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1st Session

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

TAX REFORM HEARINGS

STATEMENTS OF PUBLIC WITNESSES IN PANEL FORM TESTIFYING

ON THE SUBJECTS OF

CAPITAL FORMATION AS IT RELATES TO CARRYFORWARD AND CARRYBACK OF NET OPERATING LOSSES, MINIMUM TAX—EDUCATION, AND CAPITAL FORMATION

JULY 30, 1975

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Summary of Statement of
E. T. BARWICK INDUSTRIES, INC.
Before the
Committee on Ways and Means, House of Representatives
on
Capital Formation As It Relates to Carryforward and
Carryback of Net Operating Losses

Statement by Paul F. Schneider, Tax Manager, E. T. Barwick Industries, Inc.

INTRODUCTION

Purpose of testimony is to propose additional period in which to carryback net operating losses.

As a leading manufacturer of tufted carpets, our story is typical of the entire carpet industry.

ECONOMIC PROBLEMS OF THE CARPET INDUSTRY

Our carpets are produced from petroleum-based synthetic fibers. Due to petroleum shortages and tremendous price increases of synthetic fibers and yarns together with the drop in sales to the construction industry and the automobile industry, many carpet companies have been hurt drastically.

We have dropped approximately 30% of our workforce since October 1973.

A PROPOSED SOLUTION - 10-YEAR CARRYBACK

Congress has given loss companies 8 years in which to utilize net operating losses. However, we are limited to only 3 years in which to carryback such losses. Companies such as ours cannot derive any benefit now from this provision.

My proposal is to allow the losses to be carried back10 years, thereby helping companies when they are in greatest need of such help.

EFFECT OF PROPOSAL ON NATIONAL ECONOMY

The immediate cash outlay by the Government would generate rehiring and consequently the effect would be offset in part by individual income taxes as well as reduced Federal welfare expenditures.

July 30, 1975

Statement of
E. T. BARWICK INDUSTRIES, INC.
Before the
Committee on Ways and Means, House of Representatives
on
Capital Formation As It Relates to Carryforward and
Carryback of Net Operating Losses

Mr. Chairman and members of the Committee, I am Paul F. Schneider, Tax Manager, E. T. Barwick Industries, Inc. of Chamblee, Georgia.

I appreciate the opportunity to offer my testimony this morning on capital recovery as it relates to the carryback and carryforward of net operating losses.

Mr. Chairman, E. T. Barwick Industries, Inc. is one of the leading manufacturers of tufted carpets. There are now over 250 companies engaged in the manufacture of carpeting. I believe our story is typical of what has happened to the carpet industry since 1973.

ECONOMIC PROBLEMS OF THE CARPET INDUSTRY

All of our company's carpets are produced from petroleum-based synthetic fibers. Due to the worldwide petroleum shortages which we have experienced, we are currently on an allocation from suppliers of our synthetic fibers and yarns. We were hit with tremendous price increases over the previous two years. As these costs increased, the sales of carpets to the various industries which use carpets have plunged. These include the home construction industry, the commercial construction industry and the automobile industry.

Consequently, we have been hurt drastically as a result of these past events and the current economic recession. The industries which I just mentioned have been severely damaged over the past two years.

Our sales have dropped approximately 18% from $205.9 million in 1973 to $169.5 million in 1975. The profit we showed in 1973 of $5.2 million has now become a loss of approximately $27.5 million for the year just ended in April 1975.

Our company has been one of the leading employers in the state of Georgia. In 1973 we employed over 5,500 people. As of April 1975, this figure has dropped approximately 30%. Industry figures average out to an approximate unemployment rate of 9.7%.

We have, of course, trimmed costs in every area of the company. However, it is now a matter that our survival and the survival of many of the companies in the carpet industry hinges on some immediate help.

The relief that the Congress provided in the Tax Reduction Act of 1975 has been of no help to our company or others in similar loss situations. What I am asking for this morning is that the Congress extend the period to which a corporation may carryback its net operating losses so as to return some of the taxes previously paid during prior profitable years.

EXTENDING THE LOSS CARRYBACK PERIOD

As a result of the energy crisis and the uncertainty of future petroleum supplies, business cycles have been greatly disrupted.

Congress has given us 8 years in which to carry our net operating losses; that is 3 years back and 5 years forward. Due to the disruptions caused by the energy crisis, it appears a longer period is needed; specifically, a longer carryback period.

In our situation, we have little income available in the past three years to be offset by our current year's loss. This means that we will not derive any benefit from our losses until we become profitable. This may be too late.

