state and local governments to meet their financing needs. The American Bankers Association urges this Committee to give great weight to the very broad public questions and economic effects of any changes in this vital area.

TABLE 1.—YIELDS ON LONG-TERM STATE AND LOCAL ISSUES AND CORPORATE BONDS[1]

	Yield, percent per annum						State and local yields as percent of corresponding quality-rated corporate yields		
	State and local			Corporate					
	Total[2]	Aaa rated	Baa rated	Total[2]	Aaa rated	Baa rated	Total	Aaa rated	Baa rated
1965	3.34	3.16	3.57	4.64	4.49	4.87	72.0	70.4	73.3
1966	3.90	3.67	4.21	5.34	5.13	5.67	73.0	71.5	74.3
1967	3.99	3.74	4.30	5.82	5.51	6.23	68.6	67.9	69.0
1968	4.48	4.20	4.88	6.51	6.18	6.94	68.8	68.0	70.1
1969	5.73	5.45	6.07	7.36	7.03	7.81	77.9	77.5	77.7
1970	6.42	6.12	6.75	8.51	8.04	9.11	75.4	76.1	74.3
1971	5.62	5.22	5.89	7.94	7.39	8.56	70.8	70.6	68.8
1972	5.30	5.04	5.60	7.63	7.21	8.16	69.5	69.9	68.6
1973	5.22	4.99	5.49	7.80	7.44	8.24	66.9	67.1	66.6
1974	6.19	5.89	6.53	8.98	8.57	9.50	68.9	68.7	68.7
1975	7.05	6.42	7.62	9.46	8.83	10.39	74.5	72.7	73.3
1965-75 average							71.5	70.9	71.3
1976: May	6.85	5.88	7.75	9.06	8.58	9.76	75.6	68.5	79.4

[1] Maturity about 20 years, Moody's Investors Service Series.
[2] Average includes Aa- and A-rated bonds not shown separately.

TABLE 2.—YIELDS ON LONG-TERM STATE AND LOCAL ISSUES AND CORPORATE BONDS,[1] DECEMBER 1968 TO JULY 1970

	Yield, per cent per annum						State and local yields as percent of corresponding quality-rated corporate yields		
	State and local			Corporate					
	Total[2]	Aaa rated	Baa rated	Total[2]	Aaa rated	Baa rated	Total	Aaa rated	Baa rated
1968: December	4.76	4.50	5.18	6.80	6.45	7.23	70.0	69.8	71.6
1969:									
January	4.89	4.58	5.34	6.89	6.59	7.32	71.0	69.5	72.9
February	5.02	4.74	5.44	6.93	6.66	7.30	72.4	71.2	74.5
March	5.25	4.97	5.61	7.11	6.85	7.51	73.8	72.5	74.7
April	5.24	5.00	5.57	7.17	6.89	7.54	73.1	72.6	73.9
May	5.39	5.19	5.63	7.10	6.79	7.52	75.9	76.4	74.9
June	5.78	5.58	6.01	7.27	6.98	7.70	79.5	79.9	78.0
July	5.80	5.61	6.08	7.39	7.08	7.84	78.4	79.2	77.5
August	5.98	5.74	6.28	7.37	6.97	7.86	81.1	82.3	79.9
September	6.21	5.83	6.58	7.53	7.14	8.05	82.5	81.6	81.7
October	6.12	5.80	6.45	7.72	7.33	8.22	79.2	79.1	78.5
November	6.25	5.88	6.60	7.76	7.35	8.25	80.5	80.0	80.0
December	6.84	6.50	7.23	8.13	7.72	8.65	84.1	84.2	83.6
1970:									
January	6.74	6.38	7.13	8.32	7.91	8.86	81.0	80.7	80.5
February	6.47	6.19	6.80	8.28	7.93	8.78	78.1	78.1	77.4
March	6.08	5.81	6.40	8.18	7.84	8.63	74.3	74.1	74.2
April	6.50	6.24	6.87	8.20	7.83	8.70	79.3	79.7	79.0
May	7.00	6.70	7.33	8.46	8.11	8.98	82.7	82.6	81.6
June	7.12	6.81	7.41	8.77	8.48	9.25	81.2	80.3	80.1
July	6.68	6.40	7.02	8.85	8.44	9.40	75.5	75.8	74.7

[1] Maturity about 20 years, Moody's Investors Service Series.
[2] Average includes Aa- and A-rated bonds not shown separately.

TABLE 3.—GROSS NEW ISSUES OF STATE AND LOCAL AND CORPORATE BONDS

[In millions of dollars]

	State and local issues	Corporate bonds
1965	11,329	13,720
1966	11,405	15,561
1967	14,766	21,954
1968	16,596	17,383
1969	11,881	18,347
1970	18,164	29,026
1971	24,963	30,062
1972	23,653	26,132
1973	23,969	21,049
1974	24,315	32,066
1975	30,607	42,830

Source: Federal Reserve bulletins.

TABLE 4.—STATE AND LOCAL ISSUES HELD BY COMMERCIAL BANKS ANNUAL INCREASES AND PERCENTAGES OF TOTAL ASSETS

[Dollar amounts in billions]

December each year	State and local issues		Total assets	State and local issues as percent of assets
	Holdings	Annual increases [1]		
1965	$38.7		$378.9	10.2
1966	41.1	$2.4	406.5	10.1
1967	51.1	9.0	454.6	11.0
1968	58.7	8.6	504.6	11.6
1969	59.4	.6	535.7	11.1
1970	69.8	10.5	581.5	12.0
1971	87.6	12.8	646.3	12.8
1972	89.8	7.2	746.1	12.0
1973	95.5	5.7	842.9	11.3
1974	101.0	5.5	927.5	10.9
1975	102.3	1.4	983.5	10.4

[1] Increases may not be equal to the differences in holdings due to roundings.

Source: FDIC assets and liabilities statements.

TABLE 5.—COMMERCIAL BANK INTEREST ON STATE AND LOCAL OBLIGATIONS AND INVESTMENT PORTFOLIO BY MATURITY

[In millions of dollars]

	Total	Deposit size classes							
		Under 5	5 to 10	10 to 25	25 to 50	50 to 100	100 to 500	500 to 1,000	1,000 and over
INCOME									
1974	4,452	25	127	515	517	496	914	454	1,404
PORTFOLIO HOLDINGS BY TERM TO MATURITY									
June 1975:									
Under 1 year	20,012	207	440	2,352	1,916	2,020	4,565	2,184	6,328
1 to 5 years	26,174	229	1,024	3,863	3,718	3,299	5,723	2,569	5,749
5 to 10 years	27,237	234	1,079	4,172	3,991	3,434	5,751	2,712	5,864
Subtotal	73,423	670	2,543	10,387	9,625	8,753	16,039	7,465	17,941
Over 10 years	26,890	133	592	2,525	2,777	2,601	5,142	3,341	9,779
Total	100,313	803	3,135	12,911	12,403	11,353	21,181	10,806	27,721
Percent—10 years or less	73.2	83.4	18.1	80.5	77.6	77.1	75.7	69.1	64.7

Source: FDIC.

Note: Detail may not add to totals due to rounding.

TABLE 6.—OWNERSHIP OF STATE AND LOCAL OBLIGATIONS

[In billions of dollars, December 31, each year]

	1973	1974	1975
Households	50.5	60.5	71.6
Corporation business	4.0	4.7	4.5
State and local, general fund	2.5	2.8	2.6
Commercial banking	95.7	101.2	102.5
Mutual savings banks	.9	.9	1.6
Life insurance companies	3.4	3.7	4.2
State and local government, retirement funds	1.4	.8	1.9
Other insurance companies	30.4	32.2	34.3
Brokers and dealers	1.1	.7	.6
Total	190.0	207.4	223.8

Source: Federal Reserve; Flow of Funds data.

STATEMENT OF CHARLES F. HAYWOOD ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

I am Charles F. Haywood, Professor of Economics, University of Kentucky, Lexington, Kentucky and Consultant to the American Bankers Association. I appreciate the opportunity to testify on behalf of the American Bankers Association on the subject of proposals to withhold Federal income tax at source on interest and dividend payments to U.S. citizens.

The American Bankers Association is in complete accord with the objectives of the Congress and the Treasury Department to require the reporting of all taxable dividends and interest and the payment of Federal income taxes thereon.

The banks of this country do not condone the failure by any individual or business to report all taxable income and to pay the taxes that are due thereon, whether such failure was intentional or was brought about through inadvertence, carelessness, or ignorance. The Government needs to collect every dollar owed to it and it is the responsibility of every citizen to report all taxable income.

As evidence of this position, the American Bankers Association in 1962 supported the enactment of legislation requiring the filing of information returns reporting the payment of interest and dividends to assist taxpayers in the preparation of their tax returns and to aid the Internal Revenue Service in its tax collection efforts. The 14,500 commercial banks in the U.S. annually file approximately 130 million 1099 and 1087 information returns with the IRS. While the costs of preparing and filing information returns varies from bank to bank, the overall costs for the industry are considerable. For example, it is estimated that *the annual cost of postage alone* exceeds $10 million for the commercial banking system.

Proposals to require withholding at source on interest and dividends have been considered and rejected by the Congress on at least two previous occasions. In 1962, the House passed H.R. 10650. Section 12 of this bill contained a relatively comprehensive interest and dividend withholding system. The Senate rejected this proposal, and in lieu thereof, Congress the same year enacted P.L. 91–173 which established the information return system.

In 1969, Senator Edward M. Kennedy introduced a lengthy amendment to H.R. 13270, the 1969 Tax Reform Act, which would have established a highly complex and costly system of withholding on interest and dividends paid to U.S. taxpayers. The Congress rejected this proposal.

The American Bankers Association, the other national organizations representing financial institutions, and a host of other organizations representing interest and dividend payors, have strongly opposed these withholding proposals essentially on public policy and economic grounds.

The opposition of the American Bankers Association to withholding on interest and dividends is based on four major points: (1) the need for withholding cannot be demonstrated; (2) withholding will be burdensome and inequitable for taxpayers; (3) withholding will require arbitrary and complex rules which will impose excessive costs on payers of interest and dividends, particularly on commercial banks, which are the Nation's principal financial intermediaries; and (4) withholding on interest paid by financial depositories will have an adverse impact on the economy.

THE LACK OF NEED FOR WITHHOLDING

Recent proposals for withholding-at-source have been based upon the apparently mistaken belief that there is excessive under-reporting of interest and dividends with a resulting significant under-payment of tax. There have been some recent unsubstantiated estimates that between $10 million to $12 billion a year in interest and dividends is not reported and that $2 billion a year in tax revenue is lost because of this unreported income (see Washington Post article, April 11, 1976). These estimates of the potential revenue gain from withholding-at-source are not supported by recent data provided by the Internal Revenue Service.

Since 1962, the Internal Revenue Service has developed and is continually improving a highly effective method of obtaining full reporting. The information return reporting system enacted in 1962 was intended (1) to increase taxpayer confidence in the Service's ability to enforce the tax laws equitably, (2) to foster a high degree of voluntary compliance, and (3) to provide the basis for matching information returns against income tax returns to increase revenue collection. Commissioner Alexander stated that, according to IRS studies, voluntary compliance has improved markedly since the enactment of the information reporting system.

On April 12, 1976, before the Subcommittee on Commerce, Consumer and Monetary Affairs of the House Committee on Government Operations IRS Commissioner Donald C. Alexander testified that, based on estimates derived from the IRS Taxpayer Compliance Measurement Program for 1973, interest and dividends detected through the IRS audit process were correctly reported in 96.5 percent in the case of taxable dividends, and 97.7 percent in the case of interest. However, even as late as 1974 there was matching of only 40 percent of all 435 million information documents filed in that year including wage statements on Form W-2 and information returns on interest and dividend payments.

Commissioner Alexander testified that at an additional cost of $140 million, a program for matching all documents could be implemented. Full matching would result in a gross tax benefit of $600 million. The net revenue gain, after refunds for taxpayers who have overpaid their taxes, would be in the range of $260 million.

Therefore, within the framework of existing 1099 and 1087 information reporting systems, the Internal Revenue Service has at hand the means to assure full reporting of all interest and dividends, and to collect under-reported or unpaid taxes at relatively minimal additional costs. Obviously, this is a much preferable solution to this problem—rather than instituting a costly and inequitable withholding system.

WITHHOLDING IS BURDENSOME AND INEQUITABLE TO TAXPAYERS

It is assumed that any withholding system would provide for exemption for certain classes of lower-income individuals. For example, the Kennedy proposal in 1969 provided for execution of exemption certificates by individuals under the age of 18 and individuals who "reasonably believe" that they would not be liable for the payment of any tax. Thus, lower-income taxpayers such as retired persons and widows would be required to execute exemption certificates annually to obtain relief from withholding.

It must also be assumed that any withholding system would provide for a flat rate of withholding, e.g., 20 percent under the Kennedy proposal. A flat withholding rate of 20 percent or some similar figure would result in *over-withholding* for many small taxpayers and *under-withholding* for taxpayers in higher brackets. Many non-exempt small taxpayers would be required to file quarterly claims for refund or wait until the end of the taxable year to recover the tax over-withheld on their interest or dividend payments. During such period, these taxpayers would lose the use of the money that was withheld-at-source.

It is probable that many taxpayers will make errors on their returns and fail to claim the full credit for the tax withheld. Similarly, where the amount withheld is small, a taxpayer who is not otherwise required to file a tax return (e.g., students, part-time workers or persons living on social security and pensions) many never claim a refund.

Complex exemption, refund and credit provisions which would be necessary to effectuate a system of withholding-at-source are contrary to the national goal of tax simplification.

Invariably, banks and other depositories will incur certain operating costs related to withholding that will be passed on directly to bank customers in the

form of specific charges for such services such as handling matured U.S. Government obligations or trust department fees.

WITHHOLDING WILL IMPOSE EXCESSIVE COST BURDENS ON BANKS AND OTHER PAYORS OF INTEREST AND DIVIDENDS

Unlike wage withholding, which applies evenly to all employers, the burden of withholding on dividends and interest will be concentrated on financial institutions, particularly commercial banks. This is because of the wide range of depository, fiduciary, and financial agency services which commercial banks offer to their customers.

According to the most recently available data, there were over 131 million time and savings accounts in commercial banks, 68 million accounts in savings and loan associations, 32 million accounts in credit unions, and 9 million accounts in mutual savings banks. Thus, there are approximately 240 million deposit accounts in financial institutions which may be subject to withholding. This figure exceeds by 75 million the number of wage and salary withholding returns that are currently filed with the Internal Revenue Service.

It is also significant to note that a large percentage of bank savings and time accounts are quite small in amount. Based upon data compiled by the Federal Reserve, over 43 percent of bank savings accounts, that is approximately 20 percent of all bank interest paying accounts, are less than $100. Therefore, in the case of millions of depositors, the amounts subject to withholding will be in pennies.

It should be recognized that the withholding requirement would be *in addition to*, and not instead of, the already substantial burden of filing 1099 and 1087 information returns. Under current law, information reports are not required for interest or dividend payments under $10 but withholding may be required as to such payments. For withholding purposes, current methods of recordkeeping and data processing would have to be changed in order to be able to report to bank customers gross interest paid, tax withheld-at-source and the net amount credited to their account. Extensive and costly customer information programs would be necessary to familiarize depositors with the new withholding procedures.

In the interest of maintaining their customer relationships, banks and other financial institutions would have to be able to provide similar information on a quarterly basis which would enable qualified customers to file for refunds or claim credits. Another example of the burden that would be imposed on financial institutions involves a customer who closes an account. While the customer waits at the window, the teller would not only have to post any interest earned to the date of withdrawal, but compute and deduct the necessary withholding on such interest.

Withholding on deposit accounts in only one of the numerous ways in which withholding-at-source would affect commercial banks. Banks would be required to withhold on dividends paid to their stockholders as well as interest paid on their capital notes and debentures. Banks will also be affected with respect to (1) dividends on the stock and interest on the obligations of other corporations for which they act as paying agents, (2) interest on Government and corporate bonds which are presented to them for collection, (3) redemption of United States savings bonds, and (4) the receipt and distribution of income to trust beneficiaries for whom they act in a fiduciary or custodial capacity.

Thus, banks would become the major tax collector for the Treasury under any system imposing a withholding tax on dividends or interest-at-source.

A system of withholding-at-source by necessity will require an elaborate system of exemptions. The heavy burden upon banks and other financial institutions to secure, renew, and maintain properly executed exemption certificates would be equally as burdensome as withholding.

The withholding amendment by Senator Kennedy in 1969 ran over six-pages in the Congressional Record, and, in addition, would have required extensive rulings and regulations. I would just like to note a number of the specific technical problems that would have to be resolved by similar legislation or the regulations issued thereunder.

1. In the case of negotiable certificates of deposit, it would be necessary to provide guidelines for treatment of obligations sold between interest payment dates.

2. In the case of certificates of deposit or other interest paying obligations that are issued with original issue discount, provision would have to made for relief from withholding for tax which is paid under Section 1232.

3. A similar problem could arise in the case of non-interest bearing U.S. Government obligations issued at a discount where the taxpayer elected under Section 454(a) to treat the increase in the annual redemption price of such obligation as income received in that year.

4. Specific rulings and regulations would be necessary to deal with joint accounts, nominees, and custodial arrangements.

5. Under regulations of the Federal Reserve Board, substantial interest forfeiture penalties are imposed if a long-term certificate of deposit is prematurely redeemed. A substantial amount of tax may have been withheld on the interest credited to the depositor, which was subsequently forfeited due to the early redemption. Provision would have to be made to refund the tax over-withheld in these situations.

TRUST OPERATIONS

Some 4,000 banks in the country have trust powers and administer more than 1.3 million fiduciary accounts, providing services for many millions of individual beneficiaries. Many trust departments have common trust funds, and provide services for corporate pension, profit-sharing, and welfare trusts and for charitable foundations and other tax-exempt entities.

Many beneficiaries of common trust funds and individual trusts are low-income or non-taxable individuals, such as retirees, widows, and children. If the 20 percent withholding rate were applied to the earnings of billions of dollars of trust assets held in the form of stock and corporate and governmental obligations, millions of dollars of *refundable* taxes withheld on interest and dividends will be unavailable for reinvestment between the time of withholding and the dates of refund. A similar loss of income would arise if pension, profit-sharing, and charitable trusts were not exempt from withholding.

Proposals for quarterly refunds to non-taxable individuals, beneficiaries, and tax-exempt organizations would clearly complicate trust operations. If a trust beneficiary is not subject to tax, he will need information on the amount of dividends and interest paid to the trust subject to withholding and the proportionate share of the tax withheld as to amounts distributed or payable to him on a quarterly basis. In order to provide this information, bank trust departments may find it necessary to convert their reporting to a quarterly basis and to allocate fees and other charges quarterly, quadrupling much of their paper work. Trustees would have the additional responsibilities of allocating the tax withheld to each beneficiary and to the trust itself in accordance with the terms of the trust instrument, which alone will be a tremendous burden at tax payment time.

INTEREST AND DIVIDEND PAYING AGENTS

The work of banks acting as dividend paying agents will be complicated in several ways. Extensive computer programming will be required to inform stockholders of the gross dividend, the amount of tax withheld, and the net dividend paid. There would be additional problems where a dividend is paid partly from income and partly from capital or where a corporation makes a dividend distribution in kind.

Interest coupons are clipped by the owners and cashed or deposited at a bank. The bank is responsible for verifying and totaling the coupons and then must obtain reimbursement through banking channels (either from a correspondent bank or a Federal Reserve bank). In many cases, these coupons may pass through several intermediary banks before they are forwarded to the bank which is responsible for the payment of the coupons and final accounting to the issuing corporation. If the amount of tax is deducted from the face value of the coupon, proof of withholding must be provided if the taxpayer is to be protected. This will complicate recordkeeping at the many stages of handling the coupon. In addition, exemption certificates would have to be provided before full payment could be made to non-taxable individuals. Coupons from exempt individuals would have to be separately aggregated and transmitted. Similar proof and recordkeeping would be required for the redemption of U.S. savings bonds and other government obligations.

COSTS OF WITHHOLDING

It is impossible to estimate the total cost burden on commercial banks for withholding on the full range of bank activities that would be affected by this requirement. A conservative range of estimates for the continuing annual cost of

withholding *on savings and time deposits alone* is in the $25–$35 million range. Start-up costs would almost certainly double these amounts for the first year in which withholding is imposed. The estimates of continuing annual costs for withholding on time and savings deposits is based on data derived from the 1974 "Functional Cost Analysis" publicized by the Federal Reserve Board.

As indicated above, the $25–$35 million figure does not include the very large costs that banks would incur—and for which banks would probably not be fully reimbursed—in their capacity as fiduciaries and paying agents for virtually all publicly held corporations for dividend and interest payments.

A withholding system will impose substantial costs upon the Internal Revenue Service. An effective audit program would require verification of the accuracy of all exemption certificates. The elaborate refund and credit procedures that would be necessary to alleviate over-payment would be extremely costly. It is likely that a substantial number of erroneous or incorrect reports would be filed for several years until taxpayers are able to familiarize themselves with the new withholding system. Finally, a comprehensive 1099 information return matching program will continue to be necessary to ensure full compliance by taxpayers at higher brackets than the withholding rate.

ECONOMIC IMPACT

To force compliance on the relatively small percentage of taxpayers who fail to report or under-report interest income, withholding would require periodic deductions from *all* interest earnings. In 1975, the amount of interest earned and credited represented a large share—as much as 55 percent—of the approximately $90 billion increase in savings and time accounts of all depository institutions.

Many individual taxpayers pay taxes due on interest income out of current earnings or income rather than through withdrawals from savings and time accounts. Thus, depository institutions are *now* permitted to retain these funds for investment purposes that would be withdrawn through withholding on interest. Accordingly, unless replaced by account holders, which is initially most unlikely, tax withholding would almost certainly represent a drain out of depository institutions and into the Treasury.

At a withholding rate of 20 percent, some $10 billion would have been remitted to the Treasury by depository institutions in 1975 if a withholding system had been in force. Thus, up to $10 billion of funds would not have been available for home mortgages, for consumer loans of all kinds, or for business and other loans.

At the very least, there would be a large "one-time" net drain from institutions. Such a drain would be akin to the "one-time" increase in taxes paid by corporations when corporate tax payments were successively speeded up. To the extent the net drain on institutions is not replaced by depositors, the "one-time" loss will be permanent.

A corollary "one-time" effect would be the transfer of assets or wealth from individuals to the Federal government. Depending on the timing of the withholding payments, there would also be a loss of interest on the amounts given up and an interest gain to the Treasury. When this is realized, depositors may seek to be compensated for the loss of assets and the interest on those assets by demanding higher rates of return on their remaining funds. To the extent that their demands for higher savings rates are met; depository institutions would find it necessary to charge rates of interest for mortgages, other consumer loans, as well as for loans to businesses.

Another possible effect could result from the fact that tax refunds would substantially increase. This would occur because taxes on interest withheld at source may exceed tax liabilities in respect to such payment. If the resulting increases in refunds are spent rather than saved, the initial impact of the withholding program could add to inflationary forces already strong, as economic recovery turns into economic expansion.

CONCLUSION

Withholding-at-source on dividends and interest is far more complex and burdensome than perceived at first glance. It is extremely questionable whether withholding-at-source will provide substantially more revenue than effective utilization of current information reports, but it is certain that it will impose heavy additional costs upon banks and other financial institutions and other

payors of interest and dividends. Such a system would be very complex and would be inequitable and impose burdens upon taxpayers.

There is already an existing mechanism which will enable the IRS to obtain full reporting of dividends and interest. Information reporting should be fully and efficiently utilized rather than imposing a basically unworkable system of withholding on the Nation's economy.

Senator BYRD. The next witness is Mr. Edwin S. Cohen, accompanied by Mr. Robert L. Auglick, president of the Investment Company Institute.

Glad to see you again, Mr. Cohen. You are always welcome before this committee.

STATEMENT OF EDWIN S. COHEN, ACCOMPANIED BY ROBERT L. AUGENBLICK, PRESIDENT OF THE INVESTMENT COMPANY INSTITUTE

Mr. COHEN. Thank you, sir. I am accompanied today by Mr. Robert L. Augenblick, who is the president of the Investment Company Institute, which is the national association of the mutual fund industry. We appear before you today to discuss two different matters on the agenda. If I may, I will speak first with respect to withholding of tax on dividends and interest, and Mr. Augenblick will speak with respect to a proposal that is pending in the Congress to broaden the market for tax-exempt State and local obligations through permitting the organization of mutual funds that would invest in these obligations and be able to pass through to their shareholders currently the interest in the form of tax-exempt bond interest. Mr. Augenblick will speak with respect to that proposal.

Senator Byrd, I think it was a little over 14 years ago when I had the honor and opportunity of appearing before your father, when he was chairman of this committee, on this very subject of withholding tax on dividends and interest on behalf of the Investment Company Institute. We had been asked by the chairman in 1960 to meet with Mr. Colin Stam, who was then chief of staff, and to present our views on how withholding on interest and dividends might properly be accomplished. We presented detailed studies which appear in the record of the Ways and Committee in its 1961 hearings and further studies that we submitted in the record of the Senate Finance Committee in its 1962 hearings. After that, I propared a paper which turned out to be purely of historical interest at that time, because the Finance Committee rejected withholding on dividends and interest, and I attach that paper as an appendix to our statement here today.

I started out in 1960 with the assumption that since we had for years been withholding Federal income tax on salaries and wages, that it should be readily possible to have similar withholding with respect to dividends and interest. I found after a long period of thinking about it, that there are a number of significant differences that make the problems with respect to dividends and interest quite a deal more difficult. I will mention three of them, if I may.

The first and most important of these differences is that an individual generally has only one employer and it is possible then to tailor the witholding by his employer on his salary and wages to the individual's own number of personal exemptions, the size of his family, and whether he is married or single. In contrast, many individuals have more than one source of investment income—a saving bank

account, a U.S. savings bond, a share of stock in a mutual fund, and so on, so the problem becomes more complicated when you have different sources of payments going to the individual.

Second, salaries and wages are earned only by individuals, whereas dividends and interest go to corporations, charities, universities, estates, trusts, and a number of other entities, and you do not want to withhold from most of those, so you have some types of recipients on which you want to withhold others on which you do not. You do not have that problem with salaries and wages.

Finally, with respect to investment income, you find that shares of stock and other bonds are often registered in the names of persons other than the beneficial owner—for example, in what is called a street name, or in the name of custodians or fiduciaries, and this tends to complicate the matter. Moreover communication is generally by mail and not by direct contact between the individual and the payor of the income, and that factor produces a number of errors that are more difficult to correct because intermediaries, brokers, and bankers come between the payor and the taxpayer and most of the contact is by mail.

You can institute withholding on dividends and interest readily if you adopt a blunderbuss method of taking, say, 16⅔ or 20 percent or all of the dividends and interest paid. If you did that, say, at 20 percent, then for every 80 cents of dividend income one received, in cash, one would know it represented a dollar of income. One would gross it up to a dollar and take credit for 20 cents paid in tax. But the difficulty is that if you do that by that blunderbuss method you will be taking 20 percent of the income from retired people, for example, who do not have enough income to require them to pay tax and who live off of retirement funds, savings, and dividend income and they will object. The charities will object, the universities will object, because 20 percent of their income will be lost to them in the first year. They will not get it back until after the close of the year. There is no point in my withholding on interest I pay to a bank, because it will be an unnecessary complication if I withhold tax from the bank and have to turn the tax over to the Government. When you put in exceptions to withholding you then are involved in a much more complicated system. As these gentlemen representing the Treasury Department and the Internal Revenue Service were talking earlier today, you have to decide what exemptions from withholding you are going to have and how you balance the convenience of the taxpayers, the payors, and IRS with your desire to provide equity for the retired, for the children, for charities, and others. That is where the problem comes.

Senator BYRD. Would that not greatly increase not only the administrative difficulties but administrative costs to the Treasury?

Mr. COHEN. It will, Senator, it will increase that cost. I am not saying not to do it, because I think that is the humane approach to the problem, to allow exemption certificates to be filed and I think payors are willing to a reasonable extent to try to administer it, but you complicate the system tremendously when you do that.

Senator BYRD. I meant the whole question of the withholding from dividends, would that tend to increase the cost to the Treasury and increase the number of personnel that would be needed and all that?

Mr. COHEN. I think it would. As the Commissioner asked this morning, I think there is a need for additional personnel under whatever system that you have. He made a strong plea for that today. I disagree with him only in that I think that an increase in personnel for the purpose of keeping track of the certificates that would be filed is essential whether you put in withholding or you do not put in withholding. I do not think withholding is a substitute for that.

Senator BYRD. I regret that we will need to recess just temporarily. There is a tie vote and I do not want to take a chance of not being over there for that vote. So we will recess temporarily.

Senator Long will be back in a moment and I will come back as soon as I vote.

[A recess was taken.]

The CHAIRMAN. Have you completed your statement yet?

Mr. COHEN. I was about half-way through, Mr. Chairman. I could summarize my summary.

The CHAIRMAN. Summarize what you said for my benefit and proceed from there.

Mr. COHEN. On my right is Robert L. Augenblick, president of the Investment Company Institute. We are testifying with respect to both of the matters on the agenda this afternoon, and I would speak first with respect to withholding of tax on dividends and interest and Mr. Augenblick would speak with respect to a proposal for mutual funds that would be organized to invest in State and local bonds.

I was saying when Senator Byrd was in the Chair that I testified before this committee 14 years ago on this subject and had at that time presented a number of studies on withholding which I had made on behalf of the mutual funds. I had started out with the assumption that withholding on dividends and interest ought to be possible as long as we had successfully managed to have withholding of tax on wages and salaries and I was surpprised to find that there are many differences that exist between the two types of withholding. I was saying that three of the important differences are, first, that the average employee receives salaries and wages only from one employer, whereas those with investment income frequently receive that income from a number of different payors. That tends to complicate the matter.

Second, wages and salaries are received only by individuals and we are concerned here with withholding on individuals. But dividends and interest are received by corporations, by charities, by universities, and colleges, and various tax-exempt organizations and by persons who are not subject to tax because they have income below the level of taxation.

Third, in the case of an employee, there is a direct contact between the employee and the employer. If something is wrong with the withholding, it is adjusted by talking to his employer. In the case of investment income the matter is usually handled by mail and frequently there is an intermediary—a broker, a custodian, a fiduciary—and stocks are often held in a nominee's name or street names and investment interest stocks and bonds are sold from one person to another. You get a set of complications that you do not have with salaries and wages.

These special problems might be solved if you have a flat withholding, say, of 20 percent on all dividends and interest. That is a simple system. You just take 20 cents out of every dollar of dividends and interest and the payor pays the 20 cents over to the Government. The payee gets 80 cents and he knows he has a dollar of income for every 80 cents he received in cash, and he gets an offsetting tax credit of 20 cents. The trouble with that is that it is a rough, tough inhumane system for people, for recipients, who are not subject to income tax. And so we have to have exemption certificates introduced.

Once you have exemption certificates you have a great many complications in trying to keep track of them, deciding who is exempt, who is not exempt from withholding, and what the payor should do with the exemption certificates. You can have many choices of how to provide withholding exemptions and you have to go back over each of the choices carefully. I have presented, as an appendix to my statement, a paper that I wrote back in 1962, after this was over, that reviewed many of the problems; you have to go through those problems and you find you have a choice at every turn between on the one hand, a simple system which is tough and, on the other hand, one which is more complicated and which has to be kept track of at every turn, but which is more humane and takes into account the special situation of each recipient. If you do not do the latter, you are going to hear from the retired people and the tax-exempt persons who will have the money withheld from them unnecessarily.

Mr. Alexander, the Commissioner, this morning said that he did not have the funds with which to match the forms 1099 and the tax returns. Now, I would like to urge on the committee the fact, as I have seen it, that it will still be necessary to match the form 1099, even with the withholding system, against the tax returns, because the taxpayer recipient is seldom going to owe 16⅔ percent or 20 percent of the dividend and interest income. Seldom is that going to happen. He is either going to owe less or more. If he owes less, he is going to claim a refund, and you are going to have to match his return against the form 1099 to see whether he is entitled to his refund. If he owes more, and that is where the evasion of tax on interest and dividends must come, if it is significant in amount, you have still got to keep track of the form 1099 because 16⅔ percent or 20 percent is not enough tax from a person who ought to be paying 50 or 60 or 70 percent.

So I think you will still have to have the money and the personnel for the matching.

I have said to the Commissioner and to the Treasury that the mutual fund and other organizations, I am sure, would be happy to cooperate with him in trying to design such a system. I think much could be done to improve the existing matching system and we would be glad to cooperate.

Mr. Augenblick will speak with respect to the other proposal.

Mr. AUGENBLICK. Mr. Chairman, I turn to the other item on the agenda for this hearing, namely, the taxation of interest on debt obligations issued by State and local governments. The Investment Company Institute urges the adoption of a proposal which is before this committee and which merits serious consideration. This is a proposal to expand the market for municipal bonds by amending the Internal Revenue Code to permit regulated investment companies to be formed

to invest in tax-exempt municipal bonds on a basis which preserves the tax-exempt character of the interest on such bonds when distributed currently to the shareholders of a company. The largest segment of the regulated investment company industry is the group of companies known as mutual funds.

We have previously submitted to this committee a memorandum dated April 14, 1974, in favor of such passthrough treatment, as part of our statement on H.R. 10612, the Tax Reform Act of 1975. We certainly shall not burden this committee with a repetition of the reasons for our position, but for the sake of convenience, we attached to our present statement a copy of such memorandum as Appendix II.

Actually, a somewhat similar proposal was approved by this committee in 1958 in section 42 of the Technical Amendments Act of 1958 and passed the Senate, but was deleted in conference.

Now, since our April 14 submission, several developments have occurred. First, on April 21, 1976, a mutual fund organized in the form of a limited partnership for investment in municipal bonds was registered with the SEC and is offering its shares to the public. This limited partnership fund has received a ruling from the IRS that tax-exempt interest on municipal bonds owned by the fund will retain its tax-exempt status when distributed to the limited partners.

The use of mutual funds in limited partnership form is a more awkward and difficult means of achieving such passthrough treatment than would be the case with an incorporated mutual fund. If a limited partnership is appropriate to receive this treatment, there is every reason to permit this through the usual type of incorporated mutual fund.

Second, as Mr. Andre Blum of the Municipal Finance Officers Association testified this morning, the Municipal Finance Officers Association on May 5, 1976 adopted a resolution supporting amendments to the Internal Revenue Code as may be required to permit the passthrough of the municipal bond interest exemption to shareholders of regulated investment companies.

Third, Chairman Hills of the Securities and Exchange Commission has announced the support of the SEC for our proposal for such passthrough treatment of municipal bond interest.

In summary, such passthrough treatment would not only broaden the market for municipal bonds to the benefit of the issuing governments but would also benefit the investors of moderate means by making it feasible for him to invest in a diversified portfolio of municipal bonds under professional management. Moreover, this would be entirely consistent with the theory underlying taxation of regulated investment companies—that is, placing investment company shareholders essentially in the same position as if they owned directly the securities held by the fund.

Thank you.

The CHAIRMAN. Mr. Cohen, you are a law professor, as well as being a good lawyer and a scholar. Did you write this Law Review article that I see attached to the statement?

Mr. COHEN. Yes.

The CHAIRMAN. What does that Latin mean?

Mr. COHEN. Well, I apologize for submitting a statement with a title in Latin. The reason for it was——

The CHAIRMAN. You put footnote 1, non semper ea sunt quare videntur (see appendix 1 to statement). Then your footnote 1 says Phaedrus book IV. I thought you were going to say what that meant in English.

What does it mean?

Mr. COHEN. Well, it developed from the thought I had in the beginning that this ought to be simple but it turns out to be complicated. It means "Things are not always what they seem," and it came from a Phaedrus Fable in A.D. 8 via Gilbert and Sulivan, who wrote, "Things are seldom what they seem, skim milk masquerades as cream." And Henry Wadsworth Longfellow, who I quoted at the top, said:

> "Tell me not in mournful numbers,
> Life is but an empty dream!
> For the soul is dead that slumbers,
> And things are not what they seem."

The CHAIRMAN. Longfellow was about 2,000 years later with that quotation.

Mr. COHEN. Yes, he was.

The CHAIRMAN. He said it in English.

Mr. COHEN. I think Phaedrus probably got it from the Greeks.

The CHAIRMAN. Well, now, you have undoubtedly thought about this matter. How you researched the authorities enough to advise us what your opinion is on the constitutional question of the Federal Government's right to tax the interest on State and municipal debentures?

Mr. COHEN. Mr. Chairman, I have never made what I would consider to be a thorough and exhaustive study of the point. People differ in their views. I will note this from my recollection, that in the case of Pollack against the Farmers' Loan & Trust Co., decided in 1894, which held the income tax unconstitutional and necessitated the 16th amendment, is generally referred to as a 5-to-4 decision. But it was argued twice, and the first time with eight justices on the court, and they divided 4–4 on the issue of constitutionality of taxing dividends; but they voted in the first decision eight to nothing that a tax on State and local bond interest was unconstitutional. So they were not in doubt about that.

The scholarly debate is whether subsequent decisions indicate that the present court could not follow that decision but follow other lines of cases that have, for example, sustained a Federal income tax on the wages and salaries paid to employees of State and local governments. The answer is no one is going to know for certain until the Supreme Court has spoken again.

I think several witnesses this morning have said that undoubtedly there would be a challenge, and one can have a view one way or another but that view is not going to be very material until the court itself has spoken.

The CHAIRMAN. Well, so far as you know, the Congress has not been willing to give them a statute to let the court decide it, because Congress has not been willing to vote for something that would tax this interest.

Now, what is your view with regard to this problem I raised this morning where someone owes a lot of money, and even though it

would be on balance a wise thing to sell his State and municipal bonds in order to retire some of that indebtedness, it turns out to be a profitable proposition for him to keep with the bonds and the indebtedness. In view of the fact that Uncle Sam picks up the tab, a person can actually make money. If he is in the 70-percent bracket, and if he has $9,000 of interest expense, and if he has $6,000 of nontaxable transaction, in fact he makes about $3,300 if he is in the 70-percent bracket. Now, what would your reaction be and what advice would you give us on the proposition that rather than look to the intent of the taxpayer, we would simply say you have to reduce your interest deduction by the amount tax-exempt interest that you have.

Mr. COHEN. Mr. Chairman, the Commissioner said this morning, and I would agree with him, this is a very difficult provision to administer because the language of the statute limits or eliminates deductions for interest paid or incurred to purchase or carry tax-exempt bonds. What does it mean to purchase or carry?

Now, the Senate debated, I think in 1934 and back in the twenties—at one time I looked at those debates—debated a proposal such as you have suggested and they voted it down each time that it was raised, I think the last time was some 40 years ago. With such a flat rule you would run into cases that are somewhat difficult to handle.

Mr. Goldstein, Secretary Goldstein, this morning raised the question about the person who has a home mortgage. Would you say that a person with a $30,000 mortgage, say, who may be paying $2,400 interest at 8 percent on his mortgage, could not have tax-exempt interest income up to that amount? If he had a thousand dollars of tax-exempt interest income and a $2,400 mortgage interest deduction, should we, say, limit his home mortgage interest deduction to $1,400? Now, the IRS has a ruling out under present law that says no, we are not going to adjust that mortgage interest deduction. You also have to consider the case of a man in business. If he has a sole proprietorship and he has tax-exempt bonds, are you going to offset if he pays interest on a bank loan incurred to carry his inventory? Now, if he were incorporated, if he had a wholly owned corporation and that corporation borrowed the money, you would not offset.

These just illustrate some of the problems. When you have an absolute rigid rule requiring offset, you have some difficulties.

I would agree with you that it would be well to try to put some of these rules in the statute rather than have this thing continue on the basis of purpose and intent.

I might say one other thing. I think there was a misunderstanding between the Commissioner and you this morning as to his luck in the courts. He has been winning the cases and I think he said this morning that he had been prevailing in court. I think you understood him to say that he was not prevailing in court. I think he intended to say that he was prevailing in court but it was too difficult to catch up with all the tax returns in which the issue is involved.

The CHAIRMAN. Yes. Let's say a person is holding a tax-exempt bond which would draw a larger amount of interest if it were a taxable bond, he has an interest expense that exceeds that, so he is paying, let us say, at 9 percent and collecting at 6 percent. If you leave out the taxes, it would be a wise business decision for him simply to sell the tax-exempt and reduce the amount that he owes, because he would be saving on interest. But if he is in a 70-percent tax bracket that would

not be a wise thing to do, because Uncle Sam loses enough money on the transaction to make him come out at a profit, even though it is a loss transaction.

It seems to me we might be well advised to stop this thing of people borrowing money and claiming interest expense in order to buy tax exempts. Section 265 is supposed to prevent that. It does not do it in many cases.

I know people who have done this. I have talked to lawyers who have advised their clients, and I have talked to clients of the lawyers who did it, and it seems to me that this is one area where it is clear the law does not smile on that at all but the law is not adequate to prevent it. I think perhaps we ought to tighten up on section 265, not do anything about the banks and savings and loan institutions, but modify the interest expense deduction of the people who are not going into it for the tax shelter advantage of that deduction of interest expense when they have this interest income.

Mr. COHEN. It is very difficult to tell on looking at tax returns whether people have interest deductions related to tax-exempt interest or not, because they are not required to report the tax-exempt interest on their tax return. Only when you go and audit their books do you know whether they have any or not. This is not a self-policing division. It is brought into play only when the taxpayer realizes the situation and enforces the rule against himself or when an Internal Revenue agent discovers it in auditing his books. You cannot tell from the tax return.

The CHAIRMAN. My guess is if we tighten up the law and then prosecute a few criminal cases on that matter, that would solve the problem in a hurry, because the difficulty in some of these areas, like withholding on interest and dividends, is that you have to prosecute so many people. If you tried to do it criminally, if you try to do uniform justice, you would have difficulty finding a jury where 12 jurors might not be involved in it themselves.

Thank you very much.

[The prepared statement of Mr. Cohen follows:]

STATEMENT ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE

My name is Edwin S. Cohen. I am of counsel to the law firm of Covington & Burling, Washington, D.C. With me is Robert L. Augenblick, President of the Investment Company Institute, 1775 K Street, N.W., Washington, D.C., on whose behalf we appear today.

The membership of the Institute consists of 383 regulated investment companies (known as "mutual fund"), their investment advisers and principal underwriters. Our mutual fund members have about 7.5 million shareholders and assets of approximately $46 billion, representing about 93% of the assets of all U.S. mutual funds. The average investment of each mutual fund shareholder is thus about $6,000.

SUMMARY

In summary, we appear (a) in opposition to withholding of federal income tax on interest and dividends, and (b) in support of a proposal to expand the market for municipal bonds by amending the Internal Revenue Code so as to permit regulated investment companies to be formed to invest in those bonds and pass through to their shareholders the tax-exempt character of the interest.

WITHHOLDING TAX ON INTEREST AND DIVIDENDS

In early 1960 the Senate Finance Committee directed that a staff study be undertaken to determine the feasibility of enacting a system of withholding

federal income tax on interest and dividends. The Investment Company Institute, then known as the National Association of Investment Companies, along with other organizations, made a serious and lengthy study of the various possible methods of instituting such withholding, and also examined in depth other alternative means of improving the reporting of interest and dividends in the income tax returns of recipients.

