TAX REFORM ACT OF 1975

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

NINETY-FOURTH CONGRESS

SECOND SESSION

ON

H.R. 10612

AN ACT TO REFORM THE TAX LAWS OF THE UNITED STATES

MARCH 17, 18, 19, 22, 23, 24, 25, 26, 29, 30, 31, APRIL 1, 2, 5, 6, 7, 8, 9, AND 13, 1976

PART 8 OF 8 PARTS

(Written Testimony)

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Tax Treatment of Prepaid Legal Services

Statement of the National Consumer Center for Legal Services

This statement is offered on behalf of S. 2051, a bill which would grant to prepaid legal programs essentially the same tax treatment that accident and health plans now enjoy. This legislation will remove the last major obstacles to the delivery of legal services as an employee fringe benefit, a goal upon which Congress embarked more than three years ago with the amendment of Section 302(c) of the Labor Management Relations Act of 1947 (the Taft-Hartley Act), adding legal services to the list of subjects of collective bargaining. S. 2051 would amend Sections 105 & 106 of the Internal Revenue Code in order to exclude from employee gross income both the value of the benefit received through such legal service plans, and the amount contributed to the plan on the employees' behalf by the employer.

A BRIEF LEGISLATIVE AND LEGAL HISTORY OF PREPAID LEGAL SERVICES

The following short history and summary of the current status of prepaid legal services is offered as background. The first such plans originated in California where groups desiring to assist their members to obtain legal services contracted with law firms to provide free advice and consultation and reduced-fee services in return for the group's channeling its members' business to that firm. Nearly a thousand such plans are now registered with the California Bar Association.

A series of Supreme Court cases beginning with *NAACP* v. *Button* in 1934 and ending in 1971 with *United Transportation Union* v. *State Bar of Michigan* established the First Amendment right of groups to band together in order to secure high quality, low-cost legal services for their members.[1]

Involved in those cases were railroad unions which had established legal aid departments to assist their members in securing competent counsel for filing claims under the Federal Employers Liability Act, and other unions providing similar services out of union dues. In 1971, the same year as the UTU decision, the Laborers International Union, Local 229 in Shreveport, Louisiana instituted an experimental legal services program with the cooperation of the Ford Foundation and the American Bar Association. Later, with the *UTU* decision in mind, and after the demonstrated success of the Shreveport plan, proponents of these new legal service plans determined to seek an amendment to

[1] *NAACP* v. *Button*, 371 U.S. 415, 9 L.Ed.2d 405, 83 S.Ct. 328 (1963); *Brotherhood of Railroad Trainmen* v. *Virginia ex rel. Virginia State Bar*, 377 U.S. 1, 12 L.Ed.2d 89, 84 S.Ct. 1113 (1964); *United Mine Workers* v. *Illinois State Bar Association*, 389 U.S. 217, 19 L.Ed.2d 426, 88 S.Ct. 353 (1967); *United Transportation Union* v. *The State Bar of Michigan*, 401 U.S. 576, 28 L.Ed.2d 339, 91 S.Ct. (1971).

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the Taft-Hartley Act so that legal services could be a subject of collective bargaining. In 1973, Congressman Frank Thompson and Senator Harrison A. Williams introduced bills to accomplish this purpose. The National Consumer Center for Legal Services, the AFL–CIO, the American Bar Association, the consumer movement and a large part of the insurance industry supported the bills, and the amendment of section 302(c) of the Taft-Hartley Act was signed into law late in 1973. Congress was aware at that time of the tax problems created by the amendment, and it was expected that a speedy resolution would follow.[2]

Unfortunately, 1974 proved to be a year of considerable economic and legislative turmoil, and although bills were introduced, there was not sufficient time left for the 93rd Congress to act on the tax problems.

Legislation similar to S. 2051 was introduced in the House of Representatives last year by Congressman Joseph Karth (Democrat-Minnesota), as H.R. 8579. Hearings on H.R. 8579 were held before the full Committee on Ways and Means on July 14, 1975. The committee has taken no action yet concerning the legislation.

Late last year, Congress passed comprehensive legislation affecting pension and other employee welfare benefit plans, including legal service plans. The Employee Retirement Income Security Act of 1974 extended reporting and disclosure requirements and stiff fiduciary standards to legal service plans. The effect of that legislation has been to encourage the negotiation of legal service plans, now secure in a regulatory framework.

There are now better than fifty negotiated legal service plans operating through a joint trust as provided in the Taft-Hartley Act, and a smaller number of nonnegotiated but employer-financed plans not subject to Taft-Hartley. Their tax situation is chaotic.

A SIMILAR DESCRIPTION OF THE PROBLEM

Sections 105 and 106 of the Internal Revenue Code currently provide for the exclusion from employee gross income of premiums and benefits provided under accident and health plans. S. 2051 would amend Sections 105 and 106 so that parallel exclusions would exist for contributions paid to and benefits received through legal service plans.

Labor and management representatives interested in establishing a legal service plan face two distinct problems, both of which primarily concern the taxability of legal services contributions and benefits to *employees*. With respect to contributions made to legal service funds

[2] Hearings Mar. 22, 1973, on H.R. 77 before the Special Subcommittee on Labor, House Committee on Education and Labor, produced several witnesses who took note of related tax problems, including: Robert J. Connerton, General Counsel of Laborers' International Union of North America (at 222–231); Report of the Special Committee on Availability of Legal Services, New York State Bar Association (at 262). Similarly, hearings Apr. 10, 11 and 16, 1973 on S. 1423 before the Senate Subcommittee on Labor of the Committee on Labor and Public Welfare, produced witnesses to the tax difficulties such legal service plans would face, including: Robert Connerton (at 23); Dr. Lee Morris, Vice President of Insurance Company of North America (at 264); Russell M. Tolley, President, National Association of Professional Administrators, (at 295–6); National Association of Manufacturers (at 304).

on behalf of employees by the employer, considerable unclarity exists as to whether or not these contributions would constitute income. Despite the fact that a number of plans have filed requests for revenue rulings, none have been issued on which plans feel they may safely rely. Careful reading of revenue rulings on related questions suggests that the Internal Revenue Service would not consider these contributions to be taxable income to the employee because the employee has no vested right in the funds at the time the contribution is made. However, S. 2051 would remove all question by granting an explicit exclusion granted in Section 106 of the Internal Revenue Code to contributions to health and accident plans.

Second, with respect to the taxability to the employee of the value of the benefits received under such plans, the Internal Revenue Code language is clear: "Gross income includes income realized in any form, whether in money, property, or services." Treasury regulation 1.61–1-(a)). Thus, without amendment, employees would be liable for taxes on the value of services received by them under a legal service plan. S. 2051 would amend Section 105 of the Internal Revenue Code to avoid this grave result, granting to beneficiaries of legal service plans the same exclusion from taxability as is currently enjoyed by accident and health plans.

It should be made absolutely clear at this point that the tax treatment of the *employer* is not an issue here. Employer contributions to legal service plans are deductible as "ordinary and necessary expenses" of doing business under Section 162 of the Internal Revenue Code. Nor are we dealing here with the tax status of the funds themselves, although there are perplexing problems unresolved in that area. S. 2051 pertains solely to the tax consequences to the employee.

AMENDMENT OF SECTION 105, INTERNAL REVENUE CODE

Without amendment of Section 105, an employee might receive several thousand dollars in legal services benefits and face the prospect of having to pay taxes on those benefits as income. This could have a serious effect, particularly since prepaid legal service plans typically cover people whose earnings are between $5,000 and $15,000 per year. Employees would have to ask themselves whether they can afford to take advantage of their legal services benefit program. A recent study by the American Bar Foundation makes clear the fact that without some kind of legal service plan or other assistance, middle income people ordinarily seek legal services only in the most dire emergencies.[3] Amendment of Section 105 to exclude for employee gross income the value of legal services received through such plans *would eliminate the harsh prospect of taxing employees of modest income for this benefit.*

There is also a more practical consequence of amending Section 105: It avoids the difficult problem of assessing the value of services which may be provided by a panel or staff attorneys who do not bill on a fee-for-service basis. Even more difficult valuation problems loom with

[3] Curren, Barbara A. and Spalding, Francis O., *The Legal Needs of the Public*, American Bar Association and American Bar Foundation, Chicago: 1974.

services which are related to legal services but do not constitute legal services *per se*, such as paralegal assistance, marital counseling and so on. Since the Supreme Court's recent decision in *Goldfarb*, it is unlikely that there will be any bar association minimum fee schedules on which to base such valuations. Furthermore, the valuation problem is not merely one of plans which do not bill for services provided, (i.e., one where members are entitled to a limited number of prepaid hours of service for staff attorneys) but even more seriously, of plans whose delivery mechanisms enable them to deliver services far less expensively than prevailing legal practice. The use of a market valuation system would now produce real injustices.

Finally, our experience suggests that both employers and employee organizations have some reluctance about participating in a program whose tax consequence to the employee are potentially so harsh. This result would defeat the very purpose of the Taft-Hartley Amendment and frustrate the intent of Congress to improve access to legal services.

AMENDMENT OF SECTION 106, INTERNAL REVENUE CODE

As indicated, Section 106 similarly requires amendment. Treasury regulation 1.61–1(a) defines gross income to be "income realized in any form, whether in money, property, or services." It is presently unclear whether the employer contribution to a legal service fund on the behalf of the employee constitutes gross income to the employee. Although there are Revenue Rulings which suggest that the answer depends on whether the employee's rights to the assets of the fund or to contributions made to the fund had vested or were non-forfeitable, the uncertainty should be ended by amending Section 106 to explictly exclude such contributions or premiums from gross income, along lines parallel to the exclusion granted to health and accident plans.

An additional benefit of such an amendment to Section 106 would be the guarantee of equal treatment between negotiated legal service plans and those paid for unilaterally by the employer or through individual insurance contract plans. In other words, amendment of Section 106 would accomplish equal tax treatment for employees, regardless of whether the legal service benefit is provided through collective bargaining, as an employer-instituted benefit, or by employer-purchase of individual legal instance contracts for employees.

REVENUE LOSS

This section attempts to touch briefly on the question of possible revenue loss, although it is an area subject to widely differing estimates. Employer contributions for comprehensive legal services range between $40 and $75, the bulk of them probably approximately $50. Tax counsel advise that these amounts would probably not now be considered income to the employee since the employee has no vested right in the fund at the time of the contribution is made.[4] Therefore,

[4] See the tax memorandum attached as Appendix A, prepared by John Hendricks, at the request of the Special Committee on Prepared Legal Services of the American Bar Association.

if this advice is correct and if such amounts are not presently taxable, the simple *clarification* of their status in S. 2051 will not generate any revenue loss.

As to benefit limits, most plans use either dollar amounts or hours-of-service averaging 50 or fewer hours of service per year. Whether measured in dollar amounts or in hours, no plan now operating offers more than an equivalent of $4,000 in benefits per year.[5]

Figures from the Shreveport Laborers' plan, the oldest legal service plan currently in operation, suggest more accurate data for illustration.

SHREVEPORT LEGAL SERVICE PLAN

Year	Number of claims	Utilization rate	Average claim
1971	30	5	212
1972	56	9	223
1973	65	11	243
1974	92	15	211

The utilization pattern for Shreveport seems to be fairly typical for new plans, although the first year utilization rate is low. Most plans average 8–10 percent use the first year. An established plan seems to average 15–20 percent utilization. For example, the Ohio Legal Services Fund serving employees of the City of Columbus, Ohio reported 8.5 percent utilization in its first 8 months of operation, averaging slightly more than $180 per claim. The Laborer's Council (Washington, D.C.) plan, which handles 85 percent of its cases on a staff basis, and refers 15 percent to outside attorneys, pays an average of $210 per case to the outside attorneys. Cases handled on a staff basis probably average $150 per case.

Thus, in a hypothetical plan covering 100 workers (which is in actuality too small to effectively support a plan), assuming a 20 percent utilization rate, an average claim of $200, and a tax rate of 20 percent, the revenue loss if expressed on a per employee basis would amount to $5.25 per employee. The figures could actually be lower or higher. Thus, for the 125,000 workers currently covered by such legal service plans, the revenue loss could be between $656,250 and $1,000,000.

All prepaid legal service plans now providing services limit benefits in some way. A worker who takes advantage of every possible benefit under a plan can still usually only receive services valued between $2,500 and $3,000. Thus fears of excessive usage are unwarranted. Further, most plans contain the standard ethics code language which allows attorneys to decline matters that are "frivolous or without merit." Even if they do not, attorneys serving the plan remain bound by the ethical code.

It is significant that income levels for the workers served by the plans are generally low, only rarely exceeding $15,000, and frequently

[5] Such limits would be reached by a beneficiary only in the usual situation where the employee claimed all possible benefits allowable in a claim year. For example, under a plan using a schedule of benefits, the employee would have to be divorced, sued by his neighbor, involved in a traffic accident, arrested for drunk driving, default on a loan, buy or sell a house and request a will, etc., etc.

ranging between $8,000 and $10,000 annually. Most workers served by these plans are married, with children. A sizeable proportion, therefore, will pay nominal or no taxes and thus would not contribute to a revenue loss at all.

The revenue loss question is complicated by the major uncertainty about the popularity of legal services as a fringe benefit. Bargaining in a recently depressed economy offers no real clue in answering the question. More sophisticated analyses must await the attention of the Joint Committee on Internal Revenue Taxation, or perhaps the Treasury Department.

V. SUMMARY OF SUPPORT

S. 2051 has the endorsement and support of the American Federation of Labor and Congress of Industrial Organizations, the United Auto Workers, the International Brotherhood of Teamsters, the Amalgamated Clothing Workers of America, the Amalgamated Meatcutters and Butcher Workmen of America, the International Ladies Garment Workers Union, the Laborers' International Union of North America and other national and local unions.

S. 2051 also has the strong support of the American Bar Association, and particularly its Special Committee on Prepared Legal Services and the General Practice Section. Attached to this statement is a detailed memorandum in support of H.R. 3025, prepared by the tax counsel to the American Bar Association's Special Committee on Legal Services. Because many State bar associations have established legal service plans to meet the needs of moderate income citizens, they too support H.R. 2051. State bar associations, including Georgia, Wisconsin, Michigan, New York, Ohio and Oregon have recently endorsed this legislation.

Life and Health Insurance

Statement of National Association of Life Companies In Support of S. 2759

The National Association of Life Companies (NALC) is headquartered at 550 Pharr Road, N.W., Atlanta, Georgia 30305. Our association was organized in 1955 to provide progressive life insurance companies with a forum, both for internal communication of ideas and for joint commentary on items of mutual interest. NALC began with a membership of 43 companies: today its membership is nationwide, with over 225 companies represented. NALC companies have more than 143,000 home office and field employees, over 340,000 stockholders, and more than 40,000,000 policyholders. Most of our members are small and medium sized life insurance companies.

NALC supports the enactment of S. 2759, introduced on December 9, 1975 by Senator Fannin, and cosponsored by Senator Curtis. As precisely described by Senator Fannin when introducing the bill (See, 121 Cong. Rec. S 21417 (daily ed. Dec. 9, 1975)), S. 2759 would amend Section 809(d)(5) of the Internal Revenue Code to clarify the original Congressional intent that premiums on guaranteed renewable health and accident insurance policies qualify for the 3 percent of premiums deduction provided for therein. This Committee and the Senate previously approved legislation producing a result identical to S. 2759, but, unfortunately, the Conferees for the House objected on the stated grounds that they did not have sufficient time to explore its technical aspects—not because of any fundamental disagreement with its provisions.

A substantial portion of the business of NALC's member companies is health and accident insurance. Life insurance companies which write a significant amount of health and accident insurance often issue three basic types of policies. These policies may be described as follows:

1. *Noncancellable* policies are policies under which the insurance company is obligated to continue or renew the insurance coverage at a guaranteed premium.

2. *Guaranteed Renewable* policies are policies under which the insurance company is obligated to continue or renew the insurance coverage and may not cancel the policy or change the nature of the risk covered, but may, after complying with relevant State law, adjust premium rates by classes (not by reference to an individual policy) in accordance with its experience with the entire class.

3. *Cancellable* policies are policies which the insurance company may cancel for any reason at the renewal date.

As is evident from the above descriptions, noncancellable and guaranteed renewable health and accident insurance policies are very similar in that they both involve the insurance of long-term risks (*i.e.*, they may not be unilaterally cancelled by the insurance company).

Indeed, this fact has been recognized by the Internal Revenue Service. Rev. Rul. 71–367, 1971–2 C.B. 258. The only difference between noncancellable and guaranteed renewable policies is the fact that under a guaranteed renewable policy the insurance company has a limited right to adjust premiums by class in accordance with its experience with the class. Cancellable policies, on the other hand, differ from the other two types of policies in that they involve the insurance of relatively short-term risks, since they may be individually cancelled by the insurance company for any reason at the renewal date.

Section 809(d)(5) provides a deduction in an amount equal to 10 percent of the annual increase in reserves for nonparticipating policies, or in an amount equal to 3 percent of the premiums received on nonparticipating policies which are issued or renewed for periods of five years or more, whichever is greater. When, as with many of NALC's member companies, a life insurance company's business includes a substantial amount of noncancellable and/or guaranteed renewable health and accident insurance, as compared to nonparticipating life insurance, the 3 percent of premiums deductions is often significantly larger than the 10 percent of reserve increase deduction. Consequently, many of NALC's member companies have consistently claimed the 3 percent of premiums deduction with respect to their guaranteed renewable health and accident insurance policies.

In so claiming the 3 percent of premiums deduction, these companies have acted consistently with the original purpose of Section 809(d)(5), which was to permit life insurance companies issuing nonparticipating policies insuring long-term risks to compete on an equal basis with life insurance companies which issue participating policies insuring long-term risks.[1] Companies issuing participating policies are able to charge a premium on these policies which exceeds the actual cost of providing insurance coverage, and they may retain a portion of the excess premium as a cushion against the long-term risks insured. Section 809(d)(5) was intended to provide companies issuing nonparticipating policies with a similar cushion against the long-term risks insured.

Nevertheless, and in the face of the legislative purpose of section 809(d)(5) (and the express provision of section 801(e)), the Internal Revenue Service has consistently refused to allow the 3 percent of premiums deduction on guaranteed renewable health and accident insurance policies. The Service agrees that nonparticipating noncancellable accident and health policies are eligible for the 3 percent of premiums deduction under section 809(d)(5), and that cancellable accident and health insurance policies are eligible for the 2 precent of premiums deduction under section 809(d)(6). However, the Service has taken the position that nonparticipating guaranteed renewable policies are *not* eligible for *either* the 3 percent of premiums deduction *or* the 2 percent of premiums deduction. The Service maintains

[1] The action of these companies in claiming the 3 percent of premiums deduction on their guaranteed renewable health and accident insurance policies has also been entirely consistent with section 801(e), which was enacted contemporaneously with section 809(d)(5) and expressly provides that, for purposes of the taxation of life insurance companies, guaranteed renewable health and accident insurance shall be treated in the same manner as noncancellable health and accident insurance.

that, on nonparticipating guaranteed renewable policies, life insurance companies are limited to the 10 percent reserve increase deduction under section 809(d)(5)—which often is significantly less than even the 2 percent of premiums deduction under section 809(d)(6) available for short-term cancellable policies, and, of course, is also often less than the 3 percent of premiums deduction under section 809(d)(5). Rev. Rul. 65-237, 1965-2 C.B. 231; Rev. Rul. 71-368, 1971-2 C.B. 259.

The life insurance industry generally has successfully sustained its entitlement to the 3 percent of premiums deduction for guaranteed renewable policies under section 809(d)(5) in the Court of Claims. See, *United American Insurance Co.* v. *United States*, 475 F.2d 612 (Ct. Cl. 1973); *The Lincoln National Life Insurance Company* v. *United States*, No. 521-69 (Ct. Cl. January 4, 1974); and *Central States Health & Life Company of Omaha* v. *United States*, No. 276-74 (Ct. Cl. October 30, 1975). The Tax Court reached the same conclusion (48 T.C. 118 (1967)), but was reversed by the Ninth Circuit. *Pacific Mutual Life Insurance Co.* v. *United States*, 413 F.2d 55 (9th Cir., 1969). Obviously, life insurance companies will continue to resort to the courts, if necessary, to sustain their entitlement to this deduction.

However, resort to the courts should not be necessary to establish a taxpayer's entitlement to a deduction which Congress so clearly intended to provide. This Committee already has concluded "that it was the intent of Congress in the Life Insurance Company Income Tax Act of 1959 to treat guaranteed renewable contracts in the same manner as noncancellable contracts," and that guaranteed renewable contracts should be eligible for the 3 percent of premiums deduction under section 809(d)(5). See, S. Rep. No. 92-1290, 92d Cong., 2d Sess. 6-7 (1972). NALC urges the committee to reach the same conclusion again, and to report S. 2759 favorably so that its member companies' entitlement to the 3 percent of premiums deduction under section 809(d)(5) for guaranteed renewable health and accident policies will be clarified once and for all, and so that no further resort to litigation will be necessary.

OCCIDENTAL LIFE OF CALIFORNIA,
Los Angeles, Calif., April 8, 1976.

Mr. MICHAEL STERN,
Staff Director, Committee on Finance, U.S. Senate, Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: I enclose a suggested statutory clarification of subsection (h) of new Internal Revenue Code Sec. 819A(h) in Sec. 1043 of the Tax Reform Act of 1975 (H.R. 10612) relating to the tax treatment of contiguous country branches of United States life insurance companies. I respectfully request that this letter and the suggested statutory clarification be included in the record of the hearings now being held by the Committee on Finance on the Tax Reform Act of 1975 for the Committee's consideration when it is reviewing the bill.

Presently, the Canadian branch business of U.S. life insurance companies is subject to both Canadian and U.S. income taxes whereas

their Canadian competitors are subject only to the lower Canadian income tax. While a foreign tax credit is allowable for Canadian taxes, U.S. taxes on Canadian operations currently exceed allowable credits.

U.S. life insurance companies doing business in Canada price their policies and pay dividends to Canadian policyholders by taking into account the higher U.S. income tax whereas their Canadian life insurance company competition take into account only the lower Canadian income tax. Subsections (a) through (g) of the new Internal Revenue Code Sec. 819A allow a U.S. mutual life insurance company, by making the election described therein, to exclude from the computation of its U.S. taxable income all of the items relating to its Canadian branch business. This will neutralize any U.S. tax effect of having a Canadian branch operation. Thus, after the election is made under Sec. 819A, a U.S. mutual life insurance company will be able to price its policies and pay policyholder dividends without taking into account U.S. taxes in the same manner as its Canadian competition.

Subsection (h) of new Code Sec. 819A applies to U.S. stock life insurance companies and allows them to transfer Canadian insurance policies and related assets to a Canadian corporation with the same tax effects accorded U.S. mutual life insurance companies upon their election with respect to their branch operations. However, subsection (h) in its present form is incomplete in not providing for full tax neutrality from U.S. tax to a Canadian life insurance company subsidiary of a U.S. stock life insurance company.

To carry out the intent of new Code Sec. 819A to allow U.S. life insurance companies to operate in Canada free of U.S. tax, the enclosed statutory clarification of subsection (h) of Sec. 819A provides for the exclusion of the ownership of the Canadian subsidiary of U.S. stock life insurance companies from their U.S. tax computation in the same manner that U.S. mutual life insurance companies exclude the ownership of their Canadian branch operations. The enclosed clarification of subsection (h) also makes technical changes to bring the statutory language into accord with the purposes of the section as stated in the House Ways and Means Committee Report.

The Occidental Life Insurance Company of California has operated in Canada since 1928, and its Canadian operations constitute a substantial part of its total business. Like other U.S. life insurance companies, we have found it increasingly more difficult to compete with Canadian life insurance companies because we must take into account in pricing our Canadian policies and paying dividends to our Canadian policyholders the effect of U.S. taxes. Because of state regulatory obstacles, we must hold the Canadian life insurance company through which we will conduct part of our Canadian operations as a subsidiary of Occidental.

It is requested that the Senate Finance Committee in its consideration of Sec. 1043 amend new Code Sec. 819A(h) so that Occidental and other U.S. stock life insurance companies can do business in Canada through Canadian subsidiaries free of U.S. tax burdens. Under such amendment the Canadian subsidiary will be able to price

its Canadian policies and pay dividends to its Canadian policyholders free of U.S. taxes as does its Canadian competition.

Respectfully submitted.

O. L. FROST, Jr.

Enclosure.

SUGGESTED STATUTORY CLARIFICATION OF PROPOSED SEC 819A(h) OF THE INTERNAL REVENUE CODE INCLUDED IN SEC. 1043 OF THE TAX REFORM ACT OF 1975 RELATING TO THE TAX TREATMENT OF CONTIGUOUS COUNTRY BRANCHES OF DOMESTIC LIFE INSURANCE COMPANIES

"(h) Special Rule for Domestic Stock Life Insurance Companies.—At the election of a domestic stock life insurance company which has a contiguous country life insurance branch described in subsection (b) (without regard to the mutual requirement in subsection (b)(3), assets of the branch may be transferred to a foreign corporation organized under the laws of the contiguous country without the application of section 367 or 1491; subsection (a) shall apply to the stock of such foreign corporation as if such domestic company were a mutual company and as if the stock were an item described in subsection (c); and, dividends paid to such domestic company by the foreign corporation shall be treated as an addition to which subsection (e)(2) applies. The insurance contracts which may be transferred pursuant to this subsection include only those which are similar to the types of insurance contracts issued by a mutual life insurance company. Notwithstanding the first sentence of this subsection, if the aggregate fair market value of the invested assets and tangible property which are separately accounted for by the domestic life insurance company in the branch account exceeds the aggregate adjusted basis of such assets for purposes of determining gain, the domestic life insurance company shall be deemed to have sold all such assets on the first day of the taxable year for which the election under this subsection applies and the net gain shall be recognized to the domestic life insurance company on the deemed sale, but not in excess of the proportion of such net gain which equals the proportion which the aggregate fair market value of such assets which are transferred pursuant to this subsection is of the aggregate fair market value of all such assets."

Capital Loss Carryovers of Regulated Investment Companies

STATEMENT ON BEHALF OF THE INVESTMENT COMPANY INSTITUTE

CAPITAL LOSS CARRYOVERS OF REGULATED INVESTMENT COMPANIES

This statement is submitted by the Investment Company Institute in support of Section 1403 of H.R. 10612 which would amend Section 1212(a)(1) of the Internal Revenue Code to extend the net capital loss carryover for regulated investment companies from 5 years to 8 years. In so doing, Section 1403 would partially correct a serious inequity existing between the treatment of net capital loss carryovers for regulated investment companies as compared with individual taxpayers and other corporations.

The Investment Company Institute 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 share holders and assets of approximately $48 billion, representing about 93 percent of the assets of all U.S. mutual funds. The average investment of each shareholder is thus about $6,000.

Mutual funds, referred to in the Internal Revenue Code as "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, the Internal Revenue Code for many years has provided in Subchapter M "conduit" income tax treatment for those corporations, under which no corporate income tax is levied on the companies as long as they distribute currently their net income and net capital gains to their shareholders. The shareholders pay tax currently on the receipt of those distributions. The distribution made out of net-long-term capital gains, called "capital gain dividends," retain their character as long-term capital gain in the hands of the shareholders.

If the regulated investment company incurs a net capital loss for any year, the loss is not deductible by the company against other income nor is it deductible by the shareholders. The net capital loss may be carried forward by the company for 5 years and used as an offset against capital gains of the company for that subsequent 5 year period.

Prior to the Revenue Act of 1964, in the case of all taxpayers, both corporations and individuals, net capital losses could be carried forward for 5 years but not carried back to earier years. In the 1964

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Act the 5-year limit on capital loss carry-forwards was dropped for individuals, but retained for corporations. In the Tax Reform Act of 1969 corporations were allowed to carry back net capital losses for 3 years in addition to the right of a 5 year carry-forward, but the right of carry-back was not extended to regulated investment companies (Section 1212(a)(4)(B)). Thus at present corporations in general can carry over net capital losses of any year to 8 other years (3 prior and 5 subsequent years), and individuals have an unlimited carry forward, but regulated investment companies can carry over net capital losses only for 5 other years—the 5 subsequent years.

The Investment Company Institute submits that this 5-year limitation on regulated investment companies is unfair and inconsistent and believes that it should be changed. Since our surveys indicate that only about one-half of 1 percent of mutual fund shareholders are corporations (exclusive of incorporated tax-exempt organizations, such as charities), and since mutual funds distribute currently their net capital gains to shareholders (in whose hands they are taxed), there is considerable justification for making the unlimited capital loss carry-forward rule for individuals applicable to mutual funds.

At the least an 8-year carry-over, as provided in Section 1403 of H.R. 10612, should be permitted to mutual funds, since this is the number of years to which corporations may carry net capital losses. A carry-back to earlier years would be unavailing to regulated investment companies and their shareholders, since the companies would have distributed their net capital gains of prior years to shareholders, to whom they would have been taxed, and the capital loss carry-back could not be made available to the shareholders under subchapter M.[1] Hence a capital loss carry forward to 8 subsequent years should be permitted, at a minimum, to equ te these companies at least with other corporations.

Until recent years the limited 5 year carry-over period did not create a practical problem for regulated investment companies and their shareholders. However, the substantial decline of securities prices which began in the late 1960's has created a severe problem under this limitation. A number of Institute member mutual funds have incurred substantial net capital losses in years going back to 1970, and have not had sufficient capital gains in intervening years to absorb them.

Last year the Institute made a survey of 50 of its member mutual funds, representing approximately two-thirds of the assets of all mutual fund members of the Institute.

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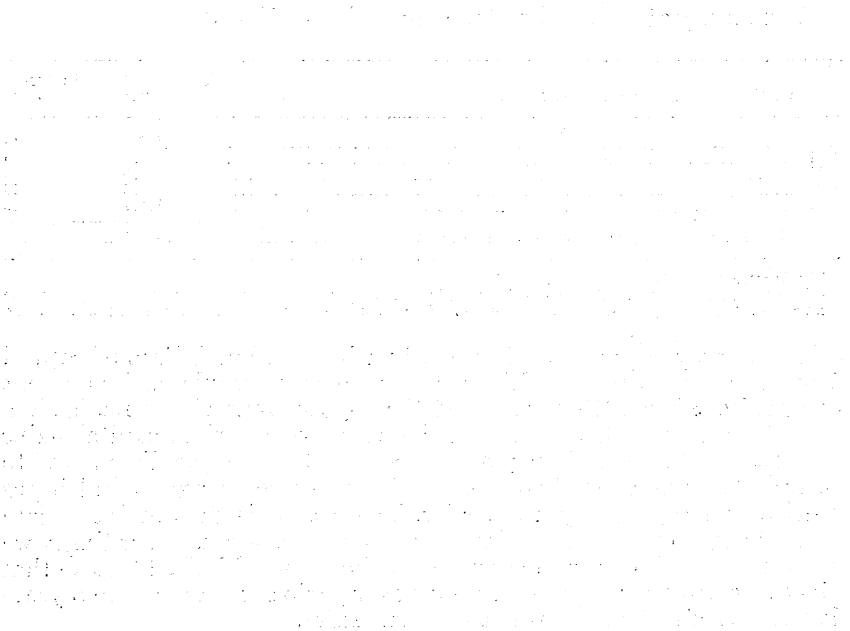
[1] Section 852(b)(3)(D) permits a regulated investment company to retain net capital gains but have the undistributed capital gains taxed to the shareholders as though they had been distributed. The shareholders including in their individual returns their pro rata share of the company's net capital gains are allowed a credit for the 30 percent capital gains tax paid by the company. This procedure is not frequently used, but even when it is used a capital loss carry-back would not be appropriate because the capital gains of the earlier year have been taxed at the shareholder level and allowance of refunds to the shareholders, stemming from the carry-back, would be impractical and inconsistent with the capital loss carry-over provisions for individual investors.

A summary of the results of the survey is as follows:

Fiscal year ending following calendar years	Future years [1] (millions)	Number of funds
1970	$458.2	13
1971	72.7	6
1972	22.5	3
1973	458.0	19
1974	920.9	36
Total loss carryover at the end of the most recent fiscal year	[2] 1,932.3	

[1] Dollar amount of capital loss carryover.
[2] These are figures for the mutual funds included in the Institute sampling. They do not include figures for: (a) Institute members not sampled, (b) "closed-end" regulated investment companies, and (c) non-Institute membe mutual funds

The survey thus shows that nearly a half-billion dollars of capital loss-carryovers will very likely be lost to these regulated investment companies after 1975 because of the 5-year limitation rule. Unless the Code is amended to extend the carry-over period, capital gains realized in 1976 and subsequent years would have to be distributed to shareholders and taxed to them without regard to net capital losses realized more than 5 years earlier. The matter is thus of immediate importance to these companies and their shareholders. Accordingly we urge that the Committee approve Section 1403 of H.R. 10612 so that the present 5-year capital loss carryover period is extended to 8 years in the case of regulated investment companies.



Tax Treatment of Dividends

CHROMALLOY AMERICAN CORP.,
St. Louis, Mo., April 6, 1976.

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

DEAR MR. CHAIRMAN: I am privileged and grateful to you, the members of the Senate Finance Committee, for the opportunity of presenting to you my views as they relate to tax reform with particular emphasis on the problems of equity financing of the nation's industries.