My proposal would merely accelerate the utilization of these losses now at a time that we most desperately need an infusion of capital, not a time in the future when we are showing a profit.

A PROPOSED SOLUTION - 10-YEAR CARRYBACK

I feel it is now appropriate to allow taxpayers that are suffering losses an opportunity to utilize the benefit Congress has given us in Section 172. This can only be accomplished by increasing the period over which losses may be carried.

I propose that the Committee adopt a 10-year carryback period. This would give taxpayers the capital needed and could be a strong factor in overcoming the recession.

The influx of capital to depressed companies would have a ripple effect in that it would generate rehiring of employees, which would consequently increase individual income taxes. This would defray a great deal of the immediate cash outlay by the Federal Government.

I feel that any such refunds of previous taxes paid should be used solely for the recovery of the recipients. A contribution by loss companies to any E.S.O.P. Plan would not appear to make sound business sense.

In summary, what I am proposing is merely a shift from a carryforward to a carryback so that companies such as E. T. Barwick Industries, Inc. would not be forfeiting its loss carryforward.

Thank you, Mr. Chairman and members of the Committee.

July 29, 1975

Mr. Al Ullman
Chairman, Committee on Ways and Means
Rayburn House Office Building
Room 2207
Washington, D. C. 29515

Dear Mr. Chairman:

This letter is being written on behalf of a large number of companies which have a vital interest in developing a more realistic and equitable period for deducting net operating losses. That subject matter will be discussed by a panel before your Committee on July 30, 1975. We would be most pleased to assist the Committee in its consideration of the matter.

The principal purpose of this letter is to notify you and the other members of the Committee that, given the current and foreseeable national economic pattern, we believe that this topic is fundamental to any meaningful tax reform, and that a permanent solution is in order. The following companies have given us permission to use their names as companies deeply concerned with this problem:

Company	Major Product Lines	Principal Office
1. The Babcock & Wilcox Co.	Steam generating equipment	New York City
2. E. T. Barwick Industries	Carpeting	Chamblee, Ga.
3. Borman's Inc.	Retail foods	Detroit, Mich.
4. Con Agra	Grain & grocery products	Omaha, Nebraska
5. Dixilyn Corporation	Drilling contractors	Houston, Texas

Mr. Al Ullman

Company	Major Product Lines	Principal Office
6. Farah	Clothing	El Paso, Texas
7. W. T. Grant Co.	General variety stores	New York City
8. Gaynor-Stafford Industries	Textile converters	New York City
9. General Steel Industries	Steel	St. Louis, Mo.
10. Kaufman & Broad	Housing	Los Angeles, Calif.
11. Management Assistance Inc.	Computers	New York City
12. Mattel	Toys	Hawthorne, Calif.
13. National Homes	Homes	Lafayette, Ind.
14. Permaneer Corporation	Furniture & Bldg. products	Maryland Heights, Mo.
15. Redman Industries	Homes	Dallas, Texas
16. Restaurant Associates	Food	New York City
17. Unishops	Clothing	Jersey City, N. J.
18. Universal Container Corp.	Cooperage	New York City
19. Westchester Co.	Real Estate	Houston, Texas
20. Westons Shoppers City Inc.	Discount Department Stores	New York City

We would appreciate this letter being made a permanent part of the record.

Respectfully submitted,

UNISHOPS

By Joseph P. Bigelow

E. T. BARWICK INDUSTRIES

By Paul F. Schmeltzer

cc: Members of Committee on Ways and Means
Mr. John M. Martin, Jr., Chief Counsel

Summary of Remarks of
Mr. John A. Ford
Executive Vice President
Chrysler Corporation

Summary
with
Oral Testimony

Capital Formation as It Relates to
Carryforward and Carryback of Net
Operating Losses

The U.S. economy is slowly emerging from the longest and most severe recession in recent history. The adverse effects of the recession have not been borne equally by U.S. businesses. Many of the businesses which are affected by the energy crisis have incurred abnormally large operating losses. At this time, all U.S. businesses, the profitable as well as the nonprofitable, face heavy capital requirements if they are to continue as viable competitors. This is particularly true of the automobile industry, which will be required to expend large sums of capital to redesign and re-engineer the industry's products and retool for production.

It is essential that the Congress enact a capital recovery provision which will aid the businesses which have suffered the greatest impact of the current recession, for these are the businesses which have been financially squeezed. These businesses, which have little or no earnings and therefore pay little or no tax, obtain no current benefit from the usual capital formation and recovery type of tax amendment, such as the investment tax credit and accelerated depreciation.