Detailed reviews of various alternatives were submitted on behalf of the Institute to the Congressional staffs in 1960 and 1961 and are set forth in full in the hearings of the Ways and Means Committee on the Revenue Bill of 1961, pp. 2404–2507. In addition, on behalf of the Institute, I testified on the subject before the Ways and Means Committee on May 31, 1961 (Hearings, p. 2395 et seq.), and before the Committee on Finance on April 18, 1962 (Hearings on the the Revenue Act of 1962, pp. 2050–2077).

In the Revenue Bill of 1962 the House included a proposed withholding system that covered 46 pages of text, but after detailed consideration this Committee struck out the House provision. The Committee's decision was sustained on the floor of the Senate by a vote of 66–20 and the House receded.

At first blush one is inclined to think that since tax withholding has operated successfully with respect to wages and salaries for more than thirty years, it should be readily possible to extend it to other types of income, particularly interest and dividends. But as one considers the matter further, it becomes readily apparent that there are major problems not encountered in wage and salary withholding. Among these differences are the following:

1. Employees generally have only one employer, and wage and salary withholding is tailored to his individual situation through his filing with his employer a Form W-4 setting forth his number of personal exemptions and his marital status. The withholding then takes into account his personal exemptions, his marital status, the standard deduction (and, if he requests, additional itemized deductions).

   However, individuals frequently have investment income from more than one source, such as one or more savings accounts, U.S. government savings bonds, mutual fund shares, stocks of other corporations, etc. Hence it is not possible to institute withholding on dividends and interest tailored to the tax situation of each investor, as is done in wage and salary withholding.

2. Wages and salaries are earned only by individuals. Dividends and interest are received not only by individuals but also by corporations, estates, trusts, tax-exempt organizations, tax-exempt pension and profit-sharing trusts, etc. Withholding that might be appropriate for individual investors may be quite inappropriate for these other investors.

3. Investments are often for reasons of convenience or necessity registered in the names of guardians, custodians, brokers, fiduciaries or their nominees, who in effect act as conduits for the beneficial owners, the taxpayers. Unlike the direct relationship between employer and employee, the payor of interest and dividends frequently does not have direct contact with the taxpayer but must communicate with him through these conduits and generally by mail. It is far more cumbersome to make adjustments than when employer and employee can talk directly.

Dividend and interest withholding could be readily accomplished by a blunderbuss method of having payors withhold in every case a fixed percentage, such as 20 percent, from all dividend and interest payments made to anyone. It could then be assumed that, for each 80 cents received in cash, there was derived one dollar of income, and the recipient could take credit for 20 cents tax withheld. Such a system, however, would lead to absurdities; for example, there is obviously no reason to require anyone to withhold tax on interest paid to a bank or other lending institution.

Moreover, under such a system there would arise an immediate problem of fairness with respect to investors who owe no tax—universities, charities and other non-taxable organizations, children, retired persons and others. They would have 20 percent of their income withhold and paid to the government and would have to await the receipt of a refund from the government. In addition, there would be many retired persons living off modest investment income who would owe some relatively small tax but far less than 20 percent of their income.

If some form of equitable relief is to be provided for these persons, a series of complex exceptions to withholding would be needed. These exceptions have always proved extremely difficult to design, and they necessarily produce administrative complexities for payors, the IRS and the taxpayer recipients. If one

simplifies the procedures for payors and for intermediaries, such as brokers and custodians, and for the IRS, then one must cut back on the equitable relief for taxpayer recipients. When withholding applies to some items and not to others, paperwork, correspondence and opportunities for mistakes proliferate, and the expense and personnel requirements for operating the system become formidable.

As one example, if an exemption is permitted for an individual who expects to owe no tax and his income increases to require a tax, he must notify all his payors and they must start withholding on his interest and dividends; if he returns to nontaxable status he must again notify them and they must cease withholding. As another example, because of administrative problems the 1962 proposal would have denied exemption certificates for dividends received by nontaxable organizations or individuals if the stock were held in the name of nominees, such as brokers, as is frequently the case, thus requiring the recipient to forgo either the convenience of a nominee or the exemption from withholding.

At every point there is involved an inherent difficulty in balancing the need for feasible administrative simplicity with reasonable equity for the many recipients who would suffer overwithholding.

An alternative or supplementary method of providing relief would be to permit taxpayer recipients to file with IRS quarterly refunds of tax overwithheld on interest and dividends. This would require three or four quarterly refund claims, and in many cases an annual return, by the recipient. It would increase paperwork and expense of the IRS and would be burdensome for the recipients, particularly the elderly. Moreover, the 1962 version of the quarterly refund procedure in many cases would have produced only partial refunds, with the balance being reserved for refund in the following year. Naturally, detailed rules would be needed to correlate interim refunds with final tax liability.

It is important to emphasize that a flat percentage withholding in the range of, say, 20 percent, should not replace the current procedures by which payors of interest and dividends report to IRS and the recipients the aggregate amounts paid during each calendar year. Many recipients will be in tax brackets above 20 percent and this information is needed in order to monitor reporting by those in higher brackets. The Investment Company Institute urged the adoption of that information reporting system in 1961 and 1962 and continues to support it. Its member mutual funds provide to each shareholder and to IRS annual information as to the aggregate dividend payments made during the year to the shareholder to enable him to prepare his return and enable IRS to check it. The Institute and its members will bend every effort to strengthen this reporting system and assist the Service in making the system operate efficiently.

In June, 1962 I prepared a paper on the subject of withholding of tax on dividends and interest, reviewing the history of withholding and many of the detailed problems presented by the 1962 proposal. A copy is attached as Appendix I.

PERMITTING CREATION OF INCORPORATED MUTUAL FUNDS FOR STATE AND LOCAL GOVERNMENT BONDS

Turning now to the other item on the agenda for this hearing, namely the taxation of interest on debt obligations issued by state and local governments, the Institute urges the adoption of a proposal which is before this Committee and which merits serious consideration. This is a proposal to expand the market for municipal bonds by amending the Internal Revenue Code to permit regulated investment companies to be formed to invest in tax-exempt municipal bonds on a basis which preserves the tax-exempt character of the interest on such bonds when distributed currently to the shareholders of the company. The largest segment of the regulated investment company industry is the group of companies known as "mutual funds."

We have previously submitted to this Committee a memorandum dated April 14, 1976, in favor of such passthrough treatment, as part of our statement on H.R. 10612, the Tax Reform Act of 1975. We shall not burden this Committee with a repetition of the reasons for our position, but, for sake of convenience, attach to our present statement a copy of such Memorandum as Appendix II.

A somewhat similar proposal was approved by this Committee in 1958 in Section 42 of the Technical Amendments Act of 1958 (H.R. 8381) and passed the Senate, but was deleted in conference.

Since our April 14 submission several developments have occurred.

First, on April 21, 1976, a mutual fund organized in the form of a limited partnership for investment in municipal bonds, was registered with the SEC and

is offering its shares to the public. This fund in limited partnership form has received a ruling from the Internal Revenue Service that tax-exempt interest on municipal bonds owned by the fund will retain its tax-exempt status when distributed to the limited partners.

The use of a mutual fund in limited partnership form is a more awkward and difficult means of achieving such pass-through treatment than would be the case with an incorporated mutual fund. If a limited partnership is appropriate to achieve this treatment, there is every reason to permit this through the usual type of incorporated mutual fund.

Second, at its annual meeting on May 5, 1976, the Municipal Finance Officers Association, an association of some 2,600 agencies and 5,200 individuals composed of the public accounting and finance officials of all types of governmental units, adopted a resolution (a copy of which is attached as Appendix III) supporting amendments to the Internal Revenue Code as may be required to permit the pass-through of the municipal bond interest exemption to shareholders of regulated investment companies.

Third, Chairman Hills of the Securities and Exchange Commission has announced the support of the SEC for our proposal for such pass-through treatment of municipal bond interest.

Such pass-through treatment would not only broaden the market for municipal bonds to the benefit of the issuing governments but would also benefit the investor of moderate means by making it feasible for him to invest in a diversified portfolio of municipal bonds under professional management. Moreover, this would be entirely consistent with the theory underlying taxation of regulated investment companies—i.e., to place investment company shareholders essentially in the same position as if they owned directly the securities held by the fund.

APPENDIX I

TAX FORUM NO. 230 (JUNE 4, 1962)

(EDWIN S. COHEN)

WITHHOLDING ON INTEREST AND DIVIDENDS: NON SEMPER EA SUNT QUAE VIDENTUR[1]

"Tell me not, in mournful numbers,
Life is but an empty dream!
For the soul is dead that slumbers,
And things are not what they seem."[2]

Seldom since the Boston Tea Party of 1773 has a proposed tax measure evoked the torrents of protest which have been produced by the Administration's plan to withhold tax on dividends and interest. The volume of mail from objecting citizens had led the President to charge that "a great number of people have been badly misinformed"[3] about the proposal; and it has led the Treasury Department to asert in a memorandum to Senators that the plan "has been grossly misrepresented and distorted," and that its opponents have fostered widespread misunderstanding of the plan and aroused baseless fears".[4]

To the contrary, the Treasury has said that "withholding will impose no hardship and little inconvenience on taxpayers;" that "the system will be simple and convenient for payors of interest and dividends";[5] that "the mechanics of withholding on dividends and interest will be simple";[6] that "dividend and inter-

[1] Phaedrus, Book IV, Fable 2, 5 (*circa* A.D. 8).

[2] Henry Wadsworth Longfellow, *A Psalm of Life*, Stanza 1 (1839). And see Gilbert & Sullivan, *H.M.S. Pinafore*, Act II:

"Things are seldom what they seem,
Skim milk masquerades as cream."

[3] Statement at the President's news conference of May 9, 1962.

[4] 108 Congressional Record 7930 (daily ed. May 16, 1962).

[5] *Ibid.*

[6] *Hearings on H.R. 10650 Before the Senate Committee on Finance*, 87th Cong., 2d Sess., Pt. 1, 91 (1962).

est withholding is equally simple for the recipient";[7] that his return "will carefully lead him through a simple gross-up procedure";[8] and that those "who may owe a little tax but less than the amount withheld can get quarterly refunds by filling out a simple refund slip".[9]

On the other hand, Senator Byrd, Chairman of the Senate Finance Committee, in announcing his opposition to the plan after the conclusion of the hearings, said that "its administration would be terribly complex, if not impracticable and unworkable", and further that the plan would be "certain to be accompanied by widespread confusion and considerable hardship."[10] And Senator Williams, the ranking Republican member of the Committee, in announcing his opposition, referred to the plan as "filled with complexities, difficulties, and hardships"[11]

The Treasury's appraisal of its plan and the criticisms of its opponents and the letter writing public seem so far apart that one is led almost to wonder whether they are discussing the same bill.

A mere reading of Section 19 of H.R. 10650, containing the withholding provisions, gives a clue as to the cause of this vast difference of opinion. Section 19, as it reads at present, is forty-six pages in length and contains a variety of exceptions and limitations difficult to appraise. It includes more than fifteen provisions, some of them of considerable practical importance, which specifically depend for their operation upon regulations to be promulgated by the Secretary of the Treasury. In its consideration of the bill for almost a year, the Ways and Means Committee of the House vacillated in its public press releases as to the withholding provisions, particularly as respects the filing of exemption certificates by recipients. Further significant changes were recommended by the Secretary in his final public appearance before the Senate Finance Committee on May 10, 1962, and it is understood that additional important changes are still under consideration.

It is probably true that most persons interested in a strong and effective revenue system will believe on first impression that since withholding on wages and salaries has operated successfully for some twenty years, it should be possible to deign a fair and workable system for other types of income, particularly interest and dividends. But it is probably also true that these persons will not proceed far with a serious study of the matter before realizing that the problems involved differ substantially from those faced in wage withholding. As each problem is solved, the solution seems to beget a host of further problems. A final workable solution seems elusive indeed. One comes to fear that the problem may be like that faced by every inquisitive student of geometry who, having learned to bisect an angle with a ruler and compass, wonders why he is unable to trisect the same angle.

I. HISTORICAL BACKGROUND OF WITHHOLDING

Few will recall that in the original Tariff Act of 1913, containing the first income tax law enacted after the adoption of the Sixteenth Amendment, withholding of normal tax was provided with respect to "interest, rent, salaries, wages, premiums, annuities", and certain other types of income to the extent the annual payments exceeded $3,000.[12] Dividends were not made subject to withholding because they were not subject to the normal tax, but only to surtax. In his annual report for the fiscal year 1915, the Secretary of the Treasury recommended abandonment of withholding, and this recommendation was accepted by Congress in the Revenue Act of 1917. A system of information reporting for payments in excess of the personal exemption was substituted in its stead.

Withholding was not used from World War I until World II, except with respect to certain payments to foreign persons.[12a] At that time, when rates were increased and exemptions were lowered, the Treasury proposed in 1941 withholding of tax on wages, salaries, interest and dividends at a 15% rate. No action was taken on the proposal. The recommendation was renewed in 1942, and as passed by the House of Representatives, the Revenue Bill provided for withholding on wages, dividends and bond interest. After much discussion, the Sen-

---

[7] *Id.* at 92.

[8] *Ibid.*

[9] 108 Congressional Record 7930 (daily ed. May 16, 1962).

[10] 108 Congressional Record 8109 (daily ed. May 21, 1962); Senate Finance Committee Hearings, Pt. 10, 4401.

[11] 108 Congressional Record 8531 (daily ed. May 24, 1962).

[12] Section II, E.

[12a] A withholdable excise tax on dividends existed for a brief period in 1933. It expired by its own terms with the repeal of prohibition.

ate Finance Committee omitted withholding on dividends and bond interest, but provided for withholding of the "victory tax" of 5% on wages and salaries effective at the beginning of 1943.

In 1943, in connection with the consideration of the Current Tax Payment Act of 1943 (involving the so-called *Ruml* Plan), the Treasury recommended withholding of income tax on wages, salaries and dividends but not on interest; both Houses of Congress applied withholding only to wages and salaries.

In the Revenue Act of 1950, the House approved withholding on dividends at the rate of 10%, with no exemptions, but this was eliminated by the Senate Finance Committee. In the Revenue Act of 1951, after much consideration the House adopted withholding with respect to both interest and dividends, but the Senate Finance Committee struck the provisions from the bill and the Senate sustained the Committee by a vote of 70 to 15.

Early in 1960 Senator Byrd, Chairman of the Senate Finance Committee, publicly requested the staff of the Joint Committee on Internal Revenue Taxation to consider and recommend the best system feasible for withholding on dividends. The staff gave the matter serious study and solicited comments from interested persons. In connection with the consideration of the Rate Extension Bill in June, 1960, the Finance Committee voted against a proposal for withholding on dividends, and also against a proposal for withholding on both dividends and interest; a motion to amend the bill on the floor of the Senate to provide for withholding on both interest and dividends was defeated in the Senate by a vote of 62 to 24.

Thus, in the past twenty years, the House of Representatives has on three occasions passed bills providing for withholding either on dividends or interest, or both, and on each occasion, as well as in 1960, after mature consideration, the Senate Finance Committee has rejected the proposals. On two occasions on which the matter has reached the floor, the Senate has defeated the proposals by an overwhelming majority.

Nevertheless, the President, in his campaign in 1960, publicly supported withholding of tax on dividends and interest. The Assistant Secretary of the Treasury, Mr. Surrey, in a law review article in June, 1958, had endorsed withholding on dividends and interest, saying without elaboration "It is clear that withholding on interest and dividends should be instituted, especially since workable withholding arrangements have been devised." [13] On April 20, 1961, the President, in a message to Congress, recommended its enactment.

II. COMPARISON WITH WITHHOLDING ON WAGES AND SALARIES

It has been frequently asserted that since withholding has been successfully applied to wages and salaries, it should be, and can be, readily applied to dividends and interest. And so it would seem at first blush—but, as the poets have reminded us, "Things are not always what they seem".

The circumstances necessarily differ in a number of respects. Among the differences are the following:

(1) Most individuals have only one employer. The relationship involves day-to-day personal contact. Thus it is possible to permit the employee to notify his employer on a Form W-4 of the number of his personal exemptions, and to permit the employer, by use of tables, to tailor the amount of tax to be withheld according to the number of personal exemptions of the employee.

Because individuals so frequently have more than one payor from whom they receive dividends and interest, no system of similarly recognizing personal exemptions has been considered feasible in connection with withholding of tax on dividends and interest.

This circumstance in itself has produced some of the greatest problems involved in the proposal. It necessarily produces overwithholding in numerous cases, since the net effective tax rate for many taxpayers, after allowance for personal exemptions, will be substantially less than 20% of their total dividend and interest income.

(2) The rate of withholding tax on wages and salaries in recent years has been 18%—equal to the bottom bracket of 20% after recognition of the standard deduction of 10%. The various systems of withholding proposed with respect to dividends and interest have failed to take account of the standard deduction (even without regard to the dividend exclusion or the dividend credit). This would be a further cause of overwithholding.

---

[13] Surrey, *The Federal Income Tax Base for Individuals*, 58 Col. L. Rev. 815, 827 (1958). For this proposition the article cited Pechman, *Erosion of the Individual Income Tax*, 10 Nat'l Tax J. 1, 23 (1957).

(3) Wage withholding is not required for sick pay under wage continuation plans; nor is it required for pension payments from qualified pension trusts or annuity programs to retired persons, who are particularly likely to incur substantial medical expense allowable to them as deductions. Hence many of the problems involved in dividend and interest withholding with respect to the elderly and the sick do not arise in wage withholding.

(4) The wage and salary withholding system has insisted that the employer deliver to the employee after the close of the year, or at the termination of employment, a statement on Form W-2 of the total amount of wages and salaries paid to the employee during the calendar year, together with a statement of the total amount of Federal income tax withheld. This statement enables the employee to prepare his Federal income tax return readily and accurately, and substantiates his claim for credit or refund of the tax withheld at the source. A copy is attached to his return to permit the Internal Revenue Service to verify readily the calculation on his return.

One of the fundamental problems with respect to dividends and interest withholding lies in determining whether a similar information receipt should be required to be furnished by payors of dividends and interest to payees. In the 1942 and 1950 proposals such receipts were required, but produced great objections from payors because of the mechanical burdens of producing so many receipts; in the 1951 and 1960 proposals, and in the pending proposal, receipts have been eliminated out of consideration for the problems of the payors. But the elimination of those receipts creates manifest problems for the payees in preparing their returns accurately, especially if withholding is not required universally on all payments of dividends and interest. It leaves the Internal Revenue Service without ready means for verifying the recipient's claim of credit for tax withheld, and opens the door for mistaken or even fraudulent claims for refund of tax alleged to have been withheld.

(5) Because of the personal contact between employer and employee and the frequent periodic payment of wages and salaries, it is possible readily to prevent or promptly correct errors with respect to wage or salary withholding. However, with respect to interest and dividend withholding there would generally be no personal contact and any exemption certificates for nontaxable persons, or other individual problems, would have to be handled or corrected largely by mail communication without benefit of oral discussion. Inevitably clerical errors would result.

(6) Wage and salary withholding is frequently a boom to the employee who might otherwise spend his earned income on personal living expenses and then be unable to meet his tax at a later date. But for investors receiving dividends and interest, even if the income were spent the principal would generally be available for payment of the tax, either voluntarily by the recipient or involuntarily as a means of collection by the Internal Revenue Service. Moreover, withholding in the form proposed would disrupt savings programs which require or permit reinvestment of dividends or interest even though the tax thereon is being paid by the investor out of his earned income.[14]

In these circumstances, while persons may disagree as to the weight to be accorded to these differences, it must be recognized that dividend and interest withholding does present a number of practical problems of administration and operation not found in wage and salary withholding.

III. ITEMS SUBJECT TO WITHHOLDING

Section 19 of the pending bill provides for withholding at the rate of 20% on specified types of interest, dividends and patronage dividends. Some ten pages in the bill are consumed in the specification of the items subject to withholding and the exception thereto.

Interest.—The first category of interest subject to withholding is "interest on evidences of indebtedness (including bonds, debentures, notes, and certificates) issued by a corporation with interest coupons or in registered form, and, to the extent provided in regulations prescribed by the Secretary or his delegate, interest on other evidences of indebtedness issued by a corporation of a type offered by corporations to the public".[15]

---

[14] The fact that Series E bond interest need not be reported until redemption while savings account interest is required to be reported as credited to the account even though not withdrawn may be responsible for some public confusion. The Series E treatment gives that method of saving a preference over other savings programs, since the interest increment may be compounded without tax.

[15] Proposed § 3452(a)(1).

It will be noted that only interest payments by corporations are included under this item. Interest payments by individuals or partnerships are excluded. Moreover, interest payments on corporate obligations are included only if (A) they are evidenced by a document bearing coupons or in registered form, or (B) (to the extent later to be prescribed by regulations) they are of a type offered by corporations to the public.

The House Committee Report says that the definition "for the most part is limited to payments made by corporations where the holder of the indebtedness is likely to be an individual (although not necessarily actually so in any given case)."[16] Further, it says that it "will not include interest on mortgage paper generally, since mortgages usually are not of a type offered by corporations to the public."[17] And, as to the regulations to be promulgated, the Report says that "it is not expected" that the Secretary will by regulation extend withholding "unless he is able to describe the instruments with such definiteness that both the issuers and holders thereof will encounter no difficulty in determining whether the interest is subject to withholding."[18]

Obviously there are several competing considerations involved in drawing this definition. For example, nothing would be gained, and something might be lost, if an individual were required to withhold tax on interest paid on his borrowings from a large commercial bank. For this reason payments by individuals are excluded. And it would seem disruptive of many business and banking transactions if corporations were required to withhold on interest paid to banks or other corporations in ordinary business transactions. The proper aim would be to require withholding only on payments to individuals; but it would be difficult as a practical matter to differentiate by types of payees because of the administrative burden on payors in making the distinction, and because securities are frequently registered in nominee name. Hence the bill seeks to differentiate according to types of obligations *likely* to be held by individuals, even though in many instances obligations subject to withholding may actually be held by corporations and obligations exempt from withholding may in fact be held by individuals. At the same time, since the bill contemplates no information receipts to be given by payor to payee for use in preparation of the payee's tax return (such as the Form W-2 for employees), it is important that the payor, payee and the auditing agent be able to recognize readily whether or not a particular type of interest at least was subject to the requirement of withholding, even if no convenient receipt is available to show whether withholding actually occurred.

The extent to which the limitations in the definition would affect withholding on individuals obviously cannot be fully predicted. The Treasury statistical data shows that for the year 1959 mortgage interest received by individuals, which would be exempt from withholding, would alone amount to more than $1.5 billion of the total of some $9 billion of interest estimated to be received by individuals.[19]

An interesting facet, not readily gleaned at first reading of the bill, is that discount obligations of corporations apparently would not be subject to withholding, even at maturity. The Committee Report explains that this is "because of differences in the tax treatment of original issue discount where the obligation is held to maturity by the initial holder and where it is acquired before that time by a subsequent purchaser."[20]

The bill specifically makes subject to withholding interest "on deposits with persons carrying on the banking business".[21] An exception is made for payments to foreign corporations and nonresident aliens not engaged in trade or business in the United States.[22]

In addition, withholding applies to "amounts (whether or not designated as interest) paid by a mutual savings bank, savings and loan association, building and loan association, cooperative bank, homestead association, credit union, or similar organization, in respect of deposits, investment certificates, or withdrawable or repurchasable shares."[23] It also applies to "interest on deposits with

---

[16] H.R. Rep. No. 1447, 87th Cong., 2d Sess. 86 (1962).
[17] *Id.* at 87.
[18] *Id.* at A141.
[19] Senate Finance Committee Hearings, Pt. 1, 149.
[20] H.R. Rep. No. 1447, 87th Cong., 2d Sess. 87 (1962).
[21] Proposed § 3452(a)(2).
[22] Proposed § 3452(b)(8). The interest is not taxable to such persons.
[23] Proposed § 3452(a)(3). An exception is made for interest on deposits in school savings accounts, to the extent permitted in regulations. Proposed § 3452(b)(7).

stockbrokers" and to "interest on amounts held by an insurance company under an agreement to pay interest thereon." [24]

With respect to United States obligations, withholding is required on all such obligations which bear interest.[25] In the case of noninterest bearing United States obligations issued at a discount, if the obligation has a maturity date more than one year from the date of issue, withholding is required on the amount by which the amount paid on surrender or redemption exceeds the issue price.[26] The latter category would include Series E bonds.

Dividends.—The bill requires, in general terms, withholding with respect to any distribution which is a dividend as defined in Section 316.[27]

It further provides that "If the withholding agent is unable to determine the portion of a distribution which is a dividend, the tax under this section shall be computed on the entire amount of the distribution." [28] This provision raises some doubt as to the operation of withholding in the case of corporations which expect that their distributions to shareholders will exceed their accumulated or current earnings and profits, in which event their distributions will be wholly or partly nontaxable to the recipients. In one sense a corporation may never be able to determine the portion of its distributions which is a dividend unless the dividend payment is made at the very close of the year, since it is otherwise always theoretically possible for the corporation to derive sufficient earnings between the payment date and the end of the year to raise its current earnings for the year above the total amount of the distributions for the year. In practice, however, it is likely that a more realistic rule would be followed by the Service; perhaps the Service might permit the calculation to be based upon the state of accumulated and current earnings to the record date for the distribution. Even so, substantial problems could exist because of a lack of accurate interim earnings statements at the time of the distribution.[29]

The bill specifically excepts from dividend withholding nontaxable distributions in stock or rights of the distributing corporation.[30] It also excepts any distribution to the extent that the amount is treated by the recipient "as an amount received on the sale or exchange of property" (a phrase which includes capital gain dividends paid by regulated investment companies) and distributions on which "gain or loss to the recipient is not recognized." [31] It further excepts amounts includible as a taxable dividend by reason of Section 302 (redemptions of stock), 306 (dispositions of preferred stock dividends, etc.), 356 ("boot" received in reorganizations) or 1081(e)(2) (distributions pursuant to SEC orders).[32] And in his final public statement before the Senate Finance Committee, the Secretary recommended that withholding not be required with respect to "dividends in kind which consist of distributions of stock of another corporation." [32a]

Both the interest and dividend provisions exempt from withholding amounts paid by one corporation to another corporation if both corporations are members of the same affiliated group which filed a consolidated return for the preceding taxable year of the group.[33]

Since withholding would apply only to selected types of interest and dividends, and the amount of tax to be withheld at the source would not necessarily rep-

---

[24] Proposed § 3452(a) (4) and (5).

[25] Proposed § 3452(a)(6).

[26] Proposed § 3452(a)(7).

[27] Proposed § 3462(a)(1). It also embraces within the term "dividend" for this purpose "any payment made by a stockbroker to any person as a substitute for a dividend." The latter provision covers cases in which stock is borrowed in connection with short sales.

[28] Proposed § 3461(c).

[29] The only discussion of this provision in the House Committee Report relates to distributions by regulated investment companies. Those companies regularly make distributions during the year representing ordinary dividends, but in addition frequently distribute capital gain dividends (which are exempted from withholding). The report states: "Thus, the total amount of a distribution made by a regulated investment company, which includes gains realized on the sale or exchange of property, must be withheld upon if at the time such distribution is made the withholding agent is unable to determine the portion of the distribution which is a dividend." p. A144. Most regulated investment companies distribute their capital gain dividends in a single sum designated separately from their distributions of ordinary income. A few such companies, however, distribute realized capital gains as a part of current distributions which include ordinary income, designating a portion of each quarterly distribution as representing capital gain dividend. Presumably the sentence in the Committee Report refers to the necessity for accurate determination of the non-withholdable amounts in the latter type of case.

[30] Proposed § 3462(b)(1).

[31] Proposed § 3462(b)(2).

[32] Proposed § 3462(b)(3).

[32a] Senate Finance Committee Hearings, Pt. 10, 4252.

[33] Proposed §§ 3452(b)(4) and 3462(b)(4).

resent 20% of the amount reportable as income by the recipient in his tax return, complications may ensue in the preparation and audit of the tax returns of the recipients because of the lack of requirement of information receipts to be furnished by the payor to the payee. This factor will be mentioned further below.

IV. EXEMPTION CERTIFICATES

In the original proposal of the Treasury Department presented to the Committee on Ways and Means on May 3, 1961, the Secretary stated:

"One of the basic considerations in the development of the withholding system was to minimize the work and cost of withholding for paying agents. To accomplish this, withholding would be universally applied to all interest and divided recipients (assuming the interest and dividends are subject to withholding) with the following exceptions: foreign corporations, foreign partnerships, and nonresident aliens. These exemptions would be made in order to avoid overlapping existing withholding requirements on such recipients.

"Any further extension of exemptions would complicate the withholding procedure and would be burdensome for payers." [84]

In its initial press release of July 14, 1961 regarding a tentative decision to approve a system of withholding on interest and dividends, the Ways and Means Committee stated that an exemption system would be provided under which an individual who "reasonably expects that he will owe no tax" could "file an exemption certificate with a bank, broker, or other source of the income", the exemption certificate to be filed each year. In subsequent press releases and decisions of the Committee, there was considerable vacillation as to the extent to which exemption certificates would be permitted. The bill as passed by the House of Representatives provides, in general, for the filing of exemption certificates as follows:

(1) *Individuals under age 18.*—If an individual files with any withholding agent an exemption certificate on which he certifies the date of his birth, all amounts payable by the withholding agent to the individual after the effective date of the certificate and before the beginning of the calendar year in which he will attain age 18 will be exempt from withholding.[85] Under this provision the withholding agent would apparently be responsible for commencing withholding at the beginning of the calendar year in which the certificate indicated the individual would attain age 18. The certificate could be filed by the individual whether or not he expects to owe tax on the income payment.

(2) *Individuals over age 17.*—If an individual files with a withholding agent an exemption certificate certifying (A) that he will have attained age 18 before the close of the calendar year for which the certificate is filed and (B) "that he reasonably believes that he will not * * * be liable for the payment of any" Federal income tax for his taxable year or years for which the certificate is in effect, all amounts payable by the withholding agent to that individual during the period the certificate is in effect will be exempt from withholding.[86] Except as may otherwise be provided in regulations, an exemption certificate will remain in effect only for the period beginning on the effective date of the certificate and ending at the close of the calendar year in which such period begins.[87] The Committee Report states that "The exemption certificates generally must be filed with the dividend or interest payor once a year."[88] With respect to the statutory authorization for regulations to permit the exemption certificates to continue in operation beyond the close of the year, the Report states:

"It is expected that, if the Secretary or his delegate finds that certain individuals, such as those over age 65, generally remain in a non-taxable status, he may provide by regulations a procedure permitting exemption certificates filed by such individuals to remain effective for more than a year. The individual would, however, be required to revoke the certificate if he becomes taxable." [89]

---

[84] Ways and Means Committee Hearings, Vol. 1, 277 (1961).
[85] Proposed § 3483(a)(1).
[86] Proposed § 3483(a)(2).
[87] *Ibid.*
[88] H.R. Rep. No. 1447, 87th Cong., 2d Sess. 89 (1962).
[89] *Id.* at A149.

(3) *Tax-exempt Organizations.*—The bill would, in general, permit organizations exempt from tax, including charities and pension and profit sharing trusts, to file with withholding agents exemption certificates, but only with respect to (a) interest on deposits with persons carrying on the banking business, (b) interest on amounts paid by mutual savings banks, savings and loan associations, etc., and (c) non-interest bearing discount obligations of the United States.[40] The exemption certificate would continue in effect until notification by either the organization or the Service that it is no longer exempt from tax; the organization would be required to notify the withholding agent if its tax exemption ceases.

Because of protests concerning the administrative difficulties of payors in processing annually exemption certificates of nontaxable persons over age 17, the Secretary in his final public statement before the Senate Finance Committee on May 10, 1962, recommended:

"Provision should also be made for exemption certificates to remain valid until revoked by the filer instead of requiring annual refiling.

"This would make the House exemption certificate system easier to administer by the paying institutions and would also reduce the number of forms which nontaxable persons would be required to file." [41]

The statement does not indicate whether payors will still be responsible for terminating the exemption of persons under 18 when they attain their 18th birthday.

While the recommendation for permanent exemption certificates tends to reduce the administrative burden on payors, it leaves open to question the effectiveness of the withholding system with respect to persons who, once having filed an exemption certificate, become liable for tax in subsequent years. The Secretary's recommendation apparently contemplates that they will voluntarily revoke all exemption certificates previously filed with their payors. Since there will be no information receipts, a superficial review of their tax returns in subsequent years would be expected to be based upon the assumption that tax was in fact withheld, although the returns presumably would not be accompanied by proof that prior exemption certificates had been withdrawn.

Because of certain practical problems with respect to stock sold near dividend payment dates, there had been some hesitation about permitting exemption certificates for dividend income. The Ways and Means Committee had finally decided to permit exemption certificates to be filed for dividend income by nontaxable individual recipients but not by exempt organizations. In his final statement before the Senate Finance Committee, the Secretary recommended that exempt organizations also be permitted to file exemption certificates with respect to dividend income.[42] The practical problems involved are noted briefly in Senator Byrd's public statement, in which he said:

"Moreover, special problems will arise where stock is sold just before a dividend date by someone who has filed an exemption certificate to someone who has not, if the stock certificate has not actually been delivered to the corporation before the dividend date." [42a]

Exceptions to Exemption Certificate Procedures. The bill does not permit the filing of exemption certificates with respect to interest on corporate evidences of indebtedness or interest on United States obligations.[43] The House Committee Report explains that this exception is necessary "because of the difficulty of making exemption certificates work where these bonds are transferred from one holder to another between interest payment dates, where one such holder might be exempt and the other not".[44] This difficulty arises because the bill apparently contemplates that in the case of coupon bonds sold between interest payment dates, the 20% tax will be withheld by the withholding agent at the time the coupon is presented for payment when it matures;[45] and that accordingly when the bond itself is sold between interest payment dates, the purchaser, mindful of the ultimate 20% withholding at maturity, will pay to the seller only 80% of the interest accrued from the last interest payment date to the date of the sale. Ap-

[40] Proposed § 3488(a)(3).
[41] Senate Finance Committee Hearings, Pt. 10, 4252.
[42] *Id.* at 4251.
[42a] 108 Cong. Rec. 8109, 8110 (daily ed. May 21, 1962); Senate Finance Committee Hearings, Pt. 10, 4404.
[43] Proposed § 3483(b)(1)(A) and (C).
[44] H.R. Rep. No. 1447, 87th Cong., 2d Sess. 90 (1962).
[45] See proposed §§ 3488 and 39(c) relating to credit for tax withheld with respect to interest on obligations sold between interest payment dates.

73-744—76——9

parently it is feared that this assumption would not be correct if one or both of the parties to the transaction was permitted to file an exemption certificate.

Presumably for similar reasons, exemption certificates are not permitted with respect to interest on deposits in mutual savings banks or savings and loan associations in respect of "a transferable certificate or share." [46]

With respect to redemptions of discount obligations of the United States (including Series E Bonds), a separate certificate must be filed with respect to each redemption.[47]

Exemption certificates may not be filed with respect to dividends "paid through nominees".[48] Apparently this is intended particularly for the relief of stock brokers with respect to stock standing in street name, in view of administrative problems which they would have at dividend payment dates in separating out stock held for the account of customers who are not liable for tax. As a result, persons entitled to file exemption certificates would have to forgo the convenience of leaving stock in street name if they should wish to be exempt from withholding. The prohibition against filing exemption certificates on dividends "paid through nominees" might also extend to other cases in which stock is held in nominee names, such as cases in which stock is pledged to secure debt, or perhaps if it is held in custody accounts at banks or trust companies, etc.

The bill permits, to the extent provided in regulations (but not with respect to interest on corporate or United States obligations or transferable certificates of savings institutions), the filing of exemption certificates with respect to "amounts paid to custodians" and "amounts paid jointly to 2 or more individuals".[49] The reference to "custodians" was apparently intended by the draftsmen to refer to securities held in custodian accounts for minors under the recent enabling statutes passed in various states. As applied to a bank or trust company acting as a "custodian", however, this provision seems somewhat inconsistent in practice with the prohibition against exemption certificates for dividends "paid through nominees", since most bank and trust company custodians will of necessity register stocks held in custody accounts in the names of nominees. It is possible that the bill will be changed to permit bank and trust companies acting as custodians to file exemption certificates on behalf of their nontaxable customers; if so, this would presumably require the custodians to register securities held for nontaxable persons in the name of a different nominee from that used for taxable customers.

Since the bill permits exemption certificates to be filed only by individuals and tax-exempt organizations, it does not permit exemption certificates with respect to income received by an estate or trust, whether or not distributed to the beneficiary. Neither the fiduciary nor the beneficiary is permitted to file an exemption certificate with the payor. It is understood that consideration is being given to some modification of this position. One suggestion that has been made would permit the fiduciary of an estate or trust to file an exemption certificate, and require the fiduciary to withhold the proper amount from taxable beneficiaries but not from nontaxable beneficiaries. This, however, would substantially increase the number of exemption certificates to be processed by payors, and presumably would require the fiduciary to calculate, at the time of each distribution to a taxable beneficiary, the portion of the distribution constituting withholdable dividends and interest. Other solutions to the fiduciary problem may be considered and evolved, but no simple answer seems available.

No corporation is permitted to file an exemption certificate. This produces a special problem for regulated investment companies, since substantially all their income would be subject to 20% withholding, and they would have to invade principal in order to make full current distribution to nontaxable shareholders who file exemption certificates with the investment companies. The investment companies have asked for permission to file exemption certificates with their payors.

Finally, the bill authorizes the Secretary to prescribe regulations to provide for the form and content of exemption certificates and to specify the date on which an exemption certificate shall become effective.[50] The effective date of a certificate would be a significant fact, since payors having to process thousands of such certificates would have to receive them well in advance of a payment date in order to have time to record them and determine which payees are to receive 100% and which are to receive 80% of the amounts due.

---

[46] Proposed § 3488(b)(1)(B).
[47] Proposed § 3483(b)(2).
[48] Proposed § 3488(b)(3)(A).
[49] Proposed § 3483(b)(3) (B) and (C).
[50] Proposed § 3488(b) (4) and (5).

V. INTERIM REFUNDS

One of the principal objections to the various plans for withholding on dividends and interest advanced in Congress in prior years stemmed from the fact that in the cases in which overwithholding occurs, refunds by the Service would not be made until after the filing of the final income tax return of the recipient, a delay which might last longer than a year. In the pending proposal, despite obvious administrative disadvantages and expense in so doing, the Treasury has offered to make refunds, subject to a number of limitations and exceptions, on a quarterly basis.

The pending bill provides, in general, that the tax withheld with respect to amounts received by an individual during the first three quarters of his taxable year shall, to the extent the tax does not exceed his "refund allowance" as of the time claim is filed, be promptly refunded to him as an "overpayment of tax."[51]

The bill then defines the term "refund allowance" as follows:[52]

"For purposes of this section, the refund allowance of an individual as of the time the claim for refund is filed is an amount equal to the excess, if any, of—

'(1) an amount equal to 22 percent of—

'(A) the total of the deductions which, on the basis of facts existing at the time the claim for refund is filed, such individual would be allowed for the taxable year under section 151 (relating to deductions for personal exemptions), plus

'(B) in the case of an individual who, at the time the claim for refund is filed, reasonably expects that he will be allowed a credit under section 37 (relating to retirement income) for the taxable year, the amount which, at such time, such individual reasonably expects to be the amount of his retirement income (as defined in section 37(c) and as limited by section 37(d)) for the taxable year, less

'(C) the amounts (other than amounts on which tax is required to be deducted and withheld under this chapter) which, at the time the claim for refund is filed, such individual reasonably expects to be includible in his gross income for the taxable year; over

'(2) the amounts of tax with respect to which an allowable claim for refund has been previously filed under this section during the tax year."

Although the Treasury has stated that the refund claim may be made on "a simple refund slip",[53] no draft of the form to be used has been released; and upon a reading of the above-quoted definition there is some reason to question whether, particularly in view of the "gross up" requirements and the complication of the retirement income allowance, the form of refund claim is likely to be simple.

The 22% figure used in the calculation of the refund allowance is apparently designed to take some account of the standard deduction. However, the formula used will take account of the standard deduction only to the extent of 10% of the sum of the personal exemption plus the retirement income allowance, and will not take account of it to the full extent of 10% of the adjusted gross income as permitted by the standard deduction. For this reason, among others, the "refund allowance" for quarterly refund purposes may produce a different figure from the final refund as calculated on the tax return for the year.

Again, the bill does not permit itemized deductions to be taken into account. In his final public statement before the Senate Finance Committee, the Secretary recommended that itemized deductions be permitted to be taken into account in determining quarterly refunds.[54] It is not clear at this time how this change would affect the provision. The Secretary did not indicate whether the deductions would be based upon those incurred to the date of the filing of the quarterly refund claim, or whether they would be based upon a reasonable estimate of deductions for expenditures to be made for the entire year.

The House Committee Report explained that—

"Actually the taxpayer generally will need to compute his claim for refund only in the first quarter. In the second and third quarters it is expected that the Internal Revenue Service will automatically mail him partially completed refund claims refund [sic], based upon the information the taxpayer previously submitted. This procedure can be followed in all cases where the taxpayer indi-

---

[51] Proposed § 3484(a).
[52] Proposed § 3484(b).
[53] *Supra*, n. 9.
[54] Senate Finance Committee Hearings, Pt. 10, 4252.

cates his income status has not changed significantly from his prior expectations."[55]

In this regard the bill states that an individual who files more than one interim claim for refund for any year may use the same estimate of his income not subject to dividend and interest withholding as he used in the preceding claim unless he "reasonably expects" such income to exceed the prior estimate by more than $100.[56] He must determine his personal exemption and retirement income allowance on the basis of the facts at the time the particular claim is filed.[57]

The interim refund provisions permit the recipient to receive refund of the entire amount withheld from him in the early quarters of the year until the total amount to be refunded to him reaches his "refund allowance" for the year. No interim refund may be made to an individual, however, unless the amount claimed and allowable exceeds $10.[58]

In addition, the bill bars interim refunds to a single individual who "reasonably expects" that his "gross income" for the year will exceed $5,000, or to married individuals who reasonably except that their aggregate gross income will exceed $10,000.[59] No special definition of "gross income" is provided. It would apparently include the gross amount of capital gains, without reduction for one-half of long-term capital gains or reduction for capital losses. The use of the undefined phrase "gross income" may cause difficulties for those who have small incomes from rentals of real property, for sole proprietors of small businesses, for persons who have reimbursed expenses, etc.

Due to changes in a person's reasonable expectation of his gross income, some persons eligible for refund in the early quarters may become ineligible in later quarters, and vice versa. Pressures are necessarily placed here, as in the case of exemption certificates, upon the good faith of recipients in stating their reasonable beliefs and expectations as to their prospective income and tax liability for the year.

Provisions are also made with respect to states, tax-exempt organizations and corporations for credit of tax withheld from them on dividends and interest against amounts due to the Government in respect of employment taxes, taxes withheld from employees, taxes withheld on dividend and interest payments, and estimated corporate income taxes.[60] Provision is also made for quarterly refunds of excess tax withheld.[61] The bill permits quarterly refunds to corporations only with respect to receipts of dividends and interest during the first three quarters,[62] but the Secretary recently recommended that interim refunds be permitted to corporations for the fourth quarter as well.[63]

VI. "GROSS-UP" AND THE LACK OF INFORMATION RECEIPTS

In its initial proposal in the spring of 1961 the Treasury, mindful of the complaints of payors regarding prior proposals, endeavored to limit the administrative burden upon payors. This was a significant reason for its initial recommendation against permitting exemption certificates for nontaxable persons. Doubtless for similar reasons, the Treasury recommended that there be no requirement that payors furnish to payees following the close of the year an information receipt, such as the Form W-2 given to employees, setting forth the aggregate amount of dividends and interest paid to the payee during the prior year and the amount of tax withheld thereon.