I serve as Board Chairman and Chief Executive Officer of Chromalloy American Corporation. We are a diversified company with manufacturing and service companies located in a number of states represented by you who are serving on this committee. We currently employ 22,000 people, a number which has decreased from 26,000 on January 1, 1974. This lack of growth in the number of employees brings me to the subject under discussion today.

Basic to our economy is the production of food and fiber and our ability to provide products and services. All require three ingredients. First, a public need for the products or service; second, money to design products and to house and equip production facilities; and third, people to man the machines to produce the food, the product, or service. Any one of these ingredients, in short supply, cripples the ability of an industrial nation to prosper. The past few years have seen a growing inability of American business to raise the money or capital needed for its growth or survival. This ingredient in short supply is basic to our economic problems of this period.

Over the years, due to budget deficits including costs of wars, defense, foreign aid and social problems of an expanding population, our government has become annually a greater competitor for the use of the existing money supply. The result of government financing and refinancing of its obligation has been to dry up sources of equity capital for the industry and commerce of the nation.

Since business and industry cannot finance these needs through the sale of corporate securities, it became necessary to revert to credit sources, banks, life insurance companies and other lending institutions. They become competitors with the government in the money markets thus creating exorbitant interest rates. Increasing interest rates, in my opinion, represent the greatest single source of inflation represented by spiraling costs and resultant prices. Add to this capital needs to provide nonproductive, antipollution devices and equipment to meet ever increasing requirements of government regulations. This, I realize, is an over-simplification of a few causes of inflation that seem apparent to me.

In the event that the Federal Reserve System is to prevail at maintaining a money supply growth at an annual basis of 5 percent, we will be faced with an ever decreasing supply of money in proportion

to the demand. If American industry is to remain viable, it must be able to raise new funds through equity financing. Ability to do this would be enhanced if stockholders were placed on the same footing as individuals who acquired tax free government securities. Currently, corporate dividends have been reduced by corporate profits tax of approximately 50 percent and, when received by the stockholder, are again subject to individual income tax. In face of the risk of corporate investment with returns subject to double taxation, investors find corporate securities undesirable. Exemption of dividends paid on corporate securities from individual income taxes would place them on equal footing with tax exempt securities.

An exemption of the corporate dividends tax at first glance would seem to be prejudicial in favor of business and industry. However, upon closer examination, one finds that business and industry are largely owned by some thirty million shareholders in the United States most of whom are middle income married adults. They represent a huge percentage of the electorate which in this issue (double taxation) has been grossly abused and neglected. In our corporation alone, approximately ten percent of its shares are held by labor pension funds. While the pension funds are not taxed, it must be remembered that they have a deep interest in a recovery in the marketplace of the equity values. Certainly you are aware of how badly these values have deteriorated.

Investment tax credit is under constant attack. In fact, it is inadequate to enable industry to retain sufficient earnings after taxes to cope with the monetary demands placed on them for capital. This capital is necessary if industry is to expand, to provide job opportunity and to modernize to increase productivity, which the economists claim will help defeat inflation, and to clean up the air and water to satisfy the environmentalists.

At the risk of being repetitious, I would like at this time to attempt to again dispel an impression that seems to prevail in the Federal Government. This impression being that organized labor and its interests are diametrically opposed to the interests of business and industry. This is a totally erroneous impression. We know firsthand that both labor and business interests will work hand in hand in securing proper and prompt remedies to our current economic problems with a concerted effort in the capital providing areas that will create new jobs.

Common stock representing an equity interest in the nation's business and industry are not owned exclusively by the very rich but instead are owned by an estimated eighty million Americans. This extending to pension, insurance, and mutual funds as well as private ownership. Both labor and industry have a vital interest in maintaining the value of these assets in which they have substantial investments. It would appear that government as the representative of these same people should have a similar interest.

To return to the subject of capital formation, we must first recognize that industry depends for its existence and its growth upon an ability to get money permanently invested in the corporation itself. That means through the medium of the sale of shares of its stock. Now, with the decline in value of those shares, not actual value but at least in selling prices which has taken place through some five years now of

constant attrition, the employers—the thousands like myself—are denied the opportunity to issue additional shares because the shares are not selling, not being bought by the public for anything near their real value. There are several hundred fine corporate stocks on the New York Stock Exchange that sell today for as little as thirty percent of their book value, which is the real liquidation value of the company. Our own company closed today at around $14.00 per share. The actual value of each share in goods and properties and machinery is somewhere in the neighborhood of $22.00. If I want to expand my business and I want to get capital to do so, I could not be loyal to my shareholders and offer $22.00 worth of value at a price of $14.00 and then be forced, if I want to continue to expand, to go to what is known as the "borrowed money market".

We need a frontal attack on unemployment. We need programs, policies and the funds necessary to turn the economy around now, and a recommitment to the goal of full employment set thirty years ago. This is not an impossible dream. It can and must be done.

I can best illustrate the problems and a possible solution by using the facts contained in the attached charts which are based on the financial functioning of the corporation that I am responsible for. (See Exhibit A)

For these reasons we urge that you and your Committee give full consideration to incorporation of the described amendments in any tax legislation that is reported to the Senate for action.

Thank you very much for your consideration. We would like to request that this letter be made a part of the permanent record of hearings on this legislation.

Very truly yours,

JOSEPH FRIEDMAN.

CHART DESCRIPTION ON ELIMINATION OF DOUBLE TAX ON DIVIDENDS

Chart I—America's Hunger for Capital—Capital is the essential resource if America is to continue in the path of economic growth and prosperity. The demand for this resource is projected to reach the astronomical sum of $4.5 trillion dollars.

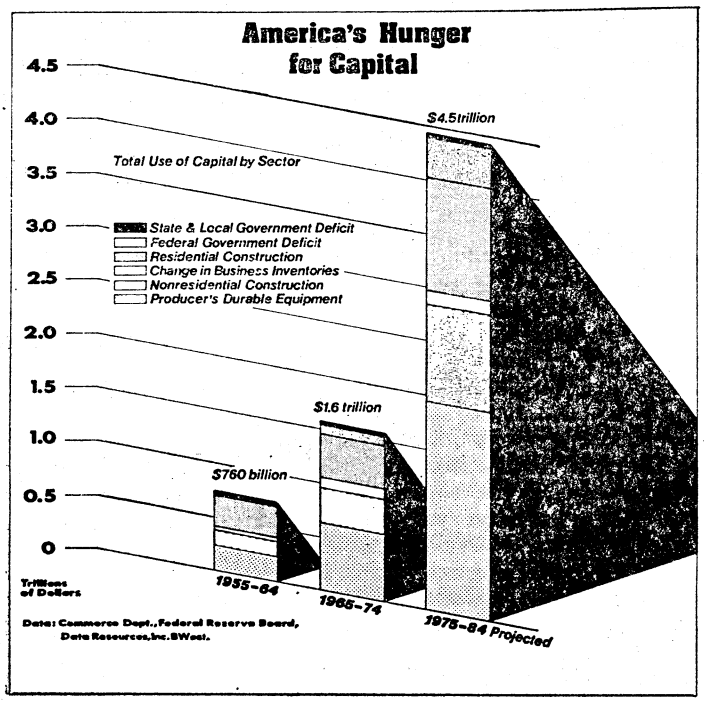
Chart II—One of the primary reasons that the demand for capital is increasing is that the capital invested per employee has been steadily increasing (partly due to inflation) in the past ten years. In fact, it has doubled.

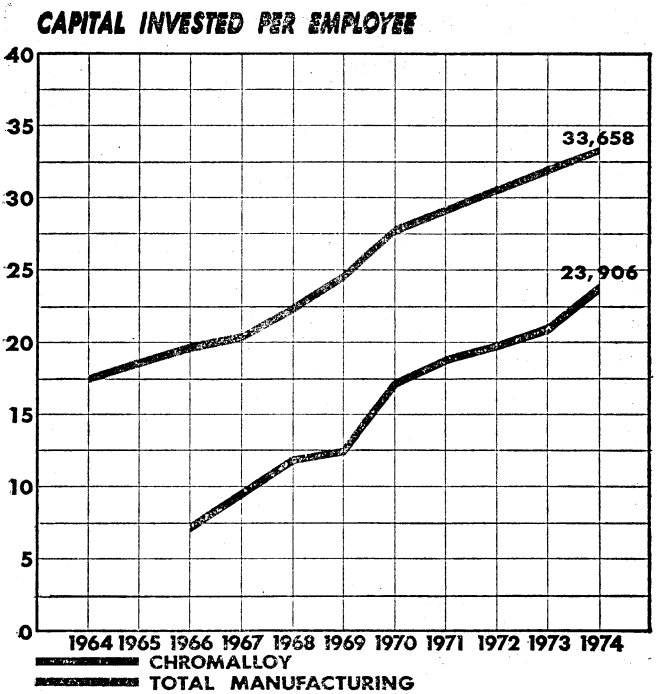
Chart III—Capital means jobs. Historically companies, when faced with a capital shortage, have reduced their capital appropriations which has had the effect of increasing the unemployment rate. Simply put, corporations without the money to expand or improve their facilities cannot create the jobs needed.

Chart IV—One solution to the capital formation problem is to eliminate the double tax on dividends. This action would place equity securities on a parity with tax free obligations and create an upward movement in corporate security paper, thus providing industry opportunities for equity financing to provide the funds for industries expansion, creating more jobs, more income tax revenues and a resumption of a growth in the gross national product.

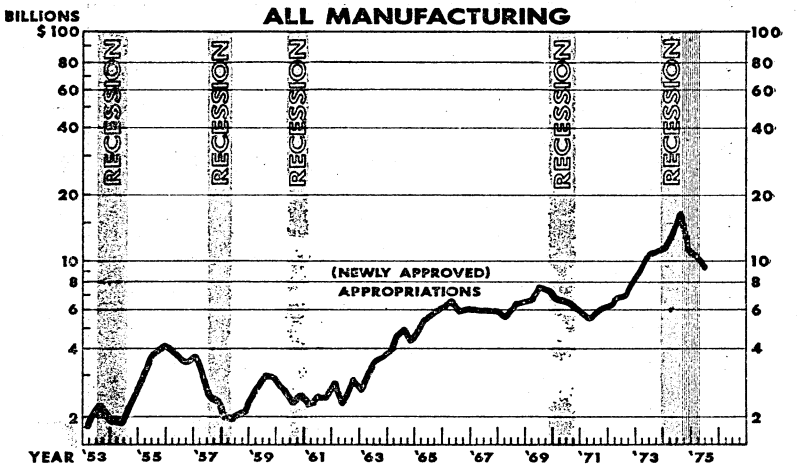
Chart V—An obvious question concerning the elimination of the double tax is the effect on federal revenues. Various Treasury and private studies indicate a possible revenue loss of $19 billion. However, these estimates *do not* take into account any changes in economic activity which would flow from the proposed change. In effect, it is assumed that the provision will be enacted in a vacuum and that no compensating changes would result. With respect to provisions affecting available capital and productive investment, this is an unrealistic procedure. Taking into account the increased economic activity which would result from having additional capital to invest, we estimate that instead of a large revenue loss, there would actually be a small revenue gain. More importantly, by the end of 1978—1,700,000 additional jobs would be created.

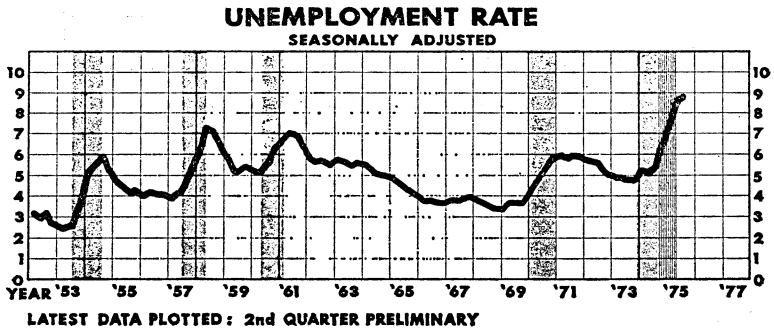
Chart IV—Elimination of Double Tax on Dividends—Effect on Chromalloy.

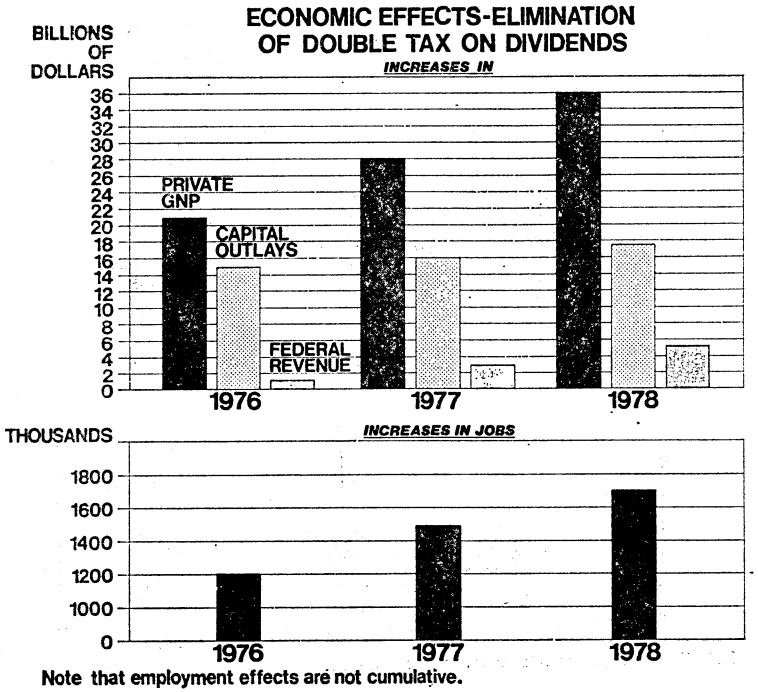



CAPITAL INVESTED PER EMPLOYEE
40
35
30
25
20
15
10
5
0
33,658
23,906
1964 1965 1966 1967 1968 1969 1970 1971 1972 1973 1974
CHROMALLOY
TOTAL MANUFACTURING

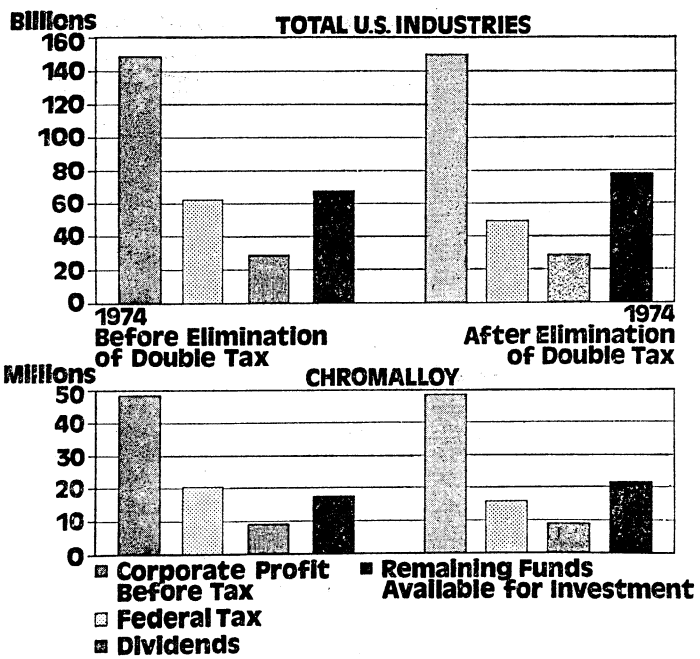
CAPITAL APPROPRIATIONS IN RECESSION/EXPANSION

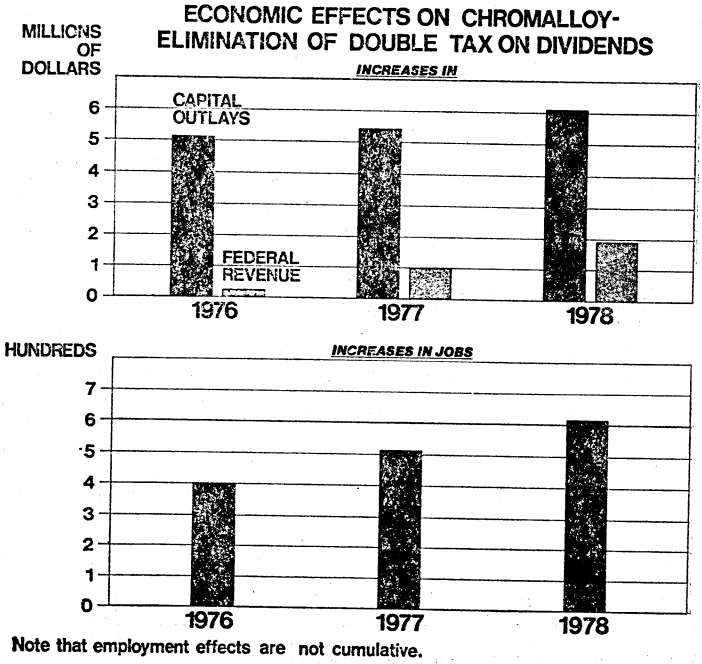






Note that employment effects are not cumulative.





Note that employment effects are not cumulative.

Highway Use Tax on Conservation Vehicles

Statement of Michael E. Strother, Representing the Land Improvement Contractors of America

This statement addresses the problem of the Federal highway use tax on conservation vehicles. This tax and its state counterparts are particularly burdensome to the small land improvement contractor doing soil and water conservation work for farmers and under various government programs. The bills S. 17 and H.R. 2260, pending before the Finance Committee and Ways and Means Committee respectively, would exempt these vehicles from the highway use tax.

The bills, as written, would exempt those vehicles "not for hire" and used *exclusively* in soil and water conservation work. A conservation vehicle is a tractor-trailer or dump truck used to perform conservation work or for hauling conservation related equipment and materials to and from job sites. They now fall under the general Internal Revenue Service tax classifications as outlined on the attached diagram. Conservation vehicles are primarily A, B, D, H models shown, depending on axles, trailers, and weights. They are used to transport bulldozers, trenchers, crawler loaders, draglines, materials, and earth itself.

Conservation vehicles are employed in the construction of farm ponds and dams, waterways, terraces; and in construction of watersheds, floodwater retarding structures, and stream bank stabilization projects.

The local conservation operator is a small businessman with limited operating capital. Capital formation is a chronic problem in his business operations. He employs an average of only six full-time employees and grosses under $100,000 a year. He is primarily engaged in work for the Soil Conservation Service (USDA), the Agricultural Stabilization and Conservation Service (USDA), and local farmers. The conservation contractor plays an important part in keeping the cost of food production low and in maintaining our soil, water and food producing resources for future years.

The small business status of the conservation contractor is certified by the attached letter from Mr. William Pellington, Director of Size Standards, Small Business Administration, and in a corresponding letter from Senator Gaylord Nelson, Chairman of the Senate Small Business Committee.

There has been a chronic shortage of private contractors in recent years. Existing conditions have driven many qualified operators into other fields or to reduce operations. Thus, a significant incentive is needed to attract new contractors to this vital work. Mr. Mel Davis,

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Administrator of the Soil Conservation Service, said of such an exemption in a letter to Senator Robert Dole:

> In recent years, there has been a shortage of contractors to perform soil and water conservation work approved by conservation districts with Soil Conservation Service technical help. Any incentive to encourage contractors to enter or remain in this field of work would help ensure that more land gets the protection it needs on time.

The present federal highway use tax on conservation is grossly inequitable in our estimation. These limited-use vehicles average only 5,000 miles a year—with over 70 percent of this mileage on state and country roads. In comparison, a similar "for-hire" commercial rig often will travel as many miles in a single week on Interstate and other federal highways. Yet, both pay the same highway use tax.

The average *federal* tax paid on a conservation vehicle nationwide is $175 a year. *State* taxes range up to several thousand dollars a year. The federal highway use tax paid on all vehicles ranges from $81 to $240 a year. It is not unusual for an operator to pay $1,000 a year on a tractor-trailer that carries a bull-dozer from one conservation project to another while traveling under 1,000 miles in the year. The equivalent tax here is over $1 per mile. Yet, the vehicle is employed in the public interest and rarely uses federal roads.

An industry-wide survey conducted in May of 1975 showed there are approximately 40,000 vehicles in the country which could possibly qualify as "conservation vehicles." Not every one of these would ultimately qualify, however, under subsequent federal regulations. Each operator owns an average of two such vehicles.

According to the Joint Committee on Internal Revenue Taxation, tax revenue loss would not exceed $7 million a year from such an exemption. A copy of Dr. Laurence Woodworth's letter containing this estimate is attached.

Conservation vehicles serve the public interest in many ways. A majority of these vehicles are at one time or another employed in the U.S. Agriculture Department's Agricultural Conservation Program (ACP). ACP has helped farmers establish conservation practices on about 1 million farms a year. In a typical recent year, the program helped build 45,000 water storage reservoirs, to help control erosion, conserve water, and extend pollution abatement, and provide habitat for wildlife. During the same year 600,000 acres were serviced by terraces to stabilize land and reduce stream pollution; another 300,000 acres of contour and field strip cropping reduced air and water pollution.

In recent House hearings on conservation it was demonstrated that we started with about 500 milion tons of topsoil to grow our food. To date some 200 million tons have washed or blown away, and another 100 million tons are now being eroded. This eroded soil has caused the biggest single water pollution problem in our Nation's waterways.

Support for an exemption for conservation vehicles has come from several sources. The National Association of Conservation Districts endorsed both S. 17 and H.R. 2260 in December of 1975, in letters to Chairmen Russell Long and Al Ullman. A copy of their letter is attached. Mr. Mel Davis, Administrator of the Soil Conservation Service, said of the proposed exemption:

> Today, when full farm production is a major national thrust, resource protection is vital. Most acres now being brought into crop use to meet food and fiber needs will require careful conservation measures for sustained production and protection against air and water pollution. Thus, there is a need for more conservation contractors to place the practices on the land.

Six states have provided full or partial exemption from state use taxes for these vehicles. They are Illinois, Kansas, Minnesota, Nebraska, South Dakota, and Texas. We offer the following excerpt from Nebraska state law as a sample of wording now on the books:

> 60–331.03. Registration fee; trucks, truck-tractors, trailers, semitrailers; For the registration of trucks or combinations of trucks, truck-tractors or trailers or semitrailers which are not for hire and engaged in soil and water conservation work and used for the purpose of transporting pipe and equipment exclusively used by such contactors for soil and water conservation construction, the registration fee shall be one half of the rate for similar commercial vehicles registered under section 60–331; Provided, that no vehicle registered under this section shall be registered for a fee of less than eighteen dollars; and provided further, that such vehicles shall carry on their license plate in addition to the registration number the letter A.

State experiences with their own exemption programs have been universally good. Officials from several states have directly endorsed S. 17 and H.R. 2260.

Illinois.—"In my opinion it is definitely in the public interest and greatly to the advantage of rural America for (the passage of) either S. 17 or H.R. 2260." (Hon. Gale Schisler, Chairman, Agricultural Committee, Illinois House of Representatives.)

Nebraska.—"As Chairman of the Public Works Committee, may I encourage consideration for . . . the proposal to exempt (conservation operators) from paying the federal highway use tax on such trucks." (Hon. Maurice A. Kremer, Chairman, Public Works Committee, Nebraska State Legislature.)

South Dakota.—"We have not found that the exemptions granted are difficult to enforce. In fact, the members of the State Conservation Contractors Association do a commendable job of self-policing." (Col. Dennis Eisnach, Superintendent, South Dakota Highway Patrol.)

Copies of the letters containing the above quotations, and others concerning state experiences with the use tax exemption, are attached for the Committee's reference.

A federal use tax exemption for these vehicles, pending subsequent federal regulations, would be monitored by the IRS as the tax itself is

now. In addition, state motor vehicle departments would be involved where corresponding state exemptions are in place.

As a result of various court proceedings, certain other vehicles have been exempted from the federal highway use tax based on their limited or special use. Now exempt are derrick-drilling trucks, certain logging trucks, and certain over-sized vehicles. These exemptions were established as a result of the following respective court cases: Stafford Well Service vs. U.S.A. (Civil Action 5568—Wyoming, 1971); Carl Nelson Logging Co. vs. U.S.A. (281 F. Supp. 671, 1967); and Rossi vs. U.S.A. (220 F. Supp. 694, 1963) *In both the Stafford and Rossi cases the determining factor was that the highway use of the vehicle was merely incidental to its industrial use. The same is true of vehicles involved strictly in conservation work.*

A study of the several existing state exemptions and current circumstances in the industry suggest that the following features might be used as guidelines for federal regulations under a use tax exemption for conservation vehicles:

(1) To qualify, equipment should be that which is used on a "not-for-hire" basis, and exclusively for the purpose of transporting machinery used in soil and water conservation practices;

(2) The annual mileage for the vehicles over the public highways should not exceed 6,000 miles a year;

(3) The equipment should be operated within a radius of 500 miles from the owner's residence or place of business;

(4) The requirement of a sworn affidavit attesting to the above stipulations to accompany the annual registration;

(5) A requirement of the states that they issue special registration license plates to identify and control such vehicles.

We sincerely believe the exemption of conservation vehicles from the federal highway use tax is equitable and will stimulate more conservation. Such an incentive would encourage other states to follow suit on their own use taxes, and thus significantly increase the incentives to attract and hold new operators for vital soil and water conservation. Proper conservation in turn reduces the cost of producing our food and fiber needs. Such a move would also improve the health of one sector of the small business community and so contribute to our overall national economic growth. Thus, the Committee's action would have an aggregate effect beyond the seemingly small proportions of the exemption itself.

In closing, we urge the Committee to take the lead in exempting bona fide conservation vehicles from the highway use tax by so amending H.R. 10612, the Tax Reform Act of 1975.

We thank the Committee for the opportunity to submit this statement and related materials in their entirety. A summary fact sheet of background information on this provision is reproduced on the next page for the Committee's reference.

FACT SHEET ON H.R. 2260 AND S. 17

(1) H.R. 2260 and S. 17 are companion bills designed to exempt vehicles used *exclusively* in soil and water conservation from the federal highway use tax.

(2) S. 17 was introduced by Senator Robert Dole (R–Kan), and now has two other cosponsors—Senators Dick Clark (D–Iowa), and Paul Fannin (R–Ariz.), giving it bipartisan support. H.R. 2260 was introduced by Rep. Charles Thone (R–Nebr). Both bills have been endorsed by the National Association of Conservation Districts.

(3) Conservation vehicles are tractor-trailers and dump trucks used solely in conservation. There are approx. 40,000 eligible vehicles nationally. They are now subject to an *average* federal tax of $175 a year, and state taxes up to $1,000 a year.

(4) The annual lost revenue would not exceed $7 million, as projected by the Joint Committee on Internal Revenue Taxation.

(5) These are limited use vehicles. The average conservation vehicle, as determined by national survey, travels only 3,000 miles a year—with 80% of that over state and county roads.

(6) Other highway vehicles have been exempted from the federal use tax through legal proceedings. These include derrick-drilling trucks, certain logging trucks and oversized vehicles.

(7) Conservation vehicles are used in preventing soil erosion and water pollution. In a single recent year they were used to build 45,000 water containment structures, 600,000 acres of agricultural terraces, and to date, to build 400 watershed projects covering over 700 million acres of land.

(8) In virtually every case, these vehicles are operated by small businessmen as defined by the Small Business Administration in a recent evaluation transmitted to the Senate Small Business Committee. The average operator has only 6 employees and grosses under $100,000 a year.

(9) The present Administrator of the Soil Conservation Service (USDA) formally said of a use tax exemption for conservation vehicles:

> In recent years there has been a shortage of contractors to perform soil and water conservation work . . . any incentive to encourage contractors to enter or remain in this field of work would help ensure that more land gets the protection it needs on time.

(10) Six states now make some provision for reduced taxes for conservation vehicles. These are: Illinois, Kansas, Minnesota, Nebraska, South Dakota, and Texas. State experiences with their own exemptions have been good. In many cases special license plates are issued to control vehicle use. Illinois Secretary of State Michael Howlett wrote to the two Congressional tax committees:

> This privilege has not been abused. . . . The plate has not resulted in a significant loss of revenue and has not caused administrative problems.

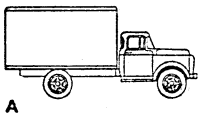
Federal Highway Use Tax

on trucks, truck-tractors and buses

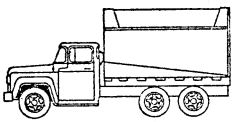
Publication 349
(Revised May 1973)

Department of the Treasury
Internal Revenue Service

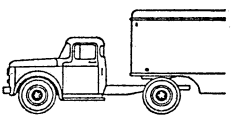
These pictures illustrate most of the types of vehicles subject to the use tax. Its taxable category is indicated by the letters. Consult the tables on pages 9, 10, and 11 for the amount of the tax on each taxable category.



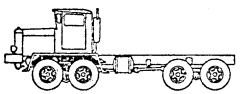
A



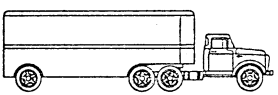
B, C



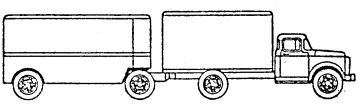
H, I, J, K



D, E, F



L, M, N



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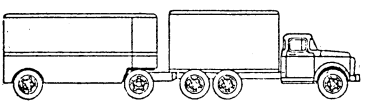

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U.S. SMALL BUSINESS ADMINISTRATION,
Washington, D.C., December 10, 1975.

Mr. MICHAEL E. STROTHER,
Washington Representative, Land Improvement Contractors of America, Washington, D.C.

DEAR MR. STROTHER: We are pleased to reply to your letter dated December 3, 1975, concerning the size standard applicable to your membership.

All of the activities listed in your letter are classified in SIC Industry 1629, *Heavy Construction, Not Elsewhere Classified.* The applicable size standards for SIC 1629 are average annual receipts of $12 million or less for the preceding 3 fiscal years for the purpose of bidding on Government procurements, and $9.5 million or less for the purpose of obtaining a Small Business Administration loan.

If further information is required, please let us know.

Sincerely,

WILLIAM L. PELLINGTON,
Director, Size Standards Division.

U.S. SENATE,
SELECT COMMITTEE ON SMALL BUSINESS,
Washington, D.C., December 18, 1975.

Mr. MICHAEL E. STROTHER.
Washington Representative, Land Improvement Contractors of America, Washington, D.C.

DEAR MR. STROTHER: This will acknowledge your letter of December 11, transmitting background material on the percentage of land improvement contractors who might be classified as small business.

We note from the article in *Land and Water Development* magazine that the average payroll of a member company is about 11 persons, less than half of which are full-time. We also noted that almost two-thirds of your member companies have gross incomes of under $100,000 a year, with 96 percent grossing less than $400,000 a year, figures well below the SBA size standards of $9½ million for the applicable SIC No. 1629.

We appreciate having this information and will bear it in mind in considering any tax matters related to this branch of the construction industry. We also appreciate your efforts in obtaining this material and in informing the Committee of the situation with your small business member companies.

Sincerely,

GAYLORD NELSON, *Chairman.*

U.S. DEPARTMENT OF AGRICULTURE,
SOIL CONSERVATION SERVICE,
Washington, D.C., July 31, 1975.

Hon. ROBERT DOLE,
U.S. Senate.

DEAR SENATOR DOLE: This is in response to your letter of July 17, 1975, concerning the impact of the Highway Use Tax on vehicles used exclusively in soil and water conservation work.

Most contractors who install ponds, terraces, waterways, and other soil and water conservation measures are small, local operators. They usually own a few pieces of earthmoving equipment, and trucks to transport the equipment from one farm or ranch to another.

These contractors, in most states, seldom travel for long distances over paved highways. Many times travel is over unpaved roads that parallel or cross major highways.

Since these small operators use highways considerably less than other truckers, some feel they should not have to pay the same rate of highway tax (according to Title 26 of the Internal Revenue Code, Section 4481, now based on a taxable gross weight of more than 26,000 pounds at the rate of $3 per year for every thousand pounds of taxable gross weight or fraction thereof). We must recognize, however, that to exempt only these vehicles, when farmers and others use highways on a comparable basis but would continue to pay the tax would also be unfair.

In recent years, there has been a shortage of contractors to perform soil and water conservation work approved by conservation districts with Soil Conservation Service technical help. Any incentive to encourage contractors to enter or remain in this field of work would help ensure that more land gets the protection it needs on time.

Today, when full farm production is a major national thrust, resource protection is vital. Most acres now being brought into crop use to meet food and fiber needs will require careful conservation measures for sustained production and protection against air and water pollution. Thus, there is a need for more conservation contractors to place the practices on the land.

Your concern for soil and water conservation work is greatly appreciated.

Sincerely,

R. M. DAVIS, *Administrator.*

CONGRESS OF THE UNITED STATES,
JOINT COMMITTEE ON INTERNAL REVENUE TAXATION,
Washington, D.C., September 8, 1975.

Hon. ROBERT DOLE,
U.S. Senate, Washington, D.C.

DEAR SENATOR DOLE: This refers to your letter of August 5, 1975, in which you ask us to assess revenue impact of two bills in which you are interested.

1. S. 17 (94th Congress) would exempt highway motor vehicles used exclusively in soil and water conservation and in transportation of equipment used for soil and water conservation from the highway use tax. It is estimated that enactment of this proposal would reduce the excise tax liability for the first full year by about $7 million.