The most effective and reasonable capital recovery provision to aid the hard-hit businesses would be an extension of the period for deducting net operating losses. If this type of provision were enacted, it would provide for a refund shortly after the loss is incurred, instead of requiring the business to wait and obtain the benefit by paying lower taxes in subsequent years. Under present law, the utilization of these abnormal losses as tax deductions would be deferred. The need for the funds these tax deductions would generate is now--today. The way to activate those deductions and thereby release funds, badly needed by the hard pressed companies to attain full employment and economic health, would be to extend the carryback period within which they can be deducted. Such a provision, by improving the financial statements of these businesses, would also strengthen their potential for raising debt capital. Strengthening these companies also bolsters the economy.

The Committee is urged to assist the financially impacted businesses in the recovery of capital by extending the period for deducting operating losses to ten years. This amendment would apply to any business, regardless of size and whether conducted by a sole proprietor, a partnership or a corporation.

July 30, 1975

July 30, 1975

Oral Testimony
of
CHRYSLER CORPORATION
Before the
Committee on Ways and Means, House of Representatives
on
Capital Formation as It Relates to Carryforward and
Carryback of Net Operating Losses

Mr. Chairman and members of the Committee, I am John A. Ford, Executive Vice President of Chrysler Corporation.

INTRODUCTION

The subject of capital formation as it relates to the carryback and carryforward of net operating losses, is one which the Committee considered during the formulation of the Tax Reduction Act of 1975. At that time, a number of the members of the Committee were of the view that such a provision would be more appropriately included in a tax reform measure. Now the Committee is considering tax reform and the problems connected with capital recovery and formation. It is very important, we believe, that the Committee's first legislative action provide capital recovery provisions for the financially squeezed businesses of this country.

As this Committee knows, the relief the Congress provided by way of a temporary increase in the investment tax credit, as well as the many recommendations which the Committee has received in recent weeks relating to capital formation, provide no current benefit to the many businesses, small or large, that have borne the brunt of the current recession.

In our view, the most reasonable and appropriate capital recovery provision to aid the hard-hit businesses would be an extension of the period for deducting net operating losses. If this type of provision were enacted, it would accelerate the utilization of these recession period losses and promptly return to these businesses, a portion of the taxes they paid during the extended carryback period. Under present law, the utilization of these recession losses as tax deductions would be deferred. Yet, the need for the funds these tax deductions will generate is now--today. The best way to restore these recession-hit companies to full employment and economic health is to permit them to generate needed funds through an extended period for deducting losses.

Prior panels have discussed the investment tax credit and the refund of unused credits as a means of assisting ailing companies in the formation of capital. I shall, therefore, restrict my remarks to the net operating loss carryback provision and its function in the recovery of capital.

THE SEVERITY AND CAUSES OF THE RECESSION DICTATE A CHANGE

Depth and Length of Current Recession

The current recession, aggravated by the 1973 oil embargo and its consequent uncertainties, has had a devastating effect on the U.S. economy. It has cost the country more than $150 billion in goods and services irretrievably lost. In the automotive industry, car sales dropped 29.8% from average 1972-1973 October sales to October 1974 sales. We thought this was a very severe drop, until the level of sales plummeted a further 31% within the next two months. Within a four-month period, Chrysler was forced to temporarily reduce

its work force by over 50 percent. The impact of the current recession, coupled with the oil embargo, not only hit hard on the automotive industry, the effect rippled throughout other industries.

Some economic experts are of the view that the recession has bottomed out, and they may be correct. However, all the economic experts seem to be unanimous in their projections that recovery from the recession will be slow, and in many industries the future appears to entail as much readjustment as it does recovery.

Economy Directed By Government Policy

Actually, the current recession is properly seen as the second and severest phase of a prolonged period of underemployment of the economy dating back to 1970 when, from a condition of nearly full employment, the economy lapsed into the recession of 1970-71, peaking at 6.2 percent unemployment. A partial recovery brought it to 4.6 percent unemployment around the end of 1972, after which it drifted through a year of slow growth, followed by the precipitous decline into which it has now fallen.

The severe underemployment of the economy which we are now experiencing differs from other postwar business cycles in that it is the result of a calculated and deliberate policy whose primary aim is to resort to a soft economy as the means to combat the inflation which had begun to gather momentum after 1966. The recession of 1970-71 was in fact accompanied by an easing in the rate of inflation; but when the ensuing upturn threatened renewed inflation, price controls were invoked to permit the recovery to proceed through 1972 with comparative price stability. When controls were

lifted early in 1973, the inflation accelerated, even under conditions of very slow growth, with the result that by the end of 1973 the Government invoked stringent fiscal and monetary measures to contract the economy and break the inflationary cycle.