The Treasury proposal contemplates that the recipient will use a "gross-up" procedure in the preparation of his income tax return and refund claim. Under this proposal the recipient will first report on his tax return his net cash receipts from dividends and interest which were subjected to withholding; he will then on the following line divide that amount by four to obtain a quotient which will represent the amount of tax withheld; and he will then add the two amounts together to reflect in the sum the gross amount of his income from such dividends and interest. After taking into account his other income and deductions and personal exemptions, and calculating his tax, he will then take credit against the

---

[55] H.R. Rep. No. 1447, 87th Cong., 2d Sess. 90 (1962).
[56] Proposed § 3484(b), last sentence.
[57] Proposed § 3484(b)(1) (A) and (B).
[58] Proposed § 3484(a), last sentence.
[59] Proposed § 3484(e) (1) and (2).
[60] See proposed §§ 3487 and 3505. The provisions for states and tax-exempt organizations differ somewhat from those relating to corporations.
[61] See proposed §§ 3485 and 3486.
[62] Proposed § 3486.
[63] Senate Finance Committee Hearings, Pt. 10, 4252.

tax so calculated for the amount he computed on the second line as representing the tax withheld on the dividends and interest. Finally, after recognition of any quarterly refunds allowed to him, he will calculate the final refund due him for the year, or pay any additional tax still due.

The Treasury has described this as a "simple gross-up procedure". However it is described, the following aspects, among many others, would have to be taken into consideration in appraising the prospective operation of the system without information receipts:

(1) As indicated earlier, not all items of interest and dividends would be subject to withholding. Thus the return form would have to distinguish between dividends and interest which are subject to withholding and require use of the gross-up procedure, and those which are not subject to withholding and are not involved in the gross-up procedure. Additional lines or schedules for dealing separately with the two categories must undoubtedly be provided on the tax returns. Taxpayers must be careful to report the two types of dividend and interest income in the proper category. The procedure would seem inevitably to complicate further the tax return forms; in particular it is likely either to complicate, or limit the use of, the popular simplified postcard size Form 1040A. Moreover, if the dividend exclusion and credit are retained, the return forms must deal separately with dividends and interest.

(2) Individuals who are not meticulous keepers of records will have problems in knowing, at the time of preparing their tax returns, whether the particular items of interest and dividends were of the type subject to withholding. This could be a significant problem, for example, with respect to the substantial amount of mortgage interest which is not subject to withholding.

(3) The lack of readily available information at the time of preparation of the tax returns is doubtless responsible today for some of the underreporting of dividend and interest income. Similar resort to estimations of dividend and interest income by persons entitled to refunds can lead to erroneous refunds.

(4) The privilege of filing exemption certificates accorded to persons who reasonably believe they will be nontaxable may produce a variety of errors unless the individual concerned retains precise records as to the payors with whom he filed such certificates and as to the effective dates of the certificates. For example, a nontaxable person may file an exemption certificate with his savings bank, and neglect to file it with his mutual fund. He may file it when he redeems a Series E bond but not file it for his dividends on stock of a particular corporation. He may not have been eligible to file an exemption certificate for dividends and interest payments in the early part of the year, but by reason of subsequent substantial medical expense may file exemption certificates for the latter part of the year. He may simply be late in filing his exemption certificate, and be subject to withholding in the early part of the year but not in the latter part. And if permanent exemption certificates are permitted, he may not be prompt in revoking his exemption certificate. Yet in all these cases, and in many others, he will not be provided with an information receipt to permit him to prepare his return correctly or to permit the Service to audit it readily. The Service will not have a Form 1099 with respect to any interest payments totalling less than $600 for the year.

(5) With respect to corporate distributions which are wholly or partly nontaxable, tax may have to be withheld upon the full amount of the distribution, but the gross-up procedure, starting with only the taxable portion as a base, will not produce on the tax return the proper calculation of tax withheld.

(6) Since withholding operates on a cash basis, recipients on an accrual basis will have to accrue the interest income in one year and take credit for the tax withheld in the year in which payment is actually or constructively made. While accrual basis taxpayers must keep books of account, and may be expected to keep records properly, the system will provide obvious complications for corporations, partnerships and sole proprietorships on an accrual basis.

The foregoing are illustrations of complexities faced by payees and the Service without assuming any deliberate fraud. But some note should be taken of the possibility that fraudulent refund claims with respect to dividend and interest withholding might be difficult to detect and prove. Without an information receipt requirement it would not be necessary for the payee to manufacture deliberately a receipt similar to Form W-2 for attachment to his return, as is necessary to obtain a fraudulent refund of the tax withheld on wages. An improper refund claim could be more easily dismissed as an inadvertent error.

VII. RELATIVE MERITS OF A WITHHOLDING SYSTEM AND AN INFORMATION RECEIPTS—ACCOUNT NUMBER—AUTOMATIC DATA PROCESSING SYSTEM

In judging the desirability of embarking upon the proposed withholding system for interest and dividends, one must consider the nature and extent of the present revenue loss stemming from underreporting, and the relative advantages of withholding and other alternative programs available as means of combatting that loss.

As to present loss of revenue, there is considerable difficulty in obtaining and analyzing current estimates. The Treasury's statistics presented to the Congressional committees do not disclose in detail the numerous assumptions which necessarily must be made in estimating the aggregate interest and dividend income not now being reported on Federal income tax returns, and the amount of such income which (after allowance for exemptions, deductions and credits) would bear tax if fully reported. Moreover, there is a substantial lag in available statistical data; final background statistics for the year 1959 have not even yet been published.[64]

There is also a considerable degree of confusion in published statements regarding the extent of the reporting "gap". On many occasions the figures quoted are those relating to the amount of dividend and interest income of individuals that is not reported on Federal income tax returns, without reduction for the amount of such income received by persons (such as minors and the elderly) who do not have sufficient income to require the filing of a return or who would owe no tax if they filed returns. The Treasury estimates show, for example, that roughly one-third of interest income and about one-tenth of dividend income unreported is received by persons who would owe no tax if they reported the income.[65] These figures are necessarily uncertain, however, since the Treasury Statistics of Income, which are derived from tax returns filed, cannot provide the data.

After allowance for the Treasury's estimate of income which would not be taxable even if reported, the Treasury's data shows that some 92% of taxable dividend income and some 76% of taxable interest income is now being reported.[66] It might be noted that in the first years of wage and salary withholding only about 93% of wage and salary income was reported; in recent years about 97% is estimated to have been reported.[67]

Another element of confusion in the use of the statistical data stems from failure to distinguish between (a) the presently estimated revenue loss from underreporting of dividend and interest income, (b) the estimated revenue to be derived from 20% withholding alone, and (c) the Treasury's estimate of the total revenue effect of withholding, which includes a substantial amount for estimated improvement in reporting in the upper brackets due to the installation of withholding. The Treasury's estimates for 1959 presented by the Secretary to the Senate Finance Committee on April 3, 1969 showed:[68]

[In millions]

	Dividends	Interest	Total
1. Revenue loss due to underreporting	$350	$500	$850
2. Revenue to be derived from 20 percent withholding only	150	320	470
3. Revenue to be derived from improved repoting in brackets above 20 percent	130	50	180
4. Total revenue from withholding	280	370	650
5. Total revenue loss remaining	70	130	200
Total	350	500	85

[64] The Treasury Statistics of Income for Corporations for fiscal years ending July 1, 1959 to June 30, 1960 were published on a preliminary basis this Spring. Final statistics for this period are not expected to be published for some months. Preliminary statistics for the period July 1, 1960 to July 1, 1961, needed for estimates of individual underreporting for calendar year 1960, would not normally be published until the Spring of 1963.

[65] See Senate Finance Committee Hearings, Pt. 1, 148–149.

[66] *Ibid.*; see also *id.* at Pt. 5, 2058.

[67] Kahn, *Coverage of Entrepreneurial Income on Federal Tax Returns*, Tax Revision Compendium, Vol. 2, 1439, 1448 (1959).

[68] Senate Finance Committee Hearings, Pt. 1, 150. Slightly revised estimates for 1959, estimates for 1960, and projections for 1963 were inserted by the Treasury in the record for May 11, 1962, Pt. 10, 4853–4856. However, there are mathematical errors, presumably typographical, in some of the revised 1959 figures; and the source of the 196^ figures, which are not yet published, is not indicated. The 1963 figures are necessarily speculative.

Whether an anonymous system of withholding at a 20% rate without an adequate information receipt system would produce improvement in upper bracket reporting, as reflected on line 3 of the above table, would seem highly problematical. Perhaps it is thought that many presently defaulting upper bracket taxpayers would be anxious to claim credit for the 20% withheld, and for this privilege would pay an even greater tax. If one does not assume this voluntary action, withholding would, on the Treasury estimates, recover only 43% of the present revenue loss from dividend nonreporting and 64% of the loss from interest nonreporting, or 55% overall. Thus there is room to question the efficiency of the system in relation to the difficulties and complexities in its operation.

It should also be borne in mind that underreporting exists to a substantial extent in categories of income other than dividends and interest. A series of studious papers included in the Compendium published by the House Ways and Means Committee in its hearings in the fall of 1959 showed that, based upon statistics available for 1957, more than $25 billion of income received by individuals failed to show up on individual Federal income tax returns; and it was estimated that of this amount some $20 billion would have borne tax if reported.[69] Of the latter total, less than $1 billion was ascribed to dividends and some $3 billion to interest. Some $5 billion was due to unreported salaries and wages, despite the existence of withholding, and some $8 billion was due to farm and non-farm entrepreneurial income. The studies indicate that far more revenue would be gained by tightening procedures with respect to underreporting of salaries, wages and entrepreneurial income than from concentration upon dividend and interest income. At least it might be said that attention to the problem of underreporting should be spread over the various categories.

For several years the Service has been directing a major effort toward the introduction of automatic data processing machines to cope with the tremendous problem of record keeping with respect to more than 60 million individual income tax returns, as well as a large number of corporate, fiduciary and other returns, including information returns. Because of difficulty in identifying taxpayers by names and addresses in the operation of the machines, the Treasury urgently requested the Congress at the close of its last session to authorize the introduction of taxpayer account numbers. The legislation, enacted in October, 1961,[70] requires taxpayers to use their social security numbers (or other numbers assigned to them by the Social Security system if they have not been subject to social security tax) on all of their tax returns; but in addition, requires payors to obtain from each payee his account number for inclusion on any information return on Form 1099 required to be filed with the Service by the payor to reflect any payment made to the payee. In his statement on the floor of the Senate urging enactment of the bill, Senator Byrd, Chairman of the Finance Committee, reported to the Senate that:

"This legislation, the Treasury testified, would result in closing loopholes so that those who are now avoiding the payment of taxes would be compelled to pay by operating this new number system through computing machines. The tax revenue, the Treasury testified, would be increased by $5 billion * * *."[71]

Senator Byrd has indicated publicly that these statements by the Treasury last autumn, when the account number legislation was being considered, were a significant factor in his conclusion that withholding should not be enacted until the account number-computer systems have been "thoroughly tried."

As a result of consideration of proposals for withholding of tax on dividends in 1950 and 1951, the requirement for the filing of information returns with respect to dividends was enlarged to insist upon such returns on Form 1099 for all dividend payments to any shareholder exceeding $10 for the year. In practice, most corporations have reported all their dividend payments rather than separate out those totalling less than $10. Interest payments must be reported, however, only if they exceed for the year a total of $600—a figure which at 4% requires a principal amount of more than $15,000. As a result, relatively few information reports are filed at present with respect to interest on savings accounts or other interest-bearing investments.

The Commissioner, saying in essence "Tell me not, in mournful numbers," has estimated that if the interest reporting requirement were reduced from $600

---

[69] Tax Revision Compendium, 1397–1459. And see Ways and Means Committee Hearings on the Compendium papers, 112, 121, 125, 767–8, 781 (1959); and Ways and Means Committee Hearings on the present bill, Vol. 3, 2472–2478 (1961).

[70] 75 Stat. 828, P.L. 87–397 (H.R. 8876) (October 5, 1961).

[71] 107 Cong. Rec. 19763 (daily ed. September 28, 1961).

to $10 (the same amount as now in effect for dividends) some 150 million additional information returns on Form 1099 would have to be filed, sorted and processed.[72] While this is indeed a large number, it is estimated that the banks throughout the United States sort alphabetically and post some 60 million checks daily, of which several individual banks process more than 500,000 daily.[73] Thus the task, while formidable, is clearly one that can be handled.

One of the difficulties today faced by the Service in the handling of information reports on Form 1099 stems from the fact that dividend payments are generally reported quarterly as a machine by-product of the customary quarterly dividend checks. As a result, more than 100 million Forms 1099 are now filed, and it is generally understood that a sample of only 10 to 15% of these have been sorted. Some corporations, however, have developed means of filing a single annual Form 1099 for each shareholder; and with the improvement of machinery and the development of new techniques, it should be possible to reduce to a marked extent the number of Forms 1099 filed for dividends. In particular, it appears feasible for payors keeping records on electronic tape to forward tapes to the Service for immediate automatic recordation and assimilation in the Service's electronic system.

Moreover, difficulty has been experienced heretofore in associating information returns with those of taxpayers due to differences in names and addresses on the two types of returns; but most of this problem will be eliminated by the use of the taxpayer account numbers. In addition, the use of electronic data processing machines will vastly increase the speed with which the data taken from information returns filed by payors can be associated with that appearing on tax returns of payees. It should also be possible to use information returns and the data processing machines with respect to information about income payments other than dividends and interest.

It must also be borne in mind that witholding at the rate of 20% will rarely produce the correct amount of tax. Due to personal exemptions, deductions and credits of various sorts, and in many cases to other items of income, a recipient will seldom owe a tax of precisely 20% on the specific items of dividends and interest. Almost always he will owe either less than or more than the amount. If he owes less than that amount, there will be overwithholding, with consequent problems of exemption certificates or quarterly or annual refunds. If he owes more than that amount, 20% withholding will not suffice to collect the tax due; and this will be particularly significant since the Treasury's statistical data asserts that presently unreported dividend income would bear an average tax of 41% and interest income an average tax of 26%.[74] In any event, information is needed both by the payee-taxpayer and the Service to determine the correct tax liability of the payee after the close of the year.

The difficulties which would obviously lie in store for a withholding scheme which does not require information receipts point to the likelihood that even with withholding information receipts would have to be required in the near future. Opponents of withholding have urged, therefore, that as a part of the program for introduction of taxpayer account numbers and automatic data processing machines, the first logical step is to insist upon an enlargement and improvement of the system of information returns, together with a practice of furnishing copies of those information returns to payees for use in the preparation of their returns. It would seem almost inevitable that we must come to this eventually. Therefore, it is argued, this system, without withholding, should be given a fair and reasonable opportunity to succeed before withholding, with its many difficulties, is introduced into the Federal revenue system. Moreover, it is pointed out that the information receipt system, with account numbers and electronic machines, should be far more effective in collecting the substantial revenue to be derived in the tax brackets above the bottom 20% than would the anonymous 20% withholding system operating without information receipts.

The Treasury urges that its automatic data processing machines, although already functioning in part of the country, will not be fully installed until

---

[72] Senate Finance Committee Hearings, Pt. 1, 165.
[73] Ways and Means Committee Hearings on the pending bill, Vol. 3, 2455 (1961).
[74] *Id.*, Vol. 1, 102.

January 1, 1965 and cannot process information returns for individual income tax returns on a nation-wide basis at least until 1966.[75] Senator Byrd, however, has stated publicly his conviction that "if the effort were made, they could be in effective operation by 1964." [76] It would seem that they could be put in operation progressively as they are installed in the several Service Centers. In addition, he has proposed to extend the statute of limitations on nonreporting of such items of income from three years to six years,[77] thus permitting the Service, when it subsequently detects a nonreporting taxpayer, to collect the unreported tax as far back as six years without proving fraud. And, as Senator Byrd has also pointed out, it is now doubtful whether a withholding system permitting millions of exemption certificates could be placed in operation effectively before 1964.[78]

The Treasury asserts further that even if information returns with account numbers and data processing machines will detect underreporting of income, the system will not collect the tax; and it insists that a substantial addition to its staff would be needed for this purpose.[79] The Treasury has made the flat statement that "The maximum additional tax that the Internal Revenue Service could collect effectively with ADP [automatic data processing] and a reasonable enforcement effort is $200 million." [80] Opponents challenge this conclusion, and point not only to the Treasury's statements to Congress last autumn but also to the fact that the new Treasury machines are understood to be designed so that when they detect underreported income beyond a preset percentage or amount, they can automatically print out the revised calculation of additional tax and interest on a form ready for mailing to the taxpayer as a statement of the amount due unless he desires to contest the calculations.

Opponents urge also that the Federal tax system is founded basically upon self-assessment, and that in the main, if the taxpayer recipients were given adequate information as to their dividend and interest receipts from their payors, and knew that the Service received and was processing the identical information, voluntary reporting would substantially increase. They argue that the very knowledge that the Service has an effective means for detecting underreporting of dividends and interest, particularly in view of the current publicity which has been given to the problem, will lead a great many presently defaulting taxpayers to greater effort in reporting their proper income. In these circumstances, opponents of the measure ask that the information return-account number-data processing machine system of attack at least be given a reasonable opportunity to prove or disprove its ability to cope with the situation before a final decision is made regarding withholding. They urge strenuously that the vast number of presently reporting recipients of dividends and interest should not be subjected to inconvenience, and in some cases to hardship, because of the omission of a minority to report their correct income—at least until the new tools of the electronic age have been given an adequate trial.

The pending bill passed the House in March by a narrow margin. We are witnessing an interesting moment in tax history, in which the checks and balances of a democracy operate in full view and the right of the electorate to appeal to their representatives and the right of the press to editorialize on either side of the debate is being widely exercised. We witness also the effect of the phenomenal growth and vitality of a people's capitalism, in which the number of shareholders in American corporations has increased in the past decade from some 6 million to some 15 million and the number of holders of savings accounts and other interest-bearing investments has likewise increased enormously. It is clear that the integrity of the Federal revenue system must be preserved; the issue is merely one of method of doing so. Doubtless only experience will provide the ultimate solution. In the measured march of history there would seem to be time to permit modern electronics, with adequate data and a taxpayer numbering system, a reasonable opportunity to show its merit before the blunderbuss of withholding is brought to bear.

---

[75] 108 Congressional Record 7931 (daily ed. May 16, 1962).
[76] 108 Congressional Record 8109 (daily ed. May 21, 1962); Senate Finance Committee Hearings, Pt. 10, 4402.
[77] *Ibid.*
[78] *Ibid.*
[79] 108 Congressional Record 7930, 7931 (daily ed. May 16, 1962).
[80] *Ibid.*

Appendix II

Supplemental Memorandum on Behalf of the Investment Company Institute[1] (April 14, 1976)

Regarding Changes in the Federal Income Tax Laws To Make Possible the Creation of Regulated Investment Companies To Invest in Tax-Exempt State and Local Bonds and Thus Broaden the Market for Such Bonds

This supplemental memorandum is submitted by the Investment Company Institute in favor of the proposal described below with respect to the taxation of interest on municipal (and state) bonds held by regulated investment companies.

If the Internal Revenue Code were amended to allow the municipal bond interest exemption to be passed through to shareholders of regulated investment companies, a *new and broader market* would be available for new issues of municipal bonds as they come out and for the many thousands of existing issues of municipal bonds. This would also benefit the investor of moderate means by making it feasible for him to invest conveniently in a diversified portfolio of such bonds. Two pending similar bills, H.R. 11955, introduced by Mr. Steiger and Mr. Frenzel, and H.R. 12217, introduced by Mr. Helstoski, provide for such amendment. The bills have been referred to the House Ways and Means Committee, which has not yet acted on them.

Such an amendment should be adopted whether or not the Internal Revenue Code is amended to permit state and local governments at their option to issue taxable bonds, since large amounts of existing tax-exempt bonds would remain outstanding and many issuers might well elect to offer new bonds on a tax-exempt basis.

Individual investors, primarily the wealthy ones, are already an important part of the market for the tax-free securities of state and local municipalities. At the end of 1974, households—including personal trusts and nonprofit organizations—owned 31.6 percent of all outstanding state and local securities, according to Federal Reserve Flow-of-Funds estimates:

Percent of outstanding State and local securities held, Dec. 31, 1975

Type of holder:	
Households	31.6
Commercial banks	46.1
Insurance companies	17.3
All other sectors	5.0
Total	100.0

It is probable that individual investors will have to continue to increase their participation in the state and local market in order to help offset the declining rate of commercial bank participation. According to Federal Reserve estimates, the commercial banks' share of the new-issue market has declined steadily during the Seventies:

	1970	1971	1972	1973	1974	1975
Total net increase in outstanding State and local debt (billions of dollars)	11.2	17.6	14.4	13.7	17.4	15.4
Commercial banks share of net increase (percent)	95.5	71.6	50.0	41.6	31.6	8.4

In the years ahead, it seems doubtful that commercial banks will add to their holdings of outstanding state and local securities at the exceptionally high rates of years gone by. Insurance companies and other financial sectors are not likely to increase their holdings significantly and offset the declining demand of commercial banks for state and local securities.

[1] The Investment Company is the national association of the mutual fund industry. Its membership consists of 383 mutual funds, and their investment advisers and principal underwriters. Its mutual fund members have over 8 million shareholders and assets of approximately $48 billion, representing about 93% of the assets of all U.S. mutual funds.

There is, however, one large market for municipal bonds that has not yet been tapped because of a roadblock that exists in the federal income tax law. This market is the regulated investment companies—companies which offer to the investor of relatively modest means the advantages of continuous professional management and diversification of investment risk. The largest segment by far of the regulated investment company industry is the group of companies known as "mutual funds." As stated earlier, the Institute's mutual fund members today have approximately 8 million shareholders and assets of about $48 billion.

Regulated investment companies provide a medium for large numbers of persons to pool their investment resources in a diversified list of securities under professional management. The regulated investment company represents, in general, an intermediate layer between the investor and the entities whose securities it acquires with the investor's funds. It does not compete with those entities but merely provides an alternative means for investing in them with diversification of risk and professional investment management.

In recognition of these functions, for many years the federal income tax laws applicable to mutual funds and other regulated investment companies have been designed to subject an individual investing via a regulated investment company to substantially the same income tax burden he would have borne had he invested directly in his proportion of the underlying securities held by the company. In general, the investment company is treated by the tax law as a conduit through which its income passes currently to its shareholders. If the investment company complies with the rules of Subchapter M of the U.S. Internal Revenue Code, there is no federal corporate tax on its income at the company level—the income tax is paid by the shareholders based on the investment company income distributed to them, substantially as though they had invested directly in the securities in the investment company's portfolio.

Under the present federal tax laws, however, a dividend paid by a corporation is generally taxable to the shareholder who receives it, regardless of the type of corporate income out of which the dividend is paid. There are specific provisions in the present tax law to preserve the character of long-term capital gains when distributed to shareholders by a regulated investment company, but there is no such provision with respect to tax-exempt bond interest. Hence, at present, if a regulated investment company receives tax-exempt bond interest and distributes it to shareholders, the amounts received by the shareholders are fully taxable as dividends. This is the roadblock to the creation of regulated investment companies specializing in municipal bonds.

In 1942 when the present income tax provisions covering regulated investment companies were enacted, the absence of a special rule allowing the exempt character of interest to be passed through to the shareholder was not a deliberate policy decision. It was simply not a matter of concern—probably because of the then low interest rates which made municipal bonds unattractive to individual investors unless they were in relatively high tax brackets. Today the situation is quite different. In recent years, as states, municipalities and other political subdivisions have increased the quantity of their borrowings, the interest rate on their obligations has increased to a marked extent so as to make such bonds attractive to the investor of modest means.[3]

For a number of reasons, persons of modest means find difficulties in investing in municipal bonds, but these difficulties would be removed if they could do so through a mutual fund:

(*a*) Municipal bonds are generally issued in denominations of $1,000, often with minimum purchase requirements of $5,000, a minimum price too high for many small investors. By contrast, shares of mutual funds are generally more modestly priced, and are suitable, therefore, to periodic savings programs for individuals.

(*b*) The "market" for municipal bonds is an extremely intricate one requiring professional expertise not possessed by most individual investors. There are many thousands of state and local government entities issuing municipal bonds

[3] Between 1963 and March 1976, for example, the average yield on seasoned Aaa state and local bonds increased from 3.06% to 5.99%. This compares to a rise in federal long-term bonds for the same period of 4.00% to 6.87% and for Aaa corporates of 4.26% to 8.52%. To a married person with taxable income of $16,000 a yield of 5.99% on state and local bonds is equivalent to a yield of 8.82% on taxable obligations; to an unmarried person it is equivalent to a yield of 9.07%.

and many have outstanding different securities issued at different times and at different interest rates. The average individual investor would usually be "lost" in trying to appraise quality, safety and market price.

A mutual fund, however, will provide the investor with diversification of investment risk and expert investment management. Moreover, with these advantages, it should be possible to include in an investment portfolio bonds of smaller and lesser known municipalities bearing higher interest rates, thus increasing the yield as compared with that which the average investor might be able to obtain by selecting individual bonds.

(*c*) Market quotations are not as readily available in the case of municipal bonds as in the case of other securities, and the large number of municipal bond issues outstanding makes the ascertainment of such information a burdensome task. On the other hand, the market value of mutual fund shares is readily ascertainable by the investor, since the net asset values of the funds are determined daily and the prices of the shares are reported in many daily newspapers throughout the country.

(*d*) An individual seeking to liquidate a small investment in municipal bonds will very likely suffer a sacrifice in price if he is disposing of less than $10,000 or $20,000 principal amount. Shares of mutual funds, however, are redeemable by the fund at the election of the shareholders at a price based on the net asset value, and the investor may liquidate his interest promptly and without difficulty.

Moreover, the potential breadth of a mutual fund market is illustrated by the several billions of dollars of municipal bond trust units which have been offered in recent years by Merrill Lynch and other large broker-dealers and which permit the investor to receive tax-free income on his municipal bond trust units. But these fixed bond trusts have a number of disadvantages.

For example: their original portfolio holdings may not be changed if the investor is to receive the income tax-free; the trust units are generally priced at a level of $1,000 and there are frequently minimum purchase requirements, such as $5,000; and the market value of the trust units are not reported in daily newspapers and are not readily ascertainable. These trusts do not continuously offer new units and are therefore not suitable for periodic savings plans. Nevertheless, the relative success of these fixed bond trusts indicates the much larger market that would be created by municipal bond mutual funds which could pass through tax-free income to shareholders without the disadvantages of the fixed trust.

Therefore, it is proposed that the existing federal income tax law be promptly changed so that the public can purchase shares in mutual funds and other regulated investment companies which would be created to invest primarily in tax-free state and municipal securities. Small investors could thereby participate in a pool of tax-free securities, with interest income flowing through tax-free to the investor. Such a change would invite the service and promotional capabilities of the mutual fund industry, and might well increase by many billion dollars the market for municipal bonds. Moreover, it would be wholly consistent with the theory underlying mutual fund taxation—i.e., to place a mutual fund shareholder in the same position as if he owned directly the securities held by the mutual fund.

Attached is a copy of H.R. 11955 which would accomplish this result.

Appendix III

Resolution on Permitting Mutual Fund Investment in Municipal Securities

Whereas, the MFOA supports efforts to broaden the municipal bond market by promoting greater investment interest in and competition for municipal securities as a means to lowering borrowing costs and stabilizing the flow of credit to state and local borrowers, and

Whereas, mutual funds and other regulated investment companies under the Internal Revenue Code are not permitted to pass through tax-exempt interest income to their shareholders and this treatment is inconsistent with prevailing theory of mutual fund taxation which is to place such shareholders in the same position as if they owned the securities directly, and

Whereas, the present inability to pass through tax-exempt income unfairly denies investors that prefer to use this investment medium certain advantages

of convenient investment techniques, diversification, and professional management when it comes to investment in tax-exempt securities, and

Whereas, the consequent inability of state and local governmental borrowers to enjoy the advantages of investment by mutual funds in tax-exempt securities unfairly and unnecessarily restricts the demand for such securities; therefore, be it

Resolved That the MFOA supports such amendments to the Internal Revenue Code as may be required to permit the pass through of the municipal bond interest exemption to shareholders of regulated investment companies.

(Adopted May 5, 1976.)

The CHAIRMAN. Next; we will call Mr. William Hallahan, economic consultant to the National Savings and Loan League and Mr. Edwin Brooks, president of the Security Federal Savings and Loan Association of Richmond, Va.

STATEMENT OF WILLIAM J. HALLAHAN, ON BEHALF OF THE NATIONAL SAVINGS AND LOAN LEAGUE

Mr. HALLAHAN. Mr. Chairman, and members of the committee, my name is William J. Hallahan. I am a consultant for the National Savings and Loan League, a nationwide trade organization for savings and loan associations, which I am representing today.

Mr. Chairman, because of the relative short notice which we received for these hearings, our statement will be very brief. We believe, however, that a reiteration of our views on this subject, coupled with what we regard as constructive alternative suggestions, will assist the committee in its deliberations on this subject.

We appreciate the opportunity to express our views on the subject of withholding at the source, Federal income taxes on dividend and interest payments. Our comments will, however, be limited to the effect of the proposal on savings and loan associations and our depositors. Our principal concern is with withholding on payment of interest.

The record of the debates on past proposals in Congress and in this committee on this subject have amply demonstrated, in our opinion, the burden which withholding by savings institutions will place on our institutions, as well as on their depositors.

The procedure employed by savings institutions on passbook accounts is to issue a passbook to the saver upon his initial deposit and then it is up to him to bring his passbook to the institution at periodic intervals for the crediting of the dividends due.

A great many savings accounts are held by nontaxpayers in the names of minors, established by their parents to provide savings for various purposes, widows, aged, and retired persons and small savers and nominees and trustees of these nontaxpayers. The procedures for refunds for overwithholding would be especially troublesome, and in most of these cases no tax would be due. We believe that many depositors would fail to file for refunds and others, to whom even the small amount of money involved means a great deal in their living expenses, would be denied this money for several months.

Past experience also indicates that attempts to deal with these problems in legislative proposals result in unduly complicated procedures for advance filing of exemption certificates or recurring "quick refunds" for those who either expect to pay no tax, or for those who

anticipate overwithholding. As the Assistant Secretary testified this morning, the statutory language was 50 pages and the technical explanation an additional 30 pages of such a proposal in the draft of the revenue bill of 1961 prepared for the House Ways and Means Committee. Adding such a complex set of procedures to the existing IRS instructions for form 1040 is, in our view, simply not warranted. In addition, such a proposal would certainly cause large numbers of persons to file for refunds who would not otherwise be required to file a return under current rules.

We were pleased to hear Deputy Assistant Treasury Secretary Goldstein's testimony this morning where on page 6 of his statement he thoroughly documented our concerns in this regard. He said that with respect to a 1973 audit of individual tax returns there were some 5 million such returns of individuals with interest and dividend income which were nontaxable. He said, obviously, there were also many other individuals who received dividends and/or interest but who were not even required and had no need to file returns.

There is little wonder that these 5 million or 10 million or maybe 15 or 20 million individual receivers of savings interest who probably would be covered by withholding would bear an inequitable burden. One that should not be placed upon these nontaxpayers.

Mr. Goldstein also identified the major underreporting of interest as the nonreporting of interest on bearer obligations and he mentioned principally those bearer issues of the U.S. Treasury, and E bonds, which in the 1977 budget with respect to E bonds the President estimated that $700 million of taxable interest that otherwise would be paid on E bonds would not be received in fiscal 1977. Other issues of bearer obligations are those of banks and especially the commercial paper markets, either in the form of CDs, commercial paper, bankers acceptance or other trade obligations, and the third major segment of bearer instruments referred to were loan transactions between individuals.

Now, I would like to point out that thrift institutions do not issue any bearer obligations. All of our interest payments are recorded and the payee identified, as far as possible except in the cases of nominees, trusts and other situations where the actual beneficiaries for many reasons, is difficult to establish. But these accounts usually have no tax liabilities anyway.

We estimate that there is little, if any, unreporting of dividends received or interest received from thrift institutions. In fact, the case can be made that withholding would create a serious equitable and economic loss to the saver since, as I mentioned before, many would not file for exemptions or refund.

Mr. Alexander this morning commented on how nice it would be to adapt a 1099, as the wage withholding form is presently used, to apply to interest withholding. We merely say that if there is any thought of underreporting of dividends by savers in our institutions, all IRS has to do is require that a copy of the 1099 be attached to the tax return of the individual.

Mr. Chairman, our institutions for the last few years have been attempting to secure new legislation, which I am sure the chairman of this committee and its members are well aware which your body

passed last December. It was known as the Financial Institutions Act. In the other body it is known as the Financial Reform Act. And one of the major objectives of this legislation was to increase the return to the small saver considering the inflationary times that this country has been going through and the fact that the small saver was, if I might use the expression, getting the short end of the stick.

We think that this stick would be made shorter for those savers if in addition to his inability to compete in our inflationary environment, he also was subjected to the unwarranted withholding of what interest he does get on his savings accounts.

We are just about the only industrialized nation in the world that does not allow a tax incentive to encourage savings. It is true that we do have a small one with respect to a dividend credit on dividends received from stock organizations but there is none on savings accounts, and our league has recommended in testimony before this committee on H.R. 10612 that a tax credit for savers equal to 14 percent of their interest income up to a maximum of $250 be enacted.

This proposal is designed to encourage savers to place an increased proportion of their income into savings deposits, thus helping to relieve capital shortage problems generally and to provide adequate flows of residential mortgage funds in particular.

Any new requirements which would diminish the flow of funds for housing construction, with resulting diminution in employment and sales of goods and services related to housing, would not be a policy consistent with national priorities in the housing field.

Our savers are divided into two general categories. The first is composed of individuals who are regular savers accumulating funds for retirement or other special purposes. Their accounts are generally among the largest and tend to be relatively stable. Typically, these depositors leave their accumulated interest in their accounts. Income taxes on this interest income are paid from other income streams, principally from funds withheld from wages.

Industrial figures show that retained interest is a substantial contributor to net increases in annual savings deposits, particularly in times of monetary restraint. Recent figures estimate that in 1974, retained interest made up 87.4 percent of net savings deposit increases, up from 59.4 percent in 1973.[1]

It is obvious that a reduction of these amounts by a withholding formula of 20 percent, for example, would substantially reduce savings flows and severely reduce housing construction.

At this point I would like to refer to Assistant Secretary Gerard's concern this morning about the impact of a minimal tax on municipal capital markets. The same concern would apply to withholding of interest on thrift savings accounts.

As I said, the increases in savings accounts are substantially dependent upon interest earned on those accounts where the average saver does not require the interest for use in meeting current living expenses and prefers to increase his capital base by adding interest earned to his savings balance and meeting his tax obligations out of other income. This, of course, is automatic reinvesting, also.

---

[1] Sources: Federal Home Loan Bank Board; United States League of Savings Associations.

To take these funds out of the housing market would have a substantial impact upon housing construction, and I estimate that in the current year, and certainly for 1977, this withholding would probably take out about $3.6 billion of savings that could be used in the provision of new housing for our citizens. In other words, about 80,000 new housing units could well be lost and approximately 300,000 or 400,000 jobs in the construction and allied industries would evaporate.

I think the argument can well be made that this would result in a net loss of revenue to the Treasury, because the revenue loss on income of these construction and allied workers would probably more than offset any amount of increased revenue that would be collected from the withholding of interest on savings accounts.

I think that summarizes our views on the subject and especially highlights our concern over its impact on the housing market. We are well aware of the chairman's concern about the availability of funds for housing and I think no greater expression of his concern can be found in his companionship of the $2,000 tax credit to eliminate the housing inventory that existed last year.

Thank you.

The CHAIRMAN. Thank you very much for your statement. I have no questions at this point.

Thank you.

[The prepared statement of Mr. Hallahan follows:]

STATEMENT OF WILLIAM J. HALLAHAN ON BEHALF OF THE NATIONAL SAVINGS AND LOAN LEAGUE

Mr. Chairman, and members of the Committee, my name is William J. Hallahan. I am a consultant for the National Savings and Loan League, a nationwide trade organization for savings and loan associations, which I am representing today.

Mr. Chairman, because of the relative short notice which we received for these hearings, our statement will be very brief. We believe, however, that a reiteration of our views on this subject, coupled with what we regard as constructive alternative sugestions, will assist the Committee in its deliberations on this subject.

We appreciate the opportunity to express our views on the subject of withholding at the source, Federal income taxes on dividend and interest payments. Our comments will, however, be limited to the effect of the proposal on savings and loan associations and our depositors.

The record of the debates on past proposals in Congress on this subject have amply demonstrated, in our opinion, the burden which withholding by savings institutions will place on the institutions as well as on the depositors.

The procedure employed by savings institutions on passbook accounts is to issue a passbook to the saver upon his initial deposit and then it is up to him to bring his passbook to the institution at periodic intervals for the crediting of the dividends due.

A great many savings accounts are held by non-taxpayers in the names of minors, established by their parents to provide savings for various purposes, widows, aged and retired persons and small savers. The procedures for refunds for overwithholding would be especially troublesome, and in most of these cases no tax would be due. We believe that many depositors would fail to file for refunds and others, to whom even the small amount of money involved means a great deal in their living expenses, would be denied this money for several months.

Past experience also indicates that attempts to deal with these problems in legislative proposals result in unduly complicated procedures for advance filing of exemption certificates or recurring "quick refunds" for those who either expect to pay no tax, or for those who anticipate overwithholding. The detailed explanation of such a proposal in the general explanation of the discussion draft of the revenue bill of 1961 prepared for the House Ways and Means

Committee is six and a half pages in length. Adding such a complex set of procedures to the existing IRS instructions for Form 1040 is, in our view, simply not warranted. In addition, such a proposal would certainly cause large numbers of persons to file for refunds who would not otherwise be required to file a return under current rules.

The National League, in fact, has recommended in testimony before this Committee on H.R. 10612 that a tax credit for savers equal to 14 percent of their interest income up to a maximum of $250 be enacted. A draft of an amendment to H.R. 10612 was also submitted to the Committee. This proposal is designed to encourage savers to place an increased proportion of their income into savings deposits, thus helping to relieve capital shortage problems generally and to provide adequate flows of mortgage funds in particular.

Any new requirements which would diminish the flow of funds for housing construction, with resulting diminution in employment and sales of goods and services related to housing, would not be a policy consistent with national priorities in the housing field.

Our savers are divided into two general categories. The first is composed of individuals who are regular savers accumulating funds for retirement or other special purposes. Their accounts are generally among the largest and tend to be relatively stable. Typically, these depositors leave their accumulated interest in their accounts. Income taxes on this interest income are paid from other income streams, principally from funds withheld from wages.

Industry figures show that retained interest is a substantial contributor to net increases in annual savings deposits, particularly in times of monetary restraint. Recent figures estimate that in 1974, retained interest made up 87.4 percent of net savings deposit increases, up from 59.4 percent in 1973.[1] It is obvious that a reduction of these amounts by a withholding formula of 20 percent, for example, would substantially reduce savings flows and severely reduce housing construction.

Moreover, savers in this category are not likely candidates for civil or criminal tax fraud liability as a result of failure to disclose interest income.

The second category consists primarily of minors, or older retired persons, most of whom are not required to file Federal income tax returns.

On the basis of the foregoing we assert that no useful purpose would be served, and in fact substantial harm would be done, by requiring withholding by savings and loan associations of Federal income taxes on savings deposits.

As an alternative to such proposals, we would strongly suggest that this Committee examine the possibility of having the Internal Revenue Service conduct sample cross-checking of Form 1099's with tax returns by means of social security numbers. This process should be particularly effective in cases where interest paid to depositors is submitted to IRS on magnetic tape.

We would also propose that such hearings also consider the rising costs to thrift institutions of compliance with the notification requirements of section 6049 of the Internal Revenue Code. We believe that a strong case can be made for raising the minimum reporting requirement to $50. In today's economy, the added costs of personnel and postage incurred by savings and loan associations in reporting smaller interest amounts are not justified, in our opinion, by the benefits to the Federal government or by any existing data pertaining to failure to report interest income.

STATEMENT OF EDWIN BROOKS, JR., PRESIDENT OF SECURITY FEDERAL SAVINGS & LOAN ASSOCIATION

Mr. BROOKS. Mr. Chairman, my name is Edwin Brooks, Jr., I am president of Security Federal Savings & Loan Association in Richmond, Va. I am appearing here today as vice chairman of the legislative committee for the U.S. League of Savings Associations.

We are submitting a statement for the record but in the interest of time, I want to just give you a few oral comments to summarize what is in our statement.

[1] Sources: Federal Home Loan Bank Board; United States League of Savings Associations.

We are appearing in opposition to the proposal for the withholding of Federal income tax on interest income. The savings and loan business has about $380 billion in savings accounts and some 68 million savers. Since the early 1960's the savings and loan business has been supplying the 1099 forms as a service to the public and a service to the Federal Government. This probably costs us more than $10 million annually in postage alone. This paperwork burden could be reduced significantly by the way, if the current threshold for reporting—$10—was increased to $50, if the committee would agree.

Our opposition, to boil it down, is based primarily on three viewpoints. First, from the viewpoint of the saver; the second from the viewpoint of our economy; and the third from the mechanical viewpoint, as I call it, or the implementation by the savings and loan business.

Very briefly, a few comments. As far as the viewpoint from the saver is concerned, Mr. Chairman, we feel definitely that our typical customer, the small saver, would be penalized compared to the large saver, and more particularly the large market-type investor.

The U.S. League of Savings Associations conducted a study last year, the consumer finance survey, and that showed that our average saver in a savings and loan association had a family income of only $13,200. Furthermore, it showed that 25 percent of our savers are over 65. In other words, they are retirees, and these customers have an average income of only $7,600, and two-thirds of them make $10,000 or less. So if we are going to withhold, say, 20 percent or 16⅔ percent, which has been suggested, there is going to be considerable overwithholding as far as these people are concerned. On the other hand, the wealthy saver or investor is going to be grossly underwithheld, and certainly that is not in keeping with our progressive income tax system.

Second, withholding results in a considerable loss of compound interest for all our customers. I find in my business that the average saver today is vitally interested in what type of compounding we are using. For example, on a 5¼-percent passbook account, compounding continuously makes a difference of one-quarter of 1 percent in a year's time. If you apply compounding to our 6-year certificates, it is the difference between 7.75 and 8.17 percent. Our savers, the retirees, the modest income people would be losing that compound.

There would be a lower standard of living on the part of these savers. With withholding of 20 percent of the effective rate on a passbook deposit at 5¼ percent, compounded to 5.344, drops to 4.25 percent. That is one whole percentage point. And finally, why should the small saver give an interest-free loan to the Federal Government?