2. S. 1105 (93rd Congress) would permit an immediate deduction for expenditures to remove architectural and transportational barriers to handicapped and elderly. It is estimated that enactment of this proposal would reduce the income tax liabilities for the first full year by about $10 million.

Sincerely yours,

LAURENCE N. WOODWORTH.

NATIONAL ASSOCIATION OF CONSERVATION DISTRICTS,
Washington, D.C., December 5, 1975.

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

DEAR SENATOR LONG: We would like to make known to you and your committee the support of the National Association of Conservation Districts for S. 17, the bill that would exempt motor vehicles used exclusively for soil and water conservation work from highway use taxation.

We believe that enactment of this legislation would significantly aid the small land improvement contractor who now has to pay substantial taxes on vehicles that are principally used over short distances to carry heavy equipment from field to field for the construction of terraces, farm ponds, and other vital conservation practices. The services of these contractors are essential in accomplishing soil and water conservation work on farms and ranches, and this exemption would aid materially in helping them to remain solvent and available for service.

We hope that your Committee will approve this legislation.

Sincerely,

DAVID G. UNGER.

ILLINOIS HOUSE OF REPRESENTATIVES,
Springfield, Ill., September 16, 1975.

Re S. 17 and H.R. 2260.

Hon. AL ULLMAN,
Chairman, House Ways and Means Committee,
U.S. House of Representatives, Washington, D.C.

DEAR CONGRESSMAN ULLMAN: It was a pleasure serving and working with you as a member of the House of Representatives in the 89th Congress.

I am writing you as Chairman of the Agriculture Committee of the Illinois House of Representatives.

In my opinion it is definitely in the public interest and greatly to the advantage of rural America for either S. 17 and H.R. 2260, which provide that any motor vehicle used exclusively in soil and water conservation work and in the transportation of equipment used for soil and water conservation is exempt from the Federal highway use tax.

In 1971, the Illinois General Assembly passed the following law:

"3-809.1 S 3-809.1 Vehicles of second division used for transporting soil and conservation machinery and equipment—Registration fee. Not for hire vehicles of the second division used, only in the territory within a 75-mile radius of a designated point, solely for transporting the owner's machinery and equipment used for soil and water conservation work on farms, other work on farms and in drainage districts organized for agriculture purposes, from the owner's headquarters to a farm, from farm to farm, and returning to the headquarters, shall be registered upon the filing of a proper application

and the payment of a registration fee of $325 shall be paid in full and shall not be reduced even though such registration is made during the second half of the registration year." (Ill. Rev. Stat. 1973, ch. 95–½, S 3.809.1)

We refer to the license as the "conservation plate." I regard this as one of the constructive laws enacted by the Illinois General Assembly in recent years.

A survey conducted by the Illinois Land Improvement Contractors Association in 1967 showed that vehicles used exclusively for soil and water conservation purposes used the highways very little when compared with other vehicles.

Because of the limited use of the highways and the need to encourage soil, water, and natural resource conservation, the law providing for the "conservation plate" was enacted.

The law is working very well and is accomplishing its objectives. I am informed by the Office of the Secretary of State that only 233 vehicles have the "conservation plate." The law has not resulted in any difficult administrative problems or a significant loss of revenue.

If S. 17 or H.R. 2260 become law, the Office of the Illinois Secretary of State could furnish you with the names and addresses of the persons who have the conservation plate.

I respectfully request that you use your considerable influence to obtain passage of this legislation that is very important to rural America.

Best regards,

GALE SCHISLER,
State Representative.

SEPTEMBER 29, 1975.

Hon. AL ULLMAN,
Chairman, House Ways and Means Committee,
U.S. House of Representatives, Washington, D.C.

DEAR CONGRESSMAN ULLMAN: It is my understanding that the Land Improvement Contractors of America are engaged in a campaign to gain an exemption from paying the federal highway use tax on trucks used exclusively for the activities necessary for soil and water conservation construction projects.

Several years ago the Nebraska Legislature provided for a reduced rate for licensing such vehicles. We in the Legislature felt that was justifiable in that these vehicles travelled only short distances generally and made little use of our roads and highways.

Soil and water conservation is vitally important to the economy of our State, and construction of such projects needs to be encouraged. As Chairman of our Public Works Committee, may I encourage consideration for these people in the proposal to exempt them from paying the federal highway use tax on such trucks.

Sincerely yours,

MAURICE A. KREMER,
State Senator.

SEPTEMBER 12, 1975.

Hon. AL ULLMAN,
Chairman, House Ways and Means Committee,
U.S. House of Representatives, Washington, D.C.

DEAR MR. LLLMAN: This office has been contacted regarding pending legislation. This action involved certain exemption and fee reductions for vehicles utilized for soil and water conservation construction projects.

From an enforcement viewpoint, our Division has experienced only very minor problems with the special exemption granted to these vehicles by our State Legislature. We have not found that the exemptions granted are difficult to enforce. In fact, the members of the State Conservation Contractors Association do a commendable job of self-policing.

The only area that enforcement encounters any difficulty is an unclear or insufficient legal definition as to precisely what soil and water conservation practices entail. If legislative action could more clearly define this, it would help enforcement considerably.

If we can be of further service, please communicate with us.

Kindest personal regards,

DENNIS EISNACH,
Superintendent.

OFFICE OF THE SECRETARY OF STATE,
Springfield, Ill., September 12, 1975.

Re S. 17 and H.R. 2260.

Hon. AL ULLMAN,
Chairman, House Ways and Means Committee,
U.S. House of Representatives, Washington, D.C.

DEAR CONGRESSMAN: I have been requested by the Illinois Land Improvement Contractors Association to write you about S. 17 and H.R. 2260, which provide that any motor vehicle used exclusively in soil and water conservation work and in the transportation of equipment used for soil and water conservation is exempt from the Federal highway use tax.

In 1968 the Illinois General Assembly passed the following law:

"3–809.1 § 3–809.1 Vehicles of second division used for transporting soil and conservation machinery and equipment—Registration fee. Not for hire vehicles of the second division used, only in the territory within a 75 mile radius of a designated point, solely for transporting the owner's machinery and equipment used for soil and water conservation work on farms, other work on farms and in drainage districts organized for agricultural purposes, from the owner's headquarters to a farm, from farm to farm, and returning to the headquarters, shall be registered upon the filing of a proper application and the payment of a registration fee of $325 shall be paid in full and shall not be reduced even though such registration is made during the second half of the registration year." (Ill. Rev. Stat. 1973, ch. 95–1/2, § 3.809.1)

We refer to the license as the "conservation plate."

The law was enacted following a survey which clearly indicated that vehicles used for soil and water conservation work travelled a rela-

tively small number of miles on the highway when compared with other vehicles. In addition, those using the conservation plate make a great contribution in the areas of soil, water and natural resource conservation. Further, there is a shortage of land improvement contractors in Illinois. It is hoped that the plate will encourage young people to enter the field.

This privilege has not been abused. Only 233 vehicles in Illinois have the conservation plate. The plate has not resulted in a significant loss of revenue and has not caused administrative problems.

The Illinois Land Improvement Contractors Association has carried on an effective educational program to ensure that the plate is used only on vehicles it was intended for.

If S. 17 or H.R. 2260 should become law, this office can provide representatives of the Federal Government the names and addresses of the persons in Illinois who have the conservation plate. It appears to me that if either one of these bills become law, the vehicles in Illinois entitled to the exemption would be those with the "conservation plate."

Sincerely,

MICHAEL J. HOWLETT,
Secretary of State.

STATE DEPARTMENT OF HIGHWAYS
AND PUBLIC TRANSPORTATION,
MOTOR VEHICLE DIVISION,
Austin, Tex., November 17, 1975.

Hon. BOB DOLE,
U.S. Senate, Washington, D.C.

DEAR SENATOR DOLE: This is in reply to your letter of November 7, 1975, requesting an evaluation of the Texas provisions for soil conservation vehicles, for use in connection with legislation to exempt such vehicles from the Federal Highway Use Tax.

Article 6675a-2, Section (h) [1], Vernon's Texas Civil Statutes, provides for a 50-percent reduction in registration fees for vehicles used in soil conservation work. Each owner of such vehicles is entitled to register only one (1) truck or truck tractor and one (1) semitrailer or lowboy trailer at the reduced fee.

In order to qualify for the reduction in fees, each owner must submit with his application for registration (1) an affidavit that the vehicle is to be used exclusively to transport on the highways his own soil conservation machinery or equipment used in clearing land, terracing, building farm ponds, levees or ditches, and (2) a certification by the County Agricultural Stabilization and Conservation Committee that the applicant has been approved as a vendor of conservation services or materials. These qualifying requirements, of course, result in additional expense to the State for the maintenance of special files; however, this procedure does provide a degree of regularity and control to insure that those who receive the reductions in fees are actually entitled to them.

For the 1974 Registration Year, we registered 893 vehicles with Soil Conservation license plates. A portion of these were semitrailers or

lowboy trailers, which means that the number of trucks or truck tractors registered with such plates would range between 446 and 893. We do not have the Soil Conservation registrations broken out as to power units versus semitrailers.

There are, no doubt many others engaged in soil conservation work who do not avail themselves of the Soil Conservation license plates, due to their restrictive use. Instead, they purchase regular license plates at the full registration fee so they may use their vehicles in all types of hauling.

The special provisions for soil conservation vehicles have been on the Texas Statute Books for several years and, admittedly, there is some misuse of the special plates; however, we do not believe that such violations are flagrant. Enforcement against misuse of the Soil Conservation plates is rather difficult because the operator of the vehicle must be apprehended while actually operating in violation of the provisions of the law, and this is often times difficult to prove. Suffice it to say that we do not hear of too many violations for misuse of the Soil Conservation plates.

Self-policing by individuals or associations of persons engaged in conservation work might have some merit; however, it is doubtful that it would be very effective with regard to the issuance of license plates. If an applicant for Texas Soil Conservation license plates submitted the necessary affidavits required by law, we would be obliged to issue such plates irrespective of what some other individual or group of persons might say.

Senator Dole, if we can be of further assistance to you, please let us know.

Sincerely yours,

B. L. DeBerry,
Engineer-Director.
R. W. Townsley,
Director.

POSITION STATEMENT ON FEDERAL HIGHWAY USE TAX

This material has been summarized as a result of a survey conducted by LICA in 1974 among its members.

LICA, the Land Improvement Contractors of America, consists of 2,500 members in 33 states whose primary occupation is performing conservation work for the American farmer. LICA members are representative of conservation contractors in the United States and comprise approximately 15 percent of all conservation contractors in the United States.

Equipment owned.—Conservation contractors pay Federal use tax on lowboys and dump trucks which they use on a not-for-hire basis in performing their work on agricultural projects. Their lowboys are used to haul earth moving equipment to the job site while dump trucks are used in earth moving work on the job site.

Taxes paid.—About 80 percent of the contractors own equipment on which they are required to pay Federal use taxes. Taxes paid by the contractors ranged from a low of $90 to a high of $240 per unit

owned per year. The average contractor pays an average of $175 per year taxes on each piece of equipment they own.

Since the average contractor owns more than one piece of equipment (usually a lowboy and a dump truck) his Federal use tax bill amounts to $235 per year.

Mileage driven.—The survey revealed that conservation contractors drive their equipment an average of 5,000 miles per year. Most of this mileage is over county and state highways. About 30 percent of the contractors ever use the interstate highway system. 70 percent drive entirely on county and state roads and never use the interstate system. Those that do use the interstate systems average about 2,000 miles per year per contractor. 80 percent of conservation contractors drive less than 5,000 miles per year on vehicles on which they pay the Federal use tax. Most contractors engaged in conservation work perform their work within a radius of 50 miles or less and 95 percent of these contractors do their work within a radius of 100 miles or less.

SUMMARY OF NUMBER OF CONTRACTORS WITHIN CERTAIN ANNUAL DRIVING DISTANCES

	Percent	Cumulative percent
Drove less than 1,000 miles	14	
Drove between 1,001 to 2,000 miles	22	36
Drove between 2,001 to 5,000 miles	43	79
Drove between 5,001 to 10,000 miles	14	93
Drove between 10,001 to 20,000 miles	5	98
Drove between 20,001 to 40,000 miles	1	99
Drove over 40,000 miles	1	100

Projected U.S. lost revenue.—Assuming that there are between 20,000 and 30,000 land improvement contractors in the United States who use their equipment almost exclusively for work connected with soil and water conservation and each of these contractors, as is true of the LICA member, pays $235 per year, the total revenue lost from subject bills S. 17 and H.R. 2260 would be between $4,700,000 and $7,050,000 which is an insignificant sum as far as the U.S. budget is concerned but is a considerable sum to the small contractor business man.

Reinvested Stock Dividends

TESTIMONY OF EUGENE M. LERNER, CHAIRMAN, FINANCE DEPARTMENT, GRADUATE SCHOOL OF MANAGEMENT, NORTHWESTERN UNIVERSITY

My name is Eugene M. Lerner. I am a Professor of Finance at the Graduate School of Management of Northwestern University.

I am pleased to have the opportunity to submit a statement before the Senate Committee on Finance with respect to proposed changes in the tax law. Specifically I want to urge that dividends that are automatically reinvested by shareholders be treated as stock dividends. The effect of this change would be that shareholders could defer the payment of taxes on these dividends until such time as they actually sell the new shares that they purchase.

The reason why I urge that this legislation be passed is that it will improve the effectiveness of the nation's capital market. As a consequence, our economy will be stronger and investment will be stimulated. Employment will be raised and productivity will be increased.

Why will such a relatively modest change in the tax law have such a significant and desirable effect upon the economy as a whole? The answer lies in the fact that it will contribute to improving the capital structure and therefore the financial soundness of companies.

Firms can raise the money they need to pay for their new plant and equipment through either their own operations (profits and depreciation) or through the sale of securities (debt instruments or new stock). If they issue new debt instruments, they can sell either short or long term securities. When firms sell new shares, (raise new equity) they raise permanent capital because these monies will typically never be retired.

One of the most important business decisions that a firm must make is to determine how it will finance its growth. Should it restrict its plant and equipment outlays to only the funds that it generates through operations or should it seek outside funds? Some firms only spend their internal funds because they simply do not have the business opportunities for continued growth. Most firms in as dynamic an economy as ours however do have the opportunity to invest more funds than they generate internally. These firms must then determine whether they will raise the additional funds they need through debt or through equity.

The method that a firm will use to finance its expansion depends critically upon its present level of risk. The cost of the new funds, and the return that it anticipates from the new investment.

Raising short term debt money is the most risky way to expand. The reason for this is that short term money constantly falls due and must be either repaid or rolled over. Since these funds may fall due at a time when the firm does not have the cash to repay the debt or credit markets are stringent, borrowing short term funds may lead to several financial problems.

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Raising long term debt money is an acceptable way to finance expansion if it is not carried on to excess. The payments that are required to service the long term debt, if they are modest, can be structured so that they coincide with cash inflows. If the payments are too large, i.e., if a company has an excessive amount of debt, it will have difficulty in meeting either the actual cash payments that are required or the covenants of the debt instrument itself. These covenants typically require that the companies' earnings be sufficiently high so that it covers the required payments by a specified margin.

Equity is the least risky way to finance expansion. Equity represents the investment by the owners of the firm in the enterprise. It is permanent capital and it provides a measure of safety to the bondholders.

While equity is the least risky way to finance expansion, it may also be the most expensive. The reason for this is that firms have earnings targets which stated in terms of "earnings per share" or "return on equity", i.e., the ratio of profits to equity, the larger a firm's equity, the more difficult it is to reach a stated target.

The financing decision that a firm faces therefore involves a tradeoff between expected return and risk. As it increases its reliance upon debt, it may improve its return and achieve its earnings targets. However this gain comes at the cost of increasing the riskiness of the firm. If it finances by equity, risk will fall but the earnings targets that it sets may not be achieved. Of course, if the riskiness of the firm is such that management does not want to see it increased, and equity is difficult to raise, the firm may simply cut back on its new plant and equipment outlays.

Each firm in a free and competitive society must decide for itself what is a prudent level of risk and what is a reasonable earnings target. The decision however is influenced by what other firms are doing. If competitive firms are earning high returns, new equity investors will be reluctant to invest their monies in firms that earn low returns. Similarly, if competitive firms offer creditors low risk, lenders will be reluctant to advance funds to high risk firms.

There are several measures that are used to indicate the amount of financial risk that a firm incurs. One of these measures is the ratio of total debt to total equity. The higher this ratio, the risker the firm. A second measure is the ratio of profits to interest payments. The lower this ratio (called "the interest coverage ratio") the riskier the firm.

Unfortunately, over the past decade, both of these ratios have deteriorated sharply. This is especially true in the case of utilities. For example the interest coverage ratio for all electric utilities declined from roughly 6 times in 1966 to less than 3 times in 1975. For independent telephone companies, the decline was from 4 times to 3 times over the same period. Similarly the ratio of debt to debt plus equity has increased from 52 to 55 percent for electric companies, from 33 to 49 percent for AT&T, and remained at roughly 57 percent for other telephone companies.

The deterioration in the capital structure of utilities is alarming. Changes should be made in the tax law to encourage the use of equity

so that these firms can be restored to some level of financial strength and health.

If the equity position of firms were improved they could finance the plant and equipment outlays that they must make without adding to their overall level of risk. Their willingness to take on new outlays would be enhanced and these expenditures would both raise the productivity of their own labor force and the level of employment throughout the economy. One way to raise the equity would be to defer the taxes on dividends that are reinvested.

At present if a firm elects not to pay dividends but rather to reinvest all of its earnings, the shareholder need pay no taxes on these earnings. However, if the same firm distributes all of its earnings and then seeks to sell new shares to its owners equal to the dividends it declared, the shareholder must pay taxes on the dividends. Simple equity demands that the tax law recognize that from the point of view of raising funds these two situations are basically identical, and that relief should be granted to shareholders that reinvests their dividends.

There is however an important distinction between the two cases. In the first case, the firm made the decision for the shareholder to reinvest his earnings. This denied the investor the option of choosing how to allocate his own funds. In the second case, the investor can elect to reinvest the funds he receives in the company that paid him the dividend, in another firm, or spend the money in another way. An efficient capital market would permit the shareholder to make his own decision as to how his funds should be allocated. If the shareholder wants to switch his commitment from one firm to another, he should be given the opportunity to do so. If he wishes to reinvest his dividends in the company he now owns because he has confidence in its management, he should be permitted to do so too.

Firms need more equity. Shareholders and others should be encouraged to make additional equity commitments. As the tax law now stands, however, the taxation of dividends discourages this reinvestment and encourages firms not to make any distributions at all.

I therefore urge that this committee move to correct this inequity and treat reinvested dividends on a par with retained earnings.

SUMMARY

There are many compelling reasons that the tax laws should be changed so that dividends which are automatically reinvested by shareholders will be treated as stock dividends. Among the major reasons are the following:

1. The distinction for tax purposes between stock dividends and cash dividends which are automatically reinvested is arbitrary, artificial and discriminatory.

2. Enactment would improve the effectiveness of the Nation's capital markets, help to provide needed equity capital and thus strengthen the financial structures of corporations.

3. Enactment would stimulate investment, improve productivity and provide additional job opportunities.

Motor Vehicle Excise Taxes

Statement of Hon. Guy Vander Jagt

Mr. Chairman, I am pleased to submit the following statement to your distinguished Committee. I believe you will find it constructive and that it represents an opportunity to correct an undesirable situation in our tax structure, a situation discouraging capital formation and the creation of jobs. I know both of these major economic issues have the strong interest of this Committee. I am referring to the Federal excise tax on trucks, buses, trailers, parts and accessories.

As this Committee well knows, the current Federal excise tax of 10 percent on the above products has been in effect since July 1, 1956 and was established to provide revenues for the Federal Highway Trust Fund. You will recall that passenger automobiles were likewise taxed, but the Congress, in its wisdom, repealed the excise tax on those vehicles under Public Law 82–178. I propose that this Committee include repeal of the excise tax on trucks, buses, trailers, parts and accessories as part of its 1976 tax reform proposals.

It will be recalled that your Committee incorporated this proposal as an amendment to the Tax Reduction legislation, H.R. 2166, in 1975. The Senate adopted the recommendation of your Committee, but unfortunately it was dropped in the Senate-House Conference.

The logic of repeal of this tax is substantial. While you are no doubt aware of many of the arguments favoring repeal, let me list those of which I have direct knowledge.

1. The excise tax is an inappropriate means of applying direct highway user charges to truck operators. Because the tax is imposed at the point of manufacture, it does not matter if the vehicle is driven 10 miles or 1 million miles, the tax remains the same.

2. The philosophy behind an excise tax is normally to restrict or discourage the use of the product on which the tax is imposed for some socially desirably purpose. However, this particular excise tax tends to discriminate against a specialized segment of our transportation system.

3. The tax is difficult to administer fairly. The tax may be higher or lower depending on the step in the distribution chain at which it is imposed. The tax on a truck part installed by the retailer will be higher than it would be had the part been installed by the original manufacturer, for example. The result is a competitive disadvantage for one manufacturer versus another.

4. The tax discriminates against the consumer who is dependent upon truck transportation. More and more of our population is located in suburban and rural areas not served by rail.

5. Congress over the years has substantially reduced excise taxes as a source of Federal revenues. As a consequence, and particularly in this instance, a very small segment of industry is now required to pay such taxes, a burden increasingly unfair as more excise taxes are eliminated.

6. The excise tax on heavy duty trucks now averages about $3,000. A reduction in price of this amount would provide a very substantial stimulus to scales resulting in increased production with concomitant increases in jobs. Because the trucking industry today employs in manufacture and distribution about 500,000 people, it is apparent that increased sales would effect a very substantial job base.

7. Trucks and truck equipment are capital goods. It is an unfortunate irony that we seek to increase investment in capital goods through the investment credit while continuing to impose a penalty on the trucking industry through the excise tax. Mr. Chairman, in the deliberation of the 92nd Congress, the Report of the Committee on Ways and Means accompanying the repeal of the passenger automobile excise tax contained language highly appropriate to the question of truck excise tax repeal. I quote:

> . . . the excise tax on passenger automobiles is repealed in this bill both to provide a stimulus for the purchase of cars and because of the jobs this is expected to create. In addition, Congress has previously concluded that excise taxes, such as the one on passenger automobiles, are undesirable because they interfere with the fredom on consumer choice . . .

Finally, the report indicated that this repeal:

> . . . continues the trend begun in 1965 to repeal excise taxes which place discriminatory tax burdens on the consumers and producers of the taxed products.

Mr. Chairman, to remove the excise tax on trucks, buses, trailers, parts and accessories would contribute to the slowing of the inflation rate. Lowering the purchasing cost of these vehicles would be beneficial to small businessmen, farmers, and independent-owner operators of semi-trailer rigs, who have been hard hit by the recent bout with inflation. And, it is not fair to continue this tax—a tax that applies to no other form of transportation.

Mr. Chairman, I know your Committee recognizes the importance of the jobs and new investment in capital goods which would result from repeal of this Federal excise tax. Such repeal would provide relief to the consumer, stimulate truck manufacturing and its related industries, and end a burdensome tax.

Thank you for this opportunity to present this statement to this esteemed Committee.

Limitation on Artificial Losses

STATEMENT OF THE SOCIETY OF AMERICAN FLORISTS AND ORNAMENTAL HORTICULTURISTS, SUBMITTED BY PERRY A. RUSS, DIRECTOR OF NATIONAL AFFAIRS

SUMMARY

INTRODUCTION

The Society of American Florists and Ornamental Horticulturists is the national trade association which through affiliation represents over 50,000 American businesses engaged in all forms of commercial floriculture. Our members grow, distribute, and market fresh flowers, green plants, bedding plants, florist greens, ferns, etc. which add beauty to the environment and express the deepest of human emotion.

In all Federal regulation and all legislation heretofore enacted by Congress, commercial flower and plant growers have been classified as "farmers" and fall within the purview of those acts covering agricultural producers. It is on behalf of SAF grower members that we submit the following comments to the Senate Committee on Finance in regard to H.R. 10612, The Tax Reform Act of 1975.

ROLE OF EXISTING LAW AND PRESENT FARM TAX RULES

Generally, the rules of existing law provide workable and administrable solutions to the problems of farm tax accounting. These rules have survived for many years and have been sanctioned by the Treasury Department and the Courts, including the Supreme Court. Our members have for many years, both in legislation and as a matter of practice, been treated as farmers and have been permitted to apply these rules to report their income for tax purposes. Farmers, under the current tax rules, are permitted to use the cash receipts and disbursements method of accounting without the keeping of inventories. Farmers are permitted to deduct the costs associated with planting and raising their crops even though income associated with such crops may not be earned until a subsequent taxable year.

In the case of our members, these methods will, over a period of years, accurately reflect their income. Moreover, these rules permit our members to accurately reflect their income without requiring the keeping of complicated records or requiring arbitrary cost allocations. Further, although there are a number of complex rules already in the Code to prevent abuse of the farm tax rules, the present rules are, in general, comprehensible for the small agricultural businessman.

We believe that existing law provides substantial limitations to prevent abuse of the farm tax rules. For example, section 183 of the Code provides that certain deductions will be disallowed if a transaction is not entered into for profit. This rule, if applied in appropriate circumstances, is a strong weapon against those who would market tax

shelters based upon the farm tax rules. Moreover, existing law has been interpreted to restrict the use of non-recourse financing to generate tax losses. There are also judicial limitations applicable where tax consequences are the sole motivation for a course of action. We believe that if new provisions are to be adopted by the Congress to restrict the application of the farm tax rules, that such provisions should be narrowly drawn so as to apply only where necessary to prevent abuse which cannot be properly dealt with under existing law. These new rules should not be applicable to the ordinary farmer. The members of our association should not be required to comply with a new and complex set of rules which are unnecessary to cope with any abuse of the farm accounting rules.

PROVISIONS OF TAX REFORM BILL RELATING TO FARM TAX RULES

H.R. 10612, the House passed Tax Reform Act of 1975, contains several provisions which impact upon the farm tax rules. The most significant provisions are the so-called "limitation on artificial accounting losses" ("LAL") provision and the requirement that farming corporations and partnerships with corporate partners adopt the accrual method and capitalize "pre-productive period expenses." These new provisions are not limited to large corporate enterprises or tax shelter syndicates. They are applicable to small farmers and farmers whose income derives solely from farming.

H.R. 10612 RULES INCONSISTENT WITH SOUND TAX POLICY

We believe that many of the principal effects of H.R. 10612 are contrary to sound tax policy. First, we believe that the LAL provisions of House Bill discriminate against new investors in farming ventures, and those who, in expanding their farming operations realize start-up losses. Such persons frequently operate at an economic loss during these years, but would not be permitted to offset their economic loss against non-farm income under the LAL provisions. At the same time, the LAL provisions preserve the farm tax rules for those who have been in the farming business for several years and are operating at a profit sufficient to absorb their "accelerated deductions." Second, the LAL provisions are an enormously complicated and arbitrary set of rules which will impose difficult and burdensome requirements upon small farmers and upon large full-time farmers who in one year have substantial income unrelated to farming. These persons are not the proper or intended target of any "tax reform" effort. The complexity of these rules will, in many cases, render voluntary compliance with the law difficult or impossible. Third, the rules applicable to corporations engaged in the business of farming are overly broad and largely unnecessary. There are bona-fide business reasons for adopting the corporate form and the tax rules should not arbitrarily discriminate against this form of business organization.

RECOMMENDATIONS OF AMERICAN SOCIETY OF FLORICULTURISTS

Our basic recommendation to the Senate Committee on Finance is that the approach of the House Bill be abandoned. It is unworkable

and contrary to a sound tax policy. The provisions of the House Bill arbitrarily discriminate against new business ventures, small farmers who are unable to pay for costly accounting services, farmers growing various crops, and the corporate form of business organization.

Assuming that the Senate Committee on Finance determines that the approach of the House Bill should be followed, we have specific recommendations that would permit reform of the farm tax rules where necessary and, at the same time, not interject an unworkable set of rules into the average farmer's April 15th income tax filing requirements. Our specific recommendations are:

(1) The amount of unrelated income which can be offset by "accelerated deductions" before application of the LAL rules should be increased from $20,000 to $50,000. This revised test should apply to taxable rather than adjusted gross income. Only if the taxpayer has substantial nonfarm income otherwise taxed at the higher progressive rates will he be likely to embark upon a tax shelter program of any kind. In applying this floor to corporations, the nonfarm income of individuals owning more than 10 percent of the stock should be aggregated with the corporation's nonfarm income. These changes would focus the LAL provision upon the wealthy nonfarm investor and limit to a very few cases the likelihood that a full-time farmer will be caught in the web of LAL.

(2) The carryback of deductions which have been deferred by the LAL provision, should be permitted where nonfarm income drops below $50,000 in a subsequent year.

(3) The LAL farm rules should not apply to any person for whom gross income from farming is a substantial portion (perhaps 50 percent or more) of his gross income.

(4) The required use of the accrual method of accounting should be eliminated. If the other suggested changes are agreed to, this provision is not needed.

(5) There should be no requirement that expenses allowable under the accrual method be capitalized by a corporation engaged in the business of farming.

(6) Partnerships that happen to include a corporate partner should not be required to use the accural method, unless the corporation owns in excess of 50 percent of the capital interests in the partnership.

STATEMENT

INTRODUCTION

The Society of American Florists and Ornamental Horticulturists is the national trade association which through affiliation represents over 50,000 American businesses engaged in all forms of commercial floriculture. Our members grow, distribute, and market fresh flowers, green plants, bedding plants, florist greens, ferns, etc. which add beauty to the environment and express the deepest of human emotion.

In all Federal regulation and all legislation heretofore enacted by Congress, commercial flower and plant growers have been classified as "farmers" and fall within the purview of those acts covering agricultural producers. It is on behalf of SAF grower members that we sub-

mit the following comments to the Senate Committee on Finance in regard to H.R. 10612, The Tax Reform Act of 1975.

The Tax Reform Act of 1975, H.R. 10612 ("the House Bill") was enacted by the House of Representatives for the purpose of preventing "investors" from taking ". . . advantage of the special farm tax rules to deduct farm expenses in a year or years prior to the years when revenue associated with such expenses is earned." [1] In an effort to accomplish this purpose, the House Bill provides a bewildering array mandatory accounting practices for farmers. Individual farmers may continue to use the cash method, but, depending upon the source and amount of their income, are required to adopt a highly complex system of deferred deduction accounts. The rules relating to "deferred deductions" are necessarily arbitrary since the entire concept falls wholly outside presently recognized accounting practices. Moreover, under the House Bill, certain farmers operating in corporate or partnership form are required to adopt the accrual method of accounting. In addition, such farmers are required to establish capital accounts for certain expenses which are allowable as deductions to other taxpayers on the accrual method of accounting.

Although there are special rules in the House Bill for "farming syndicates," the rules of the House Bill are not limited to "investors," or "farming syndicates," but are applicable to all who are engaged in farming, large and small, including many of our members.

The effect of the House Bill will be to require ordinary farmers to seek sophisticated professional and accounting assistance in order to comply with the law. We feel strongly that the Committee should weigh the cost of an increasingly arbitrary, complex, and unadministrable tax law against the benefits which the provision seeks. The Committee on Finance should consider specific provisions which deal with any problems directly, without penalizing the independent businessman engaged in agricultural production. In doing so, we will be happy to work with the Committee and its staff in addressing the few problems in the application of agricultural tax rules in a responsible way.

We would like to bring to the attention of the Committee certain features of the House Bill which are particularly distressing to The Society and its members.

PRESENT LAW PROVISIONS

The provisions of existing law which are under attack in the House Bill are the cash basis method of accounting and the deduction of certain expenditures during the development period of an agricultural commodity. The present farm tax accounting rules and administrative interpretations of those rules provide simple and administrable procedures for farmers. At the same time, they have been attacked as tax loopholes or tax subsidies to the farmer.

The farm tax rules have been promoted by marketers of tax shelters which promise investors, generally wealthy high tax-bracket individuals, that they will be able to deduct farm tax losses from their other

[1] H. Rep. No. 94–658, 94th Cong., 1st sess. 39 (1975).

income. In 1969 and 1971, provisions were added to the Code to deal with certain tax shelter arrangements. Three of the principal provisions of existing law that are relevant to the farm tax rules are: (1) recapture rules which treat as ordinary income gain derived from selling certain farm assets; (2) the "hobby loss" provision, which disallows deductions in the case of an activity not engaged in for profit; and (3) the provision requiring capitalization of certain developmental expenses in the case of citrus and almond groves.

The tax accounting rules for farmers, and the limitations of existing law on the use of these rules for tax shelters are described in more detail in subsequent sections of our statement.

USE OF CASH METHOD OF ACCOUNTING

A taxpayer engaged in the business of farming is permitted to adopt the cash receipts and disbursements method of accounting. Under this method, items are included in income in the year received (actually or constructively) and items of deduction are allowed in the year paid. Farmers are also permitted to deduct the cost of seeds and young plants purchased during a year for cultivation prior to sale. Farmers are not required to maintain inventories of their growing crops or supplies on hand at the end of the year.