Large Infusions of Capital Are Required

At this most difficult time, as we slowly emerge from the worst recession in recent history, the automobile industry is faced with required capital expenditures of unprecedented amounts. We need capital to redesign and reengineer the industry's products and retool for production, and to restore full employment to our workers.

The combination of heavy capital requirements and low-profit or profitless operations has produced a capital pinch that is reaching critical severity in many firms. Diminished profits or net losses, in the face of need for large capital investment, present a harsh dilemma, especially in today's money markets.

The capital expenditure requirements for hard-hit businesses are no different than those of profitable businesses. The nonprofitable businesses must continue to make capital expenditures if they are to once again become viable competitors and taxpayers in our economy. For example, Chrysler's product expenditures for the last half of the 1970's--to develop and produce fuel-efficient cars--will approach $1.5 billion. Capital of this magnitude is not readily obtainable.

Congressional Recognition of Inadequacy of Present Law

In the past, when the Congress found that certain industries had suffered extraordinarily large operating losses which the 3 year back and 5 year forward averaging rule could not adequately

absorb, it provided more appropriate averaging rules. In each such case, the enacted provision was very narrowly drawn, so as to apply to only one industry or one company. On many occasions when the Congress enacted or considered such limited legislation, it stated for the record that a more general provision providing flexibility in the loss carryback mechanism was needed to enable all industries to more effectively average their operating losses. This view was expressed by the Congress in 1967, this Committee expressed the same view in 1974, and these views were expressed when this subject was considered earlier this year.

The basic problem with the present net operating loss provision is that the current three-year carryback period is simply not long enough to absorb the extraordinary business losses which this prolonged and extraordinary recessionary cycle produced. The current operating loss period was designed yesterday for yesterday's economic cycles. Moreover, where the Government elects as a matter of policy to deflate the economy as a means of combating inflation, the interests of fiscal justice as well as the public interest in adequate capital formation require some relief for businesses whose prospects are jeopardized as a result. This can appropriately be done by allowing a longer carryback so as to permit averaging over longer periods, and to strengthen corporate capital position, when most seriously weakened. Clearly, an extension of the net operating loss period is not only sound tax policy, but also good economic sense, since it would provide funds to capital-starved businesses at the time funds are needed and when both the business and

the economy are struggling to recover. The immediate receipt of such funds would result in an additional benefit to the loss business, in that it would improve its financial statements, thereby enhancing its capacity to borrow other capital.

CONCLUSION

Looking to both periods, the past and the future, the 3 year carryback provision is wholly inadequate. Current losses cannot be carried back because of the brevity of the recovery from the 1970-71 recession. Looking forward, the general economic outlook is by no means bright enough to offer reasonable prospects of utilizing abnormally large loss carryovers, as a capital recovery tool, at the time funds are not otherwise available. In view of both of these adverse prospects, the hard-hit industries need an extended period of carryback years to absorb current losses.

Publicity attending the earlier consideration of a longer carryback period created the impression that such amendment would primarily benefit only a few large corporations. This is not correct. It is estimated that a major portion of the benefits of this provision would go to small and medium sized taxpayers. The amendment would be applicable to any business--regardless of size and whether conducted by a sole proprietor, a partnership or a corporation. It is not known exactly how many firms would benefit from this legislation, but it is clear that it would reach into all areas of the economy and all sizes of companies.

Mr. Chairman, as I mentioned earlier, the unprofitable companies derive no current benefit--no benefit at the time they need help--from tax rate reductions, from increased investment tax credits, or from greater depreciation deductions. The particularly hard-hit

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companies, because they have little or no earnings and pay little or no tax, get no benefit from the usual capital formation-type tax amendments. I therefore urge this Committee to assist these companies in the recovery of capital by extending the period for deducting operating losses to ten years, which would permit a current refund of prior taxes rather than a reduction of future taxes otherwise payable, and thereby help restore these companies to full productivity.

Thank you, Mr. Chairman and members of the Committee.

July 30, 1975

Statement of
CHRYSLER CORPORATION
Before the
Committee on Ways and Means, House of Representatives
on
Capital Formation as It Relates to Carryforward and
Carryback of Net Operating Losses

Mr. Chairman and members of the Committee, I am John A. Ford, Executive Vice President, Chrysler Corporation.