From the viewpoint of the economy, we feel that there will be a shift of funds from the private sector to the Government and this is particularly questionable when we are in a recovery from a very damaging recession. I came before you when we talked about the $2,000 tax credit for housing last year, Mr. Chairman, and we were trying to get the economy started. The economy is now recovering—thanks to that and other actions—and here we want to take a certain amount of money out of people's savings accounts and transfer it to the Government.

Another problem we foresee would be a shift of funds to other investment areas. In other words, disintermediation would rear its ugly head again, particularly where savings funds would shift into Government obligations and maybe into corporate securities—where withholding is presumably impractical.

The effect on housing would be considerable. We estimate that the amount that would be withheld by the savings and loan associations and deposited with the Government would be $2½ billion. That would mean that there would be 73,500 less homes built a year in the country. And, we all know housing has borne the brunt of the recent recession.

Now from the mechanistic viewpoint or implementation: There would be difficulties of assuring funds being on hand when we had to pay them. People are coming in and changing their accounts every day. They are withdrawing from their accounts, closing them, transferring funds and whatever. Would we have to have some kind of duplicate impound account for each savings account or would we have to have two sets of ledger cards to assure that tax withholdings were available on tax payout days?

I mentioned compounding of funds. That would aggravate the mechanical problem because part of that account would be compounded, say, quarterly or continuously, and part of it would not be compounded at all. Maybe, as mentioned this morning, interest may not be paid on it.

In addition, there are advertising problems. When we advertise now we have a stated rate. Then we have an effective yield. With withholding we would have in addition to those, a rate of return that the customer actually gets after taxes. There would be special mechanical problems with certificate accounts. Suppose you had a 6-year certificate. In my association, say at the 5th year due to an emergency you had to cash it in or part of it, what kind of calculations do we make to make the adjustment equitable to that customer?

There are problems, of course, of tax-exempt depositors—churches, charities, and so forth. There would be an obvious increase in the cost of servicing savings accounts. We are trying to keep mortgage rates down as low as we can now, but this proposal certainly would not do anything to help that. On the contrary, there would be a tendency to increase operating costs, and thereby mortgage interest costs.

We feel there would be widespread customer dissatisfaction. Can you imagine 60-some million customers in this country calling the savings and loan about their tax withholding calculations, or in the case of my association, some 10,000 to 12,000 customers calling us as to the tax calculations that we made on their accounts.

Mr. Chairman, in closing, I would like to say that we feel that the proposal runs counter to the interest expressed by you and many of your colleagues in promoting adequate savings and capital formation for our Nation's economic stability in the future.

Withholding of taxes on savings accounts interest is a disincentive to savings and thrift and it reinforces a bias in our tax laws toward consumption. Savings help hold down inflation. Long-term

economic growth and economic stability depends upon our ability to keep inflation under control.

Therefore, Mr. Chairman, we would ask the Finance Committee to oppose any plan for withholding of Federal income tax on interest income.

Thank you for the opportunity, sir, to present our views on this important matter.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Brooks follows:]

STATEMENT OF EDWIN BROOKS, JR. ON BEHALF OF THE U.S. LEAGUE OF SAVINGS ASSOCIATIONS

SUMMARY

The United States League of Savings Associations, on behalf of its 4,600-member savings and loan associations, *opposes* the proposal for a statutory change to require withholding of Federal income tax on interest income for the following reasons:

1. The U.S. League strongly believes that our savers accurately report and pay taxes on the interest earned on savings deposits.
2. The present system of providing Form 1099 to depositors with a copy to the Internal Revenue Service enables accountholders to accurately report interest earned and facilitates tax compliance.
3. To be workable, we assume a common withholding rate would apply to all accounts. Setting a fixed, arbitrary withholding rate for all savings customers has numerous drawbacks, among them:

(a) Savings and loan customers are predominantly from modest income families and a significant percentage are retired; these depositors are likely to experience "over-withholding"—a particularly serious matter for retired persons who depend on savings' interest for everyday living expenses.

(b) Higher bracket customers would benefit from "underwithholding," distorting the progressive nature of the tax code.

4 Depository institutions could anticipate significant customer relations' problems in responding to inquiries about rate as well as tax calculations; non-taxed accountholders (e.g. minors, tax-exempt organizations) might receive interest amounts different from those provided other customers.

5. The reduction in account balances would have an immediate negative impact on funds available to support home lending and construction just as the housing sector is beginning to recover from a prolonged recession.

6. Withholding would generally discriminate against savings accounts in favor of Government, agency, municipal and other market instruments—leading to renewed disintermediation.

7. Certain mechanical problems are anticipated, including the maintenance of duplicate "impound" accounts to assure the availability of tax monies.

8. The proposal discourages savings and capital formation, with inflationary consequences for the general economy.

STATEMENT

Mr. Chairman, my name is Edwin Brooks, Jr. I am president of Security Federal Savings and Loan Association of Richmond, Virginia, and Vice Chairman of the Legislative Committee of the United States League of Savings Associations.[1]

I appear today in opposition to the proposal for a statutory change to require withholding of Federal income tax on interest income.

---

[1] The United States League of Savings Associations (formerly the United States Savings and Loan League) has a membership of 4,600 savings and loan associations, representing over 98 percent of the assets of the savings and loan business. League membership includes all types of associations—Federal and state-chartered, insured and uninsured, stock and mutual. The principal officers are: Robert Hazen, President, Portland, Oregon; John Hardin, Vice-President, Rock Hill, South Carolina; Tom B. Scott, Jr., Legislative Chairman, Jackson, Mississippi; Norman Strunk, Executive Vice President, Chicago, Illinois: Arthur Edgeworth, Director—Washington Operations; and Glen Troop, Legislative Director. League headquarters are at 111 East Wacker Drive, Chicago, Illinois, 60601; and the Washington Office is located at 1709 New York Avenue, N.W., Telephone: 785-9150.

As of year-end 1975, the savings and loan business had 68 million savings accounts, amounting to $280 billion on deposit nationwide. Since the early 1960's we have provided accountholders (with $10 or more in interest credited) with Form 1099. This information permits our customers to accurately report income received from their savings accounts for Federal income tax purposes. Copies of the 1099 Form (and summary Form 1096) are forwarded to the Internal Revenue Service. This system, while imposing a significant paperwork burden and expense on our operations, has no doubt provided a service to the public and aided the Government in its tax collection efforts. We see no compelling reason to consider replacing this procedure with a tax withholding system for interest income. The U.S. League strongly believes that the savings accountholders of our members accurately report and pay taxes on the interest income earned of their deposits. If, however, failure to report is a concern, rather than go to a withholding system, why not simply require taxpayers to clip their 1099 Forms to their tax return? Even with a withholding arrangement, our members would still have to notify the saver of the details of his account—much as employers now provide a W-2 form showing annual wages earned and taxes withheld.

While we do not have comprehensive figures available on the costs to our associations of providing these services, we would estimate that postage alone must amount to $10 million annually. Indeed, we might suggest that the present reporting procedure be modified to include only accounts with significant amounts of interest credit—for instance, $50 or more—rather than the $10 threshold now used for reporting. Such a change would still assure reporting for the overwhelming proportion of interest needed by taxpayers for income calculations and needed by the Government as revenue. It would, however, significantly relieve the costly paperwork burden imposed today on depository institutions.

It is somewhat difficult to address this proposal without knowing details. But, we would assume that any withholding system, to be workable, would have to adopt an approach of withholding an arbitrary, fixed percentage—say, 20 percent—of interest earned on accounts. Otherwise, depository institutions would be put in the very difficult position of requiring customers to reveal and certify their anticipated marginal tax bracket on an annual basis—which would be objectionable for privacy and other compelling reasons.

Application of a fixed withholding percentage such as 20 percent would create a situation of "over-withholding" for a majority of our depositors. The U.S. League's "Consumer Financial Services Survey" of nearly 100,000 savers at savings and loan associations, completed in May, 1975, disclosed that the average family income of our customer is only $13,200—which, in most cases, places these savers-taxpayers below the 20-percent bracket.

The over-withholding possibility is even more marked with retired persons who comprise 25 percent or more of our depositors, according to the survey. Our customers age 65 or older have an average household income of only $7,600, and two-thirds of this group have incomes less than $10,000. The marginal tax rate for these persons is much less than 20 percent, if there is any tax liability at all. These individuals or couples often depend upon their savings account interest for everyday expenses. An automatic 20-percent cut would severely affect these customers.

Thus, elderly savers would bear the burden of lower living standards, loss of income which would otherwise be received because of compounded interest in the amounts withheld, and, because of their limited tax liability, would be placed in the position of providing the Government with an interest-free use of funds needed for household expenses throughout the year.

Another implication of any fixed withholding percentage is the benefit it provides higher bracket taxpayers; even if the "under-withheld" taxpayer must report the difference between the fixed withholding rate and his higher rate at the time taxes are paid, his under-withheld deposit has accumulated interest. The end result is to distort the progressive nature of our tax laws.

The compounding procedures in widespread use by savings and loan associations today magnify the impact of a fixed withholding pattern. For example, on a $1,000 deposit at 5.25-percent interest, assuming quarterly compounding, the saver would receive total interest of $53.44 for the year. If, on the other hand, 20 percent were withheld each quarter and forwarded to the Internal Revenue Service, the total interest paid to the saver would be $42.59. The corresponding drop in the effective annual interest rate to the saver under the withholding arrangement is from $5.344 percent to 4.259 percent.

We would anticipate serious customer relations' problems from this proposal. Obviously there would be confusion between the advertised rate and the funds in the account after withholding. Additional inquiries could be expected on the calculation of amounts withheld—adding to the operating expenses of institutions. Then, too, accounts of minors or tax-exempt entities might be segregated from other depositors because of the unlikelihood of tax liability—but these accountholders would receive higher amounts than their tax-paying counterparts. Special problems would be created with certificate of deposit accounts, particularly when early withdrawal occurred and a portion of interest was forfeited.

The proposal would have some serious economic consequences, as well. In the immediate future, it would syphon funds from the private sector to the Government in the midst of our economic recovery. Withholding of interest on savings deposits would also result in shifts of funds from depository institutions to other investment areas—particularly Government, agency, municipal, and some market instruments where presumably withholding would not be applied. Thus, the proposal would risk inciting another round of disintermediation—the process where funds are withdrawn from financial intermediaries and directly invested in market instruments. (As an aside, it is interesting to note that under present reporting procedures, Form 1099 is provided to the IRS for savings account customers, while no such information return is required for the generally wealthier investors in U.S. Treasury, agency, municipal, and other debt securities.)

The withholding plan would have an immediate and adverse effect on the funds available for mortgage lending and home construction. If a 20-percent withholding rate is assumed, there would have been an estimated $2.5 billion less in the funds available at savings and loan associations for home lending during 1975. (This estimate disregards losses from shifts to other investments as suggested by the paragraph above.) Concerted to the number of loans, the withholding proposal would have resulted in a loss of financing for 73,500 single family homes last year (given the average mortgage size of $34.000 per home). The immediate impact of this is thus seen to be particularly severe on housing – the economic sector which bore the greatest burden of our recent recession and is only now approaching normal activity once again.

There are some obvious mechanical difficulties with the proposal for depository institutions. For example, if it was decided to simplify procedures by making the withholding calculation on a particular date—say, the interest accumulated at the end of each calendar quarter—the savings and loan association or other financial institution would have to develop a system to assure that adequate funds were on hand in the event of withdrawal just before those dates. A separate "impound" fund might be necessary for each account. This would be complicated still further by the widespread use of continuous compounding and day-of-deposit to day-of-withdrawal interest-crediting procedures.

These mechanical problems further discriminate against savings deposits as investments. Withholding is more easily applied to corporate bond coupons or corporate stock dividends since these income items are generally paid at fixed intervals without compounding.

Finally, the proposal runs counter to the interest expressed by you, Mr. Chairman, and many of your colleagues in promoting adequate savings and capital formation to provide for our nation's economic stability in the future. Withholding of savings account interest is a disincentive to savings and thrift. It merely reinforces the bias in our tax laws toward consumption and the use of consumers credit—which has become a way of life for a significant portion of our population. Most economists would agree that one major benefit of a pattern of savings for future needs is the salutory effect it has in holding down inflation. Long-term economic growth and stability depends upon our ability to keep inflation under control.

Therefore, Mr. Chairman, we would ask the Finance Committee to oppose any plan for withholding of Federal income tax on interest income.

Thank you for the opportunity to present our views on this important matter.

The CHAIRMAN. Now, the Senate is voting again and so I am going to recess for 10 minutes so I can go and vote. We will hear Mr. Lawrence Brown as soon as we can go and vote and come back.

[A recess was taken.]

Senator BYRD. I understand there is one more witness and in the absence of Senator Long, who has gone over for a vote, we will proceed.

The next witness is Mr. Lawrence R. Brown, Jr., the second vice president and general counsel of the Provident Mutual Life Insurance Co. of Philadelphia.

Will you proceed, Mr. Brown?

STATEMENT OF LAWRENCE R. BROWN, JR., REPRESENTING THE AMERICAN LIFE INSURANCE ASSOCIATION

Mr. BROWN. Thank you, Mr. Chairman.

My name is Lawrence R. Brown, Jr., and today I am representing the American Life Insurance Association which has a membership of 380 life insurance companies which have in force approximately 90 percent of the life insurance written in the United States.

I appreciate this opportunity to express the views of the ALIA on the issue of withholding Federal income tax on interest and dividend income. I would like to present our prepared statement, and then I will be happy to attempt to answer any questions the committee may have. If the committee subsequently considers a particular bill, I hope we may have the opportunity to comment on the specifics of that bill.

The question of withholding on dividends and interest was considered by Congress in connection with the Revenue Act of 1962. Although it was not adopted, it led to the enactment of a considerably expanded information reporting system for dividends and interest. It is difficult to comment on the need for, or the possible design of, a withholding system for these items of income without knowing the results of the new information reporting procedures in terms of closing the reporting gap with respect to this income. Thus, we can address ourselves only to broad concepts.

Basically, the factors which led us, in 1961 and 1962, to oppose withholding with respect to interest payments to our policyholders have not changed. Under the prior proposal, life insurance companies would have been required to withhold on (1) interest on the proceeds of an insurance policy which are held under an agreement to pay interest thereon, and (2) interest with respect to policyholder dividends held by an insurance company. Withholding on these items would result in serious administrative difficulties, as well as burdensome expenses.

In addition to these general problems, each of the interest items described above presents special considerations which argue against a withholding requirement. First, as respects interest payable on the proceeds of an insurance policy held under an agreement to pay interest, it is likely that the recipient will be a widow or an orphan child and, thus, will not be taxable (if at all) at the rate set for the withholding.

Thus, without allowance for adjustment, a considerable amount of overwithholding would occur which would be particularly burdensome on this group of individuals.

The introduction of an exemption certificate system to meet the overwithholding problem would, at best, produce only a rough corre-

lation with actual tax liability and, in addition, would add substantial expense to the withholding process. In this regard, it is relevant to note that, in implementing the voluntary withholding system for pensions and annuities (section 3402(o)), which became effective in 1971, the Treasury Department decided that the most practical system for meeting overwithholding problems was to have the taxpayer notify the payer as to the dollar amount he desires withheld.

This, of course, would not be practical for a broad scale, mandatory withholding system. We seriously question, therefore, whether the improvement in revenue collection through a withholding system would be sufficient to justify the expense together with the hardship and inconvenience that would be imposed where overwithholding did occur.

In the case of interest on policyholder dividend accumulations, withholding would present a unique problem in that it would impair valuable policyholder rights. When the interest is credited, it becomes a part of the policy and may be utilized in a number of ways for the policyholder's benefit, as, for example, to automatically keep the policy in force on nonpayment of premiums or to increase the duration of extended term insurance available in the event of premium nonpayment.

Alternatively, the accumulated dividends and interest may be used to provide additional benefits during the life of the policy, or at its maturity, at favorable rates guaranteed by the company. Withholding would operate as an automatic and involuntary withdrawal by the taxpayer, with the result that the withheld funds would not be available to support the rights previously mentioned. It would seem that policyholders should be permitted to pay their taxes from other funds in order to preserve these valuable rights.

Thus, for all these reasons, we would oppose the introduction of a withholding system which would encompass interest payments of the type described above.

Thank you for giving me this opportunity to present the views of the American Life Insurance Association on this very important subject. I will be happy to answer any questions you may have.

Senator BYRD. I take it that you feel that this proposal would be quite complicated from the point of view of working it out within the insurance industry?

Mr. BROWN. Yes, sir.

Senator BYRD. And also it would have an adverse effect on the policyholder?

Mr. BROWN. Yes; indeed, because it would lessen the rights guaranteed under the contract.

Senator BYRD. It would lessen the rights of the policyholders?

Mr. BROWN. Yes, sir.

Senator BYRD. Thank you very much, Mr. Brown.

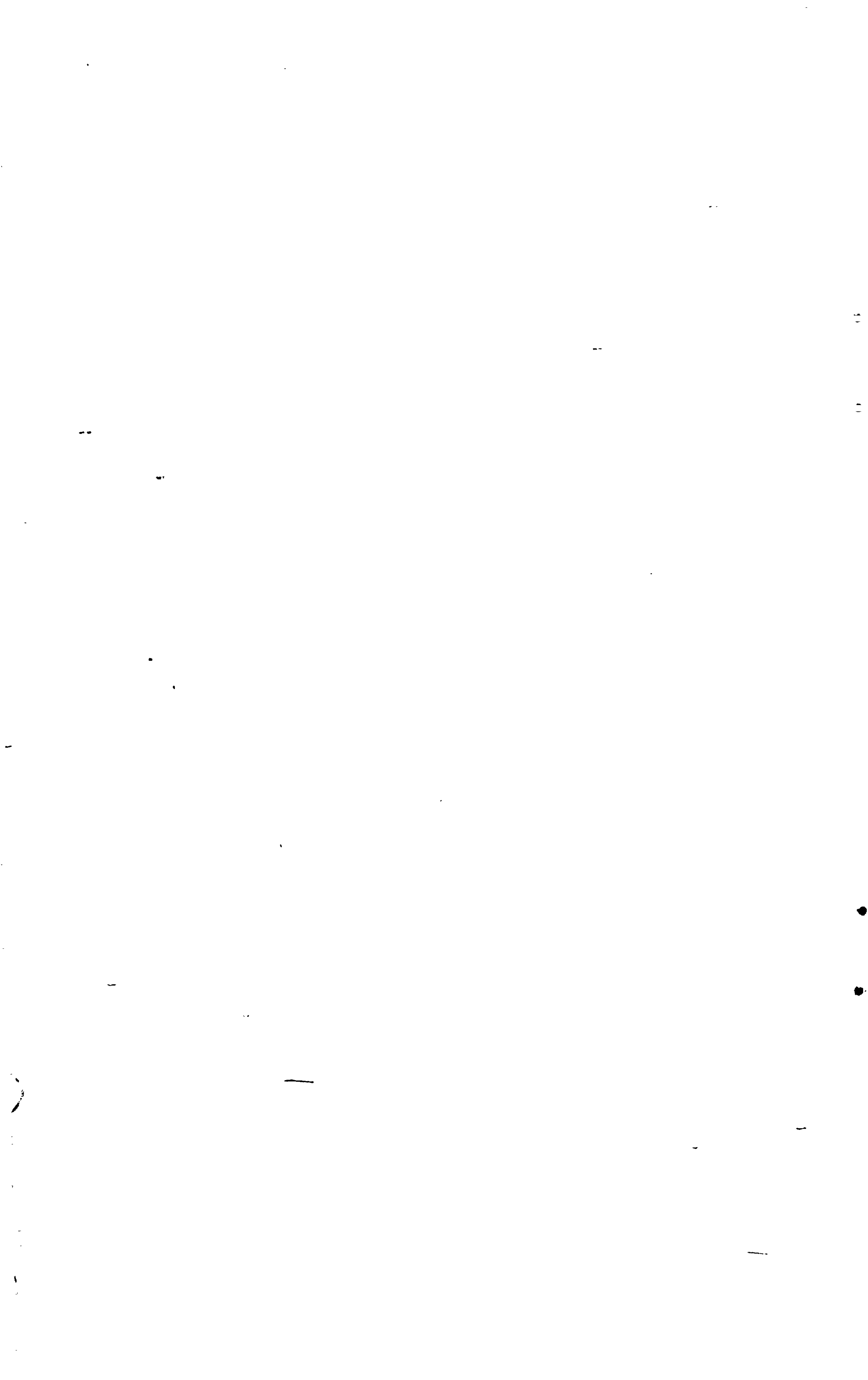
Mr. BROWN. Thank you.

Senator BYRD. The committee will stand in recess subject to call. There will be an executive session on Thursday.

[Whereupon, an adjournment was taken at 5:15 p.m.]

APPENDIX

Communications Received by the Committee Expressing an Interest in These Hearings



STOCKHOLDERS OF AMERICA, INC.,
Washington, D.C., June 9, 1976.

Re withholding of Federal income tax on dividends.

For the Committee on Finance:

As spokesman for Stockholders of America, Inc., I want the record to show that this organization is strongly opposed to the withholding of Federal Income Tax on dividends. The withholding tax on dividends is not analogous to withholding on salaries and wages. The administration of withholding tax on dividends would be very complicated, if in fact, workable.

It would cause confusion and hardships to all individual stockholders, many of whom are small investors of modest means, many retired with limited incomes and not subject to the tax.

It would cause havoc in the market at this period when the number of stockholders has declined.

It would discourage the flow of capital to the equity market at the very time capital formation is of major concern in the nation's effort to broaden the economic base with a corresponding increase in the labor force.

Our concern also carries over to the future investors who must be recognized as the backbone of the future free enterprise system. Thus, assuring a continuation of the system which has built our great country and made us a nation of owners.

Respectfully submitted.

MARGARET COX SULLIVAN, *President.*

LAW OFFICES OF WEBSTER, KILCULLEN & CHAMBERLAIN,
Washington, D.C., June 9, 1976.

Re proposal to withhold tax on interest and dividends.

Hon. RUSSELL LONG,
Chairman, Committee on Finance, U.S. Senate,
New Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: This letter represents a statement on behalf of the National Fraternal Congress of America, of Chicago, Illinois, an association of more than 100 fraternal benefit societies described in Sec. 501(c)(8) of the IRC.

I. INTRODUCTION

One of the purposes of a fraternal benefit society is to provide the payment of life, sick, accident and other benefits for its members. A fraternal benefit society is exempt from federal income tax as an organization described in Sec. 501(c)(8) of the IRC. The income of a fraternal benefit society consists of premiums paid by members in connection with the life, sick, accident or other benefits together with investment income, such as interest, dividends, rents, royalties and capital gains. The investment income of a fraternal benefit society is directly related to the performance of its insurance function since such income is used to defray the costs of the payments of benefits.

II. TAX EXEMPTION OF SOCIETIES

When the tax on unrelated business income was extended to fraternal benefit societies by the Tax Reform Act of 1969, the Congress recognized that dividends, interest, rents, royalties and capital gains was a form of related business income for fraternal societies:

"On the other hand, receipt of investment income for use in an insurance function of such [fraternal] organizations presents a different set of considerations. Investment income is an integral part of the insurance function of such organizations as it is part of the traditional and normal manner in which insurance com-

panies provide for the covering of losses. The correct treatment of this income, then, is related to the overall questions of the treatment of insurance functions of all exempt organizations presently permitted to engage in such activities.

* * * * * * *

"The bill continues to exclude from unrelated business earnings from businesses related to an organization's exempt function—such as the earnings received directly from its members by a fraternal beneficiary society in providing fraternal activities or insurance benefits for its members or their dependents. For example, if a fraternal beneficiary society directly provides insurance for its members and their dependents, or arranges with an insurance company to make group insurance available to them, the amounts received by the society from its members for providing, or from the insurance company for arranging, for this exempt function will continue to be excluded from the unrelated business income tax.

"In extending the unrelated business income tax to virtually all exempt organizations * * * the bill continues to exclude from 'unrelated business income' earnings from the business related to an organization's exempt function—such as the insurance business run by a fraternal beneficial association for its members. S. Rep. 91–552, 91st Cong., 1st Sess., Nov. 21, 1969 at 68."

The foregone quotation indicates that the Congress approved or re-approved the exempt status of fraternal benefit societies even though they utilized investment income as an integral part of their fraternal benefit function. Given the fact of Congressional approval for these investment earnings, we find no basis for suggesting that a tax be imposed, by withholding, on such earnings since such a tax in no way would be relevant to the exempt status of the fraternal benefit society and would not, in fact, correlate in any way for the income tax exemption currently enjoyed by such a society.

We therefore suggest, should the withholding tax be enacted, that an exemption from withholding be provided for fraternal benefit societies much in the manner of existing law relating to withholding on dividends paid foreign corporations. IRC Sec. 1443. In such a case, exemption is accorded to foreign tax exempt organizations so the actual procedure for the exemption, if a domestic withholding provision is enacted, could be essentially the same.

III. ECONOMIC IMPACT

Because of the shortness of time, it is impossible for counsel to assay the adverse economic impact of such tax on fraternal benefit societies. In 1974, fraternal benefit societies earned approximately 6.1 billion dollars in investment income. Assuming a 10-percent withholding rate (such as that suggested in the Revenue Act of 1950) would mean that 610 million dollars would be withheld from fraternal benefit societies during the course of a quarterly, semi-annual or annual withholding schedule. Assuming that fraternal benefit societies were liable for such withholding tax, and were entitled to solicit refunds on a quarterly basis and refunds were paid to the societies within 90 days, lost earnings on the approximately 150 million dollars refunded quarterly would approximate 9 million dollars per quarter or 36 million dollars each year.

We assume, if withholding was imposed, no interest would be paid between the date of withholding by the payor and the date of the refund by the United States. This means that fraternal benefit societies, a rather small class of exempt organizations, would lose income, from withholding, in excess of 35 million dollars a year. That is a rather extraordinary tax for an exempt organization to pay when it would not be liable for any income tax on those earnings in the first place. The impact of such loss of earnings on currently established life, sick, and accident policies cannot, of course, be readily calculated. Obviously, the entire premium structure of all societies would have to be altered for all new policies to try to recoup the sums lost to withholding. The economic dislocation caused by withholding and refunding would be extraordinary.

IV. FURTHER STUDY URGED

It is regrettable that we are unable to provide the Committee with any further details because of the shortness of time, but we believe much more thorough study and examination of this subject is appropriate.

Sincerely,

WILLIAM J. LEHRFELD.

MACHINERY AND ALLIED PRODUCTS INSTITUTE,
Washington, D.C., June 8, 1976.

Re withholding of Federal income tax at the source with respect to payments of interest and dividend income.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR LONG: In a press release of May 28, 1976, the Committee on Finance announced public hearings on, among other issues, withholding of federal income tax on interest and dividend income payments. The Machinery and Allied Products Institute is the national spokesman for manufacturers of capital goods and related equipment, and has a direct and immediate interest in this subject. Accordingly, we are pleased to submit our views on this subject for the public record. In doing so, we will address the interest and concern of business as well as the impact on stockholders.

The issue in brief is whether or not there should be federal income tax withholding at the source on payments of interest and dividend income. As noted in the Committee's press release of May 28, 1976, interest income and dividend income are subject to federal income taxation—in the case of dividends, to the extent that they exceed $100 for an individual or $100 each for a married couple filing a joint return. However, generally speaking, federal income tax is not withheld at the time interest or dividend payments are made. On the other hand, withholding generally is required for such payments made to foreign persons or entities, and withholding is required with respect to wages and salaries. Also, payors of interest and dividends above certain amounts to domestic recipients are currently required by law to report those amounts to the Internal Revenue Service.

To summarize our position with respect to withholding on interest and dividends, based on systems we have seen proposed in the past or can conceive of now, we are opposed for the following reasons:

1. Withholding would shift the burden of more tax collection to the private sector and accelerate the payment of taxes on interest and dividends notwithstanding current high taxes on middle-income individuals and the sensitivity of the current economic recovery to consumer activity;

2. A system of withholding on interest and dividends would necessarily be complex if it is to be equitable for many income recipients; and

3. There is, in our opinion, a better way than withholding to curb such noncompliance as may exist in the reporting of interest and dividends.

In stating our opposition to withholding on interest and dividends, we should add that we recognize the difficult position in which the Committee finds itself in attempting to meet the letter and spirit of the spring budget resolution. As usually is the case, the demand for resources exceeds the supply. Also, there is vigorous debate about the impacts of proposed tax revisions and reductions, which debate recently has focused on the Committee's action concerning the $35 personal exemption credit. As more fully set forth herein, we do not, however, think that withholding is the solution.

Our comments are set forth in more detail following a background note.

BACKGROUND

By way of background, we understand that the question of withholding on "all" interest and dividend payments arose late in the course of the recently concluded mark-up sessions of the Senate Finance Committee dealing with tax revisions and reductions. To the best of our knowledge, the subject was not considered earlier by the House Ways and Means Committee in its deliberations on tax revision. Concern had been aroused by Internal Revenue Service speculation that some amounts of taxable interest and dividends are not being reported by recipients of such income. Also, certain supporters of withholding would like to offer legislation for that purpose as an amendment to the bill on tax revisions and reductions. Consequently, public hearings were called on very short notice. It is our further understanding that there is no Administration-supported or other bill before the Committee on this subject of withholding.

In the past, withholding on interest and dividends was considered by Congress in 1942, 1950, 1951, 1960, and 1962. It is noteworthy that on each occasion the Senate found the proposal before it, including alternatives, to be fatally defective. Furthermore, when the issue was considered in 1962, it was concluded

that there was a better way than withholding to deal with such noncompliance as may exist in this area of federal taxation. A closer look at the 1962 experience is instructive.

The 1962 proposal

As a part of the Revenue Act of 1962, the Kennedy Administration proposed and the House of Representatives subsequently amended and passed a system of withholding at the source on payments of interest, dividends, and patronage dividends (of cooperatives), all as elaborately defined to include some amounts and exclude others. The withholding by payors was to be at 20 percent of the payment otherwise due, with some exceptions. Further, the withheld amount would have been payable to a government depositary by the last day of the first month after the end of each quarter of the payor's taxable year.

In filing his own return, the recipient of the interest or dividend would have been able to claim a credit for the tax payment made by the payor on his behalf. This would have been done after grossing up the amount received and then computing tax in the normal way. If an individual had expected no tax liability at all and would have made that representation under penalty of perjury, he could have submitted to each payor of interest or dividends a withholding exemption certificate. In that case, the payor would not have withheld tax. If an individual had anticipated some tax liability not amounting to 20 percent of the interest and dividends, he would have been able to file quarterly claims for refunds of overwithheld amounts provided his income was less than $5,000 (or $10,000 in the case of a married couple).

Also, under certain circumstances, governments, tax-exempt organizations and corporations could have used exemption certificates, intra-annual refunds, and credit-and-offset procedures.

The 1962 review of withholding initiated by the Kennedy Administration was, at that time, the fifth such review to have occurred in a score of years. Then-Treasury Department Secretary Dillon asserted his belief that the Administration had developed a plan which would overcome the objections raised previously. In the view of the Administration, the system would not have imposed any substantial burden on payors of interest and dividends. Also, the Administration thought its proposal was simple and fair to affect income recipients.

The Senate Finance Committee found otherwise (Senate Report No. 1881, 87th Congress, 2nd Session) after studying the House-passed version of withholding at length and considering numerous alternative withholding provisions. As documented in the public record, the Committee found that proposals for withholding on interest and dividends are "neither simple in operation nor free of substantial hardship for broad groups of taxpayers." Moreover, according to the Committee as then constituted, withholding would have been a "heavy administrative burden" for the businesses performing it. The answer, eventually enacted, was an improved reporting system rather than withholding.

COMMENTS ON WITHHOLDING FOR INTEREST AND DIVIDENDS

We obviously have no quarrel with the proposition that taxpayers who owe federal income taxes on their interest and dividends should pay the same in full and in a timely manner in accordance with the Internal Revenue Code. That there is underreporting has been a perennial complaint of IRS leading to withholding proposals, and, if that still is the case, as alleged, the possible remedies should be explored. However, whereas withholding would go a long way toward eliminating the problem of underreporting, it is a "cure" with very undesirable side-effects.

Soaking the nonrich

One serious problem with withholding is that it would result in collecting the tax due on interest and dividends sooner than now occurs. In other words, the cash flow of recipients of this type of income would be altered. Whether this would constitute a tax increase—and it would be such in the amount of the time value of the related tax liability—can certainly be argued. The fact is that the government would be siphoning off income at an earlier date than at present, so taxpayers would not have that income to use for the customary amount of time.

In our opinion, this type of a tax change is objectionable, particularly at a time when the economy has not fully recovered and the focus of tax policy attention is on tax reductions rather than increases. We would add that the economic recovery to date has been led by the consumer, and any acceleration

of the consumer's tax payments could be expected to dampen his enthusiasm, such as it is.

Getting down to individual cases, the Committee will recognize that some persons depend partly or solely on interest and dividend payments, and need every cent for necessities of life. A significant proportion of these persons are in middle-income brackets and are not "rich" by any stretch of the imagination. For example, according to the "1976 Fact Book" of The New York Stock Exchange, approximately 84 percent of individual U.S. adult shareowners (i.e., actual or potential dividend recipients) have annual incomes of less than $15,000; more than 70 percent have annual incomes of less than $25,000. For some such persons the equilibrium of cash income and outflow is an uneasy one likely to be disturbed by a chance of this sort.

In that connection, we think it would be unfortunate to cause persons to dip into savings in order to meet an accelerated tax liability. Notwithstanding the public concern about private savings and investment and how that might be encouraged, a depletion of savings (i.e., invasion of capital) is what often could occur. Considered in these terms, withholding seems even less timely now than when it has been reviewed in the past.

Complicating the code

In past efforts to strike a balance between simplicity and fairness in the design of a workable withholding provision, the result has been unacceptable complexity. For example, one way to give the concept a semblance of simplicity has been to propose that there be withholding at a flat rate, specifically at the lowest-bracket rate. However, it occurred to those with a sense of tax equity that some recipients of this type of income have no federal income tax liability whatever or owe less on the income than has been withheld. (Significantly, the Kennedy Administration in 1962 proposed across-the-board withholding and the House of Representatives would not accept that approach.) Consequently, it was necessary—in elementary fairness—to plan for withholding exemptions, quickie refunds, and other relief mechanisms which, unfortunately, complicate compliance and collection. To further muddy the waters, also in the case of the 1962 proposal, there was a gross-up, tax credit mechanism to be used by taxpayers, partly to eliminate the need for certain information reporting and receipt procedures.

Although it might be possible to implement withholding in 1976 with less disruption for business than in 1962 because information reporting already is in place, the system would be very complex—perhaps hopelessly so for the income recipient. As the Committee knows, interest and dividends are paid or credited to income recipients in different ways and varying amounts depending on the contractual arrangement. The 1962 proposal had elaborate definitions and rules to cover certain payments but to exempt others where withholding was found to be infeasible. Although collection agents might be expected to master the rules and regulations governing this activity, that would be too much to expect of all income recipients. Many individual taxpayers would be overwithheld for failure to file withholding exemption certificates with all payors.

Other problems

Although the untimely speed-up of tax collections and the complications inherent in withholding weigh heavily against its use for interest and dividends, these are not the only problems. For example, withholding would detract from the desirability of automatic dividend reinvestment plans, which, among other advantages contribute to corporate capital formation; detract from the usefulness of bearer bonds, assuming across-the-board withholding for them; involve a sizable new educational program for taxpayers, payors, and government agents; require new procedures of payors for withholding and paying amounts to the government and reporting on the same to IRS and taxpayers; cause new investor relations problems for payors; and present, as indicated by the Ford Administration, "a myriad of technical dilemmas" to those responsible for drafting the legislation.

The better idea

If the Treasury Department's admittedly rough figures on nonreporting (possibly as much as $1 billion of dividends and $7 billion of interest) are correct (amounts which, on their face, seem unbelievable) and there is an annual revenue loss of $1.5 billion as a result, then something surely must be done. The "better idea," in our judgment, is for IRS to get on with the task of matching

Forms 1099 and tax returns. If this presents problems, they certainly can be overcome by modern technology and imaginative administration. We are not in sympathy with Commissioner Alexander's position on this point.

In other words, IRS ought to *use* the information it is receiving rather than impose a withholding system which will add to the burden of payors, overtax many interest and dividend recipients, and reduce the cash flow of persons who have faithfully paid the tax they owe. We realize that "matching" is not a simple or inexpensive task, but it is less objectionable than the alternative which has been tentatively advanced and is the subject of this statement.

We appreciate having the opportunity to present our views to the Senate Finance Committee on this important subject.

Respectfully,

CHARLES W. STEWART, *President*.

STATEMENT OF THE PRUDENTIAL INSURANCE CO. OF AMERICA

The Investment Company Institute has proposed changes in the federal income tax laws to permit regulated investment companies which invest in municipal bonds to pass through the municipal bond interest exemption to their shareholders. The principal reasons advanced in support of the proposal are that it would make available a new and broader market for new issues of municipal bonds and would make it feasible for an individual to invest conveniently in a diversified portfolio of professionally managed bonds..

The Prudential Insurance Company of America believes that these proposed changes are desirable, but that they should be expanded to permit the same type of treatment to be afforded in the case of life insurance companies which use separate accounts invested in municipal bonds to fund fixed and variable annuity contracts.

The reasons for extending such treatment to annuity arrangements are essentially the same as the reasons for extending such treatment to mutual funds. Like mutual funds, life insurance companies also may be financial intermediaries that provide professional management to individuals who participate in commingled arrangements. To some extent, mutual funds and life insurance companies compete in the same markets.

Prudential would expect to market a tax exempt based annuity contract in both non-qualified and qualified markets. In the qualified market, the tax-exempt annuity would be used in connection with defined contribution plans and as an optional mode of annuity benefit payment in the case of defined benefit plans.

A draft of proposed amendments designed to extend the tax exempt pass through treatment to life insurance company fixed and variable annuity separate account arrangements is attached. The general requirements of these provisions are the same as those proposed with respect to mutual funds with the adjustments required to meld such taxation with traditional section 72 annuity principles.

PROPOSED AMENDMENTS RELATING TO EXEMPT-INTEREST PAYMENTS UNDER ANNUITY CONTRACTS

SEC. —. EXEMPT-INTEREST PAYMENTS BY LIFE INSURANCE COMPANIES

(a) *Exempt-Interest Asset Accounts.*—Section 801(g) of the Internal Revenue Code of 1954 (relating to contracts with reserves based on segregated asset accounts) is amended by changing paragraph (8) to paragraph (9) and adding the following new paragraph:

"(8) *Exempt-Interest Asset Accounts.*—An exempt-interest asset account is a segregated asset account of the company (described in paragraph (1)(B)(i)), to which amounts are allocated in accordance with the provisions of a contract relating to tax-exempt assets if at the close of each quarter of the taxable year of the company at least 50 percent of the value (as defined in section 851(c)(4)) of the total assets of the account consists of obligations described in section 103(a)(1). Paragraph (2), (3), (4), (5), (6), (7), and (9) of this subsection shall be applicable to exempt-interest asset accounts.

(b) *Exempt-Interest Amounts under Annuity Contracts.*—Section 72 of the Internal Revenue Code of 1954 relating to amounts received under annuity contracts) is amended by changing subsection (o) to subsection (p) and inserting the following new subsection:

"(o) *Exempt-Interest Amounts*

(A) *Definition.*—An exempt-interest amount is the amount of exempt-interest of an exempt interest asset account (described in section 801(g)(8) allocable to the account maintained therein for an account-holder and designated by the company in a written notice mailed to the account-holder not later than 45 days after the close of its taxable year. The aggregate amount so designated with respect to an exempt-interest asset account shall not exceed—

(i) the cumulative amount of interest (less amounts previously designated) allocable to such account and excludable from gross income under section 103(a)(1), over

(ii) the cumulative amount allocable to such account and disallowed as deductions under section 265 and 171(a)(2).

(B) *Treatment of Exempt-Interest Amount by Account-Holders.*—An exempt-interest amount shall be treated by the account-holder as follows:

(1) Any amount so designated with respect to periods prior to the annuity starting date shall be treated as an additional consideration paid for the contract by the account-holder for purpose of section 72;

(2) any amount so designated with respect to periods after the annuity starting date shall be excluded from gross income (as otherwise determined under this section); and

(3) for all other purposes of this subtitle as an item of interest excludable from gross income under section 103(a)(1).

SEC.- . TECHNICAL AMENDMENT

Section 103(e) of such Code (relating to exclusions from gross income of interest on certain governmental obligations) is amended by inserting the following new paragraph:

( ) *Exempt-Interest Amounts*

"For treatment of exempt-interest amounts, see section 72(o)."

SEC.—. DISALLOWANCE OF DEDUCTIONS

Section 265 of such Code (relating to nonallowance of deductions for expenses and interest relating to tax exempt income) is amended by adding at the end thereof the following new paragraphs:

"( ) *Exempt-Interest Asset Accounts*

"In the case of an exempt-interest asset account which during the taxable year allocates to the account maintained therein for an account holder an exempt-interest amount, that portion of any amount otherwise allowable as a deduction which the amount of the income of an exempt-interest asset account wholly exempt from taxes under this subtitle bears to the total of such exempt income and its gross investment income."

"( ) *Interest Related to Exempt-Interest Amounts*

Interest on indebtedness incurred or continued to purchase or carry an exempt interest asset account (or contract) described in section 801(g)(8) which during the taxable year of the holder thereof designates exempt interest amounts, but in an amount not in excess of the amount of the exempt interest amounts designated by such holder during such year."

SEC.— EFFECTIVE DATE

The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1975.

NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS,
New York, N.Y., June 7, 1976.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance, U.S. Senate, Dirksen Office Building, Washington, D.C.

DEAR CHAIRMAN LONG: The National Association of Mutual Savings Banks appreciates the opportunity to present the savings bank industry's views on proposals to withhold federal income tax on interest income, and requests that

this letter be included in the record of the Committee hearings held Monday, June 7, 1976.

Savings banks recognize their obligation to assist the federal government in the collection of all taxes due on interest and dividends received by taxpayers and our Association has supported realistic and reasonable steps to collect such taxes. Accordingly, we believe that proper administration of the rules and regulations requiring savings banks and other financial institutions to report on Form 1099 the gross amount of interest paid or credited to a depositor during the year where such interest exceeds $10 is the appropriate answer to the problem of underreporting.

Our industry believes that the full use of information returns made possible by taxpayer numbering and automatic data processing, is an effective answer to the problem of under-reporting. Further, it would be less costly than withholding if the deterrent effect of the former and the cost of the latter to the public were properly taken into account. Moreover, withholding could produce an absolute reduction in the flow of savings in savings banks and other mortgage-oriented thrift institutions resulting in an adverse effect upon the supply of funds available to finance housing. And in addition, imposition of withholding on savings bank interest could produce substantial shifts of funds to such investments as tax-exempt securities and government savings bonds which are not presently subject to withholding. In addition to funds actually lost or diverted to other investments, the interest credited on such amounts (an additional source of mortgage funds) would not be available. It must be assumed that many, if not most, savings bank depositors pay their taxes from current income, particularly the low income taxpayer. Compelling him to pay these taxes from savings will result in these funds being irretrievably lost to thrift institutions.