The cash method of accounting has been accepted as a method for reporting income and expenses of agricultural operations for more than fifty years. It has withstood the test of time and been approved by the Treasury Department and by the courts for the reason that it is well adapted to the needs of the small agricultural businessman. The cash method of accounting is simple to apply and requires a minimum of complicated record keeping. It has been recognized, moreover, that the allocation of costs necessary to inventory growing crops is difficult and arbitrary in many ordinary situations. To illustrate this problem, consider the effect an inventory requirement would have on a grower of ornamental plants. Since the plants are sold at different prices for different sizes each of several thousand plants would have to be measured at year end and an allocable portion of the farmers cost assigned to each plant in order to properly value the year-end inventory and determine the farmer's cost of goods sold.

It has long been recognized that the cash method of accounting does not have as a primary goal the matching of income and related expenses. That is the primary goal of the accrual system. In particular situations, the effect of the failure to match income and expenses is to permit a deduction of losses from farming operations against income unrelated to farming and reporting of the related farm income in a subsequent year. Nevertheless, the cash receipts method of accounting is authorized for individuals and many businesses other than agricultural. This method gives considerable latitude in the timing of income and deductions. For example, payment of a medical expense, or a gift of property to a charity on the last day of the year will be allowed as a deduction even if the effect may distort the taxpayer's true income for the year.

CURRENT DEDUCTION OF DEVELOPMENT COSTS

Costs associated with cultivation of orchards and vineyards and similar products, and those associated with raising of farm animals may be deducted although they result in an asset having a productive life of several years. Income from the sale of fruit or the livestock is realized in subsequent years. In certain situations, the income realized is capital gain, and the capital gain is taxed at a preferential rate even though the deductions were used to offset ordinary income.

The deduction of development costs is justified on the same grounds as the cash method of accounting. That is, the farmer is not required to allocate his costs of cultivation or raising livestock to particular plants or animals in order to determine his income or loss.

LIMITATIONS OF EXISTING LAW

1. Recapture of certain farm losses

Section 1251 of the Code treats as ordinary income gain from the disposition of farm recapture property in certain limited situations. Thus, if a taxpayer has nonfarm income in excess of $50,000 in a year, uses the cash method of accounting, and has a farm net loss in excess of $25,000, the excess must be placed in an "excess deductions account." If, in a subsequent year, farm recapture property is sold, any gain recognized will be ordinary income, and not capital gain to the extent of the amount of the excess deductions account.

Section 1252 of the Code operates in a similar manner to recapture income derived from sale of farm land which has benefitted from the deduction of soil and water conservation expenditures.

2. Deductions in the case of business not engaged in for profit

Section 183 of the Code limits the current deduction of expenses in the case of an activity not engaged in for profit. Thus, if a farming venture is engaged in, the venture operates at a loss, and the taxpayer is unable to show a profit motive, only deductions such as interest and taxes, which are allowed whether or not a taxpayer is engaged in a trade or business will be allowed. Deductions for depreciation, purchase of plants and expenses of cultivation will not be allowed in excess of the income from the venture.

3. Capitalization of development costs of citrus and almond groves

Section 278 of the Code requires that taxpayers engaged in the business of planting, cultivating, and developing citrus and almond groves must capitalize their development expenses during the first four years after planting.

H.R. 10612 PROVISIONS RELATING TO AGRICULTURAL OPERATIONS

There are two provisions in H.R. 10612 which are directed toward the agricultural tax rules and affect our members. These are: (1) the limitation on artificial accounting losses ("LAL") provisions in section 101; and (2) the requirement that certain corporations engaged in agriculture adopt the accrual method of accounting (section 204). Other provisions in the Bill are intended to restrict the tax benefits

of certain tax shelter partnerships. These latter provisions include those relating to partnerships first-year depreciation (section 210(a)), special partnership syndication fees (section 210(b)), and retroactive partnership allocations (section 210(c)). Other provisions of the Bill restrict the deduction of non-business interest (section 206) and the deduction of pre-paid interest (section 205). Another provision (section 207) relates to the use of non-recourse financing for livestock ventures and for certain crops. These provisions, which are related to the syndication of partnership tax shelters and in several cases correct doubtful interpretations of existing law are not objectionable to the members of our association. Our concern is with the LAL proposal and the requirement that certain corporations adopt the accrual method of accounting and capitalize pro-productive period expenses.

THE LAL PROVISION

LAL ("Limitation on Artificial Accounting Losses") was first proposed by the Treasury Department in testimony before the House Committee on Ways and Means on April 30, 1973. The basic tenet of the proposal is that certain tax rules permit the deduction of expenses involved in a business prior to the time the income from the activity is realized. Assuming that it is the intention of good accounting rules to associate expenses and related income, the LAL proposal treats these deductions as "accelerated." If the accelerated deductions result in a loss for tax purposes, the LAL concept is to defer the loss until the property is disposed of or the income from the activity is realized. As the Treasury statement indicates, "We do not propose that any of these deductions be disallowed. Nor do we propose that they be capitalized. We propose only that if they create a loss from the activity to which they relate, that loss may not be used to offset or shelter other unrelated income of the taxpayer."

The LAL proposal, as applied to farming is as follows.[2] First, the general rule is that the farmer's accelerated deductions are not allowed to the extent they exceed the taxpayer's net income from related sources. These deductions which are disallowed are deferred until the property to which they relate is sold or there is an excess of net related income in a subsequent year. The LAL provision does not apply to disallow any portion of a farm loss unless the farmer has more than $20,000 of non-farm income in a taxable year. If the farmer has more than $20,000 of non-farm income, his allowable farm loss cannot exceed $40,000 minus his non-farm income. This threshold rule is intended to assure that full-time farmers are not subject to LAL. Thus as it applies to farming, the LAL proposal is supposed to affect on[l]y non-farm wealthy individuals who are seeking to shelter their n[on]-farm income. However, if the farmer has more than $20,000 of [non]-farm income, and his non-farm income plus his farm loss wou[ld] exceed $40,000, the LAL provision is applicable and the farme[r] apply the entire panoply of LAL rules in order to determine will be entitled to the deferred farm loss. Thus, if the phas[e] is applicable, the taxpayer must compute his income and under the LAL system until that farm loss is allowed.

[2] There are special rules applicable in the case of farming syn special rules are not considered in this summary of the LAL

Accelerated deductions are defined as (1) pre-productive period expenses, (2) pre-paid feed, fertilizer, and supplies, and (3) accelerated depreciation of animals, trees or other property. The pre-productive period expenses include any amount attributable to crops, trees, or animals during the pre-productive period except (1) interest and taxes, (2) casualty losses, (3) expenses attributable to wheat, alfalfa, barley, oats, rye, sorghum, and cotton, and expenses attributable to livestock other than poultry. The pre-productive period includes the period before the disposition of the first marketable crop or yield (in the case of property having more than a single crop or yield) or the period prior to the disposition of property (in the case of all other crops).

The definition of net related income, for purposes of the LAL farming proposal, is any income from farming.

The LAL provisions apply to individuals (including estates and trusts) and corporations which are not subject to the rules regarding the accrual method of accounting (section 204 discussed *infra*). LAL may be avoided if the individual or corporation adopts the accrual method of accounting, and agrees to capitalize pre-production period expenses.

The special threshold rule discussed above is applicable only to individuals. Thus, a corporation that is not required to adopt the accrual method of accounting under section 204 of the Bill (generally family corporations electing to be taxed under Subchapter S of the Code) are required to refer any farm loss if the corporation has $100 or more of nonfarm income.

REQUIREMENT THAT CERTAIN CORPORATIONS AND PARTNERSHIPS ADOPT THE ACCRUAL METHOD AND CAPITALIZE PRE-PRODUCTIVE PERIOD EXPENSES (SECTION 204)

Section 204 of the Bill would amend the Code to require that corporations (other than "family" corporations and corporations electing to be taxed under Subchapter S of the Code) and certain partnerships with a corporate partner which are engaged in the business of farming, use the accrual method of accounting and capitalize pre-productive period expenses. The pre-productive period expenses which are required to be capitalized are those described above in the summary of the LAL provision. Unlike the LAL provision, this provision is applicable regardless of the crop or horticultural commodity which is grown. In the case of a partnership, this provision means that each partner is required to compute his farm income under the accrual method of accounting used by the partnership even though the corporate partner has only a one percent interest in the partnership.

The bill provides a special ten year spread for income which is realized as a result of a required change to the accrual method of

CONSIDERATION OF CHANGES IN FARM TAX RULES

[illegible] believes that the approach of H.R. 10612 to the farm [illegible] on the grounds of tax policy. The LAL provisions [illegible] conceived and misdirected. Analysis will demonstrate [illegible]sions will apply in many unintended situations,

will result in a greatly increased cost of compliance by many small farmers and growers of ornamental foliage, and will not be effective to prevent abuse of the farm tax rules. As our recommendations and discussion indicate, we believe that the limitations of existing law, combined with the special rules designed to prevent abuse of partnership tax provisions and interest deductions, are sufficient to prevent abuse of the farm tax rules. Moreover, even if it were demonstrated that these provisions would not be sufficient to prevent all abuse of the farm tax rules, the complexity and accounting problems which will result if H.R. 10612 is enacted are wholly unwarranted by the magnitude of the problem. The association believes that the Senate Finance Committee should review the provisions of existing law to determine whether any additional changes are needed. We believe that the Committee will reach the conclusion that existing law provides a sound basis for dealing with tax shelter speculators who are abusing the farm tax rules without the addition of a new and enormously complicated set of provisions.

LAL IS INCONSISTENT WITH A SOUND TAX POLICY

The LAL proposal, as applied to farming, has the effect of preserving the farm tax rules for those established operations which are operating at a profit, while suspending those rules for new ventures and farmers who are expanding their operations and suffer losses. The effect will be to discourage new ventures in agriculture and to penalize small farmers who wish to expand their farming operations. In the very situations where a farmer is most in need of funds, i.e., the start-up period or expansion period, the LAL proposal requires the farmer to suspend the rules permitted for his more established competitor.

The LAL rules will also discourage the introduction of new capital into agricultural operations. It is widely recognized that farming ventures require substantial capital investments and that there is frequently a considerable period during which the new farm venture will operate at an economic loss. If these economic losses cannot be offset against other income, the taxpayer is in effect required to make an interest free loan to the Government at a time when he can least afford to do so. The effect of this disincentive will be less capital investment in agricultural business and a decrease in the supply of farm commodities with correspondingly higher prices.

The LAL provision also adopts arbitrary rules which discriminate against different agricultural commodities and different forms of organizations. In making these distinctions, and in distinguishing between agricultural, real estate, oil and gas, and manufacturing operations, the LAL provision erects internal barriers to capital investment which cannot be evaluated or measured accurately. Thus, for example, wheat, alfalfa, barley, oats, sorghum, and cotton farmers are not subject to the LAL provision regarding pre-productive period expenses. There would not appear to be any tax policy considerations to support this distinction. Perhaps such exceptions are justified by economic considerations, however, the fact remains that one class of farmer is singled out for favored treatment while other classes, including our members, are not treated equally.

The provisions of the House Bill discriminate against different forms of business organizations. We have not directed our attention to the rules regarding farming syndicates and, we do not support the tax shelter operations entailed in farming syndications. Nevertheless, H.R. 10612 provides very burdensome rules in the case of corporations engaged in farming. That is, corporations which have $1.00 of nonfarm income are subject to LAL unless they are required to use the accrual method of accounting and capitalize pre-productive period expenses. There are very sound business reasons for incorporation of farming ventures. There appears to be no sound tax policy reason for the punitive effect of the LAL provisions of the Bill in corporate farming ventures. Presumably, the nonfarm income threshold is not applicable to corporations in order to prevent a wealthy investor from sheltering nonfarm income through a corporation.

However, we believe that a corporation should be permitted to deduct farm losses against nonfarm income if the individuals owning the corporation would have been able to do so had the farming venture not been incorporated. For example, if there were a corporation which had a farm loss of $20,000 and the nonfarm income of the corporation and its shareholders were $15,000, the full amount of the loss should be deductible against the corporation's non-farm income.

LAL IS TOO COMPLICATED

The LAL rules are not limited to wealthy nonfarmer investors seeking "tax shelter" through the use of rules developed for farmers and others who are engaged in producing agricultural commodities. Instead, they are applicable, by their terms to all agricultural producers, large or small. For this reason, the burdens of compliance are relevant to our industry as a whole. The provisions of LAL are eccentric and complex; therefore, many individuals may find compliance to be beyond their own abilities, and beyond the competence of the professional advisers who may be found in rural areas.

The integrity of our tax system is maintained through "self-assessment." This means that taxpayers each year must compute their own tax liability and pay the taxes so determined. Our tax system cannot operate when the rules are so complex that the average person simply cannot comply with the requirements. The present Internal Revenue Code has reached a point where many experts believe that further complexity will be self-defeating.[3] But the new proposals add several layers of complexity on top of our already over-burdened tax system.

A former Assistant Secretary of the Treasury called the Tax Reform Act of 1969. "The Lawyers' and Accountants' Private Relief Act" because that legislation's complexity necessarily required greater reliance by the average person on professional help in computing his taxes. The LAL provisions, if enacted, will make complexities of the 1969 Act provisions look rather simplistic. The producer under the proposed Bill must take time and money away from his productive activities to seek professional advice to attempt to comply with the new Act.

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[3] Hearings on Tax Reform before House Committee on Ways and Means, 94th Cong., 1st Sess., June 24, 1975, at pp. 125–394.

One of the most respected of modern judges, Learned Hand, wrote about the tax law as follows:

> In my own case the words of such an act as the income tax, for example, merely dance before my eyes in a meaningless procession: cross-reference to cross-reference, exception upon exception—couched in abstract terms that offer no handle to seize hold of—leave, in my mind, only a confused sense of some vitally important, but successfully concealed, purport, which it is my duty to extract, but which is within my power, if at all, only after the most inordinate expenditure of time." Hand, Learned, in Irving, "The spirit of Liberty" (New York: Alfred A. Knopf, 1960), p. 213.

This is what the House Bill LAL provisions present for farmers, *i.e.*, exceptions on top of exceptions, cross-reference on top of cross-reference, all of which successfully conceal the practical application of the law to the day-to-day activities of the producer.

One example, based upon provisions in the existing law relating to farming, may illustrate the problem of administration and compliance with such legislative confusion. Section 1251 of the Internal Revenue Code was enacted in 1969. Its objective was to prevent the offset of ordinary farm deductions against ordinary income, followed by a sale of farm property at capital gain. Although the provisions were enacted in 1969, today, more than six years later, there are no final regulations which interpret this provision. There are only proposed regulations which do not even deal with certain of the more difficult problems in the field. These proposed regulations appear on eighteen small type, single-spaced pages of the Federal Register for December 28, 1971. Is it any wonder that no one understands these and similar tax provisions when the Internal Revenue Service has taken more than six years to determine its own position? The problem of drafting regulations under section 101 of the House Bill will be many times greater than those under section 1251 of the Code.

The complexity of application of the LAL provisions can be shown in the case of a hypothetical small producer of floricultural products. As is true of many products produced by our industry, each fall he expends money in the cultivation of a crop which is harvested and sold in the following spring. His calendar year tax return reasonably reflects his income in each year, since it contains the income from the sale of one crop, reduced by the money expended in that year for planting and cultivating the next year's crop. In the first few years he has less than $20,000 of nonfarm income and does not operate in corporate form. Thus the new rules would have no impact in those years. In one year, however, he sells some property and has a $20,000 capital gain which together with other income not from agricultural operations, gives him nonfarm adjusted gross income of $25,000.

In this year our member must enter the web of LAL. It may help to illustrate the arbitrary nature of the House Bill to note that LAL would not be applicable if he happens to grow wheat, alfalfa, barley, oats, rye, sorghum, or cotton. Our members, however, grow floricultural crops, so they cannot escape.

Accordingly, our hypothetical grower must first determine whether he has any "accelerated deductions." The House Bill's definition of "accelerated deductions" is not limited to solving a specific area of concern, but would include any purchased seed, fertilizer, or other supplies purchased and paid for in the ordinary course of business,

and on hand at the end of the year. The statutory definition of "accelerated deductions" also includes the costs associated with raising products which are sold after the close of the taxable year. Although our grower has been in business for many years and continues to operate in the same manner, the costs of cultivation which are incurred during each year are now "accelerated deductions" and these may not be "deferred."

But our grower has not completed the LAL cycle yet. His accelerated deductions will still be allowed in full provided he has sufficient related income from his growing operation. In order to determine whether this test is met, he must compute his income from farming, taking into account only "non-accelerated deductions." Let us assume that the grower in our case did not make a profit on his farming operations in the year under consideration. In this situation, the grower must pay an income tax on a portion of his $25,000 of nonfarm income and cannot deduct the cost of raising his winter crop. This grower has taxable income, and must pay a tax, even though financially he operated at an economic loss. LAL distorts his income, which had been accurately reported over the long period of operations.

Our hypothetical grower could have a bumper year in the next year and be allowed to deduct his "deferred deduction." Since he could be in a higher tax bracket in the second year, he might actually save taxes by deferring the deduction. If there were no changes in tax bracket, the effect of LAL in such a case may be likened to an interest free loan by the grower to the Government.

These then are the consequences to our growers of the LAL provision—distortion of income, variation in the tax rate, administrative costs, discrimination against new ventures. We do not believe that these results are warranted in order to deal with abuses of the agricultural tax rules or consistent with a sound tax system.

MANDATORY USE OF ACCRUAL METHOD

The House Bill requires that all corporations engaged in farming, except certain family corporations or those electing to be taxed under Subchapter S of the Internal Revenue Code, adopt the accrual method of accounting and capitalize their pre-productive period expenses. There are sound nontax reasons for farm businesses to incorporate and many of our members conduct their business in corporate form. They do so in order to limit their liability, to increase their ability to attract additional capital, and for other substantial nontax reasons. The fact that the House Bill deals selectively with tax shelter syndications should, we believe, wholly eliminate the need for this provision in any other situation.

Section 204 is quite unique. *In no other industry is a specified method of accounting required by Congress.* Nor is the method of accounting made to depend upon the form of business organization. The Congress, in fact, has mandated that the accounting profession cannot dictate how certain types of tax credits are to be treated.[4] In the case of farmers and agricultural producers, however, the House Bill does exactly the opposite, it dictates the use of the accrual method of accounting.

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[4] See section 101(c) of the Revenue Act of 1971.

Section 204 of the House Bill does not stop there. In addition to use of the accrual method, this provision requires that certain expenditures otherwise allowable as deductions under the accrual method must be capitalized. Unlike all other accrual taxpayers who may deduct expenses paid or incurred which are not properly included in inventory, the grower must capitalize these costs. This arbitrary rule is necessitated by the fact that in many situations, growing crops simply cannot be inventoried. Thus, the Bill arbitrarily disallows deductions which are allowable to taxpayers in other types of businesses.

Even if a farmer has been using the accrual method of accounting, the requirement that certain pre-production expenses be capitalized can lead to a "bunching of income." This problem is ameliorated by the House Bill through another complex mechanism. The "bunched income" can be spread over a ten-year period, subject to the provisions of section 481 relating to a change in a method of accounting. If, however, the taxpayer happens to have been in business for ten years, has used an accrual method throughout that period, and his products mature no sooner than the second year after planting, he is exempted from the requirement that he capitalize pre-production costs. Is this discriminatory? Of course. If such a taxpayer can continue to deduct his pre-productive costs, he has an enormous competitive advantage over newly formed competitors.

Certain provisions in the Internal Revenue Code specifically allow deductions for certain pre-productive period expenses which are not considered deductible under generally accepted accounting principles. See, for example, section 174 of the Code relating to research and development expenses. The ability to deduct research and development expenses, is not generally considered to involve a tax abuse. This proposal suggests that the average grower is being subjected to punitive legislation.

These punitive features of the Bill will have a wide effect in the floricultural industry, where many farming enterprises are carried on in the corporate form, or in the form of a partnership with a corporate partner. The inclusion of partnerships in the class selected for this drastic treatment is worthy of particular note. Generally, a partnership is viewed as a conduit, and the tax consequences of its operations are reported by each of its partners. If, therefore, three individual floricultural producers form a partnership to produce commodities for their business, they may be subject to the snares of LAL, but not forced to use the accrual method of accounting and to capitalize their pre-productive period expenses. If, however, they want to include a fourth partner which is a corporation, even as a one percent partner, the rules drastically change. All of the partners of a partnership with a corporate partner are subjected to the accrual method of accounting and the capitalization pre-productive period expenses. *This discrimination among forms of business enterprise is wholly unwarranted.*

SUMMARY AND RECOMMENDATION

Agriculture is capital intensive. The economics of farming make it a very risky operation. We believe the tax laws, at a minimum, should be neutral as between farmers and other types of economic endeavors. The House Bill violates neutrality. Agriculture is singled out and subjected to restrictive burdens not imposed on other forms of busi-

ness in the economy as a whole. Are the "abuses" of the farm provisions worthy of such measures? Again, relatively speaking, the cost to the Treasury of the farming provisions is minimal compared to those in other tax shelter areas. Yet the farming area is singled out for the "at risk" provision and the requirement of the accrual method of accounting and capitalizing pre-productive costs.

The basic recommendations of The Society of American Florists and Ornamental Horticulturists is that the House approach be totally rejected. If there are abuses in the tax system which must be eliminated, then legislation should be developed which is targeted specifically to the abuses—and does not punish our industry with a keen eye to the costs of compliance which must be borne by the small businesses when complex laws are enacted. We believe that provisions of existing law may be adequate to deal with abuses of the farm tax rules. They should be applied to "tax shelter" abuses in agriculture as well as other areas. Thus, for example, under present law deductions are only allowed if the organization is in business for profit. This rule is a reasonable and effective weapon against the abuses of the farm tax rules. Another illustration is the treatment of nonrecourse financing as equity investment (see, for example, Rev. Rul. 75–350, 1972–2 C.B. 394) and the disallowance of deductions based upon inflated nonrecourse financing. The rules of present law are in many cases adequate to protect against abuses of the farm tax rules if these provisions are applied as intended.

If, however, the approach of the House Bill is to be considered, we recommend the following specific changes:

(1) The amount of unrelated income which can be offset by "accelerated deductions" before application of the LAL rules should be increased from $20,000 to $50,000. This revised test should apply to taxable rather than adjusted gross income. Only if the taxpayer has substantial nonfarm income otherwise taxed at the higher progressive rates will be likely to embark upon a tax shelter program of any kind. In applying this floor to corporations, the nonfarm income of individuals owning more than 10 percent of the stock should be aggregated with the corporation's nonfarm income. These changes would focus the LAL provision upon the wealthy nonfarm investor and limit to a very few cases the likelihood that a full-time farmer will be caught in the web of LAL.

(2) The carryback of deductions which have been deferred by the LAL provision, should be permitted where nonfarm income drops below $50,000 in a subsequent year.

(3) The LAL farm rules should not apply to any person from whom gross income from farming is a substantial portion (perhaps 50 percent or more) of his gross income.

(4) The required use of the accrual method of accounting should be eliminated. If the other suggested changes are agreed to, this provision is not needed.

(5) There should be no requirement that expenses allowable under the accrual method be capitalized by a corporation engaged in the business of farming.

(6) Partnerships that happen to include a corporate partner should not be required to use the accrual method, unless the corporation owns in excess of 50 percent of the capital interests in the partnership.

Tax Deductions for Educational Expenses

Statement of Americans United for Separation of Church and State

Americans United for Separation of Church and State is an interdenominational organization founded in 1947 for the sole purpose of defending religious liberty and the constitutional principle of separation of church and state. Americans United has been a co-sponsor of a number of the lawsuits in recent years which have resulted in United States Supreme Court rulings banning as unconstitutional a variety of forms of tax aid for denominational private schools.

We believe that S. 2356, introduced by Senator Buckley, raises serious constitutional and public policy questions.

S. 2356 would provide income tax deductions up to $1,000 per year per student for tuition to public and private schools and colleges. Since public elementary and secondary schools do not charge tuition, and since public college tuition is generally under $1,000 per year, it is obvious that the primary purpose of S. 2356 is to aid private and church-related schools and colleges. The benefits of such legislation, therefore, would go disproportionately to the institutions enrolling the 9 percent of our students attending nonpublic elementary and secondary schools and the one quarter or so of our students attending nonpublic colleges and universities. We do not believe that providing tax benefits disproportionately to nonpublic educational institutions is fair or in the public interest.

Moreover, since tax deductions increase in relative value as family income rises and since the likelihood of enrollment in a private school rises with family income, S. 2356 would benefit the affluent far more than families of modest means. Further, schools and colleges charging higher tuition and serving more affluent families would benefit from S. 2356 to a greater extent than institutions charging little or no tuition and serving families of lower incomes. S. 2356, therefore, would aid the more well-to-do and slight the needy.

Nonpublic schools, and to a lesser degree nonpublic colleges, tend toward religious homogeneity of faculty and student body, and, especially on the lower levels, tend to inculcate particular denominational tenets. S. 2356 would therefore not only promote the division and separation of students and faculty along religious and other lines but also provide public aid for the teaching of religion. This would be divisive and of dubious constitutionality.

Donations for general purposes to private schools and colleges are presently deductible. Senator Buckley's bill would provide deductibility not to general donations but to tuition payments earmarked for specific students, students related to the payer of the tuition. Such a practice would, in our opinion, conflict with the Supreme Court's ruling in *Pearl* v. *Nyquist* (350 R. Supp. 655, 410 U.S. 907; 1973) striking down tuition reimbursement grants and tax credit/deduction reim-

bursements as unconstitutional for having "the impermissible effect of advancing religion."

S. 2356 would also cost the U.S. Treasury a not inconsiderable sum. As there are 4.5 million students enrolled in elementary and secondary nonpublic schools and 1.1 million enrolled in nonpublic colleges, S. 2356 would cost the U.S. Treasury an estimated 1.1 billion dollars annually just for the nonpublic educational sector. With public schools and colleges suffering already from fund shortages, we do not believe that we can afford the luxury of further federal aid to nonpublic institutions and their more affluent than average patrons. We believe that any benefits which Congress wishes to extend to education should be confined to public institutions.

For these public policy and constitutional reasons, we urge the Senate Finance Committee to reject S. 2356 as socially and constitutionally unsound.

Respectfully submitted.

EDD DOERR,
Educational Relations Director

Tax Treatment of Certain Cooperative Housing Associations

STATEMENT OF FRED THORNTHWAITE, GENERAL MANAGER, COOPERATIVE SERVICES, INC., DETROIT, MICH., TREASURER, NATIONAL ASSOCIATION OF HOUSING COOPERATIVES

(Concerning Title XIII, Section 1301 of the "Tax Reform Act of 1975," H.R. 10612.)

As a person involved with cooperative housing since 1940, I appreciate the opportunity to talk with you about the impact of both tax policy and housing policy on the people who are housed and on the communities where the housing is built.

It is important to recognize that tax programs and benefits are as much a part of housing programs as the loan programs themselves. And our purpose here is to ask you to think about the impact of the tax policies on both people and the housing.

The management of multi-family projects is increasingly difficult for many reasons. But multi-family housing is a crucial part of America's housing supply.

Current statistics show that multi-family housing is in serious trouble. Tenants have obtained rent control legislation to protect against unaffordable rent increases. Rent controls have discouraged investors from entering the multi-family market. Older buildings go unrepaired because investors will not get a return on their money. Homeowners abandon houses which they cannot maintain and no longer meet their needs.

One approach to this dilemma is in arrangements that permit multi-family building occupants to take responsibility for their housing. Our experience is that the cooperative offers a way to achieve ownership concern and individual responsibility in a group setting and is especially useful for low or limited income persons. In fact, most housing Co-ops are owned by persons of moderate or low income.

In pioneer days when houses were far apart, there was no apparent need for people to be involved with their neighbors. The situation is different today since for multi-family projects people must live close together. The cooperative is a means whereby the group can undertake to maintain standards. An important feature is the fact that title is held by the corporation and that member-tenants own an undivided interest in the entire project.

A CO-OP IS GROUP OWNERSHIP—AND NOT A CONDOMINIUM

By supporting a reasonable tax policy, Congress can encourage the development of a sound cooperative housing program. But you must recognize that cooperative housing is different from individual home ownership and also from condominium ownership. Because the title to all the property is held by the corporation, there is no such thing as

"common property" or "privately owned property" as referred to in the House Committee report. The member-owners work as a group; participate in board meetings, committees, and group projects; and take responsibility for the entire project—not just their individual living unit.

A CO-OP IS NOT A CONDUIT

The cooperative corporation, therefore, is not "merely a conduit". The housing cooperative is a group creation which develops standards and policies and requires member education and support. The Co-op member is under certain constraints that are not imposed on an individual homeowner nor even upon the owner of a condominium unit. The cooperative is concerned with policies that preserve the quality of all the housing—both physically and as an emotionally supportive community.

A CO-OP ASSURES GOOD MAINTENANCE

The advantages of group ownership and responsibility are possible because the members' home ownership concern is combined with the ability of the cooperative to accumulate reserve needed for good maintenance. Cooperatives we are involved with are for people with limited incomes. The membership and occupancy agreement vary with the amount of financing available. The required equity investment stays the same for the entire life of the mortgage. If the equity payment were to increase, the housing Co-op would not be able to serve people of limited means.

WHAT ARE THE RESULTS?

In the Cooperative Services buildings for senior citizens, the membership investment is still $100. The monthly rents average $93.20 for a one-bedroom apartment and $79.60 for a studio apartment. Rents are subsidized—comparable projects with same subsidies have rents that are 50 percent higher than co-op projects. Because the members work together, there have been only two rent increases of between $2 to $6 a month in the past ten years. The buildings are well maintained and are a secure, happy environment.

In contrast, there is little chance that limited income people living as private homeowners or as condominium owners would ever set up needed reserves or take care of the property.

An individual, low income person faced with a sick child and a leaking roof goes to the doctor and lets the roof rot off. For this reason, the HUD program of getting mothers receiving Aid for Dependent Children into home ownership was a disaster. A cooperative with a low fixed membership investment could have been a success at one-tenth the cost. The reserve is paid in regardless of other bills and is used to fix the roof when it goes.

Another example of the importance of cooperative ownership is in the ability of the housing cooperatives to keep down their operating costs and to serve the income groups intended under government financing programs. In a suburb east of Detroit, part of a housing development sold as a condominium has not been fully occupied and is not

as well maintained as the cooperative across the street. The Williamsburg project discussed before has largely family occupancy with incomes averaging $9,017 a year. Monthly charges average $136, not including electricity.

TAX TREATMENT

Over the years, the tax treatment of cooperatives which combined group ownership with private ownership concerns raised a number of issues. These issues include whether tenant cooperators should be allowed to deduct the interest expenses and real estate taxes incurred by their housing on their personal income tax return and whether a co-op owned building can be depreciated and who is entitled to deduct that depreciation.

PERSONAL DEDUCTIONS

Internal Revenue Section 216 enacted by Congress in 1942 answered the first issue. The rationale apparently was that co-op owners should have a tax benefit similar to homeowners because they do take an ownership responsibility. Practically all interest and tax payments of any kind are deductible by individuals. Cooperators are individuals who have joined together to undertake the financial risks and obligations incurred in any multi-family project. It is their money which goes almost directly for the interest and tax expenses. Hence cooperators are allowed these deductions on their personal return, even though they are acting, through the legal vehicle of a corporation. Without this benefit there might be less incentive for individuals to use any capital on their own housing and to assume any of the responsibilities involved in cooperative ownership.

DEDUCTION FOR DEPRECIATION

The right of the cooperative housing corporation to take depreciation in the same way as any business corporation has always been assumed. Recent IRS rulings have denied this right. Part of the confusion seems to stem from the addition of Section 216c in 1962. The legislative history does not include the news reports which explained that Bobby Baker owned a number of apartments in a cooperative housing development. These apartments were rented. If he could take depreciation on these apartments, it would be to his advantage and so the law passed.

We believe this provision for depreciation in the law erodes the intent of Congress to support and encourage an individual who joins a cooperative housing endeavor. This depreciation deduction can be taken only when the member uses the property as a business. Renting out a co-op apartment is forbidden in most Section 213 cooperatives and in the Section 221D3 cooperatives. Such a practice would not be appropriate or desirable in cooperative housing developments operated for the benefit of the user-occupants.

The tax situation of housing cooperatives is further eroded by a 1972 decision in the tax court, *Park Place, Inc.*, which holds that cooperative corporations may not deduct depreciation. The rationale of the court is that, legally, the cooperative corporation involved in the

case was no more than a mere custodian of the building for its tenant-stockholders. The corporation had no investment as such in the building and hence, the corporation really owned nothing to depreciate.

The decision, we believe, offends good housing policy and is questionable legally.

Legally, co-ops are a hybrid of the typical multi-family rental project and of typical individual, single family homes. To pick out, as the tax court did, one element of a co-op's legal structure, namely the member-tenants' ownership of stock in the co-op corporation, and to peg the decision on that one element is unfortunate in view of the decision's impact on cooperative housing and housing policy. We might even ask about the fairness under the court's reasoning.

Good housing policy is offended because to deny depreciation deductions to co-op housing corporations means seriously undermining their financial viability. This is so because such deductions are one of the keys to the buildup of adequate cash reserves. Without reserves for major repairs or capital replacements, the cooperative is at the mercy of lenders or can make capital assessments against the members. Borrowing money is very expensive. This defeats common control and use of the reserve fund by the corporation. Capital contributions simply cannot be made by low income families.