We would respectfully suggest that information return reporting supported by the increased use of automatic data processing equipment and a numbering system for all taxpayers is the most efficient and equitable method of insuring compliance. The technological improvements in data processing, the ability to correlate readily information returns with the taxpayer identified, and the attendant publicity, provide the most equitable method of solving the problem of underreporting

That the majority of taxpayers report honestly and pay their taxes has been substantiated annually by compliance figures released by the Internal Revenue Service. With respect to the minority who through either ignorance, neglect, or willfulness do not report accurately and truthfully, rigid enforcement efforts should be and have been consistently applied.

INFORMATION RETURNS HAVE BEEN AN EFFECTIVE METHOD OF IDENTIFYING INCOME RECIPIENTS

Withholding is not only burdensome to those who pay and those who receive interest, but in our judgment would be a less effective solution to the problem of under-reporting than the efficient use of information returns has been. Withholding at a specified rate would not prevent under-reporting by taxpayers whose effective rate is above the designated percentage. For those taxpayers with effective tax rates below the designed percentage it would result in excessive withholding and create additional paperwork, and in many instances an undue economic hardship. For those taxpayers in the higher brackets, the present estimated tax requirements together with the penalties for underestimating taxes should have the same effect as would withholding on these funds.

Information returns (Forms 1099–INT) on the other hand, enable accurate determination by the Internal Revenue Service of the income received. If the interest recipient knows the information return has been filed with the Internal Revenue Service, and that his taxpayer identification number is included on that information return, he would be compelled to report the interest income correctly on his tax return or be readily identified as having under-reported his interest income. The National Association supported in the past the lowering of the $600 limit on information returns, beneath which interest payments did not have to be reported, to the present $10 limit, and it is our position that lowering the limit has resulted in the effective use of information returns.

Internal Revenue Service compliance reports have shown that taxpayers in overwhelming majority report true incomes and pay proper taxes. In these circumstances it appears grossly unfair to impose the costs and inconveniences

of withholding on an overwhelming majority. As to the evading minority, it should be made clear to taxpayers that the Treasury will undertake to use the information returns energetically, and systematically to search out unreported income that is subject to tax. Sample audits and selected deficiency assessments should be used to make sure that interest is fully included in tax returns. If these steps were taken, an improvement in reporting of interest income could be expected which would be far out of proportion to the costs of the enforcement efforts.

The record-keeping required of the millions of Americans who have savings accounts will be considerably increased under a withholding system, particularly for those taxpayers who would be compelled to file claims for refund. Under a withholding system, many savings bank depositors, having relatively small accounts, would be compelled to come in person to the banks, not merely to ascertain the amounts of interest credited to them, but additionally the amounts of interest withheld, and to obtain assistance in claiming refunds.

Furthermore, many savings banks mail monthly interest payments to retired depositors who, in most instances it must be assumed, are in lower income tax brackets, and are often dependent upon these monthly payments as a significant source of their support. To withhold income tax on these interest payments in cases where little or no tax will ultimately be owed, with the resulting inconvenience, would obviously be an inequitable method of solving whatever problems of under-reporting presently exist.

The disadvantage of withholding as a means of improving collection of tax on investment income is clearly indicated by the experience of the Dominion of Canada. During World War II, withholding was applied by the Canadian Government to certain types of investment income bank was abandoned after a short trial as administratively impractical. In explaining the decision to drop withholding, Finance Minister J. L. Ilsley stated before the House of Commons on October 12, 1945:

"It is proposed to drop the requirement by which those disbursing dividends, registered interest and royalties are required to deduct at the source seven per cent on behalf of the taxpayer. This requirement is of little value in obtaining current payment of taxes which the taxpayer himself is required to pay in installments. The requirement that the disbursers of these payments must report the amount of the payments to the inspector of income tax will, of course, be retained and it is this which is the important provision as far as ensuring the reporting of income is concerned. The elimination of the seven percent deduction at the source will save a very considerable amount of clerical work and some confusion to small taxpayers."

WITHHOLDING WILL RESULT IN THE DIVERSION OF FUNDS FROM MORTGAGE-ORIENTED SAVINGS BANKS AND OTHER THRIFT INSTITUTIONS

We believe that withholding on interest income will discourage new savings, the importance of which to the residential mortgage and housing markets cannot be overstated. In addition, it will encourage the flow of existing savings from banks to investment sources the income from which is not subject to current withholding.

The recipient of wages and salaries, confronted with withholding, has for practical purposes no escape; but the holder of investable funds has a variety of alternatives, and the savers in the lower income group may even stop saving. Rather than cope with amended returns and complicated refund procedures, many depositors may consider withholding so onerous as to justify their withdrawal and spending of those funds which they formerly would have saved.

We believe that by bringing about a reduction in new financial savings, in the form both of interest credited and loss of additional deposits, and by causing some withdrawals of existing savings, a withholding system on bank interest payments will reduce the effectiveness of mutual savings banks in performing their basic mortgage lending function.

An additional loss of funds available to the savings banks for investment in mortgages, moreover, could result because of uncertainty regarding potential withdrawals. Savings banks would then have to place funds which would otherwise be invested in mortgages in more liquid assets. Reduced mortgage lending by mutual savings banks and other lenders would have an adverse effect on homebuilding. This in turn could result in reduced incomes and tax payments in the construction industry.

In conclusion, we believe that an interest withholding system will not solve whatever problems exist in the area of under-reporting, but rather will create

administrative problems for the disbursing banks and additional inconvenience to the depositor, particularly the lower income and retired taxpayers on whom the burden of withholding would most heavily fall. We would reiterate our contention that the utilization of taxpayer account numbers and automatic data processing equipment is the best, most feasible method of insuring that all taxpayers properly report interest income without unduly burdening lower income taxpayers.

We hope these comments will be helpful to the Senate Finance Committee.

Sincerely,

KENNETH L. BIRCHBY,
Chairman, Committee on Taxation.

TAXABLE MUNICIPAL BOND OPTION AND WITHHOLDING TAX ON INTEREST AND DIVIDENDS

(By Thomas J. Reese)

Mr. Chairman and members of the committee, my name is Thomas J. Reese, and I am legislative director of Taxation with Representation, a public interest taxpayers' lobby with almost 18,000 members throughout the United States.

Taxation with Representation strongly supports the adoption of a taxable bond option for state and local governments. We also strongly support the withholding of Federal income tax on interest and dividend income.

TAX EXEMPT INTEREST ON STATE AND LOCAL BONDS

How would you like to have $5,000,000 in income every year and not even have to bother filing a tax return? That was the situation of the late Mrs. Horace Dodge, who put all of her substantial inheritance into tax exempt state and local bonds, and who thereafter thumbed her nose at the tax collector for the rest of her life. Meanwhile, ordinary taxpayers paid more to make up for the taxes she escaped.

Or how would you like to be an owner of the Chase Manhattan Bank, one of the largest commercial banks in the country? It had net earnings in 1974 of $235,488,000, but it paid no federal income tax. The key factor in producing this result was the tax exempt interest privilege, which clipped 23.8 percentage points off the 48 percent tax rate that Chase Manhattan would otherwise have had to pay. (Other tax loopholes eliminated the rest.) And Chase Manhattan was no exception. Not one of the ten largest commercial banks in the country paid more than 9 percent of net earnings in federal corporate income tax in 1974, as compared with the 48 percent statutory rate.[1] The key factor in reducing the tax in every case was the exemption for the interest received by the banks on state and local bonds.

The tax exempt bond privilege is truly a rich man's tax loophole. Aside from the banks, virtually all tax exempt bonds are owned by extremely wealthy individuals. The richest 10 percent of U.S. families own virtually *all* of the tax exempt bonds now outstanding, and the richest *eight tenths of one percent* own *three quarters* of the outstanding bonds.[2] These facts should not be surprising, since the savings that can be realized from tax exempt bonds increase in proportion to income, as Table 1 indicates.

Table 1.—Average annual tax savings from tax-free bonds

Income group:	*Average annual savings*
$1,000,000 or more	$36,000.00
$500,000 to $1,000,000	18,000.00
$25,000 to $50,000	24.00
$10,000 to $25,000	0.80
$5,000 to $10,000	0.10
Under $5,000	0

This outrageous system of tax welfare for the rich is a result of historical accident. To get the Sixteenth Amendment ratified, assurances were given to

---

[1] See "Tax Notes," April 28, 1975, pp. 16ff.

[2] These data, and the statistics in Table 1 are derived from Stern, "The Rape of the Taxpayer," Random House (1973), pp. 62–66.

key governors that outstanding bond issues would not be taxed. And there were doubts, back in 1913, about the constitutionality of taxing the states, their employees, or their bonds. These constitutional doubts have now been laid to rest, but the tax exempt bond privilege continues, thanks to the lobbying efforts by the commercial banks and the super rich.

Howls by states and cities have also helped to keep the tax exempt bond privilege in existence. In 1969, these protests (and behind-the-scenes maneuvering in the executive branch by a former bond attorney, John Mitchell) prevented any reform in the treatment of tax exempts. Since that time, however, many state and local officials, and the National League of Cities, have come to the realization that they would be better off today if the 1969 tax reform proposals had become law. The time is therefore ripe for a new effort to end the outrageous tax abuses to which the exempt bond privilege gives rise. Accordingly, Taxation with Representation recommends a federal interest subsidy to state and local governments which is large enough to insure that they will voluntarily issue taxable rather than tax exempt bonds.

The defects in the tax exempt bond privilege

Tax exempt bonds are designed to facilitate state and local borrowing, by lowering the amount of interest that must be paid to raise funds in the bond market. There are three things seriously wrong with this system:

(1) The system is very inefficient. The federal government loses far more than states and localities gain.

(2) The system seriously undermines the equity of the federal tax system.

(3) The system is not providing adequate funds to states and localities.

Inefficiency.—In fiscal 1976, the Treasury estimated $4.2 billion, due to the tax exemption for interest paid on state and local bonds, but the interest saving for state and local governments amounts to only about $3.0 billion. The remaining $1.2 billion stayed in the pockets of banks and high income individuals who own tax exempt bonds. That $1.2 billion was lost by the federal government, but states and localities got no corresponding gain.

Inequity.—The tax exempt bond privilege is in effect a subsidy for banks and for the rich, to induce them to purchase tax exempt bonds. As is shown in Table 2, the value of this subsidy increases with income. The richer the individual, the bigger the subsidy he receives. This arrangement is contrary to basic principles of tax equity. The tax burden is supposed to be distributed according to ability to pay, but the tax exempt bond privilege permits those best able to pay to enjoy the biggest tax subsidies.

TABLE 2.—TAX-EXEMPT BOND PRIVILEGE EXPRESSED AS A FEDERAL SUBSIDY

	Tax-exempt interest	Federal subidy
Married taxpayer's taxable income:		
Over $200,000	$1	$2.33
$100,000	1	1.00
$30,000	1	.64
$10,000	1	.28
$1,000	1	.16
No taxable income	1	0

Insufficiency of aid.—The tax exempt bond privilege is no longer providing enough aid to states and localities. There are too few wealthy people to buy the bonds that state and local governments need to sell. Because of the pressure of governmental borrowing in the relatively small market for tax exempt bonds, the interest rate is often driven upward to a point where it approaches the rate for comparable taxable bonds. In 1969–1970 and more recently, the interest rate for tax exempt bonds was nearly 80 percent of the interest rate paid on comparable grades of federal corporate bonds.[3] As the rate on tax exempt bonds approaches the rate on taxable bonds, more of the Treasury's loss is diverted to the wealthy and away from the governmental entities which need the help. State and local borrowing is expected to put even more pressure on the market for tax exempt bonds in the future, so this problem is expected to become worse. What is needed is a means by which state and local governments can begin to borrow from taxable sources, without incurring added interest costs.

[3] Statement of Frank E. Morris, President, Federal Reserve Bank of Boston, in Panel Discussion before Ways and Means Committee, 93rd Congress, 2nd Session, Part 8, 1196 (February 28, 1973), and Fortune, December 1975.

The reform proposal

For all these reasons, the future needs of state and local governments for capital financing must be met with taxable bonds and not with tax exempt bonds. Under the proposal, the Treasury will pay 40 percent of the interest on bonds if the state and local governments elect to have the interest taxable to the bond holders. The subsidy would be automatic, like payments on the federal debt, and would leave state and local governments free to decide how the bond proceeds would be spent. No federal restrictions will be placed on the issuance of bonds by states and localities—and state and local governments could therefore continue to issue tax exempt bonds if they chose to do so. It is therefore important to set the level of the Treasury interest subsidy high enough so that states and localities will not have an incentive to switch back to tax exempt bonds.

Setting the level of the subsidy

The subsidy must be high enough to reduce tax exempt issues to a mere dribble paying insignificant interest. Because high income taxpayers can switch to use of other tax loopholes when the tax exempt bond privilege begins to dry up, current estimates indicate that the Treasury subsidy at any feasible level would cost Treasury more than the extra taxes that it will collect due to closing the exempt interest loophole. However, at all feasible subsidy levels, the net cost to the Treasury is far less than the added benefit to state and local governments.

According to Treasury estimates, each dollar of net Treasury cost, at a 40 percent subsidy level, would lead to more than $6 in benefit to state and local governments. Clearly, the tax reform proposal outlined here is one of the most efficient available means of aiding state and local governments, and the existing tax exemption privilege is one of the worst.

With a 40 percent subsidy, the borrowing power of state and local governments would improve greatly. At present, state and local governments sometimes pay interest equal to 80 percent of the interest cost on comparable federal and corporate bonds. With the subsidy set at a 40 percent level, the state and local governments would pay only 60 percent of the cost of comparable bonds, a saving of 20 percent. Thus, the interest costs of state and local governments would be reduced, and their tax bite on their citizens would also drop.

There is one other reason for setting the federal subsidy at a high, 40 percent level: the subsidy must be high enough to end all aspects of the abuses of the tax exempt bond privilege. At present, commercial banks that hold tax exempt bonds have a special, additional advantage, over and above the tax exempt privilege. Unlike individuals, they are permitted to deduct all the expenses of administering their tax exempt investments. This facilitates the conversion of ordinary bank income into tax exempt income.[4] Accordingly, the federal subsidy level must be set high enough to overcome the effect of this special, additional tax privilege enjoyed by banks.

Providing a taxable bond option will also help those government bodies which still want to issue tax exempts. The more principalities that use the taxable option, the fewer there will be competing for funds in the tax exempt market. As a result, interest rates on tax exempt bonds will fall.

Competition from leasing tax shelters

In addition to supporting a taxable bond option for state and local governments, I would like to comment on two other tax matters which affect the market for tax exempt municipal bonds. First, it should be noted that every time a new tax credit or accelerated depreciation is approved which can be used by a taxpayer on equipment that is leased to another taxpayer, the municipal bond market is affected. One of the reasons for the decline in purchases of tax exempt bonds by banks is the fact that banks are now getting deeper and deeper into the leasing business. This is also true of wealthy people who would normally buy municipal bonds. The limitation on accounting losses provisions (LAL) approved by the House will cut down on the tax shelter aspects of equipment leasing by individuals but not by banks and other corporations.

As Fortune magazine points out, "The tax burden of the banks has declined because of their large municipal-bond purchases and the enormous growth in

[4] Here's how this conversion works: If a bank has $100 of income that would otherwise be taxable, it can convert this into tax exempt income by borrowing from its depositors, paying them $100 in deductible interest, and investing the proceeds of this borrowing in municipal bonds. The deduction for interest then shelters the $100 in income from tax, and the income from the amount invested in municipal bonds is entirely tax exempt. The result is a net gain for the bank measured by the amount of tax exempt interest received.

their leasing activities, which enable them to take advantage of the investment tax credit and the privilege of accelerated depreciation. But many banks have now reached the point where they consider it politically dangerous to reduce their tax liability any further. Unless Congress acts to deprive them of the leasing tax shelter—which seems most unlikely—the banks will have little incentive to buy very many tax-exempts." Fortune, December 1975, page 180.

Attached to my testimony is a list of 19 banks whose effective U.S. tax rate on their worldwide income is 2 percent. Table 3 shows that, on average, these banks have reduced their effective rate by 18 percentage points through the use of tax exempt interest on municipal bonds. Their tax rate was reduced another 6.4 percentage points by use of leasing operations. If the Committee wishes to help state and local governments get lower interest rates on their tax exempt bonds, then the Committee should close the leasing tax shelter for banks and other corporations.

Table 3.—Federal tax burden of 19 commercial banks, weighted average[1]

Statutory rate	48.0
Permanent items:	
Investment credit	0.7
Tax-exempt interest income	18.2
Foreign income taxes	.2
Miscellaneous	1.1
Quasi-permanent items:	
Leasing operations, mainly accelerated depreciation	6.4
Excess loan loss provision	2.5
Worldwide rate:	
Worldwide income	19.0
Share to foreign government	17.0
U.S. rate on worldwide income	2.0

[1] For an explanation of the terms used in table 3 see footnotes for charts on the following pages, and also consult "Tax Notes" April 28, 1975 and December 8, 1975.

Repeal tax exemption for IDB's and pollution-control bonds

Taxation with Representation also strongly supports repeal of the existing tax exemption privileges for industrial development bonds and pollution-control bonds. These bonds are currently crowding out of the tax exempt market many bonds issued for normal municipal purposes.

Pollution control bonds now allow state and local governments to finance pollution control equipment for the benefit of private businesses. Under this arrangement, corporations lease pollution control equipment from a government body, and the money from the lease is used to pay off the bond. Private corporations benefit from the government's lower borrowing costs. They can also depreciate the equipment as if it were their own. Sometimes they can even deduct the interest payments as a business expense. And, at the same time, they can avoid payments of local property taxes on the equipment.

The costs of pollution should be borne by the polluter and by those who use his products, not by the American taxpayer. Providing tax subsidies for polluters lower the price of their products, thereby encouraging their use and leading to more pollution. That is why environmental groups oppose pollution control bonds.

The problem of industrial development bonds and pollution-control bonds will not be solved by exempting them from eligibility for the taxable bond option. Exemption would only leave them with a much larger tax-exempt market, lower interest rates, and an even greater incentive to flood the bond market with tax-exempt issues. They would continue to compete with municipalities which issue tax exempts and they will keep interest rates in the tax-exempt market higher than they would be otherwise. For that reason, the full benefits of the taxable bond option will only be realized by states and localities if pollution control bond privileges are repealed.

Conclusion

Taxation with Representation supports a Taxable Bond Option with a 40 percent subsidy and the repeal of tax-exempt status of pollution control bonds and industrial development bonds. But there is no need to repeal tax-exempt bond privileges outright. These privileges should be retained in case states and localities need them for legitimate municipal purposes in the future.

CORPORATE FEDERAL TAX BURDEN—COMMERCIAL BANKS

[Dollar figures represent 1974 pretax financial income. Other figures are expressed as percentages of that base[1]]

	Bank of America	Bankers Trust	Chase	Chemical	Citicorp	Manufacturers Hanover	J. P. Morgan	Security Pacific	Wells Fargo
1974 pretax financial income [1]	$365, 547	$84, 668	$235, 488	$97, 046	$517, 827	$201, 750	$278, 300	$69, 964	$60, 028
Statutory rate	48.0	48.0	48.0	48.0	48.0	48.0	48.0	48.0	48.0
Permanent items: [2]									
Investment credit	.4			.5		1.4	.1	2.0	2.7
Tax-exempt interest income	14.5	27.5	23.8	34.8	7.2	11.9	13.8	25.0	29.8
Foreign tax									
Miscellaneous [3]	3.3	4.8	1.0	.1	1.4	2.0	3.9	.9	1.1
Quasi-permanent Items: [4]									
Leasing operations, mainly accelerated depreciation	5.7		2.9	3.6	3.7	9.2	4.2	12.3	13.0
Excess loan loss provision			1.9			9.4	5.3		
Worldwide rate on worldwide income	24.1	15.7	18.4	9.2	35.7	18.1	20.7	7.8	3.6
Share to foreign government	17.5	14.8	26.2	12.7	31.1	9.1	13.4	2.8	8.6
U.S. rate on worldwide income [5]	6.6	.9	7.8	3.5	4.6	9.0	7.3	5.0	5.0

	Charter New York	Continental Illinois	Crocker National	First Bank System	First Chicago Corp.	First National Boston	First Pennsylvania	Marine Midland	Mellon National	National Detroit	Number of companies

Base figure (in thousands)[1]	$46,582	$145,750	$17,905	$71,020	$145,148	$76,133	$38,738	$41,570	$74,758	$50,967	
Statutory rate	48.0	48.0	48.0	48.0	48.0	48.0	48.0	48.0	48.0	48.0	10
Permanent items:[2]											
Investment credit		2.0	7.2	.5	2.9			1.2	.7		6
Tax-exempt interest income	30.8	[6] 17.4	88.5	[6] 28.1	18.1	21.2	35.6	42.4	30.4	33.9	10
Foreign income taxes		4.3									1
Amortization of goodwill			6.4								1
Miscellaneous[3]	.4	1.5	3.8	.1	.5	.4	3.8	1.0	2.0	1.7	10
Quasi-permanent items:[4]											
Leasing, primarily accelerated depreciation		9.4	22.8	17.4	15.3	8.5	19.3	2.7	3.8	1.5	9
Excess loan loss provision	5.3	8.1		1.9	7.3	.1				3.4	6
Unrepatriated dividends from foreign subsidiaries						1.6					1
Worldwide rate on worldwide income	12.3	16.9	60.3	0	4.9	17.0	10.7	.7	15.1	7.5	10
Share to foreign governments	9.4	12.6	13.5		7.6	16.0	10.0	9.9	8.6	3.9	9
U.S. rate on worldwide income[5]	2.9	4.3	73.8	0	2.7	1.0	20.7	9.2	6.5	3.6	10

[1] The base figure for the computations summarized in the table is net earnings before Federal income taxes. This base figure is derived by reducing the net earnings before income taxes, as shown on a firm's income statement, by the provision for State income taxes. This is done because State income taxes are merely another deduction for purposes of Federal income taxes. The base figure which results from this subtraction is a more accurate standard for comparison with the Federal statutory rate.

[2] Permanent differences are items such as credits, deductions or exclusions from taxable income which are not intended to be recaptured under the provisions of the Internal Revenue Code. The classification of permanent differences shown in the table is based on the corporation's classification of these items in its form 10K reports filed with the Securities and Exchange Commission.

[3] Categories constituting less than 2.4 percent of net earnings before Federal income taxes are not required by the Securities and Exchange Commission to be separately reported. These categories are often shown as "miscellaneous" on SEC reports.

[4] The quasi-permanent items are those portions of deferred taxes which, in the judgment of tax notes' accounting consultant, will probably not be recaptured through taxation in future years. Such items, therefore, reduce the current tax bill and will not increase future tax bills. Hence, the tax reductions to which they give rise are permanent in effect.

[5] The table does not state the U.S. rate on U.S. income, because it is not possible to derive the U.S. income figure from the data currently required to be filed with the Securities and Exchange Commission.

[6] Includes excluded dividend income; no breakdown disclosed.

The Municipal Bond Market: The Need for Reform

(By Peter Fortune [1])

The crisis in the municipal bond market in the past year has differed in fundamental ways from the periodic crises of the postwar period. For the first time, the basic question has been that of default by state and local governments. This has, at least temporarily, reversed the postwar trend of decreasing risk premiums required by investors when choosing between the obligations of prime and lower quality communities.

The difficulties encountered by state and local governments in obtaining external financing during the past year have had a significant impact on the ability of those communities to maintain growth in public services. In addition, the New York City crisis, and the increased investor perception of the risks associated with municipal bonds, may have had a significant impact on the rate at which the U.S. economy will recover from the most severe recession of the postwar period. One study, recently completed by a major private research firm, estimates that the New York City crisis will reduce the rate of growth of real gross national product by more than 1% in 1976 as a result of the cutbacks in spending by state and local governments by $5 billion.

While the current problems in the municipal bond market are quite real, they are primarily short-run in nature and are in large part associated with the severity of the 1974–75 recession. As the economy recovers, and as state and local governments adjust their budgets and their balance sheets in recognition of the obvious fact that severe recessions are not an anachronism, the financial health of states and municipalities will improve and the financial difficulties of 1975 will become a distant, if painful, memory.

But there are longer-term and more fundamental problems in the municipal bond market. These problems are not associated with the financial policies of particular communities but with the very structure of the market. Dealing with these problems requires a restructuring of the market, in particular a reform of the method by which the federal government subsidizes the capital costs of state and local governments. A failure to restructure the municipal bond market will not only result in periodic repetitions of the "crises" of 1966 and 1969–70, but may contribute to a deterioration of the performance of the municipal bond market in the future.

In this article, I will describe the nature of the longer-term fundamental problems created by the current reliance on tax exemption as a method of subsidizing capital costs of state and local governments. In addition, I will compare two reforms which have received the most attention and present my reasons for preferring one reform—the taxable municipal bond option. Finally, I will present some estimates of the effectiveness of a taxable bond option as a method of stabilizing the municipal bond market, as a method of tax reform, and as a

---

[1] Peter Fortune is an assistant professor of economics at Harvard University and the author of a noted study of tax-exempt bonds which was done under the auspices of the Federal Reserve Bank of Boston.

In this article, Professor Fortune says the crisis in the state and local bond market in the past year, marked by the threat of a New York City default, is based primarily on short-run phenomena, mainly the severe recession. Nonetheless, he adds, there are some fundamental problems in the municipal bond market that require basic reform. The municipal market does not operate well when performing its primary function of changing a stable flow of credit to state and local governments. In addition, reliance on federal tax-exemption for municipal bond interest as the principal means of subsidizing state and local capital investment is inefficient. This is so because there is "wastage" when a substantial portion of the tax revenue given up by the federal government goes not to the states and localities but to the investors in the tax-exempt bond.

Fortune examines two options for dealing with these problems: the Urban Development Bank and the taxable bond option. URBANK, as it is presently being presented, does not specify a level of subsidy nor is its use by the state and local governments an automatic right. Also, its subsidy payments (in the form of interest rates on loans that are lower than URBANK would pay to raise the money in the first place) must be met by annual appropriations and this could act as a severe limitation on the amount of subsidy funds made available.

The taxable bond option, which Fortune favors, would provide for issuance of bonds by state and local governments, interest on which would be taxable by the federal government. In return, the federal government would pay a direct and automatic subsidy to the issuing government equal to a portion of the interest costs. Professor Fortune feels that a subsidy of 40 percent would achieve the optimum combination of tax reform and revenue sharing.

method of revenue sharing. These benefits will then be compared with the costs to the U.S. Treasury.

THE CASE FOR MUNICIPAL BOND MARKET REFORM

The case for municipal bond market reform rests on two fundamental problems created by the existing structure of the market. First, the market does not operate well in its primary function of channeling a stable flow of credit to state and local governments. Instead, the volume of credit available to municipalities and the terms of obtaining that credit are subject to cyclical volatility exceeding that faced by other borrowers. Second, the approach of subsidizing borrowing costs of state and local governments via sole reliance on exemption of interest payments from federal income taxes is both inefficient (in the sense that not all costs to the federal taxpayer accrue to state and local governments as interest savings) and inequitable (in the sense that the federal government costs go to high tax bracket investors).

The magnitude of the cyclical market problems is indicated by examining the ratio of interest rates on "representative" municipal bonds (of 10-year maturity and Aa credit rating) to interest rates on equivalent taxable bonds. Over the period 1960–74 the average ratio was about 65% indicating a subsidy of about 35% on interest payments by state and local governments. However, this interest rate ratio exhibited significant cyclical fluctuations, rising to about 75% in 1966 and 1969–70, years of tight monetary policy, and falling to about 60% in 1971–73, years of easy monetary policy.

The effect of this special sensitivity of the interest rate paid by state and local governments to monetary policy is not only to force upon municipalities an excessive share of the financial burden of fluctuations in monetary policy, but also to induce postponements of their capital expenditures. In addition, the burden of capital expenditure postponements is unevenly distributed. Those borrowing units with alternative sources of financing, such as bank loans or liquid assets, may merely postpone bond issues while maintaining capital expenditures when faced with rising long-term borrowing costs. But other units, with more limited financial alternatives, may have to postpone spending. Thus, the existing structure of the municipal bond market creates the equivalent of a tax on borrowing and on capital expenditures which is related to the state of monetary policy and is also distributed rather capriciously among borrowers, resting largely on those with weaker financial positions.

This "tax" is the unintended result of the excessive reliance of the municipal bond market on the amount of loanable funds of commercial banks, which bought roughly 70% of net municipal bond issues in the 1960's This, in turn, is the result of the tax-exemption of state and local government interest payments which limits the incentives of financial institutions with low tax rates and more stable sources of loanable funds, such as pension funds and life insurance companies, to buy municipal bonds.

Hence, one of the major objectives of municipal bond reform is to make the flow of credit available to municipalities behave more like the flow of credit available to other borrowers, such as corporations. In other words, the goal should be to make the municipal bond market perform more like the corporate bond market.

THE EQUITY SIDE OF THE COIN

The equity and efficiency problems are two sides of the same coin. Because of the different marginal tax rates of investors in municipal bonds, the average investor will have a tax rate greater than the marginal investor, the one who is just indifferent between tax-exempt and taxable bonds. Since it is the tax rate of the marginal investor which determines the interest savings of municipalities arising from tax-exemption, other investors get a tax-saving which is greater the higher their tax rate is relative to that of the marginal investor. Those tax savings represent a cost to the U.S. Treasury which is not passed on as interest savings to municipalities.

Estimates of the proportion of costs to the U.S. Treasury of tax exemption which are actually passed through to municipalities (i.e. which actually benefit municipalities) are difficult to make because of inadequate data on the distribution by tax bracket of investors in municipal bonds. The most common estimate

is that 70–75% of the taxes lost to the Treasury as a result of tax-exemption are passed on to municipalities, with the remaining 25–30% captured by high-bracket investors as tax savings greater than necessary to induce them to buy municipal bonds.[2]

In my view, this considerably understates the efficiency of tax-exemption. The basic reason is that the method of calculating the efficiency assumes implicitly that tax-exemption gives municipal borrowers a subsidy of only 30% of the interest they would pay if they were required to sell taxable securities. While this is true of municipal bonds with maturities of 20 years or more, the subsidy provided on bonds of shorter maturities is larger than 30%.

There is a relationship between the subsidy provided by tax exemption and the maturity of municipal bonds. For 20-year maturities tax-exempt yields are roughly 70% of taxable bond yields, indicating a subsidy of 30%. But at the other end of the maturity spectrum, at one year maturities tax-exempt yields are roughly 55% of taxable bond yields, indicating a subsidy of 45% for short term borrowing.

When the relationship between maturity and the interest subsidy provided by tax-exemption is taken into account, I estimate that about 85–90% of costs to the federal taxpayer are passed on to state and local governments.[3] When translated into dollar terms this means that the estimated costs to the Treasury of $4.2 billion in income taxes lost during fiscal year 1976 have created interest savings for state and local governments of between $3.6 billion and $3.8 billion. The amount of windfall income received by high-bracket investors in fiscal year 1976 is between $200 million and $400 million.[4]

The inefficiency of tax-exemption provides the second basis for reform. The portion of costs to the federal taxpayer which accrue to high-bracket investors represents an unnecessary expense, and an inequitable impact of income distribution, which can and should be eliminated.

THE FUTURE OF THE MUNICIPAL BOND MARKET

While an examination of past experience provides, in my view, a sufficient case for reform, current evidence suggests that in the absence of reform the performance of the market may deteriorate in the future.

This possibility arises from three major sources. First, commercial banks, which have been the mainstay of the market, though a volatile one, may play a smaller role in the future. Second, capital spending by state and local governments to meet both state and federal environmental standards is expected to rise sharply. Third, an increasing share of corporate pollution control expenditures is being financed in the municipal bond market through tax-exempt pollution control bonds.

The withdrawal of commercial banks from the municipal bond market is associated with the development of new tax shelters provided by their expansion abroad, which generates foreign tax credits, and their expansion into new activities, such as equipment and real property leasing, which generates accelerated depreciation and investment tax credits. The result is an erosion of the commercial bank tax base which will, if continued, reduce the proportion of com-

---

[2] This estimate is derived in the following manner. A Treasury survey indicates that the average marginal tax rate of investors in municipal bonds is about 42%. This means that investors who buy tax-exempts rather than taxable bonds save, as a group, 42¢ of taxes for every dollar of taxable bond interest sacrificed. On the other hand, municipalities save about 30¢ in interest by selling tax-exempt bonds rather than taxable bonds, since (at least for long maturities of 20 years or more) tax-exempt yields are only 70 percent of taxable bond yields. Thus, the ratio of interest savings to Treasury costs is (30/42) = .71.

[3] This calculation rests on the following assumptions. First, the subsidy provided by tax exemption is 45% for borrowing with maturity of 1–10 years, 35% for maturities of 10–20 years, and 30% for maturities over 20 years.

Second, 40% of municipal bonds have a maturity of 1–10 years, 30% have a maturity of 10–20 years and 30% have a maturity over 20 years.

The weighted average rate of subsidy provided by tax exemption is, then.

$$(.4)(45) + (.3)(35) + (.3)(30) = 32\%$$

Then using the Treasury estimate of 42% as the average marginal tax rate yields an efficiency of (32/42) = .90.

[4] The estimate of $4.2 billion is taken from Congressional Budget Office, *Five-Year Budget Projections, Fiscal Years 1977–81*, January 26, 1976. Treasury costs on industrial revenue and pollution control bonds are not included since these do not give rise to interest earnings for state and local governments.

mercial bank investments placed in municipal bonds. That this is a real possibility is indicated by the decline in the effective tax rate of commercial banks insured by the Federal Deposit Insurance Corporation from 26.6% in 1965 to only 14.9% in 1974.

The rise in municipal capital expenditures on waste treatment facilities resulting from the Federal Water Pollution Control Act of 1972 is likely to place additional pressure on the municipal bond market. In a recent study completed for the National Commission on Water Quality, I predicted that this alone could result in a rise in the interest rate on long-term (20-year Aaa-rated general obligations) from an average level of 6% to about 6.6% over the next eight years.

In addition to these pressures, the use of tax-exempt financing of corporate pollution control expenditures could, according to my estimates, push up by another 40 basis points, to about 7%.

If these predictions are realized, the need for municipal bond reform is even greater than past experience suggests. Of course, such projections may be too bleak. It is quite possible that other changes in financial structure could offset the capital shortage which I predict for the municipal bond market. For example, there is currently a great deal of pressure, which I hope will be successful, for restricting the access of corporations to tax-exempt financing. In addition, part of the pressure on the market from municipal waste treatment expenditures may be mitigated by the anticipated decline in state and local government capital expenditures for education and transportation. Finally, if commercial banks do participate less actively in the municipal bond market, their place might be taken in part by increased purchases of municipal bonds by other financial institutions, such as thrift institutions, whose tax shelters have been reduced in recent years.

While my projections may be too pessimistic, the basic prediction I would make about the future of the municipal bond market is that it is not going to perform better in the future than it has in the past. In short, crystal ball gazing does not suggest to me that reform is an idea whose time has passed.

Thus, the basic question is not "to reform or not to reform," but just how the municipal bond market should be restructured to reduce its cyclical instability and the inefficiencies and tax inequities which accompany tax-exemption.

POSSIBLE REFORMS: URBANK VS. THE TAXABLE BOND OPTION

Two reforms which have been seriously considered in recent years are an Urban Development Bank (URBANK) and adoption of a taxable municipal bond option. While both approaches could, in principle, be equally effective in dealing with the problems created by sole reliance on tax-exemption, they are likely to differ considerably in their actual effects. Because of the operating problems which are likely with an URBANK, my choice would be a taxable bond option.

URBANK would be a new financial intermediary which would borrow in the market for taxable securities and use the funds to buy tax-exempt securities. The losses resulting from the difference between the interest rate paid on taxable securities and the rate received from tax-exempt bonds would be covered by annual appropriations.

The taxable bond option would provide state and local governments with a choice between selling tax-exempt bonds or taxable bonds. Governments which choose the taxable form would receive a direct subsidy equal to some proportion of the net interest cost of taxable municipal bonds.

The primary objective of both proposals is to stabilize the interest rate paid by municipalities, eliminating or at least mitigating the current cyclical volatility of the interest rates paid by municipalities relative to those in the taxable bond market. URBANK would do this by operating on the demand side of the municipal bond market, lending more heavily to municipalities in periods of pressure on the market for tax-exempt securities and less heavily when the market is functioning well. The taxable bond option would work through the supply side of the market, with municipalities shifting the composition of their new issues between tax-exempt and taxable forms according to the relative pressures in each market.

The taxable bond option would act as an automatic stabilizer of the municipal bond market since it would be available to any municipality for purposes which are eligible for tax-exempt status under current regulations. For example, suppose the taxable bond option carried a 40% subsidy rate, as is currently proposed in the Kennedy-Reuss Municipal Capital Market Improvement Act (S. 2800, H.R. 11214). In this case the cost of borrowing would be set at 60% of the rate paid

on taxable municipal bonds. This would be true regardless of the form of municipal debt sold, since if the rate paid on tax-exempt bonds were higher relative to the rate paid on taxable bonds, a municipality would have the option of choosing the taxable form. The option would retain the advantages of the current method—the automatic eligibility for subsidy at the volition of the borrower—while eliminating the disadvantages—the cyclical volatility of interest rates paid by municipalities vis-a-vis interest rates on taxable bonds. Furthermore, it would increase the interest rate subsidy provided by the federal government and increase both the efficiency and equity of the subsidy.

An URBANK could have exactly the same effects if it bought tax-exempt bonds at a yield of 60% of the interest rate paid on its taxable obligations and if it did not ration its lending, that is, if it would lend any amount at the fixed interest rate ratio. However, this is not the way the proponents of URBANK visualize its operations. First, URBANK proposals do not specify a particular level of subsidy. Second, an URBANK would necessarily involve the screening of potential borrowers according to their credit ratings, purposes of borrowing and other characteristics, and thus credit would not automatically be available. Third, the requirement that URBANK losses, which are a necessary condition for it to be effective, be covered by annual appropriations raises the possibility that the funds necessary to stabilize the municipal bond market may not be available in sufficient amounts to do an adequate job.

THE TAXABLE BOND OPTION

A taxable bond option offers several benefits. First, the option would reduce the instability of the flows of credit to municipalities, thereby mitigating the cyclical fluctuations in interest rates paid by state and local borrowers. Second, the option would provide some tax reform by reducing the windfall income of high-bracket investors which they currently enjoy as a result of tax-exemption. Third, the option would have some revenue-sharing effects since it would provide an increased subsidy of state and local government borrowing costs.

The effects of the option on market stability arise from the ability of municipalities to shift the form of their bond issues from tax-exempt to taxable bond markets in response to the relative pressures in each market. For example, if a subsidy rate of 40% were adopted, municipalities would sell tax-exempt bonds if the interest rate on tax-exempts is less than 60% of the rate on taxable bonds, and would choose taxable bonds if the interest cost on tax-exempts were greater than 60% of that on taxable bonds. As a result, the interest rate paid on municipal bonds would tend to stabilize at a level of 60% of the interest rate on taxable bonds.

The tax reform features of the taxable bond option arise from two sources. First, there is no windfall income for investors who buy taxable municipal bonds. Second, since the interest rate on tax-exempt bonds would fall in response to the reduced supply as municipalities use the taxable bond option, those investors who still buy tax-exempts would find their windfall income reduced.

The revenue sharing effects of the option result from the decrease in interest rates paid on municipal bonds. For example, under normal conditions 20-year bonds sell at a yield equal to 70% of the yield on taxable bonds. With an option providing a direct subsidy of 40%, the interest rate on all long-term municipal borrowing would fall to 60% of the taxable bond yield.

The extent to which these benefits are realized will depend on the subsidy rate. The greater the subsidy rate the larger the benefits. The Treasury has supported a taxable bond option with a 30% subsidy rate while the Municipal Capital Market Improvement Act contains a 40% subsidy rate. These define the limits of subsidy rates which seem to be under serious consideration and I will therefore focus on the possible benefits of an option at rates of 30–40%.

The first point which should be made is that the Treasury's proposal is likely to offer few benefits. A 30% subsidy rate is too low to be effective under normal market conditions. In recent years the rate of subsidy provided by tax-exemption alone has ranged from about 45% of the interest rate on very short term municipal issues to about 30% for issues with maturity of 20 years and greater. Thus, under normal conditions, an option with a 30% subsidy rate will not provide an incentive for municipalities to choose to sell taxable bonds. However, the 30% option will provide some benefits in periods of unusual stress on the market for tax-exempt bonds. Even so, its effects will be confined to long maturities and the

instability of the market for short and intermediate maturities will not be mitigated.

Thus, in my view the Treasury proposal is better than no option, but will provide only limited stability for the market and will have virtually no tax reform or revenue-sharing features. An effective reform requires a higher subsidy rate.

But how high? In an attempt to answer this question I have estimated the effects of options with 35, 40, 45 and 50% subsidy rates. The results are shown in Table 1.

TABLE 1.—TOTAL COSTS TO TREASURY, INTEREST SAVINGS OF STATE, AND LOCAL GOVERNMENTS AND WINDFALL INCOME OF INVESTORS FROM REFINANCING OF 1975 STATE AND LOCAL DEBT OUTSTANDING WITH A TAXABLE BOND OPTION [1]

[In billions of dollars]

	No option	Taxable bond option with subsidy rate (percent)—				
		30	35	40	45	50
Treasury costs	-7.0	7.0	7.0	7.1	7.5	8.3
Interest savings	6.3	6.3	6.5	7.0	7.5	8.3
Windfall income	.7	.7	.5	.1	0	0
Efficiency (percent) [2]	50	90	93	99	100	100
Proportion of windfall income eliminated by option (percent)		0	29	86	100	100

[1] Assumes normal market conditions and interest rates; 1975 State and local bonds outstanding are $205,000,000,000.
[2] The percent of Treasury costs accruing as interest savings to State and local governments.

Let me concentrate on the tax reform and revenue sharing features of an option at 35% and 40% subsidy rates.

One method of estimating the effectiveness of an option as a method of tax reform is to ask what proportion of the windfall income of investors would be eliminated by an option if the $205 billion of municipal bonds outstanding at year-end 1975 were refinanced under the terms of an option. This requires making assumptions about the yields on taxable and tax-exempt bonds in the future, as well as assumptions about the tax rates of investors. The results are shown in Table 1.

If an option is not adopted, the windfall income of investors after complete refinancing of the stock of municipal bonds is estimated to be about $700 million per year. An option with a 35% subsidy rate would eliminate about 30% of that windfall income. A 40% option would eliminate about 85% of the windfall.

Thus, the magnitude of the tax reform benefits of an option increases sharply as the subsidy rate rises from 35% to 40%. Furthermore, as the subsidy rate rises about 40%, the increment in tax reform benefits is small. For example, at a 45% subsidy rate virtually all windfall income is eliminated, but this means only an increment of 15% of initial windfall income is eliminated by choosing a 45% subsidy over a 40% subsidy.

My conclusion from these projections is that a 40% subsidy rate offers an effective method of achieving tax reform via a taxable bond option. Lower subsidy rates offer significantly smaller tax reform benefits while higher subsidy rates do not offer significantly larger benefits.

The second issue is the relationship between the subsidy rate and the revenue sharing effects of an option. If normal market conditions prevail in the future, I estimate incremental savings for municipalities of about $50 million in the first year at a 35% subsidy rate cumulating to almost $650 million per year in the tenth year. A 40% subsidy rate would give first year savings of about $130 million and tenth year savings of almost $2 billion.

Thus, a 40% option will generate significant interest savings for municipalities as well as providing an effective vehicle for tax reform, at least so far as the tax-inequities created by tax-exemption alone as concerned.

COSTS TO THE TREASURY

These benefits are not created out of thin air but require incremental costs to federal taxpayers. According to my estimates, if normal market conditions prevail, the cost to the Treasury of a 35% option will be only about $5 million in the

first year, cumulating to slightly more than $50 million in the tenth year. The costs under a 40% subsidy are about $20 million in the first year and slightly over $300 million in the tenth year.

The absolute costs of a 35% option are negligible. Furthermore, when compared with the interest savings generated for municipalities, a 35% option would provide interest savings of about $12 for each dollar of cost to the Treasury. In my view a 35% subsidy rate is easily acceptable.

However, I would urge the adoption of a 40% subsidy rate, as proposed in the Municipal Capital Market Improvement Act. The benefits in terms of tax reform and revenue sharing are far greater than those of a 35% subsidy. While the costs to the Treasury are also greater, they are in my view a small cost to pay for the advantages a 40% subsidy rate provide. At a 40% subsidy rate the interest savings of state and local governments would be about $6 for each dollar of cost to the U.S. Treasury and the absolute cost to the Treasury in the tenth year of operation is only $300 million.

Three Arguments for the Taxable Bond Option: Equity, Efficiency, and Marketability

(By Stanley S. Surrey[1])

In 1969, the House Ways and Means Committee took the innovative step of authorizing state and local governments to issue, on an optional basis, taxable bonds on which a part of the interest would automatically be paid by the federal government. It was understood the federal interest payment would be 40% of the bond interest. Such a taxable bond could be issued instead of the traditional tax-exempt state or local obligation. This step was hastily misunderstood as an attack on tax-exempt bonds and it was consequently dropped from the legislation by the Senate Finance Committee. It is now recognized, however, that instead of an attack, the step represented a distinct benefit to state and local governments and in no way harmed their interests. It would have been an added option in their financial alternatives that did not in any way detract from other alternatives, including the alternative of continuing to issue tax-exempt bonds. Many financial authorities and government officials now recognize the real merit of the 1969 proposal.

There are three solid arguments for legislating this optional taxable bond device:

1. It will open a large new market for state and local governments at a time when their traditional tax-exempt market is shrinking dangerously.
2. It will end a present wastage of federal funds of over $1.3 billion annually, certainly a very large sum for a single federal program and for which there can be no justification at all.
3. It will greatly diminish the present escape from tax of wealthy individuals who today are able to enjoy large interest payments on state and local bonds—reaching up to a million dollars in some cases—without paying federal income tax on that interest—a situation which no one, I believe, would directly defend.

A New Market

The market for state and local obligations is today dominated by a single factor—the value of exemption of the interest from federal income tax. Since these obligations sell at an interest rate below that of taxable corporate obliga-

---

[1] Stanley S. Surrey is a professor at the Harvard Law School. He served as Assistant Secretary of the Treasury for Tax Policy from 1961 to 1969.

In this article, based on recent testimony before the House Ways and Means Committee, Professor Surrey argues for providing a taxable bond option to state and local governments. Although these governments would, of course, have to pay a higher rate of interest to attract investors if the interest on their securities no longer was tax-exempt, they would receive a direct payment from the federal government to make up a portion of the interest cost. Surrey argues that such a system would have three advantages over the present one:

Since taxable securities would be attractive to individuals, corporations and institutions for whom tax exemption is not a prime consideration, the new system would open up a large new market for state and local bonds.

The current "waste" represented by the $1.3 billion in lost Treasury revenue that goes to holders of tax-exempt securities (rather than to state and local governments in the form of lower interest payments) would be eliminated, and

Tax equity would be advanced, since a reduction in the availability of tax-exempt securities would diminish the tax escape routes now available to wealthy individuals.

tions, the exemption of the lower interest can be their only attraction (in the absence of forced buying by units subject to state or city controls). The value of exemption rises with the federal tax rate. Hence the market for state and local bonds is essentially that of either wealthy individuals or of corporations with a large amount of funds to invest in securities and with a high marginal tax rate, such as commercial banks. Banks are aided by the fact that, alone of all buyers, they are not required to offset against the exempt interest their interest payments on funds they borrow, so that the interest payments remain entirely deductible. A market so circumscribed is bound to be precarious and unstable, and this has been the experience. The desire of commercial banks to be in this market fluctuates widely, and therefore dangerously, for state and local governments. When business demand presses or when other federal tax shelters are available, such as leasing of equipment, the banks will invest elsewhere, and this has been happening in this decade.

Other corporations with funds to invest and a high federal income tax rate, such as fire and casualty insurance companies, will be volatile buyers depending on their profit picture. As for individuals, it appears that almost all individual holdings of tax exempt bonds are by those with over $25,000 income, with 70% held by those over $50,000. This concentration represents sensible investment judgment, since the higher the federal tax rate the greater is the value of the exemption privilege. But clearly such a situation does not offer a wide market.

In contrast, the market of foundations, colleges, churches, private pension plans, and other tax-exempt organizations is closed to state and local governments because to these organizations, themselves tax-exempt, a second tax exemption is worthless. So also is the market closed for those whose income tax rate is not high enough to make the interest exemption valuable, such as individuals in modest tax brackets or life insurance companies. The optional taxable bond proposal would at once open these broad markets to state and local governments since their taxable bonds could compete favorably on yield terms with the other taxable bonds now held by these buyers. Such access to these new, broad markets can only be a distinct plus for state and local governments, coming at a time when many are feeling the pressure of the present restricted market.

END OF WASTAGE OF FEDERAL FUNDS

The federal government today subsidizes the sale of state and local obligations. This subsidy is in the form of the tax exemption of their interest, which permits the interest on these bonds to be less than that on comparable taxable bonds. The difference is a reduction in state and local interest costs—but it is a reduction directly subsidized by the federal government. The subsidy is in the form of a revenue loss—the tax exemption—on the part of the federal government. This subsidy is a direct cost—just as if federal funds were spent—and is recognized as such in the tax expenditure budget data appearing in the federal budget, in the tax expenditure list of the Congressional committees on the budget, and in the tax expenditure lists issued by the Ways and Means Committee. The amount of federal funds used for the purpose of aiding state and local governments—and it is so characterized in the above tax expenditure budgets under "Revenue sharing and general purpose fiscal assistance"—is estimated at $4.2 billion for fiscal 1976.

This aid or subsidy through tax exemption is thus a significant federal program. It is also one of the most wasteful federal programs. For it is also estimated that of this $4.2 billion aid as seen at the federal level, only about 70 percent or $3 billion actually arrives in the hands of state and local governments in the form of lowered interest rates on their bonds, which is the objective of the federal aid. On the way from the U.S. Treasury to the treasuries of state and local governments, $1.3 billion—or about 30 percent—of the federal aid disappears as aid. This large amount ends up instead as a commission to wealthy individuals and commercial banks for acting in effect as the messengers to carry the $3.5 billion to the state and local governments. This is obviously expensive messenger service and presumably few federal programs have such high delivery costs. Moreover, the $1.3 billion is simply wasted funds, for there is no need to incur such messenger service to deliver federal funds.

This wastage in messenger service—the high commission paid to wealthy individuals and commercial banks—can be described in many ways. Thus, one can say that the Treasury Department has paid 70% bracket individuals $4.02 so that a state or city can save $2.36. (I detailed this in *Pathways to Tax Reform*,

Harvard University Press, 1973. Using an average of 9.11% yield on a taxable bond, a 70% taxpayer would pay $6.38 tax, leaving $2,73 net. Using an average yield of 6.75% on tax-exempt bonds—these were 1970 figures—such a bond would provide $6.75 interest, or a net gain of $4.02. The issuing authority would save $2.36, the difference between $9.11 and $6.75.)

It is clear, then, why wealthy individuals buy these bonds—the "commission" paid by the federal government is higher than on most other tax subsidies paid by the Treasury, such as other tax shelters. As another way of describing the expensive messenger service, an Urban Institute study in 1971 estimated that for every dollar of state and local interest payments saved by those governments, the Federal Treasury lost $1.32 in taxes. Whatever the method of expression and whatever the precise figures (they vary with shifts in yields and the tax bracket of the messenger), the wastage is obviously large.

This wastage is unnecessary. The purpose of the federal subsidy—tax exemption—is to aid state and local governments. If the route chosen—tax exemption—involves so expensive a delivery service and such a high commission to the messengers, then a clear remedy is to permit state and local governments to dispense with the messenger service and take direct delivery themselves. The federal check can be conveyed directly and need not be carried by a high bracket individual or a bank at a costly commission. Such direct delivery would shift the amount of the commission to the state and local governments and this wastage would end. An obvious method of direct delivery is the optional taxable bond, for the federal check can in effect go directly to state and local governments without any third-party commission. Hence the direct federal cost in funds spent—the amount of the interest directly borne by the federal government—would all go to state and local governments. On the federal financial books a direct budget expenditure is being substituted for a tax expenditure, so that the federal cost remains. But the direct route eliminates a $1.3-billion wastage and thus permits an efficient alternative for a presently inefficient program.

Either way the federal government has a cost, be it a tax expenditure or a direct expenditure. And either way the cost appears on the federal books, there for all to see. That cost is the reflection of the basic assumption that it is a proper program of the federal government to assist state and local governments in meeting their capital costs through interest savings on their bonds. I assume that basic assumption is generally accepted. That being so, it is only the course of wisdom to use a program mechanism that eliminates wastage of federal funds. The optional taxable bond approach provides that mechanism.

Equally, state and local governments should join in ending that wastage. There are constraints on federal spending just as there are on state and local spending. When state and local governments are pressing for continued large federal spending to assist those governments—be it revenue sharing, more block grants, larger bearing of welfare and health costs—it is only sensible that those governments join in eliminating this wastage. This is especially so when elimination of the wastage aids state and local governments directly, and when it involves no constraint on them. At a time when greater federal-state and local government cooperation is needed, it is a rational and useful step for all governments to support the optional taxable bond approach.

LESSENING OF TAX ESCAPE

I have pointed out above the tax benefits to a wealthy individual in purchasing state and local bonds. This benefit—for acting as a messenger—is certainly upside-down, because the wealthier the messenger, the greater the payment by the federal government. For state and local governments, in an effort to lessen the narrowness of their markets, cannot price their bonds to appeal only to taxpayers in the 70% bracket. Those governments must at least price their bonds to attract banks with a 48% marginal rate on taxable income and individuals in brackets below 70% and even below 50%, the current maximum rate on earned income. But in so pricing their bonds, they automatically benefit the individuals in the higher brackets since the latter obtain a yield that is much higher than needed to induce them to purchase the bonds. A tax-exempt bond priced to sell to a 40% tax rate individual or a 48% tax rate bank is a distinct windfall to a 70% tax rate individual. It is no wonder that the data on the distribution of tax expenditures show that of the $2.8 billion in interest received by individuals—30% of the total tax-exempt interest—88% of the tax benefit of the exemption

goes to individuals in income brackets over $55,000, or 1.2% of individual taxpayers. Indeed 50% goes to individuals in income brackets over $100,000, or .2% of individual taxpayers. Only 2.5% goes to individuals with less than $20,000 of income.

Clearly, the tax-exempt subsidy is as inequitable as it is inefficient. The inequity of the tax subsidy and the inefficiency of the tax subsidy are just opposite sides of the same coin. They represent the unfairness and wastage in relying on the indirect route of tax exemption to deliver federal funds. The alternative of the direct route offered by the optional taxable bond could end much of this tax unfairness. In all likelihood we would no longer see individuals receiving over a million dollars of tax-exempt interest and paying not a cent in federal income tax on that income. Such a tax escape is distinctly unfair, and morally wrong. It is unfair to the millions of individuals who pay their proper federal income taxes and are often hard-pressed to do so. I doubt if any present recipient of tax-exempt interest will appear before Congress to claim continued entitlement to this tax escape. Nor do I see how any group can appear before this Committee to justify the escape or to urge that however unfortunate and unfair that escape, it nevertheless must be continued because no other course is available if the Federal government is to aid state and local governments.

Certainly at the least a very severe burden of proof and persuasion must rest on any group urging the continuance of this tax escape, and the consequent wastage of federal funds. With the alternative of optional taxable bonds ready at hand, I cannot see any group that can sustain such a burden. It cannot be investment houses specializing in tax-exempt bonds who may have to switch to marketing taxable bonds, for they can hardly claim such a vested interest in present channels of distribution as to justify this tax escape and wastage. Nor can it, as in 1969, be governors or mayors mistakenly thinking that their historical privilege of tax exemption is being withdrawn or undermined. For by now it is fully clear that "optional" *means* optional, and an added alternative is being offered them with nothing withdrawn. It also is obvious by now—with the tax expenditure budget being published in the budget documents—that tax exemption and direct subsidy each involve the use of federal funds. Tax exemption is a blanket, automatic, no-strings attached, open-ended federal grant-in-aid to the issuing state and local governments. The optional taxable bond direct subsidy can be structured the same way.

What of the worry that some day the Congress that provided the direct subsidy for taxable bonds may withdraw it? A simple answer is that in that event state and local governments would still possess the tax-exempt route, and investment houses would turn to marketing those bonds, for the expertise would not be lost and in any event could readily be reacquired. Moreover, at some point the state and local governments must place faith in their own political strength, which over the years has kept the tax exemption of their bonds in the tax law. (I doubt any governor or mayor really believes such exemption is a Constitutional mandate).

LEVELS OF INTEREST SUBSIDY

The purpose of the optional taxable bond being valid and the need for this alternative being clear, the discussion can turn to mechanics. The important factor is the amount of the federal interest subsidy. The Reuss-Kennedy bill (H.R. 11214 and S. 2800) introduced on December 17, 1975, carries a 40% figure. I understand from those who have worked in the area, especially Prof. Peter Fortune of Harvard University and formerly an economist with the Federal Reserve Bank of Boston, that with a 40% figure, nearly all state and local bonds with maturities over ten years would use the taxable route. Thus, the direct subsidy at that figure would presumably be effective in dealing with the problems of the long-term municipal bond market. Also a large proportion—perhaps well over 50%—of the five to ten year maturities would be issued in taxable form. In all, probably over 40% of municipal obligations with a maturity over one year would be in taxable form. The inefficiency and tax inequity of municipal bonds are most severe in the long-term maturities, since the present spread between taxable and tax-exempt issues narrows as maturities lengthen. Hence a 40% subsidy figure would presumably eliminate the most serious wastage and inequity. As maturities shorten, except in periods of serious tax-exempt obligations declines, the value of tax exemption becomes less to upper-bracket persons, and consequently the inefficiency and windfall benefit are less.

POLLUTION CONTROL BONDS

Another factor in the picture is the tax-exempt pollution control board. These are tax-exempt bonds issued by state and local governments on behalf of industrial concerns, usually large, to buy pollution control equipment leased to those concerns. The mechanism in effect grants to the industrial concern the state and local tax exemption and thereby enables the firm to borrow funds at a lower interest cost. These pollution control bonds are thus a form of industrial development bonds. When the general run of industrial development bonds was made taxable in 1968 by legislation, an exception was made for pollution control bonds. The exception was almost pro forma in view of the growing popularity of "doing something about pollution" and was a part of various compromises in that legislation. It was not seriously studied or considered, since no pollution control bonds were being issued at that time.

The exception for pollution control bonds now can be seen by hindsight as a serious mistake. New issues of pollution control bonds are very large in total, and often singly. The annual amount is now somewhere around $3.5 billion in public issues and perhaps an equal amount in private placements. The question whether these bonds should receive the interest subsidy is an issue of expenditure policy: Should the federal government subsidize the purchase of pollution control equipment by industrial concerns? There is no present direct expenditure program for this purpose, and it is difficult to see why this government assistance should be provided. The cost of meeting environmental standards, like safety or other standards, should be borne by each industry and the consumers of its products. The important point here is that tax-exemption for these bonds raises the same issue. If it is not proper to provide direct federal assistance, then assistance through tax exemption is equally wrong and should be eliminated. If tax exemption is to remain, then the interest subsidy alternative should also be applicable. A similar examination can be made at the same time as to other exceptions in the industrial development bond area where the amounts are significant.

OTHER ASPECTS

The optional taxable bond device will certainly assist state and local governments in their financing and this would come at an opportune time. These governments are experiencing financial problems in varying degree and hence, assuming it is accepted there should be federal assistance, there is no reason to resort solely to the inefficiencies and inequities of assistance through tax exemption. Indeed, the optional taxable bond approach will both preserve the principle of tax exemption and remove its inefficiency and inequity. At the same time it will add directly, if properly structured, at least $1.3 billion in assistance to state and local governments by turning the wasted "commissions" under tax exemption into direct aid. But some states and localities will still have credit problems. Thus, we must decide whether the federal interest subsidy should continue even though the payment of the interest share of the issuing government may be in default. Expert advice should be sought on this aspect. We should also explore the desirability of establishing a unit in the federal government to provide state and local governments with technical assistance in the marketing of bonds and related financial matters, such as budgeting procedures and management. A unit of this type is provided in the Reuss-Kennedy bill and would seem a desirable form of technical assistance.

CONCLUSION

The potential of the tax exemption device to provide financial assistance to state and local governments has been exhausted. At this juncture, therefor, the task is to broaden the financial options open to state and local governments for raising capital funds. The optional taxable bond technique is a desirable and feasible method of broadening those options. Such a broadening of financial options can only be helpful to those governments. It would at the same time end the large wastage that now exists under the tax exemption assistance and turn that wastage into direct assistance to those governments. It would also greatly improve the equity of the federal tax system. Whether we approach the situation from the aspect of improving the financial situation of state and local governments, or from the aspect of federal budget control and efficiency in spending, or from the aspect of federal tax reform, the end result of adopting the optional taxable bond device would be of benefit to all governments.

The Need for a Broader Municipal Market

(By John G. Heimann)

(Following is an excerpt from recent testimony by New York State Superintendent of Banks John G. Heimann before the economic stabilization subcommittee of the House Committee on Banking, Currency and Housing:)

As (their) effective tax rates declined, the desire of large banks for municipal securities became less robust and, though still expanding in absolute terms, large bank holdings of state and local obligations are a smaller share of their total loans and investments than they were five years ago. The effect of their relatively diminished interest also contributed to a decline in the share of commercial banks in the total outstanding state and local debt obligations from 51% in 1971 to 48% in 1974. With respect to new offerings of state and local government securities, the decline in the participation of commercial banks has been drastic in the last five years. Their share has declined steadily from a high of 95% in 1970 to about 25% in 1974.

The other major change in the financing of state and local governments has been the growing importance of individuals. As inflation increased money incomes, and states and localities have come to depend in greater degree on income taxes as a source of revenue, more individuals found themselves in marginal tax brackets higher enough to benefit from the purchase of tax-exempt securities. The yields on municipal securities rose cyclically to historically high levels. Investment bankers aided the entry of individuals into the market by developing investment trusts of tax-exempt securities which offered diversification, low dollar denominations, and reasonable turnaround costs. As a result, the share of net purchases of state and local securities by individuals has risen steadily since 1970 and 1971, and individuals now hold almost one-third of total outstandings. However, as may be clear, the growing participation of individuals in this market is based in part on cyclical and special factors. This raises a question whether with large banks retreating from the market, the individual sector will be able to continue to absorb a large part of the supply of these obligations.

The Changing Structure of Demand

From the viewpoint of the long-term health of state and local financing, the important point is that with the changing structure of the demand for state and local securities, the market has become more vulnerable. Small and medium-size banks and individuals, in contrast to large sophisticated banks, are likely to be extremely sensitive to difficulties and uncertainties in the municipal market. Thus, a default of a New York City obligation would tend to have relatively long term effects on the willing participation of those who at the present represent the major support for state and local government financing.

The reluctance of small banks to maintain a presence in the market itself would be tragic for state and local financing since small, local banks have been the backbone of finance for local communities. If anything, bank regulators, true to their mandates, would reinforce the natural tendency of small banks to retreat from a risky market. The flight of the major participants from the market would narrow the prospects for all states and localities, thereby weakening the market and raising interest costs for most of them for some time to come.

Prompt Action Needed

These considerations lead me to the conclusion that we must act promptly to provide municipal obligations with fully taxable status. Fully taxable municipal bonds would, of course, carry higher interest rates than they now do, but those higher rates will have the effect of widening the market for municipal obligations. Higher taxable rates could provide the incentive to attract the big banks to participate more fully in the municipal market. Higher taxable rates on municipals would also appeal to those individuals in tax brackets that are currently too low to make worthwhile the purchase of tax-exempt securities.

Removing tax-exempt status for state and local obligations would not necessarily entail higher costs to issuing governments if the Federal government provides a subsidy. If structured appropriately, the cost of the Treasury's subsidy would be substantially offset by the additional tax receipts collected.

Taxable municipal securities would eliminate an inequity that the Treasury Department and Joint Committee on Internal Revenue Taxation have estimated will cost the government about $5 billion in revenues in fiscal 1976 in the form of taxes that investors would normally pay on bond interest income. At the same time they estimated, in July 1975, that the states and localities will save almost $3 billion in reduced interest rates.

But even more important, the taxable municipals proposal would offer the states and localities lower real interest costs and greater savings with, at best, only a modest increase in costs to the federal government.

THE POLLUTION CONTROL BOND: A COSTLY SUBSIDY

(By John E. Petersen [1])

This article describes and analyzes the tax-exempt pollution control bond. These debt instruments represent a special class of industrial development bond that was specifically exempted from the tight restrictions that Congress in 1968 and 1969 placed upon most such tax-exempt borrowing done on behalf of private firms. The Municipal Finance Officers Association (MFOA) in the late 1960's adopted a position in opposition to the continued use of tax-exempt industrial development bonds and supported in concept that restrictions which were placed upon their use.

The explosive growth of the pollution control bond has reopened the concern of many finance officers about the real and potential problems involved in such financing vehicles. Congressmen and many bond market professionals have spoken of the need to review the pollution control exception to the industrial development bond prohibitions and to gauge its overall impact and efficiency as an aid to cleaning up the environment.

Reflecting these concerns and faced with the need to develop policy relating to these developments, the Committee on Governmental Debt Administration of the MFOA asked that a study of the pollution control issue be undertaken, tracing its development, market impact, costs and benefits and possible policy options. The findings set forth below reflect the results of this study.

SUMMARY OF FINDINGS

The use of tax-exempt bonds issued on behalf of private corporations to finance pollution control expenditures has greatly increased over the past three years. The present levels of $2 billion in annual reported sales of these obligations, which are typically large and very long-term bonds, have generated both philosophical and practical problems for the municipal bond market. This analysis assesses the past and future performance of these securities, their impact on the bond markets, and the overall cost and benefits of this use of tax-exemption.

The findings, developed in detail below, can be summarized as follows:

---

[1] John E. Petersen is director of the Washington office of the Municipal Finance Officers Association. This article is adapted from an analysis by Petersen which was published on March 10, 1975, by the MFOA.

In this article, Petersen states that natural limitations of the tax-exempt bond market, the rapid dilution of its cost-reducing benefits in the face of an over-supply of debt, the largely hidden but sizeable costs resulting from inefficient operation, and the general erosion of the tax-exmept privilege dictate an alternative to the tax-exempt pollution control bond. Unless checked, the volume of tax-exempt pollution control bonds is likely to grow throughout the coming decade, and as the volume increases the interest rates on all tax exempt bonds will rise and the interest rate difference between them and comparable taxable securities will decrease.

The annual subsidy cost of the $2 billion of pollution control bonds sold in 1973 totalled about $66 million, with the bulk of it representing U.S. Treasury tax losses. By 1980, however, projections show the annual subsidy cost could range from $800 million to $1.5 billion, with state and local taxpayers absorbing about one-quarter of the total in increased debt-service costs and foregone taxes on the bond-financed facilities. And 30% or more of the value of the tax exemption goes to investors rather than being realized in reduced borrowing costs for pollution control improvements.

According to Mr. Petersen, most pollution control bond sales are done on behalf of large corporate borrowers, with the average size of 1974 pollution control issues about $15 million. Possible alternatives include direct subsidies for pollution control bonds sold on a taxable basis, an extension of accelerated depreciation to all new pollution control expenditures, and a lifting of the investment tax credit to 12% for utilities which are heavy users of pollution control bonds.

Pollution control issues are likely to grow through the decade to $5 billion or more in annual sales (and could exceed that amount by another billion or so in unreported sales).

As the volume of pollution control issues increases relative to other tax-exempts, the interest rate difference between them and comparable taxable securities decreases. The absolute interest cost savings for issuers decline as taxable and tax-exempt rates come closer together.

As the volume of pollution bonds grows, their added volume and higher yields drive up rates on all tax-exempt bonds, anywhere from 5 to 20 basis points (at a 20-year maturity) per billion of annual pollution bond financings, depending on market conditions.

Pollution control bonds are most directly competitive with other long maturity, term-structure and lower quality tax-exempt bonds, and, therefore, they force up rates on these bonds to an even greater extent—an estimated 25 basis points or more under tight credit conditions.

The use of tax-exempt pollution bonds includes a hidden but costly tax subsidy in addition to increasing the costs for other municipal borrowers. The annual subsidy cost of the $2 billion of bonds sold in 1973 totalled about $66 million, the bulk of it representing U.S. Treasury tax losses. By 1980, projections show the annual subsidy cost could range from $800 million to as much as $1.5 billion, with state and local taxpayers absorbing about one-quarter of the total in increased debt-service costs and foregone taxes.

The subsidy is inefficient because 30% or more of the value of tax-exemption is lost to investors rather than being realized in reduced borrowing costs for pollution-control improvements.

A variety of alternative subsidy mechanisms are available involving special tax treatments and forms of loan subsidies. The costs and benefits of these should be thoroughly studied and compared with those now involved in tax-exempt financing.

PROLOGUE TO THE POLLUTION CONTROL BOND

The pollution control bond is the product of two converging trends: (1) the growth and transfiguration of the industrial development bond; and (2) public concern and legislation to abate or eradicate pollution.

The use of the industrial revenue bond began in the South in the 1930s. They were issued as tax-exempts by state and local governments to finance plant and equipment expenditures of new or expanding firms and, thereby, to bolster the state and local economies. However, their use rose dramatically nationwide in the 1960s, culminating in $1.6 billion in new issues in 1968—10% of all long-term tax-exempt bond issues.

Treasury and then the Congress moved to curb what was generally considered an abuse of the privilege of tax exemption. The Revenue Act of 1968 halted all industrial revenue bonds in excess of $1 million issued after January 1, 1969. However, the 1968 law and the Tax Reform Act of 1969 made a total of nine exceptions, one of these being industrial revenue bonds issued for pollution control facilities.

This Congressional move against the industrial revenue bond coincided with a period of federal legislation aimed at cleaning up the environment, an obvious incentive for taking advantage of the pollution control bond exemption. The cost of new plant and equipment for pollution abatement was estimated at $6.5 billion for 1974 alone.

Meanwhile, the first pollution control bond was brought out in 1971 to provide $5 million for a United States Steel Company installation in Pennsylvania. Since then, more than $6 billion in sales have been reported and several hundred million in additional sales are estimated to have taken place but not reported, primarily because the sales were done via private placement.

RESTRICTIONS ON BOND ISSUANCE

Projects for which pollution control bonds are issued must meet the following significant tests:

The improvement would not have been made but for the purpose of pollution control; and

It is not designed for any other significant purpose than pollution control.

Firms enjoying the benefits of pollution control bonds have, in recent markets, been able to save between 1.5 and 2 percentage points in interest. This can mean a gross savings of about $4 million in total interest expense on a 20-year, $10-million issue. In addition to the interest savings, certain Securities and Exchange Commission registration fees and related legal expenses are saved, because the bonds are not registered. There are some additional costs involved with the bonds, however. Municipal bond counsel fees and the somewhat higher underwriters' spread add to the costs of tax-exempts.

There are some additional tax advantages available to the firm leasing the pollution control facilities from the government instrumentality that issued the bonds. Generally, the leasing firm can treat the property as its own for depreciation and investment tax credit purposes. The company can also deduct that part of lease payments which represents interest on borrowed money. On occasion, the tax benefits can be passed along to a third party—which leases the property from the bond-issuing authority and sublets it to the company. Another advantage is that often the property is exempt from various state and local property and other taxes.

A final advantage is the availability of 100% financing of facilities that, supposedly, do not increase the profitability of the plant. Thus, marginal operations, because of the lower cash drains through interest savings on tax-exempt financing, are able to get financing which otherwise might not be available.

The growth of pollution bond sales since their inception in 1971 has been spectacular, rising from $93 million in 1971 to $1.8 billion in 1973 and receding somewhat to $1.65 billion in 1974. These figures, however, represent only publicly reported sales. Many are made by direct placement and there are indications that actual sales are nearly twice as high as those reported. This would make total sales equal to about 12% of all tax-exempt borrowing.

There have been some attacks on the pollution control bonds. The Ford Administration favors repeal of the exemption that permits issuance of this type of industrial revenue bond, and the Internal Revenue Service has been very sparing in issuing favorable rulings for pollution control bonds. The chances of Congressional action on repeal of the privileges are not certain.

COSTS AND BENEFITS

Pollution control bonds should be examined in terms of their overall costs and benefits as a form of tax subsidy. The subsidy offsets part of the expenses incurred by private industry to reduce or eliminate industrial pollution. Strictly speaking since the clean-up expenditures are mandated by law, the subsidy does not act as an incentive to such expenditures but, rather, lowers the cost of outlays that must be made in any event. Still, the lower costs achievable with tax-exempt borrowing may lessen the resistance of firms under orders to remedy their pollution problems.

The subsidy's costs are borne by the public through three major avenues:

Federal taxes on interest income are foregone when tax-exempt bonds are used instead of taxable securities. (The existence of this subsidy element is clear from the fact that the borrowing for the mandated improvements was required.)

Some state and local taxes are foregone because of the exemption of such bonds from many of the states' income, personal property and certain other property taxes.

Increased borrowing costs occur in the case of other tax-exempt bond issuers, because the increased supply of bonds pushes up rates of interest, as we have discussed earlier.

The benefits are distributed between the principal target (the firm making the control improvements) and an unintended beneficiary (the tax-exempt bond purchaser of pollution control bonds who acquires enlarged tax shelter for otherwise taxable income).

Cost-benefit analyses are usually controversial; but they have the obvious benefit of making explicit the impacts of various programs and the assumptions behind them. The tax-exempt bond market has been the subject of several such analyses, one of which has already attempted to set up costs and benefits for pollution control bonds.

Table 1 displays the primary factors in the national aggregate of costs and benefits involved in pollution control issues for 1973. The main assumptions by which these figures are derived are discussed in the notes to the table.

Table 1.—Aggregate costs and benefits from pollution control bonds estimated for those bonds sold in 1973, first year costs only

	Millions
Government costs:	
Federal income taxes foregone	$50.4
State and local taxes foregone	3.4
State and local borrowing cost increase	12.5
Total costs	66.3
Private benefits:	
Interest savings of borrowing firms	39.9
Added income to tax-exempt bond holders	26.4
Total costs	66.3

EXPLANATION.—Conditions and Assumptions: Pollution control bond sales (includes IRB's), $2.1 billion; other tax-exempt bond sales, $21 billion; average pollution control rate, 6.1 percent; alternative corporate bond rate, 8 percent; increase in average municipal rate, 6 basis points; Federal marginal tax rate, 0.30; and State and local marginal tax rate, 0.02.

Looking only at 1973, we see that the $2.1 billion sales in pollution control and industrial revenue bonds meant that an estimated $50 million in federal income tax revenues were foregone by the exemption of interest on new issues sold that year. (Since these bonds probably had an average life of about 25 years, that means that a total of $1.25 billion in federal taxes will be foregone over their lifetime.) In addition, State and local tax systems lost an estimated $3.4 million in foregone income tax revenues, to make the total one-year governmental tax an estimated $54 million in 1973.

The next item is one we have already discussed, that of increased state and local borrowing costs. In their major study, Harvey Galper and George Peterson estimated that, overall, pollution control bonds lifted municipal rates by 6 basis points (.06%) in 1973. While the rate effects may have been more severe in the long end of the market and for revenue issues, that estimate for market rates as a whole appears reasonable. Hence, for the $21 billion sold of other municipal tax-exempts, this would mean a one-year additional interest cost of $12.5 million. The overall governmental cost of the subsidy adds up to $66 million for the year 1973.

Looking at the benefit side, firms using pollution bonds saved an estimated 190 basis points in interest rates, on average, in 1973. This, times the dollar volume of bonds sold, sums to $39 million in reduced loan costs. The other $26 million of the subsidy flowed to investors in terms of additional tax shelter income. In other words, of the total subsidy outlay by government, industrial firms were able to enjoy only about two-thirds of it, the rest being passed on to pollution and industrial revenue bond purchasers. While many technical items of such analyses may be arguable, the magnitude and direction of the results are quite clear: tax exemption is a relatively expensive—and inefficient—way to cut the costs of cleaning up the environment. And, while the federal taxpayer foots most of the bill, the state and local sector comes in for a not inconsiderable share.

THE SITUATION BY 1980

While the 1973 figures are impressive, they are largely a dead letter; the bonds have been sold and the subsidies are largely sunk costs to be incurred over the next 25 to 30 years. The real issue is one of future growth. With the long life of the pollution bond and—as witnessed in 1974—its ability to help drive up rates in periods of tight money, one must look ahead to the cumulative impact on the remainder of the tax-exempt bond market. To estimate this impact, one must make several assumptions, but those shown in Table 2 are conservative: an annual average of $25 billion in other tax-exempt sales and of $3.5 billion in

73-744 O - 76 - 13

pollution control and industrial revenue bond sales in the years 1975 through 1980, leading to respective outstanding debt totals of $150 billion and $25 billion. This is combined with an assumed average pollution control bond rate of 6.25% (a savings of 175 basis points and a premium of 60 basis points over tax-exempt general obligations).

TABLE 2.—*Aggregate cost and benefits from pollution control bonds: a forecast for 1980 for pollution control bonds outstanding*

	Millions
Government costs:	
Federal income taxes foregone	$600
State and local taxes foregone	40
State and local borrowing cost increase	150
Total costs	790
Private benefits:	
Interest savings of borrowing firms	425
Added income to tax-exempt bond holders	365
Total benefits	790

EXPLANATION.—Forecasted conditions: Total outstanding pollution control bonds, $25 billion; other tax-exempts sold since 1972 then outstanding, $150 billion; average corporate rate during period, 8 percent; average pollution control rate, 6.30 percent; average increase in municipal bond rates, 10 basis points; Federal marginal tax rate, 0.30; State and local marginal tax rate, 0.02.

Collecting the above factors, we find that by 1980, the total tax loss on all outstanding pollution control and industrial revenue bonds issued during the decade of the '70s would be $640 million for 1980. In addition, state and local governments by then would be paying an additional $150 million each year in debt service cost because of the 10-basis point hike in interest cost resulting from issuance of the industrial aid debt. On the $25 billion outstanding in pollution control bonds, corporations would enjoy a total of $425 million in interest savings and investors would be receiving about $365 million in added tax-sheltered income. In that case, firms would be realizing only about 54% of the benefits of tax exemption. How much of this cost reduction would pass on to the consumer in the form of lower costs is simply not estimatable; but there is no guarantee that much of it would, or that the incidence of lower prices would compensate taxpayers for having to pick up the tab for the foregone taxes.

The above estimates, when compared to what could be the impacts, are conservative. For example, were the stock of outstanding pollution bonds to be $40 billion by the end of 1980 (rising from $4.5 billion at year-end 1974), the interest cost impacts and foregone tax revenues could push the annual total costs of the subsidy to nearly $1.5 billion by the end of the decade. Or, even with gross sales at only $2 billion to $3 billion a year, but with continued credit tightness in the long tax-exempt market, it is quite possible the increase in municipal rates could be greater. For example, an increase of 15 to 20 basis points would increase the annual debt service on the $150 billion in conventional tax-exempt bonds issued in the face of the higher rates, to $200 million to $300 million by 1980. In either instance, it is also likely that the interest rate advantage to industrial issuers would be further pinched and that the surplus flowing to investors would be heightened. Galper and Peterson in their high-volume projections of pollution control financing demonstrate a situation where, by 1980, industrial borrowers enjoy less than 40% of the subsidy in reduced costs.

It is the surplus to those tax-shelter investors who can acquire the pollution control bonds and the willy-nilliness of the incidence of final benefits that call into question the equity of the pollution bond interest exemption. Some believe that a direct tax-write-off or some other form of explicit subsidy would be preferable to the present tax-exempt financing of the pollution control outlays.

ATERNATIVES TO POLLUTION BONDS

The use of tax-exempt bonds for pollution control investments helps to reduce the cost of such investments. Two major alternatives exist to this continued use

of tax exemption: (1) force industry to find other, privately financed ways to clean-up the environment; or (2) employ an alternative form of subsidy.

The case for not subsidizing pollution control investments is that pollution is a real cost of production, that, via the price mechanism, should be passed on to the consumer. By doing this, consumption of goods that are costly in terms of the resources needed for their production will be discouraged. If consumption can be sustained only by a partial increase in prices, but production is still profitable, then part of the cost is absorbed by a reduction in the return on capital. The argument against this is typically one of hardship on the part of industry or consumers. Private absorption of the costs would mean closing or relocating certain plants, losses to foreign competition, unemployment, reduced profits and stock prices, and a host of other product and site-specific disasters that are unacceptable.

Looking at the alternative subsidy forms, those devices that favor plant and capital expenditures—such as the pollution control bond—have been criticized because they foster use of capital-intensive technology when other clean-up modes are available. However, the mobility of capital goods is realistically an asset when it comes to avoiding the trauma of radical moves and changes in processes. Furthermore, as noted, the imposition of standards practically dictates certain technologies that typically are extremely capital-intensive.

Subsidies can be and are used in order to distribute the burdens of clean-up costs and to recognize the harmful side effects of those costs were they to be entirely borne by the private markets. Several alternative forms are available. Subsidies may be either direct or provided through the tax system, as is the case with tax-exempt pollution control bonds. At present pollution control expenditures by industry on plants built before 1969 are allowed an accelerated five-year depreciation rather than useful life depreciation. The cost of this tax subsidy has been estimated by Treasury at $35 million a year (1974). Firms using the accelerated depreciation for pollution control investment cannot also take the investment tax credit.

It has been suggested that the accelerated depreciation feature be extended and broadened to include all new pollution control expenditures. Concurrently, the use of pollution control bonds would be prohibited for all new capital construction and would be permitted only in conjunction with older plants. Another approach might be the proposed lifting of the investment tax credit to 12% for utilities (heavy users of pollution control bonds) while removing the 50% limit on income tax liability that the credit could offset. Similar tax subsidies for all pollution control expenditures could be an attractive tradeoff against continued use of tax-exempts. While the argument might be advanced that tax writeoffs only help profitable companies, it should be noted that unprofitable companies are not receiving any relief by pollution control bonds, since they are secured on the creditworthiness of the underlying firm.

In terms of direct subsidies, tax-exempt bond issues could be replaced by a direct subsidy for pollution control bonds sold on a taxable basis. Such subsidized taxable bonds have already seen limited usage. It is argued that a direct subsidy would be more efficient than the present method of tax-exempt financing: the subsidy would lower tax-exempt rates in relation to taxable yields and its cost would be largely offset by increased Treasury revenues. Furthermore, it has been demonstrated that a mandatory sale of pollution control issues on a taxable basis (with a subsidy) would be less costly for Treasury than an optional sale, although either method would lower the costs of other tax-exempt borrowers. In either event, a subsidized taxable bond would shift most of the load off of the state and local governments that now partially finance the costs of the pollution control subsidy provided by tax-exempt borrowing.

Alternative subsidy mechanisms need to be examined vigorously to ascertain the comparative size and incidence of their costs and benefits for given goals and rate of environmental improvement. It has become abundantly evident that pollution control energy conservation, price stability, and capital market capacity and efficiency are inextricably interwined. Study of any one in isolation is a hazardous way to prescribe policy that affects all. The natural limitations of the tax-exempt bond market, the rapid dilution of its cost-reducing benefits in the face of an over-supply of debt, the largely hidden but sizable costs

resulting from inefficient operation, and the general erosion of the tax-exempt privileges—all dictate that a search for alternatives be given top priority.

Do Pollution Control Bonds Control Pollution?

(By Leonard Lee Lane[1])

Tax-exempt pollution control bonds issued by states and localities are currently being criticized on a variety of grounds relating to municipal finance, federal revenue loss, and undesirable income distribution effects. While many of these criticisms are valid, they do not address the question of how tax exempt pollution control bonds fit in with environmental policy. That is an issue worth exploring.

John E. Petersen of the Municipal Finance Officers Association estimates that tax-exempt bonds are financing 40% of current total expenditures on industrial pollution abatement, and that both the absolute amount of such financing and its size as a percent of total abatement expenditures is expected to grow. Thus, it is no exaggeration to state that tax-exempt bonds have become a major component of national environmental policy. Unfortunately, this financing device is neither an equitable nor an efficient method of achieving environmental quality goals.

Environmental Equity

One's view of the equity of tax-exempt bonds and other pollution abatement subsidies depends largely on the question of who has prior claim to the use of air and water resources. It is the general public or industry? The former derives pecuniary, health, and aesthetic benefits from clean air and water. Industry seeks to use these same resources as means of waste disposal (pollution). If the claims of the general public to air and water take precedence, industry should be charged for any waste disposal that reduces public benefits and perhaps should even be prohibited from certain types or levels of waste disposal.

The tax-exempt bond is actually based on the opposite line of reasoning. It is a subsidy from the taxpayers to polluting industries. Its justification rests on the tacit assumption that the public should compensate the polluters for reducing the quantity of wastes dumped into air and water. While there is no purely objective way of determining whether the public or industry has prior claim, it seems questionable that taxpayers should have to subsidize industry to reduce pollution. Yet, in effect, this is exactly what happens under the capital subsidy inherent in tax-exempt bonds.

Effectiveness in Encouraging Abatement

One might be inclined to tolerate the apparent inequity of tax exempt bonds or other subsidies for pollution abatement if they did, in fact, effectively generate more pollution control. But they are not likely to do so. Though each year pollution causes billions of dollars of social damage to health and property, each

---

[1] Lee Lane is director of education for the Public Interest Economics Foundation, Inc. He formerly was director of the Coalition to Tax Pollution.

In this article, Lane suggests that tax-exempt pollution control bonds are based on the questionable assumption that industry has a prior claim to use of air and water resources, and that a subsidy from taxpayers to clean up pollution is therefore justified. In addition to this question, Lane says, there are also important questions about the effectiveness and efficiency of the tax expenditures attributable to pollution control bonds.

In spite of the tax-exempt subsidy, there is still an incentive to delay spending funds for pollution control, Lane asserts. In his view, the monies lost through lower Federal tax revenues might be better spent on more effective enforcement of existing pollution control measures.

The tax-exempt bond system is also inefficient, he argues, because it makes capital cheaper for the polluter (though not for society as a whole). The bonds provide an incentive for a polluter to adopt capital intensive methods to deal with pollution, instead of methods which may be less costly to the economy as a whole. Lane concludes by suggesting that the most effective method of pollution control would be an emissions tax, which would place the cost of pollution directly on polluters and their customers.

polluting firm still has an economic incentive to minimize its own private abatement. While a subsidy may reduce the intensity of this resistance, the firm still has an economic incentive to delay expenditures to reduce pollution, unless a public subsidy covers the complete abatement cost. Government would be better advised to spend the revenue lost through tax exempt bonds on more vigorous enforcement programs. Even better, the imposition of a pollution tax could eliminate industry's incentive to delay abatement by imposing the costs of pollution on the firms that emit it. In sum, tax-exempt bonds are a relatively poor device for enforcing environmental quality.