Reserves are essential for a sound housing program. With the depreciation deduction, the cooperative corporation can set assessments at a break-even level and yet build up cash reserves for replacements. Without the depreciation deduction, these cash reserves would be drastically reduced by taxes and the long term stability of the housing jeopardized.

PROPOSED LEGISLATION

The "exemption" offered to cooperatives in HR 10612 is not favored by any of the housing cooperatives we are acquainted with. The pitfall for co-ops is in the fact that cooperatives—at least all through the House Committee report—are treated as if they are the same as condominiums or privately owned housing. The proposed legislation fits privately owned homes and condominiums; it will destroy cooperative housing operated by and for limited income people. Congress has expressed its intent to encourage cooperative ownership among low and moderate income families in Section 246 of the National Housing Act as amended by the Housing and Community Development Act of 1974. 12 U.S.C. 1715z–11.

The proposed legislation creates categories of acceptable expenses and acceptable income for co-ops, condominiums and housing associations. The assumption underlying these classifications is that the cooperative is the same as a condominium. For example, on page 328 of the House Committee report:

> Qualified income is to include fixed . . . assessments that vary depending upon the need of the association *to pay for maintenance,* improvements, . . . *on the common property.*

And on page 329,

> Your committee's bill provides an expenditures test . . . at least 90 percent . . . must be to manage, maintain, and care for, or improve, *association property* . . . expenditures on privately owned property—as opposed to common

property—are to qualify only in the limited situation of repair of exterior walls and roofs where the walls and roofs qualify as association property . . . transfers to a sinking fund account for the replacement of a roof would not qualify as an expenditure for the 90 percent test.

What will be the effect of all this on cooperative housing? Just plain catastrophe, that's all. There is no distinction in a cooperative between private property and common property or association property. Everything in a cooperative project is common property, including the facilities and individual units. The intrusion of a distinction between private and common property into a cooperative would be to defeat the essential concept of group control and group action that make a cooperative work for low and moderate income families. We know that Williamsburg Towne Houses, a Section 221D3 cooperative, spends money as needed to maintain good housing. This means that the Co-op replaces hot water heaters, bathroom floors, individual furnaces, garbage disposers, and repairs toilets, plumbing, and furnaces from monies collected as monthly carrying charges. Under the legislation, these expenses are not for "common property." What is supposed to happen now? Will maintenance responsibility be abandoned to the individual co-op member as it is in a condominium?

In a co-op there is *no* privately held property. Even now IRS court decisions are limiting depreciation to *common facilities*. Will the Internal Revenue Service next disallow expense incurred for maintenance work in the individual units?

Cooperative housing which can have a policy of setting aside adequate reserves will do more to assure sound housing stock than any other program—and at no added cost to the government. The person who first moves in to a dwelling is immediately using up—or wearing out—the unit. The carrying charge—or rent—should be high enough to allow money into reserves. These funds are used to replace the roof—or the furnace—or carpeting—all items whose cost should be spread over time to avoid disaster for the co-op housing project.

The ability to accumulate reserves from current charges and to maintain the property distinguishes a cooperative from condominiums and from individual home ownership. The housing cooperative is a corporation and, as such, should be allowed to take depreciation and to spend for all necessary maintenance.

When figured on a straight line basis over the life of the mortgage, the depreciation is enough to cover the payments to principal, reserves and incidental income such as interest on reserves. The members can then set the monthly carrying charges at a break even level and have a financial report that makes sense. No special tax exemption is needed for cooperative housing—just the same depreciation exemption as allowed for any corporation.

Because of tax court decisions, we urge that Congress act affirmatively for cooperative housing to be allowed a choice of taking depreciation—or being exempt. Because of court cases in which housing cooperatives have been held liable for income taxes on their reserve funds, we ure that current tax reform legislation include recognition of the right of cooperative housing corporations to deduct depreciation. We suggest that the Section 216c regarding tax depreciation for a cooperative landlord be repealed. We also believe that the tax exemp-

tion legislation with respect to co-ops is superfluous and should be dropped. The dissenting Judges in *Park Place, Inc.* stated the case simply: If all receipts by the cooperative are to be treated as income, then it should be entitled to all the offsetting business expenses, including depreciation.

Legislative recognition of the depreciation deduction for cooperatives could take the following form:

NEW SECTION 167(N)

Cooperative housing corporations as defined in Section 216(b)(1) shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) of property held by or for the benefit of such corporations. The depreciation deductions provided for in this subsection shall be computed in accordance with subsection (b) of this section.

HIGH POINT OF HARTSDALE I CONDOMINIUM,
BOARD OF MANAGERS, MANAGEMENT OFFICE,
Hartsdale, N. Y., June 30, 1976.

Re H.R. 10612 (The Tax Reform Act of 1976) section 1301 relating to the tax exempt status of Condominium housing associations.

Hon. RUSSELL B. LONG,
Chairman, Committee on Finance,
U.S. Senate, Washington, D.C.

DEAR SENATOR LONG: This letter is written in my capacity as President of the High Point of Hartsdale I Condominium, which consists of approximately 200 individual condominium apartment units located in Hartsdale, New York. In addition, I am engaged in the practice of tax law as a member of the New York City law firm of Miller & Summit.

Being President of this Condominium, I am interested in the peculiar problem dealt with in Section 1301 of H.R. 10612 as reported by you to the Senate on June 10, 1976. That Section contains amendments to the Internal Revenue Code of 1954 with respect to the tax exempt status of certain condominium management associations within the purview of the Bill. I am in favor of such an amendment.

It would seem that this Condominium would in all likelihood qualify for tax exempt status under the provision as drafted. However, I am concerned with the impact that the Bill might have upon the larger multiple condominium projects such as High Point; an impact which may not be the intended result of the Senate.

The larger condominium construction projects are often built in more than one phase for practical reasons and may, in fact, consist of more than one condominium entity joined together through another entity. For example, the High Point community consists of 500 condominium apartment units; these 500 units are divided into and operate pursuant to three separate plans of condominium ownership and are, as such, three distinct condominium entities: High Point I consists of approximately 200 units, High Point II consists of approximately 120 units and High Point III consists of the balance of the 500 units.

As is the usual case, each condominium has its own Board of Managers and each collects common charges and assessments and each maintains the common elements in accordance with its particular plan of condominium ownership. The three condominiums are, however, connected to each other through the use of a fourth entity, in this case called the High Point Community Association. It is the function of the Community Association to care for certain centralized facilities and numerous areas of concern to each of the three condominium entities. The expenses incurred by the Community Association are assessed *pro rata* to each of the three underlying condominiums; the amount of the Community Association's assessment would in turn be contained in each condominium's budget and eventually form, in part, the unit owner common charges.

It would appear that the conceptual underpinnings of the new law that condominium arrangements are essentially noncommercial and lack the profit motive on which to properly levy a tax, would clearly intend to exempt from taxation the Community Association entity in the same manner as it would exempt the individual condominium. There may be some question as to whether or not the actual words of the statute will accomplish that intent; in fact, an intention to tax, rather than exempt, such a central entity may arise. In order to qualify as a Housing Association under the statute as now prepared, a centralized association will need to qualify as a condominium management association. To do so, it would need to be organized and operated to provide for the acquisition, construction, management, maintenance and care of Association Property as defined in the statute (in the usual case, this would present no problem). However, in addition, 60% or more of its gross income must consist of amounts received as membership dues fees or assessments from "owners of residential units in the case of a condominium management association". I am concerned that the fees and assessments collected by the central associations might not fall within the statutory requirements with respect to the derivation of the payments. In many cases, such fees and assessments would not, in fact, be received directly from owners of residential units. At High Point, for example, the Community Association assessments would come from the three separate condominiums. This would leave the Community Association in the same position in which it now functions. By expanding the 60% rule to state that it refers to amounts received from owners of residential units in the case of a condominium management association "or, in the case of a central management association owned entirely by one or more condominium management associations, amounts received from such other condominium management associations", the problem might be eliminated.

That some clarification appears appropriate is demonstrated at page 396 of the Senate Finance Committee Report (No. 94-938); it is said that qualifying receipts "must be derived from members in the capacity of owner-member. . . .". It might be argued that the receipts by a central association would not be derived from members in the capacity of owner-members because the underlying condominium associations do not, in the usual case, own any residential units of their own; as such, an inference of taxability might arise.

Judging from the intent of the Senate Finance Committee and of the House Ways and Means Committee as set forth in the various reports accompanying this Bill, the intent of Congress would not be undermined by making the amendment described above. I would respectfully request that this suggestion be made part of the Senate record.

Should you wish to obtain further information with respect to the effect of this law on condominium arrangements. I stand ready to assist in any way in which you feel appropriate.

Thank you in advance for your consideration.

Very truly yours,

MICHAEL G. TANNENBAUM,
President.

Taxpayer Privacy

STATEMENTS OF SENATOR WARREN G. MAGNUSON, SENATOR HENRY M. JACKSON, AND SENATOR HUBERT H. HUMPHREY

Mr. CHAIRMAN: We appear today before the Senate Finance Committee to testify in support of fair treatment for the nation's taxpayers. Congress now knows of major, repeated abuses of taxpayers by the IRS. We call on the Finance Committee to act to correct these abuses so the tax system will be fair and equitable. Every citizen has a right to equal treatment at the hands of the tax collector. Congress has an obligation to ensure the IRS meets this standard.

The blueprint we suggest to the Committee for minimal procedural reform of the tax system is S. 2342, the Federal Taxpayers' Bill of Rights Act of 1975 and its proposed changes in the way the Internal Revenue Service does business.

S. 2342 was introduced by Senator Magnuson on September 16, 1975. The bill was widely acclaimed as a reasonable consensus for badly needed procedural reforms in the Internal Revenue Service. Twenty-two Senators are sponsoring the legislation. This includes five members of the Senate Finance Committee. Besides Senators Magnuson, Humphrey, and Jackson, Senators Case, Church, Goldwater, Philip Hart, Haskell, Hathaway, Hatfield, Inouye, Javits, Kennedy, Mansfield, McGovern, McIntyre, Mondale, Montoya, Proxmire, Ribicoff, Roth, and Tunney are cosponsors. This strong base of bi-partisan support is a clear reflection of the fear of the American people that the Internal Revenue Service cannot correct the flagrant abuses of taxpayers which have recently been revealed.

The United States collects personal and corporate income tax through a self-assessment mechanism. This assumes that individuals and businesses are familiar with the law, conscious of their rights, and willing to comply with the tax mechanism.

More importantly, the Internal Revenue Service is the one government agency which touches every employed citizen every year. It is the face of the Federal Government to most citizens. If it has no credibility or if it is arbitrary and capricious, or if it favors the rich over the poor, or if it is inefficient or bureaucratic, the entire U.S. Government stands indicted. Congress cannot tolerate any of these programs in any bureaucracy. But no agency is more important in this regard than the Internal Revenue Service. Also, if too many people question the basic integrity and fairness of their Government and the self-assessment mechanism, the fiscal integrity of the United States may be endangered. The Congress must take every reasonable action to insure fairness and equity in the tax mechanisms. Otherwise, self-assessment cannot work. The Senate has become fully aware of a whole range of abuses within the Internal Revenue Service. The Finance Committee has a unique opportunity in the context of these hearings and proposed legislation to deal significantly with these abuses.

This is April 13. Within two days, every single American wage-earner will file a tax return with the Internal Revenue Service. It is our belief that the reasonable expectations of most taxpayers that their returns will be handled fairly, equitably, without political considerations and held private are not fulfilled in the present tax system. How many taxpayers realize that their tax return information is widely accessible to all branches of the Federal Government and state and local governments without restraint on disclosure or use by those agencies? How many taxpayers will rely upon information provided them by the Internal Revenue Service that is incorrect and that an IRS error will not relieve the taxpayer of penalties and interest on any tax due? How many taxpayers know that the IRS audit procedure is an adversary proceeding and that the auditing agent will not inform them of legitimate uncertainties concerning their tax due? How many citizens will understand that they have the right of appeal from arbitrary IRS decisions? How many low and middle income taxpayers know that they will be held to a much stricter standard at audit than large-income taxpayers? For instance, how many taxpayers know that in 1974 the IRS settled cases valued under $1,000 for an average of 71 cents on the dollar, while it settled cases valued over $1 million for an average of 17 cents on the dollar.

The Taxpayer's Bill of Rights Act involves seven basic principles which we strongly urge this Committee to include in any tax legislation which it chooses to report to the full Senate:

First: The bill provides for significant new limitations on disclosure of tax return information. It permits taxpayers to recover civil damages for unauthorized disclosure of personal tax data.

Second: The bill establishes safeguards against the political misuse of the Internal Revenue Service. It limits nontax related surveillance activities of the IRS and provides criminal penalties for illegal surveillance.

Third: The bill protects taxpayers from arbitrary procedures. It places reasonable limits on the power of jeopardy assessment and termination of a tax year by IRS agents. It increases the amount of personal property exempt from tax levy for living expenses.

Fourth: It establishes a taxpayer Service and Complaint Assistance Office—a sort of ombudsman within the IRS. This new office will monitor improper behavior by IRS agents. It has the power to provide temporary relief in special cases of IRS abuse.

Fifth: It requires the IRS to fully inform the taxpayer of his rights during any audit or tax appeal procedure.

Sixth: It authorizes a pilot project of independent legal assistance to taxpayers in audits and appeals. The project would be limited to four cities over a 3-year period. The legal assistance would be available to both middle- and low-income taxpayers.

Seventh: The bill provides the General Accounting Office oversight authority over the IRS. GAO is required to report annually on the entire scope of IRS activities.

This is not a complete description of every possible administrative amendment to the Internal Revenue Code. However, it represents a reasonable, realistic goal for this session of Congress. If the Senate deals meaningfully with these particular reforms, it will take a long

step toward restoring the public's confidence in the federal tax assessment system.

TAXPAYER PRIVACY

S. 2342 provides an essential tightening of the taxpayer's right to privacy. It places realistic limitations on the disclosure of private federal tax return information. Commissioner Alexander testified before the House Treasury Appropriations Subcommittee:

> We have a gold mine of information in our tax system. We have more information about more people than any other agency in this country. We must have this. People file tax returns with us and tax returns contain a great deal of private information which we must safeguard.

Citizens reasonably expect that their tax return information will be held private by the Federal Government. In fact, tax returns are anything but private. Citizens' reasonable expectations of confidentiality must be insured. The present law does not do that.

On November 18, the Administrative Conference of the United States, an independent federal agency, released the results of a year-long study of the Internal Revenue Service. The Conference released a 1,000-page report prepared by expert tax consultants reviewing the procedures of the IRS. The Administrative Conference's privacy recommendations are very close to the provisions contained in the Taxpayers' Bill of Rights Act of 1975.

Mr. Meade Emory, who is currently an assistant to the Internal Revenue Service Commissioner, wrote the section of the Administrative Law Conference report on taxpayer privacy. As he pointed out, Congress does not require Americans to provide reports on their personal and financial affairs for general government use. Yet, we continue to tolerate a tax law which accomplishes this same potential purpose through the back door. Over the last fifty years, the IRS has provided steadily increasing numbers of tax returns to federal, state and local officials who may use them for statistical, investigative or other non-tax purposes. For instance, the Justice Department alone requested and received 19,000 tax returns from United States citizens in calendar year 1973.

How many taxpayers realize that the IRS has a procedure which requires its agency employees to report apparent non-tax law violations discovered through examination of tax returns? In the words of the Administrative Conference report, "Isn't this an all-purpose investigative body, sniffing out offenses of all kinds from compelled evidence"? The report continued, "On the Constitutional level, there is a far more insidious potential, if the information compelled against the taxpayer will be used against him."

Few of us who are Members of Congress fail to appreciate the potential for political abuse which we have observed through the Watergate years from release of tax return information to the Justice Department and the Executive Office of the President.

Our bill provides that returns will be open for inspection only by the taxpayer or by "an officer or employee of the Department of the Treasury, or the Department of Justice, or by the President personally, if such inspection is solely in connection with the administration or enforcement of this title."

Under this provision, the President would have to sign personally for the use of tax returns. There would be no more unrecorded flow of tax information to White House aides. In addition, the stronger anti-disclosure penalties in this bill will begin to adequately recognize people's reasonable expectations of privacy of tax return information.

In the past, the Justice Department has been able to obtain tax returns on individuals under investigation for criminal but non-tax related matters with no court review. Nowhere else are government investigators allowed unsupervised access to a person's home or private business information because the Constitution states that: The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures shall not be violated. . . .

We suggest that the Justice Department shall be required to obtain a search warrant issued by a competent judicial authority before the Department has access to an individual's tax return held by the Internal Revenue Service. By requiring court review, we hope that improper use of tax data by the Justice Department can be limited. And this makes the compelled disclosure of private information subject to the same procedural protections as a person's physical belongings or private business records.

We support the approach of the Administration Conference with respect to non-criminal IRS disclosure of tax return information. It should be limited by statute which designates who may see returns, the purposes for which disclosure may be made, the procedures governing such disclosure, and the limitations on the use or redisclosure of the return. For instance, the Conference staff recommended that IRS disclose tax returns only to executive departments or Federal Government agencies in connection with necessary enforcement of the tax laws, the Social Security laws, and the Employee Retirement Income Security Act. In particular, they recommended that the IRS should not disclose a tax return to any executive department or agency that is not related to tax law administration or for use in any way relating to an individual's service as a juror.

In much the same way, the recommendations of the Administrative Law Conference report with respect to discolsure of tax returns of individuals to the President or his staff parallel closely the provisions of our bill. The Conference report recommends that the President be required to personally sign a written request specifying the particular tax return, that the information be provided by the IRS only in written form, and that the President be required to return the tax material to the IRS.

The Administrative Conference report also endorses the underlying philosophy of the Taxpayers' Bill of Rights Act with respect to the availability of federal tax return information to state authorities. The Conference report recommended that states be required to enact statutes making it a crime for state personnel to disclose tax return information and that states be required to adopt legally enforceable regulations safeguarding the confidentiality of tax returns. We support this approach and note that the Taxpayers' Bill of Rights Act does not, in our view, prohibit states which passed appropriate statutes from continuing to share computer tape information and similar tax data with the Internal Revenue Service. However, the Taxpayers' Bill of Rights

Act would require that the governor request the information in writing initially, specify the purpose for shared information, why the information sought is available solely from federal tax return information and state why such use of the information is necessary to carry out a specified state legal duty. Admittedly, this is a much more stringent standard of disclosure than is currently in effect. But we submit that any lesser standard prevents effective protection of taxpayer privacy.

POLITICAL USE OF TAX RETURN INFORMATION

It is now evident that the IRS has been collecting and maintaining information on individuals and organizations over the last several years for purposes other than enforcement of the tax laws. Most of the files maintained by the IRS Special Services Staff had no relation at all to tax information needed by the IRS. Similar non-tax related data has been maintained in the IRS' intelligence-gathering and retrieval systems, a new computer system designed to help the IRS' Intelligence Division keep track of organized crime cases.

We suggest that it should be illegal to "investigate into, maintain surveillance over, and maintain records regarding the beliefs, associations, or activities of an individual or organization which are not directly related to the Revenue laws."

Our bill would give an individual or organization standing to bring suit for damages against any official who violates this provision.

ARBITRARY IRS PROCEDURES

Jeopardy assessment is a power given to the IRS to take suddenly the assets of a taxpayer if there is reason to believe the taxpayer is not going to meet his tax obligations. Historically, it has been used in cases where the taxpayer has been preparing to flee the country or otherwise hide or dissipate his assets. Termination of assessment provisions in the tax code have been used in recent years in the drive against narcotics dealers. Generally, when a person is discovered to be a drug dealer, his tax year is immediately terminated and he is assessed for the value of his assets—generally the value of the drugs or the proceeds from the drug sale as estimated by the IRS.

These are extremely powerful tools for law enforcement. At the same time, they have been misused on occasion. More importantly, there are currently no adequate restraints on how these powers could be used if persons in authority in the Internal Revenue Service or the Department of the Treasury should decide to use these mechanisms for narrow political or personal reasons.

Our bill attempts to give taxpayers certain limited recourses in cases of jeopardy or termination of assessment which are reasonable, do not conflict with lawful enforcement purposes or the Internal Revenue Service, and effectively restrain the arbitrariness of the mechanisms. Commissioner Alexander has expressed his own personal concerns about the use of these assessment powers and administratively has ordered tighter controls on the use of these tools. In fiscal year 1973, there were 3,090 jeopardy termination of assessments. In fiscal year 1975, the number of assessments declined to about 500. But we cannot

rely solely upon the discretion of administrators for restraint of the totally arbitrary powers currently residing in the Internal Revenue Service.

As former IRS Commissioner Sheldon Cohen testified on June 24, 1975 before the House Ways and Means Committee:

> The power of the jeopardy assessment or the power to close a taxable year is an awesome power. It is not often used by the Internal Revenue Service, but it is used. When it is used, the judicial remedy is down the road. There is no immediate action to report. A number of us involved in the Administrative Conference Study, I can't say unanimously, but I can say most people I believe, believe that there should be some access after the fact to a court. Perhaps within ten days after the jeopardy assessment or the close of a taxable year, the Commissioner should be bound at least to come into a court, if the taxpayer so chooses, to show prima facie that what he did had good reason.

Our bill allows for court review within 10 days of the jeopardy or termination assessment. The Secretary of the Treasury would have to appear and show reasonable cause for making the jeopardy assessment or termination of taxable period.

No one can argue that court review of IRS actions after the fact will unfairly inhibit legitimate IRS enforcement purposes. It is remarkable that Congress has not insisted before this date that citizens receive their minimum due process.

We note that the House Ways and Means Committee has proposed an amendment which is pending before your Committee on the matter of jeopardy assessments in termination cases. Again, it closely parallels our bill. The House's proposal would allow the federal court 20 days to decide whether the jeopardy assessment was reasonable and the amount appropriate. The House also would prevent the Internal Revenue Service from selling the taxpayer's property until after the court review.

A related issue that is also addressed in our bill is the matter of realistic property exemptions from IRS assessment and levy. For ten years, the American Bar Association has recommended that federal courts provide some relief to taxpayers who are so impoverished by jeopardy and termination actions that they cannot afford to pay themselves or to pay taxes on their property. The ABA has suggested that the court should be able to release some of the seized assets to the taxpayer. Our approach has been to suggest that the amount of property exempt from levy be increased to more realistic amounts: $1.500 for personal property, $1,000 for tools of trade, and a salary exemption of $100 per week plus support payments for minor children.

TAXPAYER'S SERVICE AND COMPLAINT ASSISTANCE WITHIN THE IRS

Another major mechanism of our bill to restore fairness and eliminate arbitrariness from the tax system is the creation of a new assistant commissioner for taxpayer assistance within the Internal Revenue Service.

The new Assistant Commissioner and his office will be responsible for providing responses to questions by taxpayers and assistance in filling out tax returns. In addition, he will serve as the ombudsman for taxpayers' complaints concerning the Service.

We would like to refer again to the testimony by IRS Commissioner Sheldon Cohen before the Ways and Means Committee on June 24, 1975. He stressed the need for a complaint office with the IRS:

> We are, I think, of the opinion that the Service does not have an adequate handle on tracking taxpayer complaints.
>
> It has to many different places where complaints can be handled and no organized system of maintaining records as to whether they have been services or not.
>
> Now we are attempting to address a proposed solution to the service and centralize that office somewhat, whether it is called ombudsman or office of complaints, or whatever, that there would be people in every region or district, depending on its size, who would track complaints and report solutions to the taxpayer and report to the administrative people on the kinds of problems that people are having to attempt to point out methods of solution.
>
> If the Internal Revenue Service knew the areas where it was getting the most complaints, it might be able to design techniques to be able to overcome them.

In addition to dealing with problems such as lost checks and computation questions, the Office of Taxpayer Services would be available to hear complaints of improper or abusive treatment by IRS employees. The Assistant Commissioner would have to provide an annual report to the Ways and Means Committee, the Finance Committee, and the Joint Committee on Internal Revenue Taxation on his activities. He would be given a special power to issue a "taxpayer order" if he determined "the taxpayer is suffering from an unusual, unnecessary, or irreparable loss as a result of the manner in which the Internal Revenue laws are being administered by the Secretary or his delegate."

DISCLOSURE OF INFORMATION TO TAXPAYERS IN AUDIT AND APPEAL PROCEDURES

Taxpayers who do not have legal representation face a number of problems when they are subjected to audits by the Internal Revenue Service. Few taxpayers really understand their rights. The IRS makes very little effort to inform them of their rights. Professor L. Hartwright, a University of Michigan law professor, has testified in Congressional hearings that most tax auditors do not know the law very well themselves. They are the lowest level and least well trained of the IRS's tax examiners. Yet the IRS is not required to make affirmative disclosures to taxpayers.

Our bill requires that the IRS develop a series of pamphlets describing, in clear and easily understandable language, the rights of taxpayers in audits, assessments, and the appeals process. These statements of taxpayer rights must be provided to the citizen at the time of the first communication from the IRS. The tax committees of the Congress would be given the opportunity to review and comment on the pamphlets.

The IRS already has a series of very helpful pamphlets describing the appeals process, et cetera. As a result of a series of hearings by Senator Montoya, the quality of these pamphlets has been improved dramatically in recent years. Our bill simply provides for a regular system by which a taxpayer is automatically advised of all his rights in all dealings with the IRS.

LEGAL ASSISTANCE PILOT PROJECT

Our bill would provide for a 3-year pilot project to be conducted in four cities by the Legal Services Corporation. Taxpayers would be provided with legal services in their audit and appeal dealings with the IRS. The service would be free for lower-income individuals with a sliding fee schedule for taxpayers in other income brackets.

Most taxpayers must deal with the IRS without the advantage of legal counsel. Only the wealthiest have been able to obtain adequate legal representation in tax proceedings. Therefore, there has been a record of inequitable enforcement settlements between income groups. A pilot project of legal representation will be extremely helpful in determining whether the general treatment of lower- and middle-income taxpayers can be improved through making tax legal assistance more readily available to all.

GAO OVERSIGHT OF THE IRS

The IRS has consistently refused to allow the General Accounting Office to examine its operations. Our bill provides, once and for all, that it is the law of the land that GAO may audit and investigate the IRS. It specifies that GAO is required to review a number of IRS activities and provide an annual report to the Congress. Language providing for GAO access is drawn largely from a letter of May 14, 1975, from the Comptroller General to the Chairman of the Ways and Means Committee.

CONCLUSION

There are many areas of controversy in the procedural administration of the internal revenue laws of the United States. This bill is not a cure-all. But it is a critical first step. We must act on these proposals now. It is time that people's reasonable expectations of the tax mechanism more closely parallel the reality of the law.

Mr. Chairman, we request that a copy of a section-by-section analysis of S. 2342, the Taxpayers' Bill of Rights Act of 1975 be included in the hearing record. This explains in greater detail the specific provisions included in our proposal to deal with the problems that we have outlined.

Thank you.

Employee Stock Ownership Plans (ESOP's)

69-516—76—pt. 8——9

LAW OFFICES,
HEDRICK AND LANE,
Washington, D.C., April 13, 1796

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
U.S. Capitol, Washington, D.C.

DEAR SENATOR: During its consideration of legislation dealing with Employee Stock Ownership Plans, the Senate Committee on Finance should also give attention to the problem outlined below which results in particularly harsh treatment of lower- and middle-income taxpayers.

Section 402(a)(1) of the Code provides that amount distributed to a participant in a qualified plan shall be taxable to him in the year distributed under the provisions of section 72 of the Code. Under an exception to this rule, unrealized appreciation on securities of the employer purchased with employee contributions is not included in the amount of the distribution, but is taxed as a capital item upon disposition of the stock by the distributee. However, in the case of securities of the employer purchased with employer contributions, the unrealized appreciation (as well as the employer contribution) is taxable as ordinary income to the employee upon distribution. (There is an exception to this rule for lump sum distributions under section 402(e). However, experience has shown that, in the program described below, section 402(e) is applicable only infrequently.)

Some employee stock savings programs provide that employees can contribute a portion of their pay toward the purchase of the employer's stock, and that the employer will contribute a matching or some other amount which is also used to purchase employer securities for the account of the employees. Prior to becoming vested in the employer's contributions, the participants are given an election to receive their interests either (i) after "earning out" the stock acquired with employer contributions over a period of time (e.g., 36 months), or (ii) in a lump sum distribution upon separation from employment (by retirement, death or resignation). If the participant chooses to "earn out" the stock under option (i), then he is taxed at ordinary rates on the unrealized appreciation attributable to securities purchased with employer contributions.

In many instances, the employees who choose option (i) will retain their employer securities, the value of which is subject to fluctuations in the market. Eventually, these securities may be sold at a loss, especially by lower bracket taxpayers who cannot always choose to sell at the most favorable times. (The vast majority of participants in these programs are lower- and middle-income taxpayers.) If the securities are sold at a loss and the taxpayer sustains a long term capital loss,

only 50 percent of the loss is deductible against ordinary income, subject to the $1,000 limitation on capital losses. However, part of the loss is a capital loss of unrealized appreciation previously taxed as ordinary income.

It is inequitable to treat the entire loss on the sale of employer securities as a capital loss when the unrealized appreciation on such securities was taxed at ordinary tax rates when received. This inequity can be corrected by providing that when an employee is taxed at ordinary income rates on unrealized appreciation on employer securities and the employee subsequently sells the securities at a loss, the loss is to be treated as an ordinary deductible loss to the extent that the unrealized appreciation was previously recognized as ordinary taxable income.

While this problem is under examination, your Committee may also wish to consider whether the entire loss should not be treated as an ordinary loss to the extent that the employee was previously taxed at ordinary rates. Providing for ordinary loss treatment on all of the losses attributable to the employer's contributions would remove a significant tax disincentive to participation in employee stock ownership programs.

Your consideration of this matter would be appreciated.

Sincerely,

F. Cleveland Hedrick, Jr.

Tax-Exempt State and Local Bonds

Supplemental Memorandum on Behalf of the Investment Company Institute

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:

Type of holder:	*Percent of outstanding State and local securities held, December 31, 1975*
Households	31.6
Commercial banks	46.1
Insurance companies	17.3
All other sectors	5.0
Total	100.0

*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 hase over $8 million shareholders and assets of approximately $48 billion, representing about 93 percent of the assets of all U.S. mutual funds.

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)	$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.

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 obligation has increased to a marked extent so as to make such bonds attractive to the investor of modest means.[1]

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 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

[1] Between 1963 and March 1976, for example, the average yield on seasoned Aaa State and local bonds increased from 3.06 percent to 5.99 percent. This compares to a rise in Federal long-term bonds for the same period of 4.00 percent to 6.87 percent and for Aaa corporates of 4.26 percent to 8.52 percent. To a married person with taxable income of $16,000 a yield of 5.99 percent on State and local bonds is equivalent to a yield of 8.32 percent on taxable obligations; to an unmarried person it is equivalent to a yield of 9.07 percent.

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 shareholder 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.

[H.R. 11955, 94th Cong., 2d sess.]

A BILL To amend the Internal Revenue Code to provide for distribution of certain tax-exempt income received by regulated investment companies to shareholders without change in tax-exempt status

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. Short Title.

This Act may be cited as the "Municipal Bond Fund Act of 1976".

Sec. 2. Exempt-Interest Dividends of Regulated Investment Companies.

(a) GENERAL.—Section 852(a)(1) of the Internal Revenue Code of 1954 (relating to regulated investment companies) is amended to read as follows:

"(1) the deduction for dividends paid during the taxable year (as defined in section 561, but without regard to capital gain dividends) equals or exceeds the sum of,

"(A) 90 percent of its investment company taxable income for the taxable year determined without regard to subsection (b)(2)(D); and

"(B) 90 percent of the excess of (i) its interest income excludable from gross income under section 103(a)(1) over (ii) its deductions disallowed under section 265 and section 171(a)(2), and".

(b) DIVIDENDS PAID DEDUCTION.—Section 852(b)(2)(D) of such Code (relating to taxable income) is amended to read as follows:

"(D) the deduction for dividends paid (as defined in section 561) shall be allowed, but shall be computed without regard to capital gain dividends and exempt-interest dividends."

(c) EXEMPT-INTEREST DIVIDENDS.—Section 852(b) of such Code (relating to method of taxation of regulated investment companies and shareholders) is amended by inserting after paragraph (4) the following new paragraph (5):

"(5) EXEMPT-INTEREST DIVIDENDS.—If at the close of each quarter of its taxable year at least 50 percent of the value (as defined in section 851(c)(4)) of the total assets of the regulated investment company consists of obligations described in section 103(a)(1), such company shall be qualified to pay exempt-interest dividends, as defined herein, to its shareholders.

"(A) DEFINITION.—An exempt-interest dividend means any dividend or part thereof (other than a capital gain dividend) paid by a regulated investment company and designated by it as an exempt-interest dividend in a written notice mailed to its shareholders not later than 45 days after the close of its taxable year. If the aggregate amount so designated with respect to a taxable year of the company (including exempt-interest dividends paid after the close of the taxable year as described in section 855) is greater than the excess of—

"(i) the amount of interest excludable from gross income under section 103(a)(1), over

"(ii) the amounts disallowed as deductions under sections 265 and 171(a)(2),

the portion of such distribution which shall constitute an exempt-interest dividend shall be only that proportion of the amount so designated as the amount of such excess for such taxable years bears to the amount so designated.