EFFICIENCY OF THE EXPENDITURES

Not only will tax exempt bonds fail to accelerate enforcement of environmental quality goals, but reliance on this mechanism decreases the efficiency of the overall pollution control effort. To the extent such financing is used, there will be less reduction in emissions than could have been attained through a more sensible policy. There are several reasons for this conclusion.

First, tax-exempt bonds are a capital subsidy. As such, they tend to encourage firms to use more capital intensive abatement solutions than would be applied if they were required to pay the correct cost for all the factors of production. For example, in selecting precipitators, for removing particulates from stack gases, there is a tradeoff between initial cost and operating costs. Because capital expenditures are subsidized, but operating costs are not, the firm rationally minimizing its own private cost may well select a device with a higher initial price—and a higher total resource cost—than would have been chosen without the subsidy. Hence, because capital appears to the firm to be cheaper than it actually is (for society), the total social cost for investment and operation of the precipitator may be increased. To the extent this occurs, pollution control becomes unnecessarily expensive.

Something similar happens in the choice between add-on devices and investment in process changes. Take, for instance, the case of a power plant operator deciding whether to buy a somewhat more expensive and more efficient scrubber, or to purchase a cheaper scrubber but invest in equipment improving the ratio of fuel consumption to output. Both are capital investments. Because sulfur emissions are generally directly proportionate to fuel consumption, increased fuel efficiency will actually reduce sulfur emissions—the same result as could be obtained with a better scrubber. But the scrubber would qualify for a capital subsidy through tax-exempt bonds, and the investment in better fuel efficiency probably would not. Again, there is clear danger that the option with the higher actual cost will be selected. And again the result can only be that society is getting less pollution abatement for the money spent.

The third efficiency problem with tax-exempt pollution control bonds is somewhat different. It relates to the more general effect of this subsidy in reducing the overall private cost of pollution abatement. Even though the social cost of achieving environmental quality is increased by such a subsidy, enough of the burden is shifted to the taxpayers rather than being paid by polluting industries to reduce the latter's total control expense. Because of this shift, industries that have disproportionately high levels of pollution and abatement expenditures will experience lower private costs and higher growth rates than would normally occur. This relative expansion of the high pollution industries further adds to the total social costs of pollution and of pollution control.

CONCLUSION

Despite the prominence of tax-exempt pollution control bonds in current environmental quality efforts, they represent a uniquely inappropriate control mechanism. They cannot do much to expedite enforcement. Their inequitable nature, their tendency to distort technology selection, and their encouragement of high pollution industries make them an inappropriate means of pollution control. The current tax-exempt bond debate should be used to explore other non-subsidy approaches to pollution control.

AMERICAN BAR ASSOCIATION,
Washington, D.C., June 9, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Finance Committee, Dirksen Office Building, Washington, D.C.

DEAR MR. CHAIRMAN: As Chairman of the Section of Taxation of the American Bar Association, I am writing this letter in connection with the hearings on the withholding of federal income taxes on interest and dividends.

At the time this subject was considered by your Committee in 1962, my predecessor as Chairman of the Section of Taxation, Randolph W. Thrower, submitted on behalf of the American Bar Association a detailed study on the extension of withholding of taxes to dividends and interest. Unfortunately, because of the shortness of time, the Section has not had the opportunity to update this study for purposes of these hearings. However, many of the considerations included in that study are relevant to the present inquiry. Accordingly, I am enclosing a copy of that study which was adopted as the action of the American Bar Association in August, 1961.

In our prior statement, we observed that the American Bar Association did not favor the extension of withholding to dividends and interest unless, after thorough investigation and analysis, it was reasonably apparent that such action was necessary.

Our conclusion was based on the premise that the necessary analysis would be made by, among other things, matching information returns with tax returns. We recognized that the cost of such matching would be substantial, but we emphasized that the results would justify the substantial expenditure because: (1) there should be better reporting as the result of public knowledge of the matching program, (2) additional tax will be collected from those whose understatements are revealed by the matching program, and (3) it will provide the data for a more informed determination as to the desirability of a withholding of tax on dividends and interest and its implementation, if determined to be desirable.

We understand that the Service has not been able to complete its plans for a comprehensive nationwide matching program due to a variety of reasons, including budgetary limitations on the necessary manpower and equipment.

Because the Service has not been able to complete the necessary matching program and thus has been unable to complete the investigation and analysis which we deem a prerequisite to the extension of withholding, we must again oppose such withholding until such time as a study proves that it is necessary. In this connection, we urge the Congress to provide the Internal Revenue Service with the necessary funds to establish a satisfactory matching program. All of the benefits we saw in 1962 from such a program and which have been summarized above will still result.

However, if this Committee deems it appropriate that withholding be extended to dividends and interest, then, I would offer the personal thought that consideration be given to assisting the payors and disbursing agents with the costs which they will incur in implementing a withholding program. These costs will be substantial and will require in many cases employment of new personnel and the purchase of new or additional computer equipment and software. The establishment of a withholding program on dividends and interest may create a particularly severe financial burden for small payors and disbursing agents.

For these reasons, I suggest that the payors and disbursing agents be allowed compensation equal to a small percentage of the amount of tax collected. This procedure has been used satisfactorily in connection with the collection of some state taxes and will defray in part the increased costs incident to the program. In this way, there would be some balancing of the burdens of the new program between Government and industry.

We appreciate the opportunity to offer this statement, and if we can be of additional assistance, please let us know.

Sincerely,

SHERMAN P. SIMMONS, *Chairman.*

AMERICAN BAR ASSOCIATION

SECTION OF TAXATION

REPORT ON
EXTENSION OF WITHHOLDING TAXES

LEGISLATIVE RECOMMENDATION FOR A
SYSTEM OF TAXPAYER ACCOUNT NUMBERS

ANNUAL MEETING
ST. LOUIS, MISSOURI
August, 1961

AMERICAN BAR ASSOCIATION
SECTION OF TAXATION
1961–1962

Chairman .... RANDOLPH W. THROWER
1500 First Nat'l Bank Bldg., Atlanta 3, Ga.

Vice Chairman .... ANDREW B. YOUNG
1222 Western Saving Fund Bldg., Philadelphia 7, Pa.

Secretary .... DARRELL D. WILES
1555 Railway Exchange Bldg., St. Louis 1, Mo.

Assistant Secretary .... PAUL H. WALKER
1701 K St., Washington 6, D. C.

Executive Secretary .... LUCY L. ALLEN
1120 Connecticut Ave., Washington 6, D. C.

COUNCIL

Ex-Officio ....The Chairman, Vice Chairman, Secretary, Section Delegate, and—
William R. Spofford, Last Retiring Chairman
1035 Land Title Bldg., Philadelphia 10, Pa.

For term ending 1962—William M. Emery
111 West Monroe St., Chicago 3, Ill.

Rupert N. Gresham
2100 Nat'l Bk. of Com. Bldg., San Antonio 5, Tex.

Seymour S. Mintz
810 Colorado Bldg., Washington 5, D. C.

For term ending 1963—Eugene F. Bogan
1108 - 16th St., Washington 6, D. C.

Valentine Brookes
1720 Mills Tower, San Francisco 4, Calif.

Harry K. Mansfield
50 Federal St., Boston 10, Mass.

For term ending 1964—F. Cleveland Hedrick, Jr.
1001 Connecticut Ave., Washington 6, D. C.

Clifford L. Porter
80 Pine St., New York 5, N. Y.

Meade Whitaker
902 First Nat'l Bldg., Birmingham 3, Ala.

Section Delegate to House of Delegates.......................... LEE I. PARK
808 - 17th St., Washington 6, D. C.

FOREWORD

The within report and legislative recommendation were prepared after extensive investigation by a special committee of the Section of Taxation of which Arthur B. Willis, Esq., Los Angeles, California, Chairman, and Lee I. Park, Esq., Washington, D. C., Vice-Chairman.

The report on extension of withholding taxes and the legislative recommendation on a system of taxpayer account numbers were adopted by the Section of Taxation at its Annual Meeting in St. Louis on August 5, 1961. On August 8, 1961 the report was presented to and adopted by the House of Delegates. The House of Delegates on the same day adopted the legislative recommendation. The legislative recommendation is accompanied by an explanation of the reasons for its adoption.

RANDOLPH W. THROWER
Chairman, Section of Taxation

SECTION OF TAXATION
AMERICAN BAR ASSOCIATION
1120 CONNECTICUT AVENUE
WASHINGTON 6, D. C.

REPORT ON EXTENSION OF WITHHOLDING TAXES AND LEGISLATIVE RECOMMENDATION FOR A SYSTEM OF TAXPAYER ACCOUNT NUMBERS

TABLE OF CONTENTS

	Pages
I. Report on Extension of Withholding Taxes	1
General Discussion	1
1. THE SCOPE AND NATURE OF THE PROBLEM	2
2. TAXPAYER ACCOUNT NUMBERS	3
3. THE SERVICE'S PLANS FOR AUTOMATIC DATA PROCESSING	4
4. BASIC ISSUES	4
4.1 Withholding of Tax Considered with Automatic Data Processing	4
4.2 Withholding of Tax on Dividends and Interest as an Interim Measure	5
5. WITHHOLDING PROBLEMS IN THE DIVIDEND AREA	6
5.1 Payor and Disbursing Agent Considerations	6
5.2 Payee Considerations	7
5.3 Fiscal Considerations	8
5.4 Economic Repercussions of Withholding of Tax on Dividends and No Withholding of Tax on Interest	9
6. WITHHOLDING PROBLEMS IN THE INTEREST AREA	9
6.1 Payor and Disbursing Agent Considerations	11
6.2 Payee Considerations	12
6.3 Fiscal Considerations	13
7. FACETS OF VARIOUS WITHHOLDING PLANS	14
7.1 Gross-Up with No Receipts	14
7.2 Receipts	16
7.3 Intra-Annual Refunds	17
7.4 Gross-Up with Receipts	17
7.5 Total Exemption Certificates for Tax Exempt Institutions	17
7.6 Total Exemption Certificates for Individuals	18
7.7 Partial Exemption Certificates for Individuals	18
7.8 Payees' Considerations—Interrelationship of Rates, Exemptions and Intra-Annual Refunds	18
7.9 Administrative Considerations	18
8. ADDITIONAL PROBLEMS	19
9. CONCLUSION	20
Exhibits	22
1. Withholding of Tax at 20% on Dividends and Interest (Assuming Standard Deduction)	22
2. Withholding of Tax at 20% on Dividends and Interest (Assuming Itemized Deductions)	26
3. Estimated Dividend Gap 1955 to 1959	30
4. Estimated Interest Income of Individuals Not Accounted For on Tax Returns for 1956, 1957, 1958 and 1959	31
II. Legislative Recommendation for a System of Taxpayer Account Numbers and Explanation	32

REPORT ON EXTENSION OF WITHHOLDING TAXES

General Discussion

One of the most significant tax measures before Congress in 1961 is that involving appropriate legislation to obtain better enforcement of the reporting of income from dividends and interest. Without question, the gap in underreporting of various types of income, including dividends and interest is a serious problem. The extent of the underreporting in various categories of income is illustrated in the following estimates furnished to the Ways and Means Committee at its hearings in 1959 (all figures are for 1957 and are after adjustment for estimated legitimate non-reporting because of personal exemptions):

Type of Income	Underreported (in Billions)
Dividends[1]	$ 0.9
Interest[2]	3.5
Salaries and wages[3]	5.5
Business and professional[4]	5.3
Farm operators[5]	2.9
Rent[6]	2.0
Total of above	$20.1

Unless effective steps are taken to close the gap, the careless or dishonest underreporters will continue to shift their fair share of the tax burden to the shoulders of others who report fully all income and pay tax thereon.

Recognising the interest of all concerned in this problem and the possible extension to dividend and interest payment of the withholding tax concept, in August, 1960, the Section of Taxation established this committee. The committee was instructed to investigate the various areas of problems pertaining to the underreporting of income by taxpayers and possible solutions to the problem. The committee was specifically instructed to submit a report on the advisability of and problems with respect to the extension of withholding of taxes on payments of dividends and interest.

After the appointment of the committee, its first activity was gathering available information concerning the extent of the problem and possible solutions. This included the panel discussions and the papers submitted in connection with the hearings before the Committee on Ways and Means in November and December, 1959, on the subject

[1] Holland, Compendium, page 1399, as revised in Hearings, page 768, and as adjusted in Compendium, pages 1400-1402, and revised in Hearings, pages 767-768.
[2] Holland, Compendium, page 1418, as adjusted at page 1419.
[3] Kahn, Compendium, page 1459, as adjusted in Hearings, page 781.
[4] Kahn, Compendium, page 1449, as adjusted at page 1455.
[5] Kahn, Compendium, page 1449, as adjusted at page 1455.
[6] Pechman, Hearings, page 121; see also page 125.

of broadening the tax bases. Further information was developed from other sources.

The committee made a conscientious effort to approach the problems objectively and without bias. It was agreed from the outset that steps must be taken to close the gap of underreporting of income. The only question was the best way to achieve that objective, having in mind the imminence of automatic data processing and the extent of the burden that the various proposals would impose upon the Internal Revenue Service and upon the payors and payees of dividends and interest.

The comments in this report may be materially affected by the more recent information and statistics which undoubtedly will be developed in the 1961 Congressional hearings.

There may be developments after the submission of this report (such as the introduction of a specific Administration bill on the subject of interest and dividends withholding) which might cause the committee to present, at the 1961 Annual Meeting, specific legislative recommendations. In the absence of any such Administration bill at the time of submission of this report, the committee's legislative recommendations have been confined in this report to the matter of taxpayer account numbers.

1. The Scope and Nature of the Problem

Any estimate of the gap representing improper underreporting of dividends and interest involves many assumptions, and is subject to a very large possible margin of error. Estimates made by different persons may differ substantially. However, the following table of estimated underreporting is taken from relatively recent information prepared by the Tax Analysis Staff of the Office of the Secretary of the Treasury:

Year	Dividend Reporting Gap	Interest Reporting Gap
	(In millions of dollars)	
1955	1,333	
1956	1,001	2,072
1957	851	2,534
1958	917	2,605
1959	940	2,837

Even if these estimates are subject to as much as a 50% margin of error, they still indicate a serious problem of underreporting in those areas.

The Commissioner's Annual Report for the fiscal year ended June 30, 1960, states that there were approximately 116 million Form 1099's and Form 1087's filed with the Internal Revenue Service during the fiscal year ended June 30, 1960. These report payments of dividends in excess of $10, interest in excess of $600, and other types of income such as rents, royalties, etc. The task of manually sorting these information returns and associating them with the returns filed by

the taxpayers has proved to be so massive that in the past the Service has succeeded in carrying through with the matching on only approximately 10% to 17% of the information returns.

Withholding of tax on salaries and wages has been in effect since 1943. Consideration has been given by Congress from time to time in the intervening period to the imposition of the withholding of tax on dividends and interest. Thus far, such legislation has not been adopted because it was believed to be unnecessary and to involve complexities, not present with salaries and wages, which would impose a substantial burden on business and investors.

To insure better taxpayer compliance in this area, a nationwide educational program was undertaken last year by the Treasury Department and the Internal Revenue Service to acquaint taxpayers with the legal requirements for reporting income from these sources. This campaign was conducted with the cooperation of the principal associations of interest and dividend payors and thousands of corporations, banks, and other institutions that make such payments. The analysis by the Service of the statistics of income for 1959 indicates that there was little improvement in 1959 as compared with 1958 in the reporting of dividends and interest. The improved reporting that was generally expected to follow the educational program may not be evident until 1960 or later years. Then again, the errors of estimate that are inherent in the final conclusion about the dividend and interest gaps may have offset some actual improvement for 1959 in reporting attributable to the educational program. As of the date of this report, the problem appears to be of sufficient magnitude to justify further serious consideration.

2. Taxpayer Account Numbers

This committee is taking separate action with a view to obtaining approval of a recommendation that the Congress adopt specific legislation providing for taxpayer account numbers and that such legislation be enacted as expeditiously as possible.

For the reasons set forth in the explanatory statement accompanying such legislative recommendation, the committee believes such legislation is highly desirable for effective utilization of automatic data processing whether or not a system of withholding of tax on dividends and interest is enacted. Even before automatic data processing becomes fully effective, the use of the taxpayer account number will facilitate the manual sorting and matching of information returns with taxpayer returns. During this interim period, taxpayer knowledge of the intended use of the taxpayer account numbers may have the psychological effect of encouraging a greater degree of reporting of income, including dividends and interest, than has been true in the past. Such numbers might well be used to close the gap, not only on dividends and interest, but also on other types of income where the gap is much greater. However, the extent of such effectiveness can be greatly influenced by the Treasury's program for acquiring the necessary automatic data processing equipment and instituting new procedures for the employment of such equipment as an enforcement aid.

3. The Service's Plans for Automatic Data Processing

The Internal Revenue Service plans an automatic data processing center to be located at Martinsburg, West Virginia, served by seven satellite centers located in various regions of the country. Taxpayer returns will be sent to a regional center where the information contained therein will be encoded upon magnetic tape. At the regional center the return will be mathematically verified and audit programs at the local level will be selected and processed on medium sized computers located in each regional center. Duplicate tapes will be forwarded to Martinsburg, West Virginia, where the information contained thereon will be collated with the taxpayer's master account number. Additionally, data from information returns filed with respect to each taxpayer will be inserted in his master account and collated with the other material therein. Ultimately, the taxpayer's complete tax history from the inception of automatic data processing will appear on a portion of magnetic tape located at the Martinsburg center.

Automatic data processing machines process information at extremely high speeds. Thus, the taxpayer's reported income can be matched with his information returns (W-2's, 1099's, 1087's etc.), and any discrepancies will be almost immediately available to the Service for enforcement purposes. In addition, new and accurate statistical information can be developed for use in both enforcement and legislative programs.

4. Basic Issues

The basic issues are:

(1) Would withholding of tax on dividends and interest be desirable when there is effective use of automatic data processing?

(2) If withholding of tax on dividends and interest would not be desirable when automatic data processing is in full operation, is withholding of tax on dividends and interest worthwhile as an interim measure until automatic data processing is in full operation?

(3) If the answer to either (1) or (2) is in the affirmative, what features should be included in the witholding tax system?

4.1 *Withholding of Tax Considered with Automatic Data Processing*

The suggestion has been made (by persons other officials of the Treasury Department) that withholding of tax on payments of dividends and interest is justified to eliminate the time gap on payment of income tax on income from dividends and interest as compared with income from wages, on which tax is now withheld. This does not appear to be sound. The existing statutory plan for current payments based upon declarations of estimated tax was intended to overcome this time gap.

Withholding of tax upon wages involves differing considerations. If a wage earner spends his tax money he may have nothing left with

which to satisfy his obligation for taxes, except his continuing earning capacity, which in turn is subject to additional income taxes, when realized. No similar reason exists in the dividend and interest areas. The recipients of dividends and interest, even though they spend their receipts, still own the underlying capital which produced the income and the Government can resort to this for the collection of its taxes.

It appears doubtful that, once automatic data processing is in full operation, withholding would appreciably reduce administrative costs.

If automatic data processing is used to the fullest extent practicable, it may be questioned whether withholding of tax upon dividends and interest would have sufficient administrative value, as a device for enforcing payment of tax upon income from dividends and interest, to justify the costs of imposition of such a withholding system. This assumes that the minimum requirement of $600 for reporting interest payments would be reduced, when automatic data processing is fully operative, to a level more comparable to the reporting requirement for dividends.

It has been suggested that withholding of tax on dividends and interest is justified to insure collection of tax on amounts that are too small to justify the administrative effort of identifying and collecting deficiencies in underreporting. If these amounts are too small to justify such administrative action, consideration should be given to whether they are too small to justify the burdens that would be imposed by withholding of tax on payors, payees, and the Service. It has never been suggested that there be withholding of tax solely on amounts of dividend and interest payments that are too small to justify administrative follow-up. The imposition of withholding of tax on all payments of dividends and interest in order to insure collection of a tax on the minimum fringe may involve an uneven balance of interests.

4.2 *Withholding of Tax on Dividends and Interest as an Interim Measure*

Automatic data processing will not be fully effective on a nationwide basis until approximately 1967 or 1968. The question accordingly arises as to the necessity for affirmative action prior to that time to close for the intervening years the gap in underreporting of dividends and interest.

One answer, proposed by the President, is to put in effect as of January 1, 1962, a withholding of tax on dividends and interest without issuance of receipts. Whether the problems involved in such a method of withholding of tax on dividends and interest outweigh the gains from the collection of such tax is a matter for serious consideration in the light of the discussion which follows.

5. Withholding Problems in the Dividend Area

There are more than thirty-eight million shareholder accounts in the United States, and the annual dividend payments are estimated to require in excess of one hundred million checks. However, there is a peculiarity in the dividend situation in that a substantial number of large corporations utilize the services of banks as disbursing agents. This narrows to some extent the impact of the problem, and at the same time aggravates the burdens on disbursing agents because they are acting for so many corporations.

For 1958, dividend income was reported in 5,125,813 returns of individuals in a total amount in excess of $9 billion.[7] This does not take into account dividends included in income on Form 1040A, since dividends on this form are not identified as such.[8] There were 41,955,064 returns for 1958 filed on Form 1040,[9] so that dividend income was reported in approximately 1 out of 8 returns.

Dividends in excess of the $50 exclusion were reported in 4,235,017 returns of individuals in a total amount of $8,740 million.[10] In number of returns, about one-half of the returns reporting dividend income had adjusted gross income of under $10,000.[11] In dollars reported, after deduction of the $50 exclusion, approximately one-half of the dividend income was reported by taxpayers with adjusted gross income of less than $25,000.[12] Although average dividends reported after deducting the exclusion were approximately $2,200 ($8,740,560 thousands÷4,235,017 returns),[13] over half of the returns filed reported taxable dividend income of under $400.[14]

5.1 *Payor and Disbursing Agent Considerations*

The disbursing agents who issue dividend checks for many corporations have special problems with respect to the utilization of their mechanical equipment. The committee was not able to ascertain the capabilities of existing equipment to handle additional reporting requirements, and particularly to handle reporting requirements connected with withholding of tax on dividends. Obviously, however, if a *reporting* requirement were imposed in connection with withholding of tax on dividends, both the disbursing agents and the corporations which pay dividends directly to their stockholders would be faced with the problem of changeover to new equipment which would meet the requirements thereby thrust upon them.

[7] Statistics of Income—Individual Income Tax Returns for 1958 (hereinafter referred to as "Statistics of Income"), page 4, Table B, Column (3).
[8] Statistics of Income, page 4.
[9] Statistics of Income, page 15, Table Q, Column (1).
[10] Statistics of Income, page 30, Table 4, Columns (4) and (5).
[11] Computation from data in Statistics of Income, page 30, Table 4, Column (4).
[12] Computation from data in Statistics of Income, page 30, Table 4, Column (5).
[13] See note (12).
[14] Computation from Statistics of Income, page 44, Table 6, Columns (1), (2), (3), (4) and (5).

5.2 *Payee Considerations*

Because of exemptions, standard deductions, and other such allowances, a withholding system would necessarily involve some excess withholding on dividend receipts in the lower income brackets. This will work a hardship on such recipients (with the exception of special groups such as minors supported by their parents), unless some special provision is made to rectify overwithholding.

Due to the deductions, exemptions and dividend credits allowable under existing law, surprisingly large amounts of dividends may be received, and still have overwithholding at a 20% rate, if the taxpayer's sole income is from dividends. This is illustrated in the following table, which shows the amounts of dividend income where tax payable exactly equals tax withheld at a 20% rate. If the dividend income were any less than the amount indicated, there would be overwithholding.

	Standard Deduction	Deduction of 13% of Adjusted Gross Income [16]
Married couple filing joint return; both over 65; no dependents ...	$24,950	$32,103
Married couple filing joint return; both under 65; no dependents ...	21,950	28,633
Head of household with one dependent; under 65	16,447	20,153
Single person; over 65; no dependents	13,750	16,116
Single person; under 65; no dependents	12,296	14,384

Figures are not available in the Statistics of Income as to the number of returns reporting only dividend income, so it is impossible to draw any conclusions as to the number of taxpayers in this category who will be subjected to overwithholding on dividends.

Overwithholding on dividends will not exist if there is sufficient taxable income not subject to withholding (or subject, as in the case of wages, to withholding that reflects the standard deduction and any exemptions). Some examples of the break-even point in income subject and not subject to withholding of tax are set forth in Exhibits 1 and 2, attached.

From an administrative standpoint, it is necessary to weigh the desirability of fairness to lower bracket taxpayers against the administrative problems that may be involved in reducing the hardship of overwithholding.

It is not possible to do more than to estimate the category of payees

[16] Ratio of Deductions to Adjusted Gross Income for all taxable returns with Adjusted Gross Income of $25,000 to $50,000; computed from data in Statistics of Income, page 57, Table 10.

who are principally responsible for the underreporting of dividend income. Statistics developed a decade ago indicate that a substantial portion of the underreporting occurs in connection with taxpayers in lower income brackets. Thus, it was estimated that 34.5% of the dividend underreporting for the year 1948 occurred in connection with taxpayers having an income of less than $7,000 a year.

Consideration was given by the committee to the possibility of a personal exemption, similar to that in the case of wages. The problems involved with respect to exemptions from withholding of tax are discussed at Sections 7.5, 7.6 and 7.7, *infra*.

Provision for intra-annual refunds, perhaps on a quarterly basis, would reduce the burden on the low bracket recipients of dividend income. This, however, would multiply the administrative problems of the Service, and such problems would probably be greater without receipts than with receipts. It would also present serious problems for payors if receipts were required. Even without receipts, payors would be faced with problems in connection with the necessity for furnishing information to the payee which the payee could use to support his claim for refund, assuming that such supporting information with respect to intra-annual refunds would be necessary.

The lowering of the withholding rate is one means of reducing the problem of overwithholding, but this, in turn, reduces the effectiveness of the withholding tax as an instrument to insure full reporting of dividend income and to reduce the revenue loss from underreporting.

Consideration might be given to an alternative such as allowing interest on refunds of overwithheld tax on dividends from an earlier date (for example, from June 30 of the year in which the overwithholding occurred). The additional interest on the refund would compensate for the payees' loss of use of the dividend income and the extra interest cost to the Government may be less than the administrative cost in verifying and handling intra-annual refunds.

5.3 *Fiscal Considerations*

The direct cost to the Treasury Department in administering a withholding of tax on dividends necessarily depends upon the nature of the withholding system and the extent to which an attempt is made to alleviate overwithholding by means such as intra-annual refunds. We were advised that in the case of refunds of excess withholding on wages, it is currently costing the Service 34 cents to process each refund, plus 15 cents for each refund check, a total cost of 49 cents per refund. The Service, at the present time, makes approximately 35 million refunds between January 1 and May 31 of each year. No practical estimate can be made of the cost to the Service of handling refunds of excess withholding of tax on dividends.

There is an additional cost to the Treasury Department of withholding in that payors will incur increased expenses with respect to the operation of the withholding system and additional reporting to payees and the Treasury Department. These additional costs will be

deductible in computing the taxable income of the payors, and in most cases the Treasury Department will bear 52% of these additional costs. If the Treasury Department does not require receipts, these additional costs will arise only to the extent the payor is required, or finds it appropriate, to furnish information to the payees at the request of the payee or voluntarily as a matter of good business practice.

The cost to payors is also dependent upon the nature of the withholding system. A gross-up withholding of tax, involving no receipts to payees and no additional reports to the Internal Revenue Service, would involve very little additional cost to payors. However, a system involving receipts to payees might create a large economic and administrative burden on corporations. This cost would be considerably increased if there were an enforcement of the requirement of an annual reporting of dividends paid during the year, rather than the current acceptance of reporting dividends paid on a per dividend basis.

5.4 *Economic Repercussions of Withholding of Tax on Dividends and No Withholding of Tax on Interest*

Mechanically it would appear less difficult to impose tax withholding on dividends than on interest for reasons that will be developed in Section 6 of this report. Therefore, there may be an inclination to impose the withholding of tax on dividends and not to impose a withholding of tax on interest.

It is believed that it would be unwise and inequitable to impose a withholding of tax on dividends and not on investment-type interest. A one-sided withholding might encourage investors to switch from corporate stocks to interest-bearing obligations. Further, the gap of underreporting for 1956 and 1957 appeared to be approximately two to three times as great in the interest field as in the dividend field.

6. Withholding Problems in the Interest Area

There is no centralization of payors of interest in a relatively small group as in the case of dividends. On the contrary, interest payments involve every segment of our economy, from the long-range financing of business enterprises and the United States Treasury to the typical credit transactions wherein the consumer buys merchandise on charge accounts or conditional sales contracts; from the financing of railroad rolling stock to the savings of children in their school thrift programs. There is also a wide spread of taxpayers receiving interest payments. This would range from the small savings account in a bank or savings and loan association to finance companies and lending institutions whose principal business is the earning of interest. It appears to be generally accepted that a large part of the gap in underreporting of interest income arises with respect to small taxpayers receiving relatively small amounts of interest income on government obligations and on deposits in savings accounts in banks or savings and loan associations.

There are attached hereto, as Exhibits 3 and 4, tables recently prepared by the Tax Analysis Staff of the Office of the Secretary of the Treasury which give breakdowns of interest and dividend payments by types for several recent years.

As noted at Section 5.2 in connection with dividend income, surprisingly large amounts of investment-type income may be received and there still may be overwithholding of tax at a 20% rate, if the taxpayer's sole income is from income subject to withholding of tax. This is illustrated in the following table which shows the amount of interest income if interest constitutes the only taxable income where tax payable exactly equals tax withheld at a 20% rate. If the interest income were any less than the amount indicated, there would be overwithholding.

	Standard Deduction	Deduction of 13% of Adjusted Gross Income [16]
Married couple filing joint return; both over 65; no dependents...	$19,000	$24,384
Married couple filing joint return; both under 65; no dependents...	15,400	20,125
Head of houshold with one dependent; under 65...........	12,367	14,847
Single person; over 65; no dependents	10,771	12,192
Single person; under 65; no dependents	8,857	10,063

Figures are not available in the Statistics of Income as to the number of returns reporting only investment-type interest income, so it is impossible to draw any conclusion as to the number of taxpayers in this category who will be subjected to overwithholding on interest.

Overwithholding on interest will not exist if there is sufficient taxable income not subject to withholding (or subject, as in the case of wages, to withholding that reflects the standard deduction and any exemptions). Some examples of the break-even point in interest subject to withholding tax and other income subject to no withholding tax are set forth below (Schedules attached as Exhibits 1 and 2 show more comprehensively the break-even points of income subject and not subject to withholding of tax (i.e., the points at which the tax payable exactly equals the tax withheld at source).):

[16] See footnote (15).

	Standard Deduction	Deduction of 20% of Adjusted Gross Income[17]
Married couple filing joint return; both over 65; no dependents		
1. If taxable income is	$ 1,000	$ 1,000
Adjusted gross income will be	3,778	4,250
There will be overwithholding if—		
Interest subject to withholding is more than	1,000	1,000
Interest not subject to withholding is less than	2,778	3,250
2. If taxable income is	5,000	5,000
Adjusted gross income will be	8,222	9,250
There will be overwithholding if—		
Interest subject to withholding is more than	5,100	5,100
Interest not subject to withholding is less than	3,122	4,150
3. If taxable income is	10,000	10,000
Adjusted gross income will be	13,400	15,500
There will be overwithholding if—		
Interest subject to withholding is more than	11,000	11,000
Interest not subject to withholding is less than	2,400	4,500
4. If taxable income is	15,000	15,000
Adjusted gross income will be	18,400	21,750
There will be overwithholding if—		
Interest subject to withholding is more than	18,100	18,100
Interest not subject to withholding is less than	300	3,650

6.1 *Payor and Disbursing Agent Considerations*

Many of the payor and disbursing agent considerations with respect to withholding of tax on interest are similar to those previously discussed at 5.1 with respect to withholding of tax on dividends. In addition, there are special problems in the interest area which must be considered.

One such is the "back-to-back" interest problem. Thus, a bank may have tax withheld on some of the interest it receives, on loans, and at the same time be paying interest to the Federal Reserve Bank on its own borrowings. Thus, until such time as the interest withheld could be applied against its tax liability, such a financial institution would be placed under an economic handicap. Of course, the individual

[17] Ratio of Deductions to Adjusted Gross Income for all taxable returns with Adjusted Gross Income of less than $10,000; actual figure, computed from data in Statistics of Income, page 57, Table 10, is 19.53%, which was rounded to 20%.

who has tax withheld on interest paid to him may also be put to an economic disadvantage, but the problem may be more serious in the case of a financial institution whose interest income may be in large part offset by interest payments.

Another matter to be considered with respect to withholding of tax on interest is the effect of such withholding on the normal practice of depositors leaving in the bank or savings and loan association the interest earned, thus increasing the depositors' balance. To an appreciable extent, this practice also exists in the dividend area under dividend reinvestment programs sponsored by investment companies and others.

While withholding of tax on dividends would be applicable to all payors, withholding of tax on interest would not be apt to have such wide application. In contrast to dividend transactions which involve only a corporation and its shareholders, borrowings cut across every type of business and personal transaction and the imposition of withholding requirements on every interest transaction would swamp both persons and businesses with paperwork. Such an imposition would also impose almost insoluble administrative problems upon the Service. The delinquent trust accounts would probably rise because of the failure of a payor of a few dollars of interest to remit the withheld amount to the Service. And because of the volume of transactions, most of which would involve small amounts, the cost of enforcement would be disproportionate to the amount collected. This suggests that interest payments made by individuals should be excluded from the requirements of withholding.

In the first instance at least, withholding might preferably be limited to interest on corporate and government obligations, savings accounts and like investments. Presumably there would be withholding on such investment-type interest received by corporations, partnerships and other recipients, as well as by individuals. The exclusion from withholding of other types of interest should not affect collections of tax upon interest adversely and would, at the same time, materially decrease the administrative and enforcement problem existent in this area. It would, however, seem to require separate reporting of withholdable and nonwithholdable interest in the tax return forms of recipients.

6.2 *Payee Considerations*

Payee considerations involve matters previously discussed at Section 5.2 with respect to the overwithholding of tax on dividend payments. In addition, in the case of the savings accounts at a bank or savings and loan association, the payee usually must take affirmative action to determine the amount of interest earned on his deposit. This differs from the dividend situation where the owner of the stock or his nominee receives the dividend check, and therefore has information as to his dividend income during the year. In the case of the savings account, the interest is credited to the account and the depositor gener-

ally does not know the amount of his interest income until such time as he turns in his passbook for crediting of the interest.

As in the case of withholding of tax on dividends (also discussed at Section 5.2 above), the desirability of fairness to lower bracket taxpayers must be weighed against the administrative problems to the Service and to the payor. These will depend in part upon the nature of the withholding system and the reporting requirements. The additional cost to the Service of administering tax withholding presumably would be a substantial amount, but we know of no basis for a reliable estimate. The same observation would apply to the additional cost to the payors. The increased cost of the payors would reduce taxable income and income tax liability of the payors.

6.3 *Fiscal Considerations*

In addition to the costs to the Service of administering the tax withholding system and the cost to the payors of interest, there would be significant fiscal effects upon obligations of the United States Government if there is to be a reporting requirement by payors. In the absence of such requirement, there may possibly be some effect because of requests for information from payees. The committee was informed in December, 1960, that of $288 billion of interest-bearing obligations, there are $243 billion in the hands of the public. Of the $243 billion, $185 billion are in the form of marketable securities. There are $39 billion of Treasury bills sold at a discount and $25 billion of certificates of indebtedness, most having two interest certificates attached and some only one. Of $42 billion of Treasury notes, about half have coupons and half do not. Of the nonmarketable securities, the bulk is in savings bonds, of which $9 billion are in interest-bearing form. In the case of savings bonds, there are 440 million pieces, aggregating $38 billion.

The committee was also informed in December, 1960, that providing annual information returns with respect to interest paid by the United States Government would be expensive. In the case of some bonds it might be possible to have the withholding done by banks which cash the bonds or the interest coupons. The Treasury Department now pays an average of 12 cents per bond to banks for their services in handling redemptions. If the bank is required to prepare a receipt and an information return, it is estimated this might double the cost.

In December, 1960, we were informed that the additional estimated cost to the Treasury Department of complying, as an issuer of bonds, with a tax withholding system involving receipts might run from $11 million to $25 million a year, depending upon the reporting and receipt requirements of a particular withholding system. These figures do not include the additional cost with respect to registered bonds.

An effective tax withholding system for interest payments would almost certainly have to include interest payments by the United States Government on its outstanding obligations.

7. Facets of Various Withholding Plans

It is obviously necessary to balance the considerations of fairness to taxpayers against the administrative cost to the Service and to the payors of dividends and interest and withholding agents. Any system should be so devised that it would not encourage wholesale dishonesty or errors because of the lack of reasonable verification of claims for refund of overwithholding of tax. On the other hand, if the system becomes enmeshed in too many intricacies it may strangle in its own complexity.

7.1 Gross-Up with No Receipts

A plan for withholding of tax ostensibly involving a minimum of administrative complications to the Service, to payors and recipients of dividends and interest is the gross-up plan without receipts to payees. This is the theory of the withholding plan proposed in the President's Tax Message and explained in more detail in the statement of the Secretary of the Treasury. Under this concept there would be withholding of tax at a rate which would permit easy grossing-up. For example, the withholding rate might be at 20%, with the 80% being remitted to the owner of the stock or of the interest-bearing obligation. The recipient would total the amounts he had received as dividends or interest payments and gross-up by adding 25% of the total amount he had actually received, and reporting the sum as his income from dividends and interest. He would then claim a credit in his tax return for the tax withheld in an amount equal to 20% of the total amount reported as dividend and interest income. The payor would remit the tax withheld but make no additional reports to the Internal Revenue Service and would not be required to issue any receipts to the payee.

The introduction of a gross-up concept of reporting dividends and certain interest would present substantial problems of form design, particularly with respect to Forms 1040A and 1040W. The extra gross-up computations may lead to additional errors in returns and difficulties in processing.

The principal objection to this simple approach lies in the absence of any feasible verification of refund claims. Since there would be no receipts, an individual might claim refund based on his contention that he had received $50 or $100 of dividend income, which is not taxable because of his exemptions and deductions, relying on the fact that he is not required to submit receipts or other proof of tax withheld. The Service would have to be prepared for the most part to allow the refund on a "quickie" basis without any attempt at verification. No doubt certain information would be required in the claims for refund, such as listing by payors and amounts the dividends and interest on which there was withholding. It has been suggested that this would tend to inhibit filing of false claims for refund.

Another problem of withholding of tax without receipts is the payee's difficulty in distinguishing in his tax return between interest on which tax has been withheld and interest on which there was no withholding.

This would appear to impose an additional record-keeping burden on small taxpayers.

The proponents of this plan suggest that protection against cheating could be achieved through sample checks in various communities of refund claims for overwithholding on dividends and interest. There would be letters mailed out to the sample selectees requesting specification as to the sources of the dividends and interest payments, and probably a subsequent letter to the alleged sources of these payments requesting verification that such amounts were paid to the taxpayers claiming the refund and that tax in the amount claimed was withheld. This might be done on a very small percentage of the total claims for refund, but considerable publicity would be given to the verification program, and a few criminal actions instituted in a community undertaken for the purpose of publicizing the penalties that might attach to fraudulent claims for refund of taxes alleged to have been overwithheld.

After careful consideration of this plan, serious doubts remain as to the adoption of a system permitting refunds without receipts unless Congress is satisfied that it would not lead to extensive fraudulent or erroneous refund claims against the Government. The committee did not find appealing the "in terrorem" concept that prosecution of a few violators is the proper means to deter others from cheating. If withholding of tax is adopted, it is desirable that the plan include administrative provisions that will assure proper functioning.

Such a plan would be feasible, at best, in a limited number of cases involving relatively small receipts of dividends or of interest subject to withholding from only a few sources. However, to the knowledge of the committee, no realistic estimate has been made of the number of cases of overwithholding which may arise at the proposed 20% rate. Some idea of the minimum figure of overwithholding situations is available from the information that for 1958 dividends were reported on 608,362 nontaxable returns filed by individuals and interest income was reported on 1,215,439 nontaxable returns filed by individuals.[18] There will be a substantial amount of dividend and interest income reported by tax-exempt corporations, charitable trusts, pension and profit-sharing plans, and other tax-exempt institutions. The extent to which overwithholding on dividends and interest paid to these organizations will actually be subject to offset, as suggested in the statement of the Secretary of the Treasury, against social security and wage withholding is in the realm of speculation.

In addition, there is what appears to be an unknown area of possible refunds of overwithholding on taxable returns. As reflected in Exhibits 1 and 2, attached, the dollar size of returns in which there would be overwithholding at the 20% rate is surprisingly large ($32,103 of income solely from dividends in the case of a married couple, both over 65, with no dependents and deductions of 13% of adjusted gross income, which was the national average in 1958 for this bracket; $24,384 of income solely from interest with the balance of the assumed

[18] Statistics of Income, page 30, Table 4, Columns (4) and (6), Line 38.

facts the same). The prospect of withholding of tax on dividends and interest could be approached with greater certainty if more facts were known about the magnitude of the problem, and particularly of intra-annual refunds of overwithholding.

The sizable amounts of dividend and interest income which may produce overwithholding in certain cases (see Exhibits 1 and 2, attached), raise an important question as to the administrative feasibility of properly processing refund claims without receipts. It may be feasible to spot-check refund claims involving a few hundred dollars of dividend and interest income from a small number of payors. It is difficult to contemplate an adequate verification of refund claims where the dividend or interest income runs into the thousands of dollars and may be from 50 to 100 or more sources.

7.2 *Receipts*

If Congress should adopt a tax withholding system for dividends and interest, further consideration should be given to legislation which requires issuance of receipts to payees. In the long range it is believed inevitable that receipts will have to be furnished to the payees on an annual basis, summarizing the total payments to the payee during the year. As a temporary expedient it might be satisfactory to permit receipts to be furnished with respect to each payment so as to ease the burden upon the payor during the transition period, although there may be difficulties in the replacement of lost or mislaid receipts.

Automatic data processing bears upon the necessity of receipts. Without automatic data processing, receipts seem highly desirable for good administration, both from the standpoint of protecting the Treasury from improper claims and from the standpoint of assisting the honest taxpayer by giving him supporting proof of his claim. They may prove invaluable in the processing of claims for refund of tax overwithheld or claims for credit in excess of the tax actually being paid on the reported amount of dividends and interest. With automatic data processing, the receipt system may be less important than it would be at the present time from an administrative standpoint, assuming a lowering of the present $600 minimum for filing of information returns regarding payments of interest.

Realistically, a system starting out with no receipts might well convert itself, in a relatively short time, to a receipts system. It may well be that the Treasury Department, after an initial experience with a no-receipts system, will find that receipts to payees are essential.

Even if the Treasury Department is willing and able to accept a no-receipts system, payees may well demand receipts to assist them in preparing their returns or claims for refund. The demands of the payees for receipts probably will be addressed initially to the payors. If the response is not fast enough and complete enough, Congress may be requested by the payees to enact legislation requiring payors to furnish receipts.

7.3 *Intra-Annual Refunds*

There will be hardships, especially in the first year of the withholding tax, to small bracket taxpayers relying upon income from dividends and interest as a source of livelihood if taxes are overwithheld, and the taxpayer cannot recover the tax overwithheld until after the end of the taxable year. It has been suggested that there might be intra-annual refunds to take care of these cases. The committee gave careful consideration to the problems involved in intra-annual refunds with full sympathy for the problems of the small taxpayer, but the committee concluded that intra-annual refunds would involve serious administrative complications which would have to be balanced against the hardship on payees.

It should be noted that one objection to intra-annual refunds with respect to dividends and interest is that it might establish a precedent for intra-annual refunds on overwithholding of wages. Thus, the administrative problem of making intra-annual refunds could eventually become much greater than that which would flow directly from intra-annual refunds of overwithholding solely in connection with dividends and interest payments.

7.4 *Gross-Up with Receipts*

The gross-up concept, as indicated at 7.1, is indispensable to a withholding plan which does not involve receipts to payees. It has been suggested that the gross-up concept would also be of value, even in a withholding plan which did involve receipts to payees.

The committee concluded that, while there might be some incidental benefits from ease in grossing-up receipts of dividends and interest to determine the total amount of these payments before withholding of tax, on the whole the receipt system sufficiently answered the verification problems so that the gross-up concept was not an essential feature of a withholding plan involving receipts.

7.5 *Total Exemption Certificates for Tax Exempt Institutions*

It has been proposed (by persons other than officials of the Treasury Department) that tax-exempt institutions be permitted to file exemption certificates under the terms of which they would not be subject to withholding on dividends and interest received. From the standpoint of the payor and withholding agent, this would increase the cost because these exempt institutions would have to be flagged and the full amount of any dividend or interest remitted to them. It has been suggested (by persons other than officials of the Treasury Department) that the number of total exemption certificates is sufficiently small to permit this to be done without an additional disproportionate cost burden upon the payor. The committee is informed that, to the extent payors can use automatic or machine processing of withholding, the introduction of an "all or nothing" exemption would not materially alter the system insofar as costs are concerned. The exempt recipients

would, of course, benefit from this because they would not have to wait to receive the refunds and the Service would be spared the mechanical problem of making such refunds.

7.6 *Total Exemption Certificates for Individuals*

The withholding statute might provide for no tax to be withheld on payments of dividends and interest if the payee has filed with the payor a certificate of exemption. It is further assumed that the exemption certificate would be issued only in cases where the payee's exemptions exceeded his expected income from all sources.

There occurred to the committee no serious objections to such exemption certificates, unless the number of such certificates issued was sufficiently large to cause a substantial increase in the payor's handling costs.

7.7 *Partial Exemption Certificates for Individuals*

The committee considered a plan for partial exemption certificates for individuals to be filed in much the same manner as they are with W-2 statements. Such an exemption system would be very costly to payors and withholding agents because of the difference in handling each separate payment in accordance with particular exemption certificates filed by the payee. Unlike wage withholding where there is a personal relationship between the employer and the employee, the corporation shareholder and creditor-debtor relationship is by and large conducted entirely by mail, and the additional correspondence and paperwork involved in securing both proper exemption certificates and a verification with respect to status would be immense. The personal exemption certificate works well with wage withholding where there usually is only one employer. However, the investor may have dividends and interest from several sources, thereby complicating the operation.

7.8 *Payees' Considerations—Interrelationship of Rates, Exemptions and Intra-Annual Refunds*

From the standpoint of the payee, the use of the exemption or the provision for intra-annual refunds are mechanics for alleviating the burden caused by overwithholding. To some extent the same result can be achieved by a lowering of the effective withholding rate. These three mechanics are not mutually exclusive and can be applied either alone or in combination.

7.9 *Administrative Considerations*

From the standpoint of administering a withholding system, the interrelationship of these various facets must be explicitly set forth. It can reasonably be anticipated that there will be many claims for refund filed if intra-annual refunds are permitted. This committee knows of no way effectively to check the validity of these claims without a receipt system.

The advantage to be gained by the use of the gross-up technique, that is, a flat rate and simplicity of determining the gross amount to be reported as income, disappears if personal exemptions are permitted. The use of variable personal exemptions will change the effective withholding rate on each payee, and grossing-up will then be invalid. Similarly, if personal exemptions are permitted, receipts will be necessary to permit both the taxpayer and the Service to know what the effective withholding rate was. Therefore, no personal exemption system can be permitted unless a receipt system is adopted.

Similarly, intra-annual refunds are designed to accomplish the same results as personal exemption certificates. It would seem to increase unnecessarily the paperwork of the payees, payors and the Service to use both of these techniques when one should suffice, and the addition of the second technique would not be economically sound.

If intra-annual refunds are permitted, a simple gross-up will not be valid for a person who has received an intra-annual refund and special provision will have to be made for such person.

8. Additional Problems

There are a number of additional problems which must be solved in the enactment of legislation designed to institute withholding on dividends and interest.

If no receipts are required, the payee will be in the position of having part of his money sent to the United States Government although the payor is not required to furnish any accounting to him annually or periodically. There should be considered a statutory enactment which will require certain payors to account to payees upon demand. It may be that such legislation would be necessary only with respect to United States obligations, such as Series E Bonds. A taxpayer selling or buying stock will ordinarily have the certificate or some record from the broker to show his ownership of the stock. A taxpayer buying or cashing Series E Bonds at a bank, however, may have no record of his ownership, and may be unable to prove to an examining revenue agent his right to a credit or refund.

If there are no receipts, the definition of the payments which are subject to withholding, and the payments which are not, should be very simple and very clear, so as to avoid confusion and error by payees. The definition of a dividend as presently contained in the Internal Revenue Code may be too complicated for purposes of any system of withholding without receipts.

Whether or not there are receipts, there will be special problems in determining how to treat, and who is to obtain the benefits of, the withheld amount in the case of fiduciaries who receive income and make distributions of all or part of their income to beneficiaries, in the case of partnerships, in the case of regulated investment companies, in the case of corporations which have elected to be taxed under Subchapter S, and so forth. All of these areas of the tax law are already quite complicated, and the provision for the treatment of withheld amounts in these cases should be as simple as possible. It might

be undesirable to require a "tracing" of the dividend or interest on which there is withholding.

The present income tax forms are quite complicated. The provisions for withholding may make them even more complex. This will be particularly true if the withholding system does not require receipts, since there will then probably have to be two schedules, one for dividends and interest subject to withholding, and another for dividends and interest not subject to withholding.

The present system for estimated tax returns should be reconsidered so as to coordinate its requirements with the new withholding system.

9. Conclusion

The committee would favor a withholding of tax on dividends and interest, if it were demonstrated to be a practicable way and the only practicable way to close the gap in reporting of dividends and interest within a reasonable time. However, the committee does not favor such withholding unless, after thorough investigation and analysis, it is reasonably apparent that this is necessary.

In making such investigation and analysis the following should be considered:

1. Separation from the balance of the current tax legislation the matter of taxpayer account numbers and sending that through as a separate bill.

   The effective date would be the earliest practicable. Information furnished to the committee is to the effect that a changeover to taxpayer account numbers in the case of a large proportion of dividend payors might be possible by January 1, 1963. The committee has no information as to when interest payors could commence operations with taxpayer account numbers.

2. Reduction of the information return requirements on interest payments.

   A level of around $100 may be more realistic than the present $600 level.

3. If taxpayer account numbers can go into full operation in 1963, a complete collation and matching of information returns with tax returns for that year.

   a. Acceleration of the time schedule for automatic data processing so as to obtain as much assistance as possible from the new electronic equipment.

   b. Communication with a substantial percentage of taxpayers who understate dividend and interest income for 1963 beyond a tolerance set by the Treasury Department.

   c. Examination of the returns for prior years of taxpayers who substantially understate dividend or interest income for 1963. The information developed for 1963 would assist in this operation.

   d. Development of more statistical information from the matching of information returns with tax returns. This infor-

> mation would show more accurately than is presently possible how much dividend and interest income is underreported and the brackets of the taxpayers involved. Data should be developed so that there will be information which will make it possible, for example, accurately to estimate the number and amount of refunds because of overwithholding at various alternative rates.

The cost of the matching of all information returns with tax returns will be very large. However, this committee believes that the results would justify a substantial expenditure because: (1) there should be better reporting as the result of public knowledge of the matching program, (2) additional tax will be collected from those whose understatements are revealed by the matching program, and (3) it will provide the data for a more informed determination as to the desirability of a withholding of tax on dividends and interest and its implementation, if determined to be desirable. The above suggestions are directed at all types of underreported income, which for 1957 were estimated to aggregate more than $20 billion.

EXHIBIT 1

WITHHOLDING OF TAX AT 20% ON DIVIDENDS AND INTEREST

Analysis of Points at Which There Will Be an Overwithholding of Tax Under Various Stated Assumptions

(All Computations Assume the Standard Deduction and Do Not Include the Retirement Income Credit)

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
1. Income solely from dividends; present law as to exclusion and credit for dividends					
Withholding at 20% will result in overwithholding on any income under.	$24,950	$21,950	$16,447	$13,750	$12,296
2. Income solely from withholdable interest					
Withholding at 20% will result in overwithholding on any income under.	19,000	15,400	12,367	10,771	8,857
3. Mixed income—part subject to 20% withholding and part not subject (no recognition of dividend exclusion or credit)					
a. Taxable income of $1,000					
Gross income	3,778	2,444	2,444	2,444	1,778
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	1,000	1,000	1,000	1,000	1,000
And the amount of income not subject to withholding is less than	2,778	1,444	1,444	1,444	778
b. Taxable income of $2,000					
Gross income	4,889	3,556	3,556	3,556	2,889
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	2,000	2,000	2,000	2,000	2,000
And the amount of income not subject to withholding is less than	2,889	1,556	1,556	1,556	889
c. Taxable income of $3,000					
Gross income	6,000	4,667	4,667	4,667	4,000
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	3,000	3,000	3,050	3,100	3,100
And the amount of income not subject to withholding is less than	3,000	1,667	1,617	1,567	900
d. Taxable income of $4,000					
Gross income	7,111	5,778	5,778	5,778	5,111
There will be overwithholding if—					

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
Amount of income subject to withholding is more than—	$4,000	$4,000	$4,100	$4,200	$4,200
And the amount of income not subject to withholding is less than	3,111	1,778	1,678	1,578	911
e. Taxable income of $5,000					
Gross income	8,222	6,889	6,889	6,889	6,222
There will be overwithholding if—					
Amount of income subject to withholding is more than—	5,100	5,100	5,300	5,500	5,500
And the amount of income not subject to withholding is less than	3,122	1,789	1,589	1,389	722
f. Taxable income of $6,000					
Gross income	9,333	8,000	8,000	8,000	7,333
There will be overwithholding if—					
Amount of income subject to withholding is more than—	6,200	6,200	6,500	6,800	6,800
And the amount of income not subject to withholding is less than	3,133	1,800	1,500	1,200	533
g. Taxable income of $7,000					
Gross income	10,400	9,111	9,111	9,111	8,444
There will be overwithholding if—					
Amount of income subject to withholding is more than—	7,300	7,300	7,800	8,300	8,300
And the amount of income not subject to withholding is less than	3,100	1,811	1,311	811	144
h. Taxable income of $8,000					
Gross income	11,400	10,200	10,200	10,200	Not Applicable
There will be overwithholding if—					
Amount of income subject to withholding is more than—	8,400	8,400	9,100	9,800	
And the amount of income not subject to withholding is less than	3,000	1,800	1,100	400	
i. Taxable income of $9,000					
Gross income	12,400	11,200	11,200	Not Appli	
There will be overwithholding if—					
Amount of income subject to withholding is more than—	9,700	9,700	10,600		
And the amount of income not subject to withholding is less than	2,700	1,500	600		

73-744 O - 76 - 15

EXHIBIT 1—*Continued*

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
j. Taxable income of $10,000					
Gross income	$13,400	$12,200	$12,200	Not Applicable	
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	11,000	11,000	12,100		
And the amount of income not subject to withholding is less than	2,400	1,200	100		
k. Taxable income of $11,000					
Gross income	14,400	13,200	Not Applicable		
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	12,300	12,300			
And the amount of income not subject to withholding is less than	2,100	900			
l. Taxable income of $12,000					
Gross income	15,400	14,200			
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	13,600	13,600			
And the amount of income not subject to withholding is less than	1,800	600			
m. Taxable income of $13,000					
Gross income	16,400	15,200			
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	15,100	15,100			
And the amount of income not subject to withholding is less than	1,300	100			
n. Taxable income of $14,000					
Gross income	17,400	Not Applicable			
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	16,600				
And the amount of income not subject to withholding is less than	800				

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
o. Taxable income of $15,000					
Gross income	$18,400				
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	18,100				
And the amount of income not subject to withholding is less than	300				

EXHIBIT 2

WITHHOLDING OF TAX AT 20% ON DIVIDENDS AND INTEREST

Analysis of Points at Which There Will Be an Overwithholding of Tax Under Various Stated Assumptions

(All Computations Assume Total Deductions as Indicated and Do Not Include the Retirement Income Credit)

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
1. Income solely from dividends; present law as to exclusion and credit for dividends (Footnote 1)					
Withholding at 20% will result in overwithholding on any income under.	$32,103	$28,633	$20,153	$16,116	$14,384
2. Income solely from withholdable interest (Footnote 1)					
Withholding at 20% will result in overwithholding on any income under.	24,384	20,125	14,847	12,192	10,063
3. Mixed income—part subject to 20% withholding and part not subject (no recognition of dividend exclusion or credit) (Footnote 2)					
a. Taxable income of $1,000 Gross income	4,250	2,750	2,750	2,750	2,000
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	1,000	1,000	1,000	1,000	1,000
And the amount of income not subject to withholding is less than	3,250	1,750	1,750	1,750	1,000
b. Taxable income of $2,000 Gross income	5,500	4,000	4,000	4,000	3,250

[1] These computations assume total deductions equal 13% of adjusted gross income. The ratio of deductions to adjusted gross income reflected in taxable returns for 1958 of individuals claiming itemized deductions and with adjusted gross income between $25,000 and $50,000 was 13.43%. This ratio was computed from data in Statistics of Income—1958, Individual Income Tax Returns, Table 10, page 57, Columns (2), (3) and (4).

[2] The following computations assume total deductions equal 20% of adjusted gross income. The ratio of deductions to adjusted gross income reflected in taxable returns for 1958 of individuals claiming itemized deductions and with adjusted gross income of less than $10,000 was 19.53%. This ratio was computed from data in Statistics of Income—1958, Individual Income Tax Returns, Table 10, page 57, Columns (2), (3) and (4) for the total of adjusted income brackets on lines 1 through 14, inclusive. For computation purposes, the 20% ratio was used even though the assumed adjusted gross income exceeded $10,000. For informational purposes, the actual ratios of deductions to adjusted gross income in the brackets of adjusted gross income in excess of $10,000 were as follows:

Adjusted Gross Income	Ratio of Total Deductions to Adjusted Gross Income
$10,000 under $15,000	16.91%
$15,000 under $20,000	15.55%
$20,000 under $25,000	14.56%
$25,000 under $50,000	13.43%

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
There will be overwithholding if—					
Amount of income subject to withholding is more than—	$2,000	$2,000	$2,000	$2,000	$2,000
And the amount of income not subject to withholding is less than	3,500	2,000	2,000	2,000	1,250
c. Taxable income of $3,000					
Gross income	6,750	5,250	5,250	5,250	4,500
There will be overwithholding if—					
Amount of income subject to withholding is more than—	3,000	3,000	3,050	3,100	3,100
And the amount of income not subject to withholding is less than	3,750	2,250	2,200	2,150	1,450
d. Taxable income of $4,000					
Gross income	8,000	6,500	6,500	6,500	5,750
There will be overwithholding if—					
Amount of income subject to withholding is more than—	4,000	4,000	4,100	4,200	4,200
And the amount of income not subject to withholding is less than	4,000	2,500	2,400	2,300	1,550
e. Taxable income of $5,000					
Gross income	9,250	7,750	7,750	7,750	7,000
There will be overwithholding if—					
Amount of income subject to withholding is more than—	5,100	5,100	5,300	5,500	5,500
And the amount of income not subject to withholding is less than	4,150	2,650	2,450	2,250	1,500
f. Taxable income of $6,000					
Gross income	10,500	9,000	9,000	9,000	8,250
There will be overwithholding if—					
Amount of income subject to withholding is more than—	6,200	6,200	6,500	6,800	6,800
And the amount of income not subject to withholding is less than	4,300	2,800	2,500	2,200	1,450
g. Taxable income of $7,000					
Gross income	11,750	10,250	10,250	10,250	9,500
There will be overwithholding if—					
Amount of income subject to withholding is more than—	7,300	7,300	7,800	8,300	8,300
And the amount of income not subject to					

EXHIBIT 2—*Continued*

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
withholding is less than	$4,450	$2,950	$2,450	$1,950	$1,200
h. Taxable income of $8,000					
Gross income	13,000	11,500	11,500	11,500	10,750
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	8,400	8,400	9,100	9,800	9,800
And the amount of income not subject to withholding is less than	4,600	3,100	2,400	1,700	950
i. Taxable income of $9,000					
Gross income	14,250	12,750	12,750	12,750	12,000
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	9,700	9,700	10,600	11,500	11,500
And the amount of income not subject to withholding is less than	4,550	3,050	2,150	1,250	500
j. Taxable income of $10,000					
Gross income	15,500	14,000	14,000	14,000	13,250
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	11,000	11,000	12,100	13,200	13,200
And the amount of income not subject to withholding is less than	4,500	3,000	1,900	800	50
k. Taxable income of $11,000					Not Applicable
Gross income	16,750	15,250	15,250	15,250	
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	12,300	12,300	13,700	15,100	
And the amount of income not subject to withholding is less than	4,450	2,950	1,550	150	
l. Taxable income of $12,000				Not Applicable	
Gross income	18,000	16,500	16,500		
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	13,600	13,600	15,300		
And the amount of income not subject to withholding is less than	4,400	2,900	1,200		

	Married Couple; Over 65; No Dependents	Married Couple; Under 65; No Dependents	Head of Household; Under 65; 1 Dependent	Single; Over 65; No Dependents	Single; Under 65; No Dependents
m. Taxable income of $13,000					
Gross income	$19,250	$17,750	$17,750		
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	15,100	15,100	17,100	Not Applicable	
And the amount of income not subject to withholding is less than	4,150	2,650	650		
n. Taxable income of $14,000					
Gross income	20,500	19,000	19,000		
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	16,600	16,600	18,900	Not Applicable	
And the amount of income not subject to withholding is less than	3,900	2,400	100		
o. Taxable income of $15,000					
Gross income	21,750	20,250			
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	18,100	18,100	Not Applicable		
And the amount of income not subject to withholding is less than	3,650	2,150			
p. Taxable income of $20,000					
Gross income	28,000	26,500			
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	26,400	26,400	Not Applicable		
And the amount of income not subject to withholding is less than	1,600	100			
q. Taxable income of $22,000					
Gross income	30,500				
There will be overwithholding if—					
Amount of income subject to withholding is more than—.......	30,200	Not Applicable			
And the amount of income not subject to withholding is less than	300				

EXHIBIT 3

ESTIMATED DIVIDEND GAP 1955 TO 1959
(In millions of dollars)

	1955	1956	1957	1958	1959
Cash distributions to stockholders by domestic corporations, Statistics of Income	13,592	14,498	14,914	14,952	16,159[1]
Domestic dividends received by domestic corporations, Statistics of Income, less dividends received from Federal Reserve Banks	−2,563	−2,677	−2,669	−2,816	−2,990[1]
Net dividends paid by domestic corporations	11,029	11,821	12,245	12,136	13,169[1]
Domestic dividends paid abroad	− 302	− 284	− 321	− 408	− 442
Foreign dividends received by individuals	+ 171	+ 119	+ 114	+ 114	+ 115
Distributions paid to individuals, fiduciaries and tax-exempt organizations	10,[illegible]	11,656	12,038	11,842	12,842[1]
Distributions of small business corporations taxed as partnerships	...	...	...	− 67	− 103
Distributions exempt from tax	− 125	− 150	− 175	− 200	− 200
Distributions taxable as capital gains	− 278	− 368	− 349	− 329	− 506
Dividends received by corporate pension funds[2]	− 174	− 229	− 271	− 318	− 365
Dividends received by other tax-exempt organizations[2]	− 454	− 479	− 491	− 481	− 501
Dividends received by persons not required to file or who use 1040A	− 94	− 101	− 104	− 107	− 117
Dividends retained by estates and trusts	− 340	− 346	− 365	− 365	− 396
Total deductions	−1,465	−1,673	−1,755	−1,867	−2,188
Dividends includable on individual tax returns	9,433	9,983	10,283	9,975	10,654
Dividends reported on individual tax returns	8,100	8,892	9,432	9,058	9,714
Dividend reporting gap	1,333	1,091	851	917	940
Attributable to nontaxable filers	153	125	98	104	106
Attributable to taxable filers	1,180	966	753	813	834

Office of the Secretary of the Treasury
Office of Tax Analysis

May 3, 1961

[1] Estimated by relationship to Commerce Department estimates.
[2] Estimate limited to corporate pension funds as defined by SEC. Joint, union controlled and non-profit institution funds are included with other tax-exempt organizations.

ESTIMATED INTEREST INCOME OF INDIVIDUALS NOT ACCOUNTED FOR ON TAX RETURNS FOR 1956, 1957, 1958 AND 1959

An Analysis of Payments to Individuals of Interest Includable in Taxable Income, by Source of Payment, and the Amounts Reported and Not Reported on Federal Tax Returns

	1956	1957	1958	1959
	(In millions of dollars)			
Interest payments to individuals:				
Cash interest paid on Government securities [1]	1,200	1,400	1,200	1,600
Interest paid on corporation bonds and notes [1]	746	837	883	945
Interest on time and savings deposits [1]	1,564	1,976	2,231	2,522
Interest on savings shares [1]	1,120	1,384	1,627	1,939
Interest paid on holdings of foreign bonds	50	58	62	70
Interest on farm mortgages paid to non-farm individuals	181	198	214	240
Interest paid on non-farm mortgages	1,000	1,100	1,220	1,400
Interest paid to unincorporated brokers and dealers	71	69	86	109
Interest paid to unincorporated consumer credit companies	144	155	155	161
Interest paid on life insurance dividends left to accumulate	74	80	87	94
Interest paid to retail auto dealers	50	48	51	59
Total payments	6,200	7,305	7,816	9,139
Deduct:				
Interest reported as business income by sole proprietors	331	383	407	462
Interest received by low income individuals not required to file	133	154	166	188
Interest receipts of non-profit organizations	211	244	260	295
Total deductions	675	781	833	945
Interest includable in individual tax returns	5,525	6,524	6,983	8,194
Interest reported as such on tax returns:				
Individuals—Form 1040	2,872	3,319	3,659	4,542
Individuals—Form 1040-A	3	3	8	8
Partnerships	232	268	285	324
Fiduciaries	346	400	426	483
Total	3,453	3,990	4,378	5,357
Estimated amount of interest payments not accounted for	2,072	2,534	2,605	2,837
Attributable to nontaxable filers	622	760	782	842
Attributable to taxable filers	1,450	1,774	1,823	1,995

Office of the Secretary of the Treasury
Office of Tax Analysis

May 3, 1961

[1] These items include payments to nonprofit organizations.

LEGISLATIVE RECOMMENDATION FOR A SYSTEM OF TAXPAYER ACCOUNT NUMBERS

SUPPLYING OF IDENTIFYING NUMBERS

Resolved, That the American Bar Association recommends to the Congress that it enact legislation to improve the Internal Revenue tax administration by providing for the use of numbers to identify taxpayers on returns filed by taxpayers and on information returns showing payments of income to taxpayers; and

Be It Further Resolved, That the Association proposes that this result be effected by amending the Internal Revenue Code of 1954 by adding thereto a new section; and

Be It Further Resolved, That the Section of Taxation is directed to urge the following amendment, or its equivalent in purpose and effect, upon the proper committees of Congress:

Sec. 1. Part I of Subchapter A of Chapter 61 of the Internal Revenue Code of 1954 (relating to records, statements, and special returns) is amended by adding at the end thereof the following new section (insert new matter in italics):

SEC. 6002. SUPPLYING OF IDENTIFYING NUMBERS.

In addition to the requirements set forth in Parts II and III of this subchapter, when required by regulations prescribed by the Secretary or his delegate—

(1) Any person required by this title or by regulations made under authority thereof to make a return, statement, or other document shall include in such return, statement, or other document such identifying number as may be prescribed for securing proper identification of such person.

(2) Any person with respect to whom a return or statement of information is required by this title or by regulations made under authority thereof to be made by another person shall furnish to such other person such identifying number as may be prescribed for securing his proper identification.

(3) Any person required by this title or by regulations made under authority thereof to make a return or statement of information with respect to another person shall include therein such identifying number, received from such other person, as may be prescribed for securing proper identification of such other person, unless reasonable cause is shown for failure to so include such identifying number.

Sec. 2. The title of Part I of Subchapter A of Chapter 61 of the Internal Revenue Code of 1954 is amended to read as follows (eliminate matter struck through and insert new matter in italics):

PART I—RECORDS, STATEMENTS, ~~AND~~ SPECIAL RETURNS, *AND IDENTIFYING NUMBERS*

Sec. 3. The table of sections for Part I of Subchapter A of Chapter 61 of the Internal Revenue Code of 1954 is amended by adding at the end thereof the following:

Sec. 6002. Supplying of identifying numbers.

EXPLANATION

Summary

In order to enforce the income tax laws more effectively, the Internal Revenue Service should be able to establish for each taxpayer a master file from which it can readily obtain pertinent information shown on the taxpayer's own return and on information returns showing payments of income to him. This type of file, as well as automatic matching of such information, is possible with modern electronic computing equipment if there is adequate identification of the taxpayer.

The Service has initiated a program which contemplates a complete change-over in due course to the use of such electronic computing equipment for record purposes. The name and address of the taxpayer is all that is now required on information returns (other than information returns with respect to wages), and this is not adequate identification for an automatic data processing system with modern electronic equipment. It is necessary for adequate identification that each taxpayer be assigned an account number which will be used on the taxpayer's own return as well as on information returns reporting payments of income to the taxpayer.

It is contemplated that the proposed legislation would require every taxpayer to obtain and use a number similar to the Social Security number used by recipients of wages at the present time. It is understood that the Social Security number would be used by those taxpayers who now have such numbers; other taxpayers would in effect be required to obtain Social Security numbers.

The enactment of this legislation is recommended because it is needed by the Internal Revenue Service in order to adopt and put into full operation the master file concept of tax administration. Such legislation is an important step in making it possible for the Service, when dealing with a taxpayer, to do so with full knowledge of all pertinent information in the files of the Service. With this system, it will be possible for the Service to process automatically a great deal of information made available to it each year. Such master files will also provide the Service with a valuable and ready source of statistical information needed for other purposes.

Discussion

Careful and exhaustive statistical studies which have been made during recent years by the Committees of Congress and by the Treasury Department indicate the existence of so-called "gaps" of unreported income received by individuals. It is practically impossible to determine the exact amount of each gap but estimates by reliable sources range, in the case of dividends from the neighborhood of one hundred million up to one billion dollars, in the case of interest in the neighborhood of three billion dollars, and possibly as high as ten billion dollars in the case of entrepreneurial income.

The Internal Revenue Service cannot audit every individual income tax return (around sixty million for each of the last three years) for the purpose of ascertaining and recovering this lost revenue. The manpower is not available, but even if it were, the cost, relative to the gain, would be prohibitive.

In order to facilitate the audit work of the Service, Congress has for many years provided for information returns by various types of payors of income. By matching the information in such returns with the tax returns of the recipients of the income, the Service can readily spot any omission by them of income reported on the information returns. This, however, involves the association of the information returns with the tax returns of the recipients. For the reasons stated below, the Service has found it impracticable to accomplish any general association and, as a consequence, has not been able to use the information returns as effectively as would be desirable.

Identification of the income recipient shown in the information returns, which show only his name and address, has been one of the major problems encountered in trying to associate taxpayers' returns with information returns on any full scale

basis. The identification factors of name and address are subject to an almost endless variety of errors and mutations, any one of which makes it impossible (without further investigation) to match the information document with the tax return. For example, the name of a given individual might appear on the stock ownership register of different corporations as John T. Miller, John Tracy Miller, J. T. Miller, John T. Miller, Jr., etc. Similarly, the addresses of the taxpayer used by various payors may be different and may be different from the address used on the taxpayer's return. In many instances, identification is further complicated by the fact that many married persons own stock independently but file tax returns jointly. Conversely, stocks are sometimes owned jointly by persons who file returns separately.

Thus, it seems clear that a simple and reliable identification medium should be adopted if the full enforcement potential of information returns is to be realized.

It is believed that the adoption of a system which would require each taxpayer to obtain and use a number would solve most, if not all, of the identification problems and thus greatly facilitate the association of taxpayers' returns with information returns.

The great volume of returns involved has also been a serious problem in connection with the association of returns. More than sixty million income tax returns were filed by individuals for the year 1960. Nearly 325 million information returns were received by the Service for 1960. Of these returns, more than 208 million were Forms W-2 (wages paid to and tax withheld on employees), approximately 110 million were Forms 1099 (information returns on payments of dividends, interest, etc.) and approximately 6 million were Forms 1087 (ownership certificate—dividends on stock). It appears obvious that, because of the great volume of returns involved, manual association, even with account numbers, would still be very costly, if not prohibitive.

In order to improve administration, including meeting the problem of volume, the Treasury Department now is developing plans for a change-over to a comprehensive system of automatic data processing of tax returns and related documents. A pilot plant, in the Atlanta region, is expected to begin returns processing in January, 1962. The general use of electronic equipment is contemplated as soon as projected acquisition and operational programs can be completed. An essential element of the use of such a mechanized system, however, is the use of account numbers in addition to names and addresses to identify taxpayers throughout the processing and record-keeping operations.

We are informed that reasonably complete and satisfactory association of information returns with taxpayer returns can be accomplished through the use of automatic data processing equipment if taxpayer account numbers are available for use in processing the documents through such equipment. Such association of returns should enable the Service to establish and maintain a master file for every taxpayer which would contain (in addition to taxpayer's number, name and address) such information as:

1. Detail of income and deductions as reported on his returns and as changed on account of audit adjustments.
2. Information reported on Forms W-2 (Withholding Tax Statement on Wages), 1099 (Information Return of Income Paid), 1087 (Ownership Certificate—Dividends on Stock) and other information returns by payors.
3. Estimated and withheld taxes paid by the taxpayer; bills sent to him; payments received from him; refunds made to him; balances due from him.

The recording of these categories of information in the master file would enable the Service to achieve specific objectives which are now either impractical or only partly practical. Thus, the following objectives could be accomplished:

1. Systematic check on failure of individuals and business entities to file returns.

2. Verification of mathematical accuracy of returns filed and computation of tax or refunds due.

3. Determination of taxpayer indebtedness for prior year taxes of all types prior to issuance of a current refund, and identification of duplicate refunds.

4. Provision for a consolidated tax account for each taxpayer that will reflect current tax status at any given point in time.

5. Matching of data reported on information documents with corresponding data on taxpayer returns.

6. Classification of returns for audit purposes.

7. Preparation of management, operating, and statistical reports.

It is believed that such master files would greatly facilitate the work of the Service in reducing the income gaps referred to above. They would also be of great help to the Service in detecting and correcting improper deductions.

Legislation is deemed to be needed before a general taxpayer account number system can be used by the Service. The proposed legislation would give the Service the needed authority to use such a system.

It is contemplated that if this legislation is adopted the Treasury Department would probably require those taxpayers who already have Social Security numbers to use these numbers and would probably require other taxpayers who make returns to obtain similar numbers which would be their permanent numbers similar to Social Security numbers. Since 85% to 90% of all individual income tax returns filed at the present time show a Social Security account number, this would appear to be a practical way of requiring every taxpayer to obtain a number for Federal income tax purposes.

Mention should be made of the problems of payors if a general taxpayer account number system is adopted. Payors will be required to obtain the account numbers from payees and show the account numbers thus obtained on their information returns. Admittedly this would involve additional time and expense on the part of payors, especially in the initial stages of the system. The seriousness of this factor would vary with different payors. It would also be aggravated in cases where payees were uncooperative. It might also, in some case, be more or less disturbing to payor and payee client relationships. It is believed, however, that the additional cost and inconvenience to payors would not be sufficiently great to offset the revenue benefit which would be expected to flow from a general association of returns, the establishment of taxpayer master files, and automatic data processing. This revenue benefit would redound to the benefit of taxpayers generally.

The question of sanctions should also be mentioned. It must be recognized that this legislation imposes many additional duties on payors of income. This new system may present a number of practical problems for payors, particularly during the transitional period when it is first being placed in operation. It is the opinion of the committee that, because of the nature and newness of the system, no severe sanctions should be imposed. The problem of uncooperative payees who fail or refuse to give their account numbers to payors of income should be handled by the Service; a report to the Service by the payor should discharge his duty in the matter. A penalty for noncompliance similar to that provided by section 6652, which is assessed in the same manner as taxes, would appear to be desirable. Both payors and payees should be given a reasonable amount of time for preparation for compliance before any other penalties are imposed. There should be no sanctions with respect to payors who comply with the requirements of putting on information returns the numbers received.

No specific recommendation is made with respect to the effective date of the legislation. It is believed that this determination should be made after consideration by Congress of the time needed by taxpayers for compliance with the new procedures. It may be noted in this connection that the time within which taxpayers are required to obtain and use account numbers for themselves could very well precede the time when such account numbers must be furnished to payors and used by the payors in connection with information returns. It is

further believed that in view of the additional cost and inconvenience to payors in adapting their procedures to this legislation, their problems should be given sympathetic attention, and Congress should adopt a liberal attitude with respect to the time to be granted them for compliance.

The present information return system recognizes that taxpayers may make their investments in the name of an agent or nominee rather than in their own name. Form 1087 is filed by the agent or nominee in order to disclose the true owner to the Service; this information need not be given to the payor of the income. It is expected that the Service will make appropriate provision for a similar system of anonymity for the true owner in the event the taxpayer account number system is adopted.

A mass income tax system was adopted in 1942 as a result of the demands of World War II. Prior to that date, there was a relatively thorough investigation of income tax liability. This thorough investigation has heretofore been impossible for the mass income tax system because of the vast number of returns involved. Sampling and similar techniques have been adopted to make efficient use of available personnel and equipment. The use of such techniques has failed to prevent the development of large gaps in the reporting of taxable income. Modern electronic equipment should facilitate a more thorough use of the information available to the Service (automatic data processing), and a taxpayer account number system is essential to the efficient operation of such equipment. In addition, automatic data processing is not limited to any one function, such as the matching of taxpayers' returns with information returns. It is likely that experience by the Service with modern electronic computers may enable it to develop other functions for this equipment which will permit an even more thorough investigation of income tax liability than that now contemplated.

It is believed that the adoption of the proposed legislation would, for the reasons set forth above, greatly facilitate the administration of the income tax laws, to the end of recovering large amounts of revenue otherwise lost. The enactment of such legislation is therefore recommended.

AMERICAN INSURANCE ASSOCIATION,
Washington, D.C., June 4, 1976.

Re: Taxation of interest on debt obligations issued by State and local governments.

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

DEAR SENATOR LONG: On behalf of the nationwide property-casualty insurers in this Association, I wish to submit this statement for the record of your hearing June 7, 1976 on taxation of interest on debt issued by state and local governments. Due to the short notice, we shall not be able to address some of the broader public policy questions implicit in your May 28 release, but rather will confine our remarks to the concept of federal subsidies for taxable municipal securities. This idea was revived in the present Congress by Senator Kennedy and Congressman Reuss. It is embodied in a bill, H.R. 12774, narrowly approved by the House Ways & Means Committee, and now pending before the House Rules Committee. The Ways & Means legislation would provide any state or local government issuing taxable securities an automatic federal subsidy of 36 per cent of the interest yield.

Our companies have been for many years among the largest participants in the municipal securities market. On December 31, 1974, property-casualty insurers held 15.1 per cent or $30.7 billion of the total $204.1 billion in outstanding obligations of state and local governments. On the basis of this experience, the concept of federal subsidies for taxable municipal securities appears unsound to us because:

First, it reacts to existing problems in the municipal market with large infusions of federal money before addressing more direct remedies which would cost taxpayers relatively little, if anything. To some extent this

approach may result from the fractured jurisdiction of Congressional committees in this area;

Secondly, adequate consideration has not been given to new, and perhaps greater, problems which a federal subsidy may cause for many state and local governments in their effort to raise capital; and

Thirdly, we are skeptical about the estimated cost to the U.S. Treasury, and about the ability to control future growth of federal subsidies to state and local governments.

The wisest course of action, in our opinion, would be wider exploration of these issues before any other action is taken which could disrupt the market for tax-exempt securities. Some of the areas which we feel have not been adequately considered in this Congress are set forth below:

1. Existing problems in the municipal market

a. *Lack of reliable information.* In our opinion, the largest single factor undermining investor confidence in muncipal securities is the absence of comparable, reliable information about the fiscal condition of many state and local governments. Hearings have been held in the Senate on a bill, S. 2969, which would establish federal standards for uniform disclosure by municipal issuers. No action has been taken in the House. Many of those special interests which seek federal guarantees or subsidies for their securities oppose federal disclosure standards. We believe Congress should enact S. 2969, so that accurate information will be forthcoming, before attempting to develop subsidy programs for municipal securities.

b. *Lack of an efficient secondary market for individual investors.* The success of the municipal market in 1975 is due largely to the fact individuals acquired $10.1 billion of the total $15.4 billion of annual net issues of state and local government bonds, according to Federal Reserve flow of funds data. Despite the fact individuals bought more municipals in 1975 than commercial banks, or propert-casualty insurers, the secondary market for municipals continues to place individuals at a disadvantage. This market could be significantly strengthened for individuals, and thereby expanded. The fact a typical offering consists of a large number of serial issues results in thin markets with large spreads. Individuals frequently have to pay four basis points, or $200 per $5000 bond, in order to dispose of their holdings. If state and local governments would issue term bonds with mandatory sinking funds, deeper markets might result. Another way to increase the size of municipal issues with common maturity is through state bond banks, which exist in two or three states. This marketing procedure allows the state to tap markets for small municipalities at a substantial savings. It can also allow the state to verify and vouch for the financial condition of its municipalities.

c. *Use of tax exemption to finance private projects.* State and local governments in 1960 sold $46.9 million of tax-exempt securities to finance projects of private industry. By 1972 this figure increased tenfold to $470.7 million despite substantial limitations imposed by Congress during the interim. No other single category of municipal financing increased to this extent. Instead many other project categories—schools; water and sewer districts; highways, bridges and tunnels; veterans aid; and public housing—declined as a percentage of total capital issues. Increased use of tax-exemption for private development inflates the number of bonds competing for buyers to the detriment of general obligations. Congress, in our opinion, should address this condition directly, rather than proposing federal subsidies to lessen market congestion.

2. Possible consequences of a federal subsidy for taxable municipal securities

a. *Self-dealing by municipalities with employee pension funds.* Although considerable speculation has occurred about the wide variety of purchasers waiting to buy taxable municipal securities, we doubt issuers which encountered difficulty in the tax-exempt market during 1975 due to their own financial condition will find more willing purchasers for taxable securities. If this proves to be the case, an irresistible target for their taxable securities is likely to be government employee pension funds. H.R. 12774 attempts to meet this possibility by requiring that "not less than 25% of the obligations sold . . . [must be] acquired by persons who are not related entities." Apparently the remaining 75% could then be placed in a municipality's employee pension fund. It is incongruous for Con-

gress to sanction self-dealing of this type after enacting the Employee Retirement Income Security Act to protect corporate pension plans.

b. *Higher costs to state and local governments.* The March 29 staff report to the Ways & Means Committee estimates approximately $3.1 billion would be transferred from the tax-exempt to the taxable bond market in 1976 if H.R. 12774 were enacted. According to forecasts supplied the Ways & Means Committee by Kidder, Peabody & Co., Inc., the total demands on the taxable market during 1976 are estimated at $239 billion, while the tax-exempt market is projected to raise $13.5 billion in net new financing. It is difficult to understand how state and local governments will be able to compete in the far larger taxable market unless they pay higher interest rates than more established corporate and federal issuers. This would be especially true for smaller, lesser known localities.

c. *Federal determination of priorities for state and local governments.* One of the major concerns of state and local governments about federal subsidies is future limitations on the amount of funds available from the U.S. Treasury will in effect give the Treasury power to determine which securities may receive the subsidy, and, by doing so, enable the Treasury to determine for what purpose funds may be borrowed.

3. Ultimate cost to the U.S. Treasury

The March 29 staff-report to the Ways & Means Committee estimates the gross cost of a 35 percent federal subsidy over 10 years would be $6.327 billion. It further estimates revenues will be generated from alternative taxable bonds over the same period of $4.970 billion, resulting in a net subsidy cost to the U.S. Treasury of $1.357 billion. The generated revenues appear based on an assumption "the bulk of the securities will . . . be purchased by taxable entities, such as banks, insurance companies, and individuals." This may not be true. If government units which elect to issue taxable subsidized bonds are the same ones which experienced recent financial problems, then the principal targets as purchasers are likely to be public employee plans and credit unions, which pay no taxes. Even if this proves untrue, one of the basic arguments supporters of taxable municipals have used is that the market needs to be expanded to include institutions such as banks and foundations which have little need for tax-exempt income from securities. It is difficult to understand how those same supporters can also say the U.S. Treasury will recoup most of its costs if the purchasers themselves pay no taxes.

The tax burden of H.R. 12774 will fall chiefly on middle income taxpayers who find themselves in higher tax brackets as inflation increases. Some of these taxpayers have discovered tax-exempt securities are attractive to persons earning $20,000 or more annually. The thrust of H.R. 12774 would drive these individuals out of the tax-exempt market. It would have little, if any, impact upon certain corporate taxpayers which are leaving the tax-exempt market for other shelters such as the investment tax credit and accelerated depreciation.

Another large problem relating to the cost of H.R. 12774 is the difficulty of controlling attempts to raise the subsidy level now and in the future. Some of our members are particularly concerned if the subsidy level rises above that already set in H.R. 12774 then the tax-exempt market will be destroyed, rather than supplemented. The Treasury Department recommended a subsidy level originally of 30 percent. Ways & Means has established a 35 percent level. Reports are circulating that an attempt may occur on the House floor to raise the subsidy to 40 percent.

During the Ways & Means deliberations, Congressman Vanik pointed out the difficulty of terminating programs such as this. He predicted once states and local governments learn how to issue subsidized bonds, they will be used excessively. In time a strong lobby may develop to continue federal subsidies indefinitely, and to increase the percentage of federal payments.

We hope this information will be of some help during your hearing June 7. I regret time did not allow us to address some of the broader public policy questions implicit in tax exemption for municipal securities. Our members are concerned about proposals for federal subsidies to taxable municipal securities, and hope the Congress will not act prematurely or hastily in this area.

Sincerely,

WALTER D. VINYARD, Jr.,
Counsel.

○