"(B) TREATMENT OF EXEMPT-INTEREST DIVIDENDS BY SHAREHOLDERS.—An exempt-interest dividend shall be treated by the shareholders for all purposes of this subtitle as an item of interest excludable from gross income under section 103(a)(1). Such purposes include but are not limited to—

"(i) the determination of gross income and taxable income,

"(ii) the determination of distributable net income under subchapter J.

"(iii) the allowance of, or calculation of the amount of, any credit or deduction, and

"(iv) the determination of the basis in the hands of any shareholder of any share of stock of the company."

Sec. 3. Technical Amendment.

Section 103(e) of such Code (relating to exclusion from gross income of interest on certain governmental obligations) is amended by inserting after paragraph (23) the following new paragraph:

"(24) EXEMPT-INTEREST DIVIDENDS.—For treatment of exempt-interest dividends, see section 852(b)(5)(B)."

Sec. 4. 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:

"(3) CERTAIN REGULATED INVESTMENT COMPANIES.—In the case of a regulated investment company which distributes during the taxable year an exempt-interest dividend (including exempt-interest dividends paid after the close of the taxable year as described in section 855) that portion of any amount otherwise allowable as a deduction which the amount of the income of such company wholly exempt from taxes under this subtitle bears to the total of such exempt income and its gross income (excluding from gross income, for this purpose, net capital gain as defined in section 1222(9)).

"(4) INTEREST RELATED TO EXEMPT-INTEREST DIVIDENDS.—Interest on debtedness incurred or continued to purchase or carry shares of stock of a regulated investment company which during the taxable year of the holder thereof distributes exempt-interest dividends, but in an amount not in excess of the amount of the exempt-interest dividends received by such holder during such year."

Sec. 5. Effective Date.

The amendments made by this section shall apply with respect to taxable years beginning after December 31, 1975.

Motor Fuel Excise Taxes

Statement on Behalf of the National LP-Gas Association, by Arthur C. Kreutzer, Vice President and General Counsel

SUMMARY OF PRINCIPAL POINTS

(1) The present method of taxation and handling of the motor fuel excise tax on use of propane in industrial lift trucks is inequitable and discriminatory, for the reason that equal or comparable tax is not imposed on competitive industrial lift trucks powered by electricity or diesel.

(2) The favored tax position provided for electric powered lift trucks represents stimulation of an inefficient use of energy resources.

(3) Conversion to use of propane in the desire to provide a cleaner working atmosphere should not be penalized.

(4) Revision in tax handling will eliminate substantial confusion for the lift truck user, the fuel supplier, and the tax collector.

(5) The amount of tax revenue involved is insignificant.

It is our recommendation that Sec. 4041 of the Internal Revenue Code be amended to limit the tax on liquefied petroleum gas (propane) to use in a highway motor vehicle. A suggested revision is attached to this statement.

INTERESTED PARTY AND PURPOSE

The National LP-Gas Association is a national trade association, having as members the producers of liquefied petroleum gas, the manufacturers of equipment and appliances using liquefied petroleum gas, and the distributors and dealers. LP-gas is the common name used for our product. The Association has over 5,500 members companies in 43 affiliated states. The membership represents over 90 percent of the industry's volume of business. Its membership is predominately at the distributor and dealer level. The Association's position as set out in this statement would also reflect the position of other industry companies. The more direct marketing impact of the tax discussed herein is felt by these distributors and dealers who sell LP-gas at retail. The employment and economic well-being of over 75,000 employees is involved in the LP-gas dealer's business and the problems presented. The manufacturers of, and dealers in equipment utilizing LP-gas are also adversely affected. Again, to the degree indicated in this statement, this problem is of serious concern to thousands of users of LP-gas equipment.

Our purpose in appearing is to inform this Committee of the existing discriminatory tax treatment accorded LP-gas, as compared with competing fuels in their use for the same purposes, the adverse impact on other national goals, and to apprise you of the confusing, burdensome, and impractical administrative application and handling of the present tax on LP-gas in non-highway motor fuel use incurred by both the government and the user. In solution of these problems we

recommend that the motor fuel tax on LP-gas be limited to use in a highway vehicle. This recommendation is also aimed at limiting the tax to those who receive the benefit.

PRODUCT AND TAX INVOLVED

LP-gas is composed of propane, butane, propylene, butylene, and their mixtures. It is an energy source, or fuel, and a small part [1] of total product usage is in motor fuel, principally off the highways. A portion of such motor fuel use is in industrial tractors, or industrial lift trucks. The tractor pulls or pushes a load and the lift truck carries it. It is herein that we encounter difficulties with federal excise tax administration and our statement is partially directed at that problem. In this usage LP-gas is a necessity in material handling and industrial processing, and its taxation becomes a business cost. To follow one step further, the tax burden on competitive products or business is not the same. It varies according to the means employed. Again, because of the diverse end product this tax impact cannot be evaluated.

The federal excise tax involved is the basic 2 cents a gallon tax on special motor fuel. (Sec. 4041). The additional gallonage taxes on highway vehicle use dedicated to the Highway Trust Fund are not involved. LP-gas is one of the special motor fuels subject to Sec. 4041. The others are benzol, benzine, naphtha, casinghead and natural gasoline, "or any other liquid". The other liquids that may be involved are unknown to us. The products, other than propane, have little, if any, motor fuel use.

Gasoline, or Sec. 4081 tax products, and kerosene, gas oil, and fuel oil are specifically excluded, and diesel fuel is separately handled as will be later covered. The special fuel tax is imposed on use in a motor vehicle. A motor vehicle is defined by the Treasury Department interpretation as a vehicle designed to carry or support a load. Consequently, this tax applies on LP-gas use in an LP-gas powered industrial lift truck and this is our area of concern.

DEFECTS IN PRESENT TAXATION

(1) *The Present Special Motor Fuel Tax Is Inequitable And Creates Discrimination, Placing LP-Gas At A Competitive Disadvantage.*

Competing electric battery powered or diesel fueled industrial lift trucks do not face similar fuel or power sources taxation. There is intense competition in this industrial tractor market and the LP-gas powered vehicle, and LP-gas use, is handicapped through unequal and discriminatory tax treatment that unfairly aids competition. Fuel cost is a substantial element in an industrial plant's decision on the type of lift truck to purchase and the 2 cents a gallon tax as reflected in total operating cost is many times the deciding factor.

Diesel fuel has a basic 2 cents a gallon federal excise tax *but only on use in a highway vehicle.* The tax is not imposed on use in an indus-

[1] Total internal combustion use in 1974, the latest year available was 1,309,750,000 gallons or under 10% of total product use (U.S. Bureau of Mines Report). The major portion of this 10% is on the farm, for tractors, irrigation pumping, etc.

trial plant nonhighway motor vehicle. A tax element of fuel cost is not faced when a diesel fueled industrial lift truck is purchased, or diesel fuel is used.

The electric or battery powered industrial lift truck does not face this tax, or any comparable tax, as an element of operating cost. Lower operating costs as a result of the tax favored position are a strong competitive sales argument used by electric lift truck suppliers in their advertising and promotional material. Competitive promotion of the electric lift truck emphasizes this tax advantage. Removal of the handicapping tax on LP-gas will not completely eliminate this cost differential, but it will place LP-gas on a more equitable and competitive plane. The effect of this promotion is demonstrated in the following statistical data compiled by NLPGA.

INDUSTRIAL TRUCKS IN USE

	1966	1971	1976
Total number	623,200	774,100	984,000
Electric walkers (number)	79,600	111,100	162,300
Percent of total	(12.8)	(14.4)	(16.5)
Electric riders (number)	76,200	121,100	182,100
Percent of total	(12.2)	(15.6)	(18.5)
LP-gas riders (number)	289,800	335,900	396,600
Percent of total	(46.5)	(43.4)	(40.3)
Gasoline and diesel riders (number)	177,600	205,900	243,000
Percent of total	(28.5)	(26.6)	(24.7)
	1965	1970	1975
SHIPMENTS			
Total number	59,900	69,800	66,400
Electric walkers (number)	8,200	13,800	14,400
Percent	(13.7)	(19.8)	(21.7)
Electric riders (number)	10,000	14,800	19,000
Percent	(16.7)	(21.2)	(28.6)
LP-gas riders (number)[1]	25,900	25,500	20,500
Percent	(43.2)	(36.5)	(30.9)
Gasoline and diesel (number)[1]	15,800	15,700	12,500
Percent	(26.4)	(22.5)	(18.8)

[1] Revised to reflect field conversions.

It will be seen that the market share, in the ten year period, of Electric Walkers increased by 3.7 percent, the Electric Riders by 6.3 percent while the LP-gas lift truck lost 6.2 percent of the market. While Gasoline and Diesel Riders also decreased by 3.8 percent the loss is believed to be primarily in gasoline units that were converted to propane. Contrasting 1965 and 1975 shipments reveal a much greater market takeover by electric fuel vehicles were in riders, the principal competitive unit, electric units showed a 11.9 percent gain, and LP-gas units dropped 12.3 percent. Not only did LP-gas market shares drop, but there was an actual decrease of 5,400 units.

To carry this element of discriminatory treatment between competing methods one step further, as a material handler the lift truck serves as a conveyor of materials. There is no comparable tax on the power that supplies conveyors of the many other types, such as a built-in belt conveying system. There are also material handlers or conveyors in electric powered pallets. The effect of this basic 2 cents a gallon federal excise tax on LP-gas as a special motor fuel is to create an inequitable and discriminatory tax that encourages tax free competition.

(2) *The Tax Favored Position Provided For Electrical Powered Lift Trucks Represents Stimulation Of An Inefficient Use Of Energy Resources And Impairs Energy Conservation.*

In a governmental report [2] it is estimated that the efficiencies in producing and delivering electricity range from 10 to 25 percent. In other words there is a loss of energy resource employed in the production of electricity of from 75 to 90 percent. The mentioned report further states that systems for providing fuels directly to the consumer are more efficient. "The greatest potential for energy conservation is often in the selection of the right energy system for a particular need". The direct use of propane in an industrial lift truck is both a more efficient use of a natural resource, and the selection of the right energy system for a particular need. We submit that instead of penalizing use of propane through inequitable taxation, its use should be encouraged. Or to express it otherwise, inefficient and wasteful use of energy resources should not be stimulated. These twin objectives can be met by removing the federal excise tax on use of propane in an industrial lift truck.

(3) *Conversion To Use of Propane In The Desire To Provide A Cleaner Working Atmosphere Should Not Be Penalized.*

Many industrial plants bought LP-gas fuel or converted existing lift trucks using other fuels to use of propane with the objective of providing a more desirable, or less polluted atmosphere through use of clean burning propane instead of fuels that place the worker in an atmosphere created by fuels with undesirable emissions, his upgrading of working environment should be encouraged by removal of any tax disincentive. National tax policy should encourage use of clean fuel. Propane is a clean burning gas, as contrasted with fuel used in other internal combustion engines. Some states with the objective of encouraging use of clean fuel have completely eliminated, or reduced, their highway motor fuel tax on propane. In this statement we are only requesting removal of the inequitable federal tax penalty.

(4) *Revision In Tax Handling Will Eliminate Substantial Confusion For The Lift Truck User, The Fuel Supplier, And The Tax Collector.*

The administration of the present law by IRS, and tax handling by the LP-gas fuel industrial lift truck user, is complex, confusing and costly. To appreciate the problems involved it should be first noted that the tax is applied to use in motor vehicles, defined by the Treasury Department as vehicle designed to carry or support a load. Use in a vehicle that pulls or pushes a load is not taxable. An industrial lift truck is in the first category. An industrial tractor is in the second category. Industrial operations commonly involve both types of vehicles. Consequently, we find in the same industrial plant, drawing from a common fuel source, the two types of vehicles. In addition the fuel may be used for other non-taxable purposes in the plant. The determination of how much fuel is used for taxable purpose and how much for non-taxable purpose presents problems of substantial difficulty both to the Government and to the taxpayers. Tax determination by the user and effective enforcement by the Government is costly.

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[2] Energy-Environment and the Electric Power Prepared by the Council on Environmental Quality, August 1973.

Substantial confusion exists among users as to the tax application that understandably resists clarification when the complexity is recognized. This confusion is not limited to users. In the past we have seen differing interpretations from differing IRS District Offices. A simplification of this tax will serve both Government and the taxpayer with little effect or tax income.

(5) *The Tax Revenue Involved Is Significant*

The tax dollars involved on a special motor fuels under Sec. 4041 are not consequential. While as earlier mentioned, this tax applies to specified other liquids, their taxable use is *de minimis* insofar as we can ascertain. This tax, in addition to being on use in motor vehicles, applies to use in motorboats and airplanes. LP-gas is not so used, and we understand that use of other special motor fuels, if any, is insignificant.

LP-gas taxable use in motor vehicles, other than in highway vehicles, would largely be confined to the industrial lift truck. Our calculations based on the number of LP-gas powered lift trucks in use at the end of 1976 and the average usage indicate that the tax involved would approximate $9.3 million a year.[3] Taxes would also fluctuate widely with industrial productivity.

SUMMARY AND RECOMMENDATION

Therefore, in the interest of competitive equity, efficient use of natural resources, encouragement of use of clean fuel, tax clarity, and administrative convenience we recommend that the existing special motor fuel tax law be modified to limit tax application to special motor fuel use in a highway vehicle, or if such proposal covers too broad a field of tax producing special fuels, which we consider unlikely, the motor fuel taxation of LP-gas be limited to use in a highway vehicle as is the present treatment provided for diesel.

SUGGESTED TAX REVISION

Sec. 4041. Imposition of Tax

(b) Special motor fuels. There is hereby imposed a tax of 4 cents a gallon upon benzol, benzene, naphtha, liquefied petroleum gas, casinghead and natural gasoline or any other liquid (other than kerosene, gas oil, or fuel oil, or any product taxable under section 4081 or subsection (a) of the section)—

(1) Sold by any person to an owner, lessee or other operator of a *highway* motor vehicle or motorboat for use as a fuel in such *highway* motor vehicle or motorboat; or

(2) Used by any person as a fuel in a *highway* motor vehicle or motorboat unless there was a taxable sale of such liquid under paragraph (1).

In the case of a liquid taxable under this subsection sold for use or used [otherwise than as a fuel is highway vehicle (A) which (at the time of such sale or use) is registered, or is required to be registered, for highway use under the laws of any State or foreign country, or

[3] 396,600 LP-Gas lift trucks in use with an average annual use of 1,200 gallons.

(B) which in the case of] in a highway vehicle owned, by the United States, [is used on the highway] the tax imposed by paragraph (1) or by paragraph (2) shall be 2 cents a gallon. [If a liquid on which tax were imposed by paragraph (1) at the rate of 2 cents a gallon by reason of the preceding sentence is used as a fuel in a highway vehicle (A) which (at the time of such use) is registered, or is required to be registered, for highway use under the laws of any State or foreign country, or (B) in the case of a highway vehicle owned by the United States, is used on the highway, a tax of 2 cents a gallon shall be imposed under paragraph (2).]

Taxation of Utilities

Written Testimony of A. Jones Yorke, President, Paine, Webber, Jackson & Curtis Inc.

SUMMARY

I am president of Paine, Webber, Jackson & Curtis Inc., one of the largest investment firms that deals directly with the general public. Paine Webber is a major investment banking firm with many years of experience in providing financial advice to corporations as well as marketing corporate securities. We think that Paine Webber is well qualified to speak on capital formation by utilities, having raised, as managing underwriters, over $2 billion annually in recent years for the telephone, electrical and natural gas utilities.

In recent years we have been raising increasing amounts of capital for utilities, in an environment of high interest rates, deteriorating quality of utility securities, and cutbacks in utility construction programs due to difficulties in raising capital. We recommend three basic steps in order to help utilities attract capital.

1. Permanently increase the investment tax credit to 12 percent for all utilities.
2. Defer taxation of automatically reinvested dividends (reinvested dividends would be treated for tax purposes as a stock dividend).
3. At the option of the issuer, dividends on new issues of preferred stock should be tax-deductible by the issuer.

We particularly urge that any tax legislation for electric utilities be extended equally to *all* ultilities. Any advantage given to one segment of the industry should be shared by all segments. This need results from the integrated nature of the market for the securities of public utilities. Securities of all utilities compete for the same investor dollars. Each segment is crucial to a healthy economy.

All utilities share the characteristic of being capital intensive. For the electrics and telephones, about $3.50 in capital is required to generate $1.00 in sales. (By comparison, manufacturing requires about 75 cents in capital per dollar of sales.) In addition, the capital structures of most utilities are highly leveraged with debt and share the problem of inadequate interest coverage. Moreover, in most states, the same regulatory agencies oversee the operations of all utilities and make no distinction between them. Finally, utilities are alike in that their rate of return on equity are inadequate at present levels to attract capital on favorable terms.

Apart from being capital intensive and highly leveraged, the utility industry is one of our Nation's largest employers. In this connection, it might be noted that the telephone industry employs almost one million people—approximately twice as many as the electric utility industry. Any tax legislation should be extended to all types of utilities in order to maximize job opportunities throughout the industry.

STATEMENT

Mr. Chairman and members of the Committee, my name is A. Jones Yorke. I am president of Paine, Webber, Jackson & Curtis Incorporated, one of the largest investment firms that deals directly with the general public. Paine Webber is a major investment banking firm with many years of experience in providing financial advice to corporations as well as marketing corporate securities. We think Paine Webber is well qualified to speak on capital formation by utilities, having raised, as managing underwriters, over $2 billion annually in recent years for the telephone, electric and natural gas utilities. We have recently been raising increasing amounts of capital for public utilities. At the same time, the cost of this capital has become unprecedentedly high for the issuing companies. Already, many utilities have significantly reduced their construction programs simply because of their inability to raise sufficient capital on reasonable terms.

I will address two questions: First, why should this Committee use tax policy to remedy a bad situation? Second, what can tax policy do to help meet the utilities' capital requirements?

WHY HELP THE UTILITIES?

At a time when we are struggling with recession and unemployment, the role of utilities should not be underestimated. Utilities' expansion must *precede and anticipate* growth in other sectors of the economy. Telephones and electricity must be available *before* other businesses can expand. Lead times of more than six years may be required to put these facilities in place.

The inability of the utilities to attract sufficient new capital, particularly equity capital, has contributed to slowing the pace of new construction. Unless we act quickly, we will suffer the consequences in the future. Growth of the economy could be unnecessarily retarded for lack of sufficient communications and energy facilities.

The best way to make utilities attractive to investors is to bring the rates they charge into line with the cost of the services they provide. To the extent that utilities receive sufficient rate relief, investors will be encouraged to buy their bonds and stock at more reasonable prices. Federal and state regulatory agencies have been somewhat responsive in recognizing this, and substantial rate increases, combined with large cutbacks in utility construction programs, have helped to improve the overall utility financing picture from where it was a year ago. But rate relief cannot do the entire job, because this would require rates to rise so far and so rapidly that a substantial portion of our population would no longer be able to afford these services.

I should emphasize that utilities share their staggering capital requirements with other corporate and governmental users. Tax measures that stimulate investment generally can benefit all those users, including the utilities. For instance, the introduction of measures such as Senator Bentsen's plan to lessen capital gains taxes in increments over a 15-year period would provide greater incentives to investment. Similarly, the mitigation of double taxation of dividends by increasing the

dividend exclusion from income taxes would spur investment by individual savers. Such measures could also have immediate impact on unemployment. We support the objectives of these and similar measures.

SPECIFIC RECOMMENDATIONS

Following are five recommendations for tax reform which we believe should be carefully considered for all public utilities—telephone, gas and water, as well as electric.

1. Permanently increase the investment tax credit to 12 percent

This committee's decision earlier this year to raise the limit on the investment tax credit to 10 percent was limited in impact by the two-year duration. Due to the time lag between passage of legislation and the time the legislation begins to have its desired effect, many utilities will be unable, because of their poor income positions, to take full advantage of the temporary increase in the tax credit.

It is important to make the investment tax credit permanent. Investors are aware that utilities are unable to plan capital expenditures on a cycle as short as two years and they realize that an investment tax credit of longer duration is necessary to make a significant impact on capital investment decisions. We endorse the President's Labor-Management Committee proposal of a permanent increase to a 12 percent rate.

2. Defer taxation of automatically reinvested dividends

As I mentioned earlier, we favor elimination of the double-taxation of corporate dividends. Short of complete elimination, we strongly support the proposal outlined by Secretary Simon to allow deferral of income tax on dividends that are automatically reinvested. This would encourage the accumulation from internal sources of capital which can be used to fund further growth. It would also equalize, to a certain extent, the tax treatment of an investor in a dividend-paying utility with an investor in a company which reinvests its capital rather than pay a dividend. This mechanism would thereby make utility stocks attractive to a new class of investors who seek capital appreciation rather than income. We believe that this is a key method of expanding the market for the securities of public utilities.

3. At the option of the issuer, dividends on preferred stock should be deductible

The option for a utility to issue preferred stock, the dividends on which would be tax deductible by the issuer, would have a tremendously beneficial effect on the capital position of utilities. This option would allow a utility to reach other classes of investors than the customary corporate purchasers of preferred stock. These corporate investors would continue to be attracted by the 85 percent exclusion available on the traditional form of preferred stock, which utilities could continue to offer, along with the new-type preferred. The new form of preferred would make higher dividends possible and would appeal to investors whose tax-exempt status or minimal tax liability make the 85 percent exclusion less attractive. We believe that the new option would substantially broaden the market for preferred stock, and that

the new preferred would be particularly attractive to individual investors.

Such an option would provide new capital to the utilities without diluting the position of common stockholders. Earnings per share would increase to the extent that the new preferred was substituted for old preferred or for common stock. To the extent it is used as a substitute for debt financing, the company's debt ratios would improve, thereby reducing the cost of debt financing.

4. Increase the term for loss carryback and carryforward

Many utilities are experiencing low earnings or actually operating at a loss for income tax purposes. We recommend, therefore, an increase from the present limits for loss carrybacks and carryforwards to more realistic limits such as ten and seven years, respectively.

5. Maintain competitive parity among utilities

Any advantage given to one segment of the utility industry should be shared by all segments. This need for competitive parity results from the integrated nature of the market for the securities of public utilities. Securities of all utilities compete for the same investor dollars. Each segment is crucial to a healthy economy.

All utilities share the characteristic of being capital intensive. For the electrics and the telephones, about $3.50 in capital is required to generate $1 in sales. (For comparison, manufacturing requires about 83 cents in capital per dollar of sales.) In addition, the capital structures of most utilities are highly leveraged with debt and share the problem of inadequate interest coverage. Moreover, in most states the same regulatory agencies oversee the operations of all utilities and make no distinction between them. Finally, utilities are alike in that their rates of return on equity are inadequate at present levels to attract capital on favorable terms.

CONCLUSION

We believe that the benefits of implementing these proposals are well worth the possible short-term losses to the Treasury. We urge the Committee's careful consideration of these proposals.

PAINE, LOWE, COFFIN, HERMAN & O'KELLY,
Spokane, Wash., April 2, 1976.

Mr. MICHAEL STERN,
Committee Staff Director,
Dirksen Senate Office Building, Washington, D.C.

DEAR MR. STERN: We are counsel for The Washington Water Power Company of Spokane, Washington, a utility company primarily engaged in the production, transmission and distribution of electricity in Eastern Washington, Northern Idaho and Western Montana and in the distribution of natural gas in Eastern Washington and Northern Idaho. As such counsel, we were involved in litigation challenging taxes imposed by the State of Washington on electric energy sold for export and are presently involved in litigation in Montana and Idaho involving similar taxes.

It is understandable that States hard pressed for money will be tempted to raise money painlessly by imposing taxes paid solely by taxpayers of another State. It is also the function of the United States through constitutional or legislative processes to prevent the States from placing artificial economic barriers at State lines.

We, therefore, support the general intent of S. 1957. However, it appears to go too far as presently drafted. The title to Title II refers to "Discriminatory Taxes" but the substantive provisions appear to prohibit all taxes.

The New Mexico tax is one that appears to us to be patently discriminatory. We understand that New Mexico justifies its tax, in part, by reference to the Washington tax. The practical operation of the Washington and New Mexico statutes is quite different. In Washington there is a 3.6 percent tax at the retail level. The retail price includes manufacturing costs and transmission costs as well as distribution costs. Sales at wholesale involve only the manufacturing costs and transmission costs to the point of delivery which then incur a 3.6 percent tax on those functions only when the power is exported. In *PUD No. 2 of Grant County* v. *State*, 510 P. 2d 206, the Washington Supreme Court upheld a tax on the sale at wholesale of electricity to be exported from the State. However, the 3.6 percent tax was applied to export power that sold in the neighborhood of 5 mills while it was selling at retail at anywhere from two to three times that much and the same rate of tax is applied to retail sales. Applying 3.6 percent to 5 mills results in a tax of $.00018 per kwh. Applying 3.6 percent to 1.5¢ results in a tax of $.00054 or three times the tax applied to export power. Even this was considered unfair by the Washington Legislature because it resulted in a manufacturing tax much higher than other manufacturing taxes in 1965, while the court case was pending, the rate applied to manufacture of electricity which is paid only on export power was reduced by the Legislature to .44 percent. Applying this to 5 mills results in a tax of $.000022 per kwh, which makes the New Mexico tax over 18 times the tax now charged by Washington.

In summary, the principal point of difference is that Washington bases its tax on the value of the product at each stage and picks up the value on a proportionate basis at the manufacturing stage in its tax on retail sales in the State. As the Washington Court, in *PUD No. 2 of Grant County* v. *State* pointed out, "* * * the tax deduction that is made at the sale to a Washington utility is made up at the time the Washington utility buyer sells to its customers." The .4 mills per kwh levied by New Mexico, being completely arbitrary and with a direct credit to local utilities up to and including their entire liability under the Gross Receipts Tax, *in its practical operation* does "work a discrimination against interstate commerce." It lacks the automatic apportionment of the Washington statute and the tax is not apportioned to the business done in the State.

Since the United States is moving into a period of energy shortage and since the supply of energy is not evenly distributed, the Congress should address two aspects of the problem.

First is the prevention of discrimination against interstate commerce which may be prevented in the courts by enforcing the Constitution.

Second is the prevention of discrimination against energy sources. A state should be able to levy a manufacturing tax on electricity or other forms of energy but the amount of the tax should be reasonably related to the burden imposed on the state by the manufacturing or other process. The tax rate should be comparable to the rate of taxes levied on other comparable business as it is presently in the state of Washington.

The Congress should also consider expanding the studies proposed to include other forms of energy. Confiscatory taxes placed on coal, oil, natural gas, uranium, etc. will compound the nation's energy problems. It is particularly in the area of discrimination against energy as contrasted with discrimination against interstate commerce that the courts will not be able effectively to provide solutions and the Congress will be the only body having the authority to do so.

Thank you for this opportunity to express our views.

PAINE, LOWE, COFFIN, HERMAN & O'KELLY.
By ALAN P. O'KELLEY.

PUBLIC UTILITIES COMMISSION,
STATE OF CALIFORNIA,
San Francisco, Calif., May 6, 1976.

Hon. RUSSELL B. LONG,
Chairman, Senate Committee on Finance,
Washington, D.C.

DEAR CHAIRMAN LONG: I am writing to call your attention to the undesirable economic consequences precipitated by a recent Internal Revenue Service Ruling. The nature of the dilemma created by the IRS as well as proposed legislative solution by an amendment to H.R. 10612 are outlined below.

All 400 of the water utilities under the California Public Utilities Commission's jurisdiction extend water service to individual customers, subdivisions, housing projects or industrial developments under an identical rule prescribed by this Commission after hearings and by formal decision. This rule, a copy of which is enclosed, specifically defines the terms and conditions under which Contributions In Aid Of Construction (hereafter called Contributions) are to be accepted.[1] As provided by paragraphs A–3c and A–6e, all construction for both subdivider advances as well as Contributions are adjusted to actual cost.

Utilities entering into specific agreements pursuant to this rule have on file, with this Commission, standardized contract forms. The amount of the Contribution and the specific facilities, associated with the Contribution, are set forth in these contracts. Any changes from these contract forms must be specifically approved by this Commission. Copies of the contract forms in which Contributions are required are enclosed for your review.

As indicated in Rule No. 15, contributions are, generally, paid by a developer, in cash, so that the utility may construct the necessary distribution mains, pumps or water tanks to provide service to the development. When the cost to construct becomes known, the amount

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[1] This was made a part of the official files of the Committee.

of the cash advance is adjusted to actual cost. The rule also allows the developer to construct the physical facilities himself. In this instance, the necessary record and vouchers to substantiate the actual cost is furnished the utility together with the cost of the utility's inspection and supervision.

The utility records the actual cost of the contribution in its plant accounts, and in its Balance Sheet Account No. 265, entitled Contributions In Aid Of Construction. In developing the rate base on which the utility is allowed to earn a fair rate of return, contributions are deducted. Depreciation expense on contributed plant is also not considered an allowable expense in developing appropriate rates. Thus, under regulation, contributions provide a direct benefit to the consumer, but not to the utility.

The principal beneficiary of this system is the existing ratepayer. If the water utility paid for the new plant construction the cost would be included in the utility's rate base and the utility would be entitled to a rate of return on that portion of its investment. However, since mains and services must be installed before roadways are completed and actual home construction begins, a considerable amount of time would pass before the utility realized a full rate of return on this new plant. The utility would, therefore, be entitled to increase the rates to existing ratepayers to insure a fair rate of return on this total investment. This is the situation which is avoided by developer contributions in aid of construction under Rule 15.

The IRS has, until recently, treated developer contributions in aid of construction as non-shareholder contributions to the capital of the Utility under Section 118 of the Internal Revenue Code.

In December, the IRS issued Revenue Ruling 75–557 holding that connection fees paid to water utilities constituted gross income rather than non-shareholder contributions to capital. While the ruling did not specifically consider contributions in aid of construction, it did revoke Revenue Ruling 58–555, which had held that contributions in aid of construction to regulated utilities were non-taxable contributions to capital. One must reasonably assume, as the water utilities are assuming, that the IRS intends to treat developer contributions in aid of construction as taxable income to the utility.

The legal basis for the Ruling is arguably non-existent and uncertain at best. This Commission, as well as the National Association of Regulatory Utility Commissioners (NARUC), has requested that the IRS clarify, reconsider or modify the Ruling. We were informed that such request could only come from a taxpayer who would be required to submit a specific set of facts to the IRS. This procedure is being pursued by one large utility within our jurisdiction. However, we do not expect a speedy resolution of the matter by the IRS.

Until this matter is resolved, the question remains: who will bear this tax burden? Should the utility bear it, it will simply be passed on to the ratepayer in the form of increased rates. An alternative is to require the developer to contribute an amount sufficient to cover both the cost of plant construction and the utility's tax liability. Under this plan the new home purchaser would bear the burden in the form of a higher purchase price. Neither result seems to us to be consistent with a national policy of economic vitality.

The NARUC has proposed a legislative solution to the problem described above. Their proposed amendment (copy attached) to the Tax Reform Act of 1975 would insure that developer contributions in aid of construction such as those administered by this Commission pursuant to Rule 15 would continue to be treated as non-shareholder contributions to capital under Section 118 rather than gross income under Section 61.

We strongly urge you to support this measure. It is truly in the best interest of utility consumers, the housing industry and the economy in general.

Very truly yours,

D. W. HOLMES, *President.*

Enclosure.

NARUC PROPOSED AMENDMENT TO H.R. 10612 TO PROVIDE THAT CONTRIBUTIONS IN AID OF CONSTRUCTION ARE NOT TAXABLE AS INCOME

SEC. —. CONTRIBUTIONS IN AID OF CONSTRUCTION.

(a) GENERAL RULE.—Section 118 (26 U.S.C., sec. 118) is amended by redesignating subsection (b) as subsection (c), and by inserting after subsection (a) the following new subsection.

"(b) CONTRIBUTIONS IN AID OF CONSTRUCTION.

"(1) GENERAL RULE.—For purposes of this subtitle, the term 'contribution to capital' includes any payment of money or transfer of other property made to or for the use of a regulated public utility [within the meaning of 26 U.S.C., section 7701(a)(33)(A), (B), (C), and (D)] as a contribution in aid of construction by a developer, an existing or potential customer, a governmental body, or any other person (whether or not a shareholder) if:

"(A) the money which is paid is used for (or is reimbursement for) the acquisition, construction, installation, extension, connection, or relocation of eligible property; or

"(B) the property which is transferred will, in the hands of the transferee, constitute eligible property.

"(2) ELIGIBLE PROPERTY.—For purposes of paragraph (1), the term 'eligible property' means property used predominantly in the trade or business of the furnishing or sale of services described in section 26 U.S.C., section 7701(a)(33) (A), (B), (C), and (D).

"(3) DISALLOWANCE OF DEDUCTIONS AND INVESTMENT CREDIT.—Notwithstanding any other provision of this subtitle, no deduction or credit shall be allowed for, or by reason of, the expenditure by or on behalf of a regulated public utility of any funds constituting a contribution to capital by reason of paragraph (1)."

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to transactions entered into on or after February 1, 1976.

Tax Treatment of Reusable Steel Drums

Statement of Morris Hershson, President, National Barrel and Drum Association

TAX TREATMENT OF REUSABLE STEEL DRUMS

My name is Morris Hershson. I am President of the National Barrel and Drum Association, having its offices in Washington, D.C. We represent the steel drum reconditioning industry, which reconditions and puts back into reuse approximately 40–50 million 55-gallon steel drums annually. Our Association represents about 75 percent of all reconditioners in this country and roughly 85 percent to 90 percent by volume of the total national production.

In the 55-gallon size, which is the main steel drum size in which we are interested, approximately 20–21 million drums are manufactured annually. Except for Rheem Manufacturing Company, the major drum manufacturers are subsidiaries of the steel industry: U.S. Steel, Jones and Laughlin, Republic Steel and Inland Steel, with many smaller volume, independent producers. The number of drums reconditioned annually is about 2 to 3 times the number manufactured. Although our members are all in the category of small business, our individual plant investments in this industry, essential to the environment, range from one half a million to seven million dollars in buildings and equipment. Nationally, our sales service volume is in excess of $300 million.

Reconditioners of steel drums have, for about 50 years, been conserving the nation's assets—conserving steel—conserving energy—conserving natural resources—and reducing solid waste pollution. Let us consider each of these salutary results of our industry's efforts.

With reference to energy: the study submitted with this statement, which was recently prepared by economists at the University of Illinois, calculates that manufacturing a steel drum—including the steel involved—consumes 10 times as much energy as reconditioning a drum. The conclusions are, and I quote:

"A shift from the current mix of reusable and single-use drums to an all-18-gauge drum system, with an average of 8 reconditionings per drum (9 fills), would create energy savings of 17,043 billion Btu per year, which is 23 percent of the total energy requirement of the present system, and enough energy to provide electric power for one month to a city the size of San Francisco."

"Clearly, efforts to increase the use of 18 gauge drums and the rate of return of such drums (by such means as deposits) would conserve energy. Conversely, a trend to increase the use of light gauge drums, or to reduce the return rate of drums would further burden American energy resources."

Translated into different terms, by reconditioning 40 million drums a year, our industry saves the equivalent in energy of 1 billion 800 million gallons of oil.

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As for the conservation of steel, by reconditioning 40 million drums annually, we save over 2 billion pounds, or 1 to 1¼ million tons of sheet steel. It is almost unnecessary to spell out the obvious resultant conservation of natural resources. The coal, iron ore, manganese, sulphur, phosphorus, carbon and other minerals and chemicals conserved by not manufacturing that 1 million tons of steel annually is a vital contribution to the preservation of our natural resources.

As for reducing solid waste pollution: if these drums were not picked up, reconditioned and put back into commercial reuse, they would constitute a serious blight and a contributing factor to pollution of the Earth, air and water. Most drums contain a residue of their previous contents—oils, chemicals, petrochemicals, pesticides, paints, etc. Our industry acts as an unpaid collection system, receiving all of these pollutants, treating them, cleaning the containers and returning them to commercial reuse, while at the same time disposing of the residual sludge.

Although our industry is not directly involved in the recycling business, we clean, recondition and refurbish steel drums so that they are again reusable by industrial fillers of the many products shipped in drums—both hazardous and nonhazardous. We feel that a reuse industry should be given as much, if not greater encouragement than a recycling industry.

This introduction to our industry leads me to the reason for our Submission to this Committee. For the past 10 to 15 years, the steel industry, through its subsidiaries, has been encouraging the purchase of "throwaway" (one-time use), or short-lived drums. These are thin-walled, lighter-weight drums, fabricated of 20, 22 or 24 gauge steel. The standard 55-gallon drum, for a quarter of a century, was made of 18-gauge steel, this thickness having proved itself to industry, in both peace and wartime, as bulwark of strength in transportation, storage, stacking, reconditioning and reuse, as the safest and most economical container. Furthermore, for safety reasons, according to Department of Transportation regulations, almost all hazardous materials shipped in drums must be shipped in drums made of 18-gauge or heavier steel.

The steel industry has introduced several lighter weight drums in order to compete with the reconditioned drum. They introduced a 24-gauge drum, fabricated of steel one-half the thickness of 18-gauge, which is sold in limited quantities; more importantly, they introduced the 20/18-gauge drum, made with an 18 gauge top and bottom and a 20 gauge body, 10 pounds lighter and with a short commercial life of 2 to 3 trips, compared with the 8 to 10 trips afforded by an all 18 gauge.

In recent months this trend has been accentuated. One drum manufacturer has obtained permission from the National Classification Board of the American Trucking Association to use, for the transportation of liquids, a 19/22/20 gauge drum; this drum has a light, 19 gauge bottom—a lighter 22 gauge body—and a 20 gauge top. It is marked "Nonreusable for Liquids" and therefore is, by design, a single trip, throwaway drum.

More dangerous is the all 20 gauge drum, proposed to the same Board by the Steel Shipping Container Institute, the association rep-

resenting steel drum manufacturers. This drum will be "reusable," and, in our opinion, will have an extremely short life, if any, beyond its initial use.

The steel drum manufacturers are not concerned with the wasteage of energy and natural resources. They are now asserting that they should be permitted even lighter gauge drums, in order to produce more drums per ton of steel. They disregard the fact that this increase in drum production would be illusory; actually, it would reduce the supply of used drums in the national inventory, a situation already affecting the Nation today. There is currently a severe shortage of drums because too many of the drums manufactured in recent years have been throwaway, or short-lived drums.

Because the 20/18 gauge drum uses 10 pounds less steel, there is a price differential of approximately $1.00 between it and the all 18 gauge drum. Due to this differential, many industries, such as chemicals, petrochemicals, varnishes, paints, et cetera, which sell drum and contents together, purchase the 20/18. The oil industry, in the main, is on a returnable drum system and therefore pays the additional $1.00 for the 18 gauge drum, since they consider it more economical because of its longer life.

For some years, we have endeavoured to persuade the chemical and other industries to revert to the all 18 gauge drum, for the reasons mentioned. Despite our efforts, light gauge tight head drums have increased in production from 2 percent in 1957 to 50 percent in 1974, to the detriment of the economy and the environment.

We believe that a tax incentive—or perhaps a tax disincentive—in this field would serve the national interest by reducing solid waste pollution, conserving energy and natural resources, and fighting inflation by reducing the packaging costs of essential industry products.

Let us assume that the 18-gauge drum cost $12.00, and that the lighter weight 20/18 gauge costs $11.00. If, for example, purchasers of 18-gauge, 55-gallon steel drums were permitted to deduct $13.50, or $1.50 over the cost of the drum, as a legitimate tax deduction, this would discourage the purchase of 20/18 and lighter drums.

Another avenue might be to restrict purchasers of 20/18 gauge or lighter drums from deducting the entire $11.00 cost of the package, allowing them a legitimate deduction of $9.00, or a reduction of $2.00. A simplified and more easily workable system would be to permit an increase in the tax deductible cost of 15 percent for 55 gallon drums of 18 gauge, and a decrease in the same percentage of 55 gallon drums lighter than 18 gauge. Such a tax incentive or disincentive should discourage the purchase of light-weight, nonreusable drums, and therefore would increase the production of all 18 gauge, reusable steel drums.

However, this recommended tax adjustment would not, by itself, completely achieve the desired objective. It would be in the national interest if sellers of drum and product (such as the chemicals industry) could be induced to use and reuse the 18 gauge drum. This reuse was recognized as a strategic necessity during World War II. At that time, the War Production Board prohibited the purchase of new drums unless the user had used and reused his supply of drums as

many times as possible, in order to save steel for the war effort. A similar requirement (by the tax route) should be imposed on industry today, subject of course, to Department of Transportation regulations. This would save steel needed for the economy, it would save energy and natural resources, and reduce the solid waste problem caused by throwaway drums.

Attached to this statement is a copy of the University of Illinois Energy Study referred to earlier, a copy of the remarks on the subject made by former Congressman Abner Mikva, which appeared in the Congressional Record of Nov. 1, 1971, and a copy of Senator Jennings Randolph's remarks, also, in the Congressional Record of Mar. 30, 1972. Since those remarks were made, bills have been introduced in the House to propose banning the manufacture of light-gauge, non-reusable steel drums, by former Congressman Brad Morse (H.R. 14707) in the 92nd Congress, and by Congressman Ancher Nelsen (H.R. 3471) and Congressman Edwin B. Forsythe (H.R. 11884).

We urge this Committee to recommend to the Congress the creation of a tax incentive or disincentive which, by discouraging the purchase of non-reusable, or short-lived steel drums, would provide significant environmental benefits.

Industrial Development Bonds

Testimony of Michael D. Bromberg, Esq., Director, National Offices, Federation of American Hospitals

The Federation of American Hospitals is the national trade association representing the nation's approximately 1,100 investor-owned hospitals. All of these facilities were built or acquired with private capital and a substantial number are located in medically underserved areas. These hospitals, providing quality care as efficiently as possible, are frequently the only institutions serving the communities in which they are located.

The testimony which we are submitting as part of these hearings on tax reform is meant to draw your attention to the urgent need to add hospitals to the list of categories exempt from the $5 million limitation on qualified, tax-exempt industrial developmental bonds. The need for such legislation has been recognized by Senator Lloyd Bentsen, who earlier this month introduced S. 3241, a bill designed to provide that exemption. As he noted in his introductory remarks, this bill "is needed to assure an adequate supply of health services in rural and inner-city sections of the United States. Historically, investor-owned hospitals have located in rural areas with inadequate health facilities." We would like to commend the Senator for his efforts and urge your favorable action on his bill.

Health care in the United States is desperately in need of capital financing for facility expansion and modernization. The usual sources are not always open to hospitals. Non-taxable hospitals are presently able to market their own bonds bearing tax exempt interest. At the present time, non-profit hospitals finance over forty percent of all new construction and/or modernization through the use of general revenue bonds. There is no limit on such issues, and last year they financed $4.3 billion in hospital projects.

In contrast, investor-owned hospitals must use industrial revenue bonds which are subject to a $5 million limit per issue. This limit applies to all capital expenditures related to the project which are made during the three years preceding and three years following the issuance of the bonds. The ability to finance construction and modernization projects in large part determines whether or not they will exist. Industrial development bonds figure prominently in underwriting the costs involved, and although the maximum $5 million issue adequately covered these costs in 1968, to build a similar 200 bed facility today would run over $11 million. Put another way, the $5 million limit will permit the construction of an 80 bed hospital at the present time, and generally speaking, such a small physical plant may be uneconomical unless it is a part of the integrated system.

Working from such a base, Congressional efforts to raise the maximum on small issues from $5 million to $10 million still fall short of what the investor-owned hospital industry deems to be necessary.

Since 1968, the Internal Revenue Code has permitted governmental units to issue industrial development bonds in six specified categories which bear tax exempt interest even though the proceeds from the sale of the bonds are turned over to private business. These six categories, which are exempt from the $5 million ceiling because of their public need and high construction cost, are as follows:

(1) Residential real property for family units;

(2) Sports facilities;

(3) Airports, docks, wharfs, mass commuting facilities, parking facilities, or storage or training facilities directly related to any of the foregoing;

(4) Convention or trade show facilities;

(5) Sewage or solid waste disposal facilities or facilities for the local furnishing of electric energy, gas or water; and

(6) Air or water pollution control facilities.

We believe that hospitals should be added to the above exemptions because they too serve a fundamental public need and require a considerable capital investment. As Senator Bentsen noted, "There is no justification to give priority to convention halls and sports facilities as compared to health facilities."

One of the most important reasons for warranting the reclassification of hospitals into the fully exempt status is the development of effective areawide planning authorities, largely through the passage of P.L. 93-641, the Comprehensive Health Planning Law. This law, which requires state certificate of need programs as a condition for receiving federal planning funds, effectively limits future construction of projects to those which serve a real need in the community. As a matter of course, bond underwriters normally require an extensive feasibility study to document the community needs before considering marketing the proposed bonds. Thus, to the extent that there are excessive beds in a geographic area, the expansion of industrial revenue bond financing will not result in the creation of additional beds—unneeded facilities simply will not be constructed due to the planning authorities.

It is the common desire of both Congress and the health care industry to provide high quality care in the most efficient manner possible. An expansion of the tax exempt industrial revenue bond financing mechanisms would contribute directly and immediately to the lowering of hospital costs and charges.

If construction of private hospitals was financed through tax exempt industrial revenue bonds, the savings in annual interest cost would be approximately 30%. The annual savings that would result could be passed along to patients in terms of lower charges.

In brief, we urge the Committee to carefully consider and support Senator Bentsen's measure, S. 3241, because the inclusion of hospitals as an exempt category would:

(1) Attract investment of private capital in needed hospital construction;

(2) Ease the burden on strained federal, state and local budgets for construction of health facilities in underserved areas;

(3) Encourage necessary modernization of existing investor-owned hospitals;

(4) Provide relief for investor-owned hospitals which in 1974 alone paid $46.3 million in property taxes and $125.8 million in state income taxes;

(5) Curb rising hospital costs and charges through general tax relief; and

(6) Provide greater capital resources to meet increasing demand for access to hospital care.

The Department of Health, Education, and Welfare has estimated that several billion dollars will be needed in the next decade to build needed new facilities and replace existing substandard facilities. These projections have not even been adjusted for the impact of national health insurance. In addition, the Senate is currently considering passage of a manpower bill to create the needed medical and paramedical resources which must be available to meet the anticipated increased demands which will be generated under a program of national health insurance. Manpower will be of little value, however, if there are not adequate physical plants.

The replacement of existing, outdated facilities or the construction of new ones in areas that never had a hospital, continues to be the cornerstone of our industry. There are still areas of the country—chiefly rural—where there is a tremendous need for the provision of quality health care. At the present time, there are over 300 communities where the only available hospital facility is investor-owned. There are other communities where as yet *no* hospitals exist. We are seeking to remedy that situation by building new facilities, all of which must meet specific certificate of need criteria. But financing is crucial. Reclassification of hospitals into the fully exempt industrial revenue bond category will go a long way towards meeting these capital needs through the private sector.

We thank you for the opportunity to make our views known, and ask that they be included as part of the official record of these proceedings.

Trade Associations' Income From Trade Shows

STATEMENT OF THE AMERICAN SOCIETY OF ASSOCIATION EXECUTIVES

IRS REGULATIONS ON TRADE ASSOCIATIONS INCOME FROM TRADE SHOWS

This statement is submitted on behalf of the American Society of Association Executives by James P. Low, President and Chief Administrative Officer, ASAE, has submitted separate statements concerning the deductibility of attendance of foreign conventions and advertising in trade association publications. This statement is submitted to urge the Committee to overrule IRS interpretation of the unrelated business income provisions of § 512 of the IRC as it relates to trade show income. The Service position threatens the U.S. Commerce Department's Foreign Buyer Program which was launched in 1974 to encourage foreign buyers to attend trade shows in the United States. Further, the United States stands to lose millions of dollars in export sales and jobs as the result of the Service's position on trade show income.

In many cases, one of the most important functions of a professional society or trade association is the organization and operation of regular shows, where members of a particular industry may display their products and techniques, and where manufacturers and distributors of products used in the industry may display their products. Trade shows are operated in various ways, some of which give rise to income to the organizing association. The Internal Revenue Service considers such income under certain circumstances to be unrelated business taxable income to the sponsoring organization involved.

Recently the Internal Revenue Service issued rulings specifying when income from trade shows would constitute unrelated business taxable income. Those rulings held that if an association enforces "no selling" agreements at its trade show, no particular services would be performed for particular individuals, and no unrelated business taxable income would exist. In other words, where an association or society acts as a policeman and insures that exhibitors do not sell their wares at the trade show, no income will exist. Otherwise, income from the show would constitute unrelated business income of the association or society taxable under the Internal Revenue Code.

The contribution of trade shows (including selling ones) to the exempt functions of the association is undeniable. The purpose of trade shows is to provide members of a particular industry or profession, whether or not members of the sponsoring organization, with a method of displaying industry products and services to the public and to other industries. Often an industry is composed of a great many small to medium-sized producers which are not national in scope. The trade show provides such producers with an opportunity to display their products—new products, improved products, technologi-

cal advances, etc. Other firms in the industry are forced to review their own products with a view to upgrading in order to remain competitive.

Trade shows began in order to fill a void, displaying the products of smaller industry members and assisting them to maintain an awareness of changing industry and government standards. Trade association-sponsored shows do not compete with other organizations but merely foster competition within a particular industry or profession. It provides the little guy an opportunity to display his product side by side with the biggest member of the industry on a product basis without the intervention of national advertising or franchised dealerships. Further, it allows a person to expose his product to potential foreign buyers who, but for the show, would not even be aware of his existence.

In summary, the primary purpose of trade shows is not to make money for the sponsoring association. The purposes are to provide a giant display window to enable the public and potential purchasers to view that industry's products, and at the same time, permit smaller members of that industry to become conversant with the ever-changing government standards for such products. The rulings promulgated by the Service which expose incidental income to tax would make the operation of such shows much less attractive. One wonders what is achieved by such action—a small amount of revenue as compared with the potential overall damage to smaller members of some industries. This is not a situation in which a tax exempt organization is competing with a taxable organization and is using its tax-exempt status as a means to engage in unfair competition. Rather, this is the fostering of completion and the filling of a void. Foreign countries subsidize the organization and operation of trade shows. Why should we penalize U.S. associations and societies in their efforts to compete with foreign producers or professionals? To combat foreign competition, the U.S. Department of Commerce initiated a program of encouraging foreign nationals to attend U.S. trade shows and to buy products at U.S. shows. The "Foreign Buyers" program of the Department of Commerce appears to be in direct conflict with the Treasury Department's recent regulation.

As a result of the IRS action, many U.S. associations are reconsidering plans for future trade shows, especially those to attract foreign buyers who purchase millions of dollars of U.S. products and services which, in turn, result in jobs for many thousands of Americans. For example, the Society of the Plastics Industry, Inc., New York City, has recently cancelled plans with the U.S. Department of Commerce to invite 4,000 foreign buyers to attend its 1976 trade exposition. It seems incredible that one branch of our Federal government is restricting trade show selling while another is encouraging foreign buying at U.S. trade show.

The need to overrule the IRS on this matter is obvious. Section 512(b) of the Internal Revenue Code, which lists income not falling within the definition of unrelated business taxable income of Section 512(a), should be amended to include the income derived from trade shows. ASAE is ready and willing to work with the Committee and the IRS to resolve this important issue.

Advertising in Publications of Tax-Exempt Organizations

Statement of the American Society of Association Executives, James P. Low, President

Advertising in Publications Provided to Members of Tax-Exempt Organizations

This statement is submitted on behalf of the American Society of Association Executives (ASAE) to supplement two separate statements submitted by ASAE. Each of the three issues discussed is sufficiently important to merit individual treatment. Accordingly, ASAE has elected to submit separate statements on each issue.

Most associations, professional societies and other tax-exempt organizations prepare and circulate to their membership a journal, bulletin or magazine. In most instances these publications were created to fill a void resulting from the absence of any other publication. These publications contain articles, announcements, and other information related to the association's activities. In many cases, these association publications may also contain commercial advertising related to the association's functions and its membership's particular interests. Associations accept this advertising in their publication because it is helpful and informative to their members. The revenues from advertising also defray a part, or sometimes all, of the editorial and circulation costs of the publication. Associations and other non-profit organizations do not pay federal taxes on their dues. However, if in addition to their exempt activity the association is engaged in an "unrelated business activity", it must pay income tax on such "unrelated business taxable income."

Under an amendment to the Internal Revenue Code enacted in 1969, *net* advertising income of an association is taxed as "unrelated business income."

The Treasury recently published "advertising" regulations that treat all or part of the *membership dues* of *all* associations as subscription fees allocable to association publications, whether or not any part of the membership dues is properly allocable to the magazine. In the typical case, members are not assessed a subscription fee since no part of membership dues properly can be allocated to the publication subscription price.

The Treasury regulations will result in non-profit associations, professional societies, and other tax-exempt organizations either: (i) paying taxes which divert money from their activities which the Congress has already determined to be worthy of tax exemption; or (ii) reorganizing their publications into separate taxable corporations in order to be treated no worse than an ordinary commercial enterprise that charges no subscription price and is taxable only on advertising income in excess of editorial and circulation costs. Either of these results will cause disruption and distortion of the legitimate and intended functions of these tax-exempt organizations without any increase in revenue to the Treasury.

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Attached to this statement as an Appendix is a more detailed and technical discussion of this issue and a proposed legislative solution. Under our proposed legislation, most associations properly would be freed of the obligation to allocate membership dues to its publications since association publications are merely incidental to the association's primary functions. In cases where publication of the magazine is the major function, a portion of membership dues would be allocated. In those instances where the association performs no other significant service for its membership—apparently the abuse to which Treasury's regulations were really directed—all, or nearly all, "dues" received would properly be allocated to the subscription fee.

Our proposal is consistent with the underlying premise of present law. Treasury's regulations, however, erroneously require every association to allocate dues (even though publication of the magazine is a minor and incidental part of total activities) and impose arbitrary rules which in many cases result in allocation of an amount of dues far in excess of what reasonably could be charged for the magazine. We strongly urge the Committee to consider our legislative proposal as a reasonable and equitable solution to tax treatment of advertising income. We would be happy to provide the Committee with any additional information which it may require on this matter or to explain our legislative proposal in more detail.

Appendix

Proposed amendment to section 512 of the Internal Revenue Code relating to advertising in publications of tax-exempt organizations

Proper application of the "unrelated business tax" provisions of sections 512 and 513 of the Code would treat the publication of a magazine by an association entirely separately from the general activities of the association and would tax advertising income only to the extent it exceeded editorial and circulation costs. This would be entirely appropriate for 99 percent of all tax-exempt organizations in which the publication is merely incidental to the organization's other traditional tax-exempt activities.

The Treasury regulations artificially fragment the functions of tax-exempt organizations and require allocation of membership receipts to publication activities without allowing corresponding deductions for the expenses of membership maintenance. Though it could be argued that such expenses would be difficult to allocate with an accuracy, this difficulty merely illustrates the problems of making such allocations at all—either with respect to receipts or expenses. The publication of an association magazine is an activity which stands on its own. Where the activity is carried on at a loss it may be subsidized by the association's general treasury. Except in extreme cases referred to below, no specific membership receipts reasonably can be allocated to the activity.

It is, however, recognized that in a very few cases (out of the many thousands of associations and other tax-exempt organizations), the Treasury may have a legitimate concern that the organization is pri-

marily or wholly engaged in the publication of a magazine in a commercial sense and that the so-called membership "dues" in those cases are in fact a subscription price paid solely for the magazine. In these instances, the organization has no other significant activity and the "members" have no reason for joining and paying dues other than to receive the magazine. We believe that it was a concern with such isolated cases which motivated the Treasury to issue the regulations in question. This narrow problem does not justify the recently published regulations which penalize and disrupt ordinary trade association and other tax-exempt organization activities.

PROPOSED LEGISLATIVE SOLUTION

Present law provides ample authority for the Treasury to make the needed distinction between the ordinary trade association and the isolated abuse cases with which it is concerned. Since 1967, taxpayers have worked with the Treasury to provide a satisfactory solution, but to no avail. Regulations were proposed in 1971, but were so fraught with problems that no final action was taken. Taxpayers assumed that after four years the Treasury had recognized the impossibility of achieving a fair and equitable result through allocating membership dues to subscription price as had been proposed. But, without further notice, on December 18, 1975, Treasury published final regulations which not only repeated the technical deficiencies of the proposed regulations, but made matters worse by imposing an even more disruptive and totally arbitrary rule for allocating membership dues to subscription price.

Thus, a legislative solution is necessary to eliminate any concern of the Treasury about its authority to provide some other and reasonable solution under present law and to deal with the few abuse cases which are the sole cause for concern.

The proposed statement to the Internal Revenue Code would provide as follows:

1. Associations and other tax-exempt organizations would be subject to unrelated business income tax only on *net* advertising income.

2. No amount of membership dues would be allocated to subscription price unless editorial and circulation costs of the magazine exceeded 50 percent of the organization's total annual expenditures for all purposes.

3. If such costs exceeded 50 percent, the maximum amount of membership dues allocable to subscription price would be as follows:

Editorial and circular cost as percentage of total expenditures:	*Maximum allocable membership dues (percent)*
50 or less	0
60	20
70	40
80	60
90	80
100	100

4. If a lesser allocation can be justified by reference to the subscription price charged to nonmembers or to other facts and circumstances, that lesser allocation would prevail.

Estate and Gift Taxes

APRIL 23, 1976.

STATEMENT ON ESTATE TAX SUBMITTED BY SENATOR JAMES B. PEARSON

Mr. Chairman, I am pleased to have this opportunity to submit a statement on Federal estate tax revision to the Senate Committee on Finance. The present specific exemption of $60,000 has been in effect since 1942; the last major reform in this area was the 50-percent marital deduction which was added in 1948. During the intervening years, inflation has dramatically increased property values. A thorough reexamination of estate law is long overdue.

Family farms and business enterprises play an integral role in our economy. Today their future is endangered by our Federal estate tax law which forces some families to sell part of the family enterprise in order to pay estate taxes. Over several generations, these family enterprises can be reduced to a size that is no longer economically viable as a result of efforts to comply with Federal estate tax laws.

In 1963, Brown University studied a sample of small farms that had merged, or were sold, from 1955–59. This survey found that estate taxes were a contributing factor in three out of five cases studied. During the past 13 years, inflation has magnified this problem even more. For example, from 1962 to 1972, the average value of farm production assets rose from $47,500 to $102,100.

According to the Department of Agriculture, in 1970 real estate and machinery constituted 78 percent of all farm assets in the United States. This creates substantial liquidity problems as many farms already have outstanding debts even before estate tax burdens arise. These liquidity problems are further accentuated because of the low-profit margin of small farms and the difficulty of small businesses in obtaining bank loans. The relatively high risk nature of small businesses forces heavy reliance upon internal financial sources to provide capital for expansion thereby decreasing liquidity.

Although the Congress recognized a liquidity problem when it enacted section 6166 of the code, which permits the Secretary of the Treasury to extend the time for payment of estate tax where the estate consists largely of interest in closely held businesses, this relief does not go far enough. Even when the estate tax burden is spread over several years, liquidity problems can still cause insurmountable hardship. Moreover, section 6165 of the code mitigates against the use of the installment payment privilege by providing that the Secretary of the Treasury may require the taxpayer to furnish a bond in order to be granted an extension of time to pay a deficiency.

In an effort to preserve family enterprises, I have introduced a bill that would increase the specific exemption to $120,000, provide that a spouses services, as well as monetary contributions, shall be treated as consideration for purposes of determining the value of the decedent's

estate, allow a $130,000 deduction with respect to certain family farms and small business interests passed to a related individual, and authorized automatic increases in the estate tax exemption and family enterprise deduction to reflect rises in the cost of living.

The existing estate tax exemption has not changed since 1942. During this 33-year period, the efficacy of the specific exemption has been eroded by inflation to the point that it is now grossly inadequate. To remedy this problem, I propose to double the current exemption to $120,000. This increase would serve to restore the original intent of the law.

Increasing the estate tax exemption to $120,000 will help preserve small farms and businesses, but more is needed. Therefore, I propose that an additional exemption of $130,000 should also be provided. This provision, in addition to the specific exemption of $120,000, would further enable family farms and businesses to remain in the family if the estate passes to a related individual. By doubling the specific exemption to $120,000, all estates would be benefited. However, since estate taxes have the most adverse effect upon family farms, the additional $130,000 deduction is essential. Thus, family farms and businesses up to $250,000 could pass to a related individual without a crippling estate tax burden.

This additonal exemption is designed to insure that its benefits are directed only to those who are in need of special relief. Also, in order to prevent abuse, the decendent would be required to have owned the farm for at least 5 years and have exercised substantial management and control over the farm before he died. Those who inherit would also have to exercise substantial management and control over the enterprise for a period of 5 years in order to take advantage of the deduction.

I also propose that section 2040 of the code be amended in order to provide that services performed by a spouse shall be treated as consideration. Under present law, the entire value of property owned in joint tenancy or tenancy by the entirety is generally included in a decedent's gross estate for estate tax purposes except for the part of the value as is shown to be attributable to the amount of consideration in money or money's worth furnished by the surviving joint owner. This rule is known as the consideration-contributed test. Thus, if the decedent furnished the entire purchase price for property held in joint tenancy, the entire value of the property is included in his gross estate. If it can be shown that the decendent furnished only part of the purchase price, only a corresponding portion of the value of the property is included in his gross estate.

Controversies have arisen under present law with respect to the treatment of services performed by a surviving spouse as consideration for purposes of this provision. Typically, these controversies usually involve cases where a husband and wife have jointly operated and managed a farm, grocery store, or other small business. Some courts have recognized the performance of services by the surviving spouse as consideration for purposes of determining the portion of jointly owned property includable in the decedent's gross estate. For example, in *Estate of Otte*, 31 CCH Tax Ct. Mem. 301 (1972), the Tax Court held that services performed by a surviving wife in connection

with the operation of a farm constituted consideration in money or money's worth in determining that only a portion of the value of the farm was includable in the decendent's gross estate.

My bill would make it clear that services performed by a surviving spouse in connection with a trade or business are to be taken into account as consideration furnished for jointly owned property.

I also propose that the $120,000 exemption and the $130,000 deduction be automatically adjusted each year in order to provide permanent protection against future inflation. This would be done by adjusting the $120,000 exemption each year by reference to the Consumer Price Index and by annually adjusting the $130,000 deduction in relation to the gross national product deflator.

Although Federal gift taxes enable the transfer of many estates tax free prior to death, this alternative is not available to farm owners whose assets are primarily composed of land, building, and machinery, Federal gift tax rates are equal to three-fourths of the estate tax rates and are designed to encourage lifetime giving by providing an outright lifetime exemption of $30,000 in addition to annual exclusions of $3,000 per donee. While this enables small estates composed of liquid assets to be transferred to the next generation through gifts, farm owners and businesses are denied this relief.

A tax preference is needed in order to assure the survival of family farms and businesses. Estate tax revision should properly encompass this reform by providing for incentives to business. These incentives, however, must be targeted to meet a particular need in order to prevent unnecessary revenue loss. Increasing the specific exemption to $200,000 would extend far beyond those owning farms and small businesses. The Treasury estimates that this proposal would cost approximately $2 billion with much of this revenue loss going to large estates.

My proposal would cost $1.7 billion in total and would be targeted to meet the specific problem of passing family farms and businesses from generation to generation. The Treasury estimates that increasing the specific exemption to $120,000 would cost $1.3 billion, the $130,000 exemption would cost $300 million, and the spouses services provisions would cost approximately $100 million.

It has never been the intent of the estate tax law to force the sale of small farms and businesses. To the extent that it does, changes must be made. Congress must provide targeted relief. While some will argue that revenue loss cannot be afforded, it must be borne in mind that family farms and businesses that are sold to pay estate taxes are often purchased by corporations that, because of their perpetual life, will never pay estate taxes.

Some contend that by providing special relief we are interfering with competition and protecting inefficiency. However, the question is not one of efficiency or competition but a question of liquidity as family enterprises face the burden of heavy estate taxes twice each generation. For those who still insist that we cannot afford the fiscal impact, I counter that it is the social cost of losing the family enterprise stratum of our society that we cannot afford.

The thrust of my bill is to preserve family farms and businesses. It would provide for four changes in our Federal estate tax law. In doing this, it would put estate tax law on a more equitable basis, encourage

the perpetuation of an important social and economic goal, and provide necessary safeguards in order to prevent abuse of these provisions.

Mr. Chairman, I urge that the committee make every effort to report on estate tax reform as expediently as possible.

STATEMENT OF ROBERT D. PARTRIDGE, EXECUTIVE VICE PRESIDENT, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION, ON FEDERAL ESTATE AND GIFT TAXES

Mr. Chairman and members of the committee, my name is Robert D. Partridge. I am the general manager and executive vice president of the National Rural Electric Cooperative Association (NRECA). NRECA is the national service organization of approximately 1,000 nonprofit rural electric cooperatives which provide central station electricity to nearly 25 million farm and rural people in approximately 2,600 of the Nation's 3,141 counties and county-type areas of 46 States.

We appreciate the opportunity to submit this statement on the proposals pending before this committee to update and reform the estate tax laws.

During the months of September and October of 1975, as in previous years, members of our rural electric systems met on a regional basis to discuss rural electric-related legislative matters, as well as other subjects of interests to rural people. At a number of these regional meetings last year, the membership endorsed by resolution changes in the present estate tax laws.

Then in February 1976 over 11,000 members of America's rural electrics gathered for our 1976 annual meeting, at which the voting delegates passed unanimously the following resolution:

ESTATE TAX EXEMPTION

The preservation of agricultural land should be of vital concern to all people, both to insure an adequate supply of food and to maintain open space near heavily populated areas. The present Internal Revenue Service policy of appraising farm property at its highest sale value often forces its sale for a nonfarm use in order to provide funds for payment of estate taxes.

We therefore recommend that the exemption from the Federal estate tax should be increased from $60,000 to $300,000 or more in recognition of the economic changes which have occurred since the present exemptions were provided and that gift taxes should be comparably adjusted. It is further recommended that the period in which transfers of property are held to be in contemplation of death be reduced to 1 year.

Mr. Chairman, the reasons for changing the estate tax laws are numerous and of vital concern to rural Americans who produce the food and fiber for those living elsewhere. I don't think that anyone would suggest that the farmer's life has not been extremely difficult with the material rewards for his labor falling behind those who have chosen other areas of endeavor. The investment required in an operating farm today in staggering, especially in view of the limited liquid returns. There is no better testimony to this fact than the flight from the farms which has occurred over the last half century.

The cornerstone of the world's most successful agricultural operations has been the family farm of America. The term "family farm"

itself suggests that it is not an operation by the head of the household alone, but an operation involving the entire family who frequently work long hours to build what later becomes an estate. Increasing the estate tax exemption, the marital deduction, and the amount that may be given during one's lifetime would not be a special interest reward to the family farmer, but merely a long overdue recognition of those contributions made by the entire family to the estate.

As I indicated, there are numerous other reasons for changing these laws, many very ably pointed out by others testifying during these hearings. Among these reasons, inflation is certainly one of the most significant; that factor alone is sufficient reason for raising the $60,000 present exemption established in 1942 to something in excess of $200,000. Those who indicate that the present laws have many loopholes which encourage disposing of an estate or part of the estate prior to death are not recognizing the uniqueness of the farming operation, which generally should be enlarged in order to produce a living income and most certainly should not be fragmented. And of what use is the $3,000 annual gift to such an operation? Most equipment costs in excess of this figure and the legal fees and trouble involved in carving out $3,000 worth of property from an operation each year is most impractical.

Let me add that a great deal of the increased value of farmland is attributable to competition from other sources for that land, whether it be the comparatively wealthier urbanite who wants a hobby farm for weekends, or the commercial and vacation home developer. Accordingly, I would at least recommend that land used for farming, woodland or scenic open space be assessed for estate tax purposes on the basis of its current use rather than its higher potential uses.

Finally, I wish to state that while our testimony deals with the problems encountered by the family farmer only, I am in no way indicating that persons who leave other types of estates have not encountered similar problems. I have addressed myself to the problems of the family farmer because our constituency is primarily rural and our resolution deals only with their particular problems.

Mr. Chairman, of all the proposals that we have reviewed before your committee, we feel that those recommended by S. 1173 and several identical bills most nearly reflect the views of our members.

STATEMENT OF CHARLES M. FARMER, ASSOCIATE PROFESSOR, AGRICULTURAL ECONOMICS, UNIVERSITY OF TENNESSEE

SOME COMMENTS RELATING TO ADJUSTMENT OF ESTATE TAX LEGISLATION

Contention.—The present estate tax exemption of $60,000 is unfair to farm families.

In Support of Stated Contention.—

1. *The recent trends in agriculture toward larger farms has amplified the inequities of the present exemption level.*—Due to the very competitive nature of American agriculture, farmers have been forced to increase the size of their farm operations. This trend, along with

rapidly increasing land values has made more and more estates subject to death taxes. For example, the number of Federal estate tax returns filed has increased from 17,000 in 1940 to 175,000 in 1973.

2. *If the $60,000 exemption was equitable in 1942, it is grossly unfair today.*—In 1942, the average acre of farmland in Tennessee had a value of $40. This meant that 1,500 acres of land, excluding livestock and machinery, et cetera, were needed to trigger the $60,000 exemption. In 1975, average land value in Tennessee was 13 or 14 times the 1942 level—some $516 per acre. This meant that 116 acres of land in 1975 had a value equal to the exemption level. Hardly anyone would consider this an excessive concentration of land. In fact, if livestock, machinery and equipment are included at average prices and inventory rates, a farm operation of about 80 acres would be large enough to reach the exemption level. Remember that the average farm size in Tennessee at 123 acres is 50 percent larger than the size of operation which would reach the exemption level. The average rate of return on farm investment capital is no more than 2 to 3 percent annually.

3. *Many farmers are essentially operating a small business which has a high market value.*—The average net return per acre of farmland in Tennessee for the 1972–74 period was about $20. This means that the average farm in Tennessee, 123 acres, produced a net farm income of about $2,460, barely $200 a month. Yet this farm operator had an investment of $80,000 to $85,000. A farm large enough to produce annual net farm income of $10,000 would have a value of $400,000 to $500,000. The death tax on an operation of this size would be quite substantial.

4. *The current exemption works a hardship on heirs.*—Technically, the estate tax is levied on the estate itself. In many actual situations, however, the heir or heirs must draw on other money sources, sell some of the farmland, or incur indebtedness to pay the estate tax.

FARMS IN TENNESSEE: NUMBER, AVERAGE SIZE, AND AVERAGE VALUE

Year	Number of farms (thousands)	Average size (acres)	Average value per acre	Year	Number of farms (thousands)	Average size (acres)	Average value per acre
1941		73	$37	1967	135	116	213
1942		73	40	1968	132	118	230
1960	169	99	132	1969	130	119	252
1961	163	102	137	1970	129	120	268
1962	157	104	146	1971	127	121	279
1963	152	107	157	1972	126	122	311
1964	147	110	167	1973	125	123	363
1965	142	112	179	1974	125	123	449
1966	138	114	197	1975	125	123	516

Some Questions and Answers Regarding Estate Taxes

Question. When did the estate tax become a part of the Federal revenue system and what are the present rates and exemptions?

Answer. The estate tax became a permanent part of the Federal system in 1916, although it had been used as an emergency measure prior to that year. The present exemption of $60,000 has been in effect since 1942, and the present rate scale of 3 percent graduating up to 77 percent was adopted in 1941.

Question. It is my understanding that both the Federal estate and gift tax amount to only about 2 percent of the total Federal tax receipt. How, then, do we justify the considerable current interest in what, from the standpoint of yield, seems to be a minor tax?

Answer. First, the number of estate tax returns filed has increased from 17,000 in 1940 to 175,000 in 1973. And thanks to inflation, estate taxes are taking a considerable bite out of those estates subject to the tax.

Second, although Federal tax on wealth transfers are only a small fraction of total tax receipts and occur by death only once in each generation, estate taxes do not present complex legal, economic and social problems. Present laws produce complexities in estate planning, encourage disposition of assets contrary to the best interest of the taxpayers, beneficiaries, and the economy and work inequities among taxpayers.

Furthermore, most farmers either are not aware of the laws or they simply are not in position to take advantage of them because they cannot jeopardize their current minimum earning capacity. These reasons are particularly applicable to recent trends in agriculture. In order to make a living, farmers have had to increase the size of their business and rapid appreciation in the value of farm assets has made many more estates subject to death taxes than ever before. Farmers ordinarily have little ready cash. Therefore, heirs frequently must borrow heavily in order to pay estate taxes to keep the farm operationally solvent.

Question. I understand that there are at least three main purposes for Federal estate taxes: (1) To produce revenue, (2) To prevent excessive concentration of wealth, and possibly (3) To direct the future course of society.

Is this basically true and if so how well does the Federal estate tax system serve these purposes?

Answer. No doubt estate taxes do these things. But, I question if the present structure serves the best interest of all concerned. I believe data will show there is excessive destruction of concentrated wealth. Many families remain in agriculture, realizing that the only way to leave any material goods to their heirs is through bequeathing to them a share of the farm. This is true because they ordinarily need income from the farm for family living. And because it is so difficult to accumulate other wealth. However, estate taxes are placing an ever-increasing burden on the family of the deceased. Many times a part of the farm must be sold to pay estate taxes.

Data show that the present $60,000 exemption is too severe, actually forcing excessive destruction of farm estates. This may retard progress toward aggregation of land into more productive, economical units—contrary to the interests of farm people and of our society.

Question. Today, inflation has reduced the purchasing power of the dollar by more than 65 percent of what it was when the present tax exemptions were established. With the inflationary spiral we have witnessed since 1940, would some system of adjusting the value of estate tax exemptions for inflation be appropriate for the future?

Answer. I believe it would. A periodic review would seem to be in order. Using a price deflator to adjust for inflation, the $60,000 personal estate tax exemption authorized in 1942 is worth only $18,000

in 1975, in terms of 1942 dollars. To establish the exemption at a level equal in real terms to $60,000 in 1942 would require that the exemption level be raised to approximately $200,000.

Such action would help promote the family farm; for $200,000 today will purchase only about 385 acres of land. It would still take another $100,000 for machinery and specialized equipment and approximately another $100,000 for operating capital. Thus, around $400,000 is needed to yield incomes barely up to the average for the nonfarm families.

Question. Give us an example of the direct impact of Federal estate taxes on the heir to the property of a deceased farm operator who had been making his livelihood entirely from farming.

Answer. In order to do that, let's assume we have a farm of about 300 acres with the land valued at $600 per acre including the home and buildings or $180,000. With $70,000 worth of equipment and machinery this would bring the estate to a value of $250,000. Assume further that the farmer has just enough cash to cover all outstanding debts and expenses.

Also assume that upon death only one heir—not his wife—is involved. In this case, the tax obligation would amount to $47,700 or almost one-fifth of the original estate. The heir would still be liable for additional estate and inheritance taxes to the State.

Obviously, the tax liability creates a financial burden for heirs although technically the estate tax is levied on the estate itself. The heir must draw on other money sources, sell some land or incur indebtedness to pay the tax.

And still, in our example, this is a small business in terms of the amount of annual income it generates.

Death taxes may have a large total potential impact upon farm than nonfarm estates because more of them are operated as proprietorships or partnerships. Furthermore, few farmers take advantage of legal estate management tools compared to other types of business.

STATEMENT OF DON WOODWARD, PRESIDENT, NATIONAL ASSOCIATION OF WHEAT GROWERS, ON BEHALF OF THE AD HOC AGRICULTURAL TAX COMMITTEE

Mr. Chairman and members of the committee. The following comments are presented not only on behalf of the National Association of Wheat Growers, but also on behalf of an Ad Hoc Agricultural Tax Committee. This committee includes the American Horse Council, Inc., American National Cattlemen's Association, American Seed Trade Association, American Sugar Cane League, Cotton Warehouse Association, Florida Sugar Cane League, National Association of Wheat Growers, National Cotton Council of America, National Milk Producers Federation, National Wool Growers Association, and the Rio Grande Valley Sugar Cane Growers Cooperative.

In this regard, I should mention that some of the members of the ad hoc committee are also presenting their views individually to emphasize the most important areas of concern to their particular segment of the farm community.

The committee is to be commended for calling these hearings to review the estate tax laws. Such a review, particularly as it relates to estates in which the principal assets are a family type farm and the personal property needed for its operation, is, in our opinion, long overdue. It is probably not an overstatement to say that estate tax reform for family farms is one of the most important of all farm issues now pending before Congress.

Two primary factors have contributed to the need for updating the estate tax laws for agricultural estates—inflation and increasing farm size. Along with increased farm size has come an improved technology in which specialized equipment is being substituted for farm labor.

The inflationary spiral, common to all of us, seems to have impacted more on agricultural than on the general economy. Since 1942, when the present $60,000 exemption was established for estates, farm real estate values have gone up some 1,000 percent. Values today are three times higher than they were in 1960.

Compound this increase in value by the fact that farm size on the average has more than doubled since 1942 and we find an entirely different situation today than we had in 1942 or even in 1960.

Based on U.S. Department of Agriculture figures the average farm in 1942 had 182 acres and its value, including buildings was $6,100. There are no records of the average value invested in farm equipment and other personal property at that time, but even when the value of personal property is added to the real estate value, the total was far below the $60,000 estate tax exemption. It is our conclusion that a farm had to be five or six times larger than the average farm in 1942 before it even began to pay an estate tax.

The 1975 situation is far different. The average farm now has 385 acres and, with buildings, is worth about $131,000.

Because of the great variety of farming in the United States, and within the group presenting this statement, it is difficult to place an average figure on farm equipment and other personal property. However, we do know that every type of agriculture today has costly highly specialized equipment, whether it be a tractor, a combine, a mechanical cotton harvester, self-propelled picker-sheller used in harvesting corn or a stainless steel pipeline milker and storage tank on the dairy farm. In the case of livestock farms, large sums are invested in breeding animals and other livestock. In view of this, we believe it reasonable to project that the investment in farm personal property is equal to that invested in real estate.

For the average farm cited above this means another $131,000 or a total farm investment of $262,000. Subtract the $60,000 estate tax exemption and there is a taxable estate, in round figures, of $200,000.

The estate tax on such an estate is $50,700 on a direct inheritance. In the case of a surviving spouse, who in most instances has been directly involved in operating the farm along with her husband there is a tax of about $9,000.

It is the impact of these levies which we find alarming. The income potential of farming operations does not have within it a tolerance which can pick up a $50,000 estate tax bill. And if the property is valued at other than agricultural values the tax burden becomes even greater.

Unless some changes are made in the method of dealing with the estate tax law as it now applies to family farms especially since technology requires increasingly large amounts of capital investment, we will continue to witness a trend which could ultimately bring about the demise of the family farm structure as we now know it.

There is an alternative to family farming, but it is one we do not like and we believe the Congress will like no better. It is total corporate farming financed solely by outside capital. We do not believe the Congress prefers this type of farm ownership to the present family farm structure. Yet unless action is taken this will most likely occur.

Fortunately, many members of Congress, as well as the President have come to recognize the problem. President Ford expressed concern about the situation in his state of the Union message and advanced one type of relief. We fully concur with this statement to the American Farm Bureau Federation Convention in St. Louis early this year when he said: "The continuity of our farm families is vital. I want this continuity preserved, so farms can be handed down generation to generation, without the forced liquidation of family enterprises."

The legislative branch of Government has shown an equal interest. Numerous bills have been introduced in the Senate to adjust the estate tax laws to maintain the family farm.

In the House the record is even more impressive. A check of the January 14, 1976, legislative calendar of your Ways and Means Committee shows three different categories under "Estate Taxes" which deal with "family farms", "rural property" or "real property which is farmland, woodland, et cetera." We are pleased to note that under those three headings there are 69 bills which have been introduced by 206 authors from 46 States. Since then more bills have been introduced on these subjects. These are bills directed specifically toward farming and the list does not include bills dealing with an increase in the basic exemption or the marital deduction—proposals which we also endorse but which we have not listed because they cover more than agriculture or rural areas.

Proposed Estate Tax Relief Measures

Most of the numerous estate tax proposals which I have mentioned call for one or more of the following changes to the estate tax law: (1) valuation of farmland and certain other lands on the basis of the "use" of the land rather than on the basis of "fair market value," (2) an increase in the $60,000 estate tax exemption to some higher amount, (3) an increase in the 50 percent marital deduction, and (4) a 5-year deferral of estate tax liability attributable to family farms and small businesses followed by a 20-year installment payment period at a 4 percent interest rate. This last proposal is the one offered by the President in his state of the Union address.

The various estate tax relief measures being proposed are not mutually exclusive and there is something to be said about the merits of each one. In view of this, we would hope that the committee will adopt a combination of these proposed changes. However, because our time is limited today, the emphasis of my remarks will be directed toward those proposals dealing directly with relief for family farms.

Valuation of Farmland on Use Rather Than Fair Market Value

If there is one measure which has almost universal support within the farm community it is the proposal to allow farmland to be valued on the basis of its use for farming purposes rather than valuation on the basis of fair market value. This is a type of relief proposed by Mr. Burleson's legislation, H.R. 1793 and other identical bills, which at last count has 63 cosponsors. Under the Burleson bill, land must continue to be held and used by the estate beneficiaries as farmland for at least 5 years following the death of the decedent in order to qualify.

The law now requires that property held at death, including farmland, must be included in the estate at fair market value. A large estate tax liability resulting from the valuation of farmland on the basis of its fair market value has caused in the past and continues to cause severe financial problems for the surviving members of a family. These people are forced to sell all or part of the land in order to meet the estate tax bill, or they are forced to abandon the use of the land for farming purposes and convert it to nonagricultural uses.

In determining fair market value under the present law, a variety of factors are required to be considered including the highest and best use of the property, sales of nearby or similar land, the location of the land, the size of the land, and other similar facts and circumstances. This means that farmland situated near urban areas may be valued on the basis of its use as a residential development or maybe on its use as an industrial park. This value can be many times greater than the value of the land when used for farming since the rate of return on farmland and other farm assets is generally much lower than in the case of other business uses.

By limiting the factors to be used in the valuation of farmland held by an estate to the use of the land for farming purposes, this clearly eliminates inflated values due to urban development or due to valuation on the basis of a more profitable use of the land.

It is noteworthy that 31 States already have laws allowing property tax valuations of farmland to be made on the basis of use of the land.

Mr. Chairman, for the reasons I have discussed, we strongly urge the committee to adopt a provision to allow alternative valuation of farmland based on its use for farming. In this regard, it is probably worth pointing out that the alternative valuation proposal involves a smaller drain on the Federal Treasury than the other estate tax proposals. According to Treasury Department estimates released by the Library of Congress, valuation of farmland based on use would only reduce estate tax collection by about $20 million based on 1974 levels.[1]

Increase the $60,000 Exemption

Next, let me turn to the proposal to increase the current $60,000 estate tax exemption to some higher amount. Most sponsors have suggested a rise to $200,000 in order to fully take into account the rate of inflation since the $60,000 exemption was enacted. Our organization has recommended a $300,000 exemption. The President on the other hand recently called for an increase to $150,000 to be phased-in over

[1] "Analysis of Estate and Gift Tax Proposals Introduced in the Senate in 1975," Congressional Record, Jan. 23, 1976, p. S435.

a 5-year period. Regardless of the figure, some substantial increase in the present exemption is clearly warranted. Because updating the exemption is long overdue, we favor adjusting it immediately rather than phasing it in over a period of years.

I say this from the farmer's point of view because, as mentioned earlier, the amount of capital invested by the average farm in such things as farm equipment, livestock, and other assets necessary for farming has risen dramatically over recent years. The proposal to value farmland on the basis of farm use does not provide any estate tax relief for the substantially higher value of farm property other than land. And, we believe this problem should also be dealt with. If farm equipment or other essential assets have to be sold to pay estate taxes, the effect is the same as having to sell or convert the farmland itself.

If the committee finds that from a budgetary standpoint it is not possible to increase the exemption across the board by an amount large enough to solve the problem caused by the higher values of farm equipment and other nonreal property, there is another way to treat the problem. This alternative would allow an additional exemption for the first $200,000 of the value of a family farm. This is an exemption in addition to the basic $60,000 exemption. If the committee raises the $60,000 exemption for all taxpayers, the additional $200,000 exemption for family farms could be lowered accordingly. As you are no doubt aware, the Senate in 1974 adopted an additional $200,000 exemption for family farms, but no action was taken on the measure in the House.

Before turning to the next proposal, let me make it clear that we are suggesting an increase in the exemption in addition to valuation of farmland based on use—not in lieu of this latter proposal.

Five-Year Deferral Followed by 20-Year Installment Payment of Estate Taxes

Next, I would like to briefly comment on the President's proposal to allow a 5-year moratorium on estate tax liability attributable to family farms or small businesses followed by a 20-year installment payment period at an interest rate of 4 percent rather than the current 7 percent rate. As with other proposals, this would be quite helpful to many farmers. However, we do not believe standing alone it provides sufficient relief. Consequently, it necessarily must be coupled with some or all of the other proposals. In addition, there are some technical problems with the proposal which we will be happy to discuss with the committee staff.

Increases the 50-Percent Marital Deduction

Others will no doubt discuss in great detail an increase in the 50-percent marital deduction. For that reason, I will limit my comments by stating that such an increase would obviously be helpful to everyone — farmers included — from at least two standpoints. It could eliminate estate taxes on the farm property left the surviving spouse and could also eliminate the complicated and often expensive estate planning now required to minimize taxes on the estate of the first spouse to die.

Capital Gains Tax on Property Held at Death

Finally, we want the committee record to clearly show that our group opposes a capital gains tax on appreciated property held at death. The effect of imposing such a tax would be to recreate most, if not all, of the estate tax problems which you are so diligently trying to solve through the various constructive provisions being considered. In the case of farmers, the farmland held at death has often appreciated greatly over the cost when originally purchased or when inherited. A large capital gains tax on this appreciation would again force the sale of the land in order to meet the tax liability.

In closing, I would like the committee to know that by commenting on the problems of farmers, we do not mean to imply there are not many other citizens who encounter serious problems because of the present estate tax law. We realize that you must deal with the problems of the farmer within the context of small business owners and other taxpayers, and also within budgetary restrictions. Nonetheless, within this context, we hope that the committee understands the plight of the farmer when considering estate tax changes. We urge you to adopt relief provisions along the lines suggested.

Thank you again for allowing me to present our views.

Statement of the Interreligious Taskforce on U.S. Food Policy

Reform in the Estate and Gift Tax Law

The Taskforce welcomes this opportunity to submit a statement for the consideration of the committee.

The Taskforce is a team of Washington-based staff of over 20 Protestant denominations and national Roman Catholic, Jewish, and ecumenical agencies. In each of our organizations, as well as in many other national religious bodies not related to our Taskforce, hunger at home and abroad has become a major concern and programmatic priority. New programs to deal with this problem have been developed and new funds contributed. There is widespread recognition in the religious community that public policy has played a key role in aggravating the problem of hunger and that it can play a key role in solving the problem. Thus it is commonly held that one of the primary religious duties of members of the community of faith is to address public policy issues.

The particular function of the Taskforce is to facilitate the witness of the American religious community for a responsible U.S. food policy. We are seeking to do this by clarifying moral issues in U.S. food policy by providing reliable information about policy and policy options, by identifying policies and policy objectives which in our judgment serve the cause of justice, and by recommending ways in which concerned members of the religious community can most effectively make their witness in the political arena.

The Taskforce speaks for itself only, and not for the almost two dozen national religious bodies cooperating in its work. The Taskforce speaks to those bodies, to the larger religious community, to the gen-

eral public, and, on occasion, to units of the U.S. Government such as this committee.

The grounds for our advocacy of revisions in the law

The Taskforce, whose primary concern is for justice in the production and distribution of food, is advocating revisions in the current law regarding estate and gift taxes for four reasons.

First, we are committed to the survival of the family farm. We believe that family farming as a means of producing food for the hungry at home and abroad is a precious way of life which should be continued. Some people boast of the way in which America's energy-intensive agriculture, especially in its technological forms introduced by agribusiness corporations, is making it possible for fewer and fewer people to grow more and more food. We believe that the transition of recent decades toward fewer family farms and more agribusiness operations is a mixed blessing which should not go unchallenged. Family farming is not only a rich part of our national heritage; it is also inherently more respectful of our fragile and precious farming land than is the care given by many of the large corporations.

Second, we believe that justice demands that our Nation give the family owned and operated farm a fair chance to survive as a viable social and economic unit of our society. The current structure of our estate and gift taxes, when combined with other economic factors such as the escalating cost of land and other farm inputs, unfairly stacks the deck against the individual farmer who wishes to keep his or her farm in the family.

Third, the current situation is contrary to the intent that Congress demonstrated in its most recent revision of the estate tax structure 34 years ago in 1942. Two goals of the 1942 revisions were to protect the family farmer and to break up excessive concentrations of wealth in agriculture by taxing those farmers with large landholdings. In 1942, $60,000 represented a fairly large farm estate. Hence, estates under that amount were exempt from estate taxes; only those at or over that amount were taxed. However, even though the asset value of the average American farm was only $50,000 as late as 1960, in recent years the cost of land and farm inputs has skyrocketed to the point that by 1974 the value of the average American farm was $170,000.

This combination of old law and new prices has worked considerable hardship on family farmers. An increasing number of family farmers, for example, have been required to file estate tax returns. In 1942 only 17,000 estate tax returns (farm and nonfarm) were filed, approximately 1 for every 60 deaths. In 1972 175,000 such returns were required, 1 for every 10 deaths. Many farmers have been forced either to sell a portion of their land in order to raise enough funds to pay the estate tax or, if they could get credit, to go further into debt by borrowing at the current high rates of interest. For a significant number of these, selling off a segment of their land has meant being left with an uneconomically small amount of land with which to earn a living.

Finally, the consequences of the current situation have been harmful for practically every sector of our society. For the structure of American agriculture itself, the current situation has meant that land sold of necessity by family farmers has been bought either by large agribusiness corporations or, in the case of marginally suburban land,

by developers who convert it to shopping centers or housing developments. Between 1950 and 1974, one-half—2.8 million—of the farms in the United States disappeared. Farmland lost to commercial development can never be regained.

By encouraging absentee ownership, the present tax law has contributed to dissolving the fabric of our rural communities. As family farmers move out and corporations move in, communities have less need for local businesses and services. For example, a recent study by a Wisconsin economist of the effect on small communities of the sale of small businesses in them to absentee, out-of-town owners found that employment dropped and the use of local lawyers, banking services, and other community services which kept the local economy healthy was reduced.

And then, for our national economy, present estate tax laws have meant greater concentration of agricultural land and wealth in the hands of fewer and fewer people, with the consequent loss of competition, accompanied by declining food quality and rising consumer prices.

For all these reasons—our commitment to the survival of the family farm; our conviction that justice demands that family farms be given a fair chance to survive; our sense that the current law violates the original intention of Congress; and our judgment that the consequences of the current law are harmful to practically every segment of society—the Taskforce recommends that certain changes be made in the present tax law.

Recommendations

One, we recommend that families today be provided the equivalent benefit of the 1942 exemption levels of $60,000 per estate and $30,000 per person via gifts during a lifetime. This benefit could be provided in several ways. The exemption levels could be increased. The $60,000 estate tax exemption could be updated for inflation to at least $200,000 and the gift tax exemption to $100,000.

A second option, which we would prefer, would be to substitute a reasonable tax credit for the present exemptions. This credit should be at least $50,000, which could perhaps be instituted on a gradual basis. The credit would have the positive effect of taxing the total asset value of the estate, thereby placing the greatest tax burden upon the wealthiest landholders while reducing the amounts contributed by smaller farmers and businessmen. It would also mean that approximately $1 billion less would be lost to the Federal Treasury than with a straight increase in exemption levels.

Another way of reducing the tax burden on the small farmer would be to adjust the current tax rate schedule by making it more progressive. A gross estate of $200,000, for example, is under current law taxed $20,700 plus 30 percent of the excess over $100,000.

It would be possible to adjust the current tax rates by adopting a revision such as the following one:

Taxable estate:	*Tax rate percentage*
0 to $50,000	5
$50,000 to $100,000	10
$100,000 to $150,000	15
$150,000 to $200,000	20
$200,000 to $400,000	25
$400,000 to $600,000	30
$600,000 to $1,000,000	35

Any one or a combination of the preceding alternatives would seem to us a substantial improvement over the present situation. Each should include an inflation escalator clause to prevent exemptions, credits, or tax rates from becoming outdated in the future.

Two, we recommend that some recognition be given to the unique partnership between husband and wife in operating a family farm. In the case of many families farming is a joint venture and involves a real partnership between the husband and wife. It is unfair to tax a surviving spouse on an estate that he or she has been heavily involved in building. We would favor the elimination or substantial reduction of estate taxes when an estate is being passed on to a surviving spouse who has been involved in building that estate. The estate will in any case be taxed when passing from the surviving spouse to his or her children. It seems unfair also to tax that estate when it initially passes to that surviving spouse.

Three, we recommend that the executor of a farm estate be given the option of valuing land used in farming at its value for agricultural purposes rather than at its fair market value. Under current Federal law all land, including farmland, is valued for estate tax purposes at its fair market value. Thus, land used in food production is taxed not on the basis of its agricultural use, but on its commercial potential. This inequity, combined with the antiquated $60,000 deduction for estate taxation, has contributed to the conversion of many family farms to nonagricultural uses.

Ine one sense the valuation is real, in that the land could be sold for that price to nonagricultural interests. But it is a false valuation from the viewpoint of the farmer paying the tax, because that value does not provide a commensurate profit to him or her. The farmer can only realize a profit by selling his or her land and going out of business.

This creates a peculiar and unfair burden upon the farmer. While the Government is encouraging full production of agricultural commodities which will help feed the world's hungry, the farmer is actually being penalized for producing food on the land rather than converting it to commercial use.

An attendant threat to future agricultural use of land exists if the farmer is forced to sell the farm. In a large majority of cases, it is a nearby well-established farmer with large landholdings or a nonagricultural commercial developer who can afford to purchase the land. The latter lends itself not only to nonagricultural use of the land, but to holding actions on land that is used for speculative purposes or tax shelters when it could and should be used in the production of food.

This revision providing for an optional method of valuing land would encourage continuity in the family operation of a farm and, according to the economic division of Congressional Research Service, would have a negligible effect on the total tax revenues received by the Federal Government. A safeguard is of course needed to insure that a farmer's heirs could not unfairly take advantage of a reduced land valuation for tax purposes and then at some future date sell that land to commercial interests at its higher market value.

Finally, we recommend that the current system of allowing estate tax payments to be spread out in installments over 10 years be continued but that the interest rate on the deferred balance be reduced to

4 percent from the current 9 percent. This revision in interest rate would be in line with the original intext of the law, which was to prevent undue hardship in paying estate taxes. This provision is not currently being used very widely. The interest rate should be reduced in order to encourage its use in hardship cases.

The Taskforce realizes, Mr. Chairman, that one result of the foregoing suggestions would be a reduction in the total amount of Federal tax revenue. It seems to us, however, that it is not worth the consequences of imposing such inordinate burdens upon our family farms for the small fraction of total Federal tax receipts currently represented by estate tax payments. It would also seem possible to increase taxes on larger estates and incomes in order to make up the amount lost through a reduction in taxes for small or moderate estates and incomes. This would place the heaviest burden of taxation where it legitimately belongs: upon the wealthiest segments of our economy.

The Taskforce believes that the recommendations offered in this testimony are reasonable and fair, and that they would contribute to the preservation of the family owned and operated farm and to the common good. We commend them for your serious consideration.

STATEMENT OF SENATOR DENNIS L. RASMUSSEN, SCOTIA, NEBR.

I am testifying as a farmer-rancher and concerned citizen who is interested in the preservation of the family farm.

I first became interested in the problems of our estate taxation system when I introduced a bill in our State legislature to give some relief from our State inheritance tax laws. I soon learned how difficult this is because of the credit the Federal estate tax law gives for State death taxes paid. This made it extremely difficult to give relief to the taxpayer. Rather, this original bill would have simply apportioned the total tax bill differently.

We have revised the bill considerably, and currently the bill has been advanced from committee and is waiting for action on the floor. The net effect of the revised bill is still to eliminate the estate tax on a $300,000 estate, and put that money back in the hand of the heirs.

As we worked on this bill, I gained considerable knowledge about the Federal estate tax laws, and began to realize that most of the problem results from the Federal law failing to keep pace with inflation, especially in land values. If we are really serious about maintaining the family farm, we must have help at the Federal level. There is not much a State can do, even if they are disposed to do so.

I represent one of the more rural legislative districts in an agricultural State. In Nebraska we have not had a serious problem in corporate interests buying out family farms, but we are seeing a dramatic change in the family farm. Let me illustrate what is happening to Nebraska farm families.

The current trend of family farm agriculture is to accumulate capital while sacrificing short-term income. In other words, farmers sacrifice most of their lives in order to have an estate of some value at death. Normally, a farmer will in order to increase his income, pur-

chase additional real property which will allow him to utilize the economics of size associated with agriculture.

A 1967 study of farms in eastern Nebraska showed that the average capital investment was $213,310. By 1972 the capital investment was $311,740. Capital inputs, including land, accounted for 45 percent of all agricultural inputes used in farm production in 1940, but climbed to 80 percent in 1972 and is projected to reach 90 percent by 1980.

The University of Nebraska made a study in 1972, which showed the amount of capital required for a farmer to produce approximately $14,000 per year income (range ± $1,024). The following are the results:

Type of farm	Acres	Capita
Swine, corn, eastern Nebraska	480	$250, 000
Grade A dairy, corn, eastern Nebraska	400	275, 000
Beef grading, corn, eastern Nebraska	480	425, 000
Irrigated corn, beef cowhead, central Nebraska	640	570, 000
Wheat Fallow, wheat farm, western Nebraska	6, 000	76, 000
Cow-calf ranch, northern Nebraska	22, 000	2, 765, 000

At least in the case of ranch land, the value of the land has doubled since 1972, when this study was made. The study allowed $50 per acre; in 1976, several areas of sandhills pasture sold for $100 per acre or more.

The trend is clear; farms are getting larger and less numerous in Nebraska. One may also conclude that the total acreage or capital investment is not a good indicator of the potential net income to the farmer.

The cow-calf ranch, the fallow-wheat farm, and irrigated corn-beef herd are most likely to require sale to satisfy tax liability, yet they must have substantially larger capital to produce a moderate income.

In conclusion, the capital required to operate a farm is substantial. Any type of farm capable of producing a $14,000 income probably will have capital of more than $300,000, in some cases perhaps between $1 and $2 million more.

Clearly, a $300,000 estate is not substantial by Nebraska standards.

This is not simply an agricultural problem, however. Inflation has caused the same problem for a family business which carries an inventory or has capital assets. Examples of these include a grain elevator, grocery store, and lumber yard.

Inflation has made the current $60,000 exemption, which was established in 1943, very insignificant when compared with the assets of many self-employed people. Hopefully, this dollar figure can be raised to an amount helpful to those who have worked a lifetime to help their children carry on the family business.

As a member of the Nebraska Legislature, I can also report to you that the body, voting 40–0–9, passed a resolution urging the Congress to take action on the Federal estate tax laws so that the States may pass legislation to help save the family farm.

The measure received support from all elements of our legislature, both rural and urban; Liberal and Conservative; Democratic and Republican. Not one member voted in opposition; all of our diverse body can see the need, both for farmers and consumers, to preserve the family owned farm and small business.