INTRODUCTION

The subject of capital formation as it relates to the carryback and carryforward of net operating losses is one which the Committee considered during the formulation of the Tax Reduction Act of 1975. At that time, a number of the members of the Committee were of the view that such a provision would be more appropriately included in a tax reform measure. The Committee is now considering tax reform and the economic problems connected with capital recovery and formation. It is very important, we believe, that the Committee's deliberations include this matter of an extended period for deducting operating losses.

At the outset, it should be noted that the relief the Congress provided to business by way of a temporary increase in the investment tax credit, as well as the many recommendations which this Committee has received in recent weeks relating to capital formation,

provide no current benefit to the many businesses small or large, that have borne the brunt of the current recession and are currently incurring losses or earning only modest profits. Any remedial action taken by the Committee at this time should aid the businesses hardest-hit by the recession and who have not benefited from the recently-enacted tax reform bill. In essence, what we are suggesting today is that the Congress make available to those companies hardest-hit by the recession some of the taxes they paid during their prior profitable years. Under present law, the utilization of these losses as tax deductions must be deferred. The need for the funds these tax deductions will generate is now--today. The way to activate those deductions and release those funds, at this time, is to extend the operating loss carryback period.

The capital expenditure requirements for hard-hit businesses are no different than those of profitable businesses. As in the case of the profitable businesses, the nonprofitable businesses must continue to make capital expenditures if they are to regain their position as viable competitors and taxpayers in our economy. For example, Chrysler's expenditures for tooling and equipment for the last half of the 1970's--to develop and produce fuel-efficient cars--will approach $1.5 billion. Capital funds of this magnitude are not readily obtainable.

Prior panels have discussed the investment tax credit and

the refund of unused credits as a means of assisting ailing companies in the formation of capital. I shall, therefore, restrict my remarks to the net operating loss carryback provision and the function it can play in capital formation.

THE SEVERITY AND CAUSES OF THE RECESSION DICTATE A CHANGE

Depth and Length of Current Recession

The current recession, aggravated by the 1973 oil embargo and its consequent uncertainty, has had a devastating effect on the U. S. economy. It has cost the country more than $150 billion in goods and services irretrievably lost. At mid-1975, the loss was accruing at an annual rate of about $250 billion and, although we may have reached the bottom of the decline, as some believe, it is as certain as such things can be that the recovery, when it comes, will be slow and painful, lasting to the end of the 1970's. The latest OMB Projections (May 30, 1975) assume that unemployment will still be close to 6 percent in 1979. Thus the cumulative shortfall of production will be greater in the recovery phase than it has been in the recession phase. It is likely that before we again approach full employment, the amount of output lost since the end of 1973 will total $400 or $500 billion.

Business cycles have been disrupted by the shortages and uncertainties of energy and raw materials. These factors have produced

sudden fluctuations in economic conditions. In the automotive industry, car sales dropped 29.8% from average 1972-1973 October sales to October 1974 sales. We thought this was a very severe drop, until the level of sales plummeted a further 31% within the next two months. Within a four-month period, Chrysler was forced to temporarily reduce its work force by over 50 percent. Although this is only one example of the impact of the current recession on the automobile industry, the effect rippled throughout other industries.

The extremely high price and the uncertainty of the supply of oil and many other raw materials may continue to aggravate the condition of the economy for years. For many industries and businesses, this could spell a depressed demand for goods, resulting in a continued high rate of unemployment and only marginal profits, if any, during this anemic period of recovery. The Detroit News of July 20 carried an article on a recent State of Michigan Labor Department study which indicated that another recession can be expected in 1978. That article stated: "As the U. S. recovers from the current recession, it will again come face to face with rising interest rates, increasing inflation, raw material and production shortages and a return to a tight money policy." The study went on to predict that "if that happens, unemployment in Detroit will fluctuate between 22% in 1975 and 18% in 1980". That would be for a 5½ year period.

Actually, the current recession is properly seen as the second and severest phase of a prolonged period of underemployment of the economy dating back to 1970 when, from a condition of nearly full employment, the economy lapsed into the recession of 1970-71, peaking at 6.2 percent unemployment. A gradual recovery brought it to 4.6 percent unemployment around the end of 1973, after which it drifted through a year of slow growth, followed by the precipitous decline into which it has now fallen.

Economy Reflects Government Policy

The severe underemployment of the economy which we are now experiencing differs from other postwar business cycles in that it is in large part the result of a calculated and deliberate government policy whose primary aim is to resort to a soft economy as the means to combat the inflation which had begun to gather momentum after 1966. The recession of 1970-71 was in fact accompanied by an easing in the rate of inflation; but when the ensuing upturn threatened renewed inflation, price controls were invoked to permit the recovery to proceed through 1972 with comparative price stability. When controls were lifted early in 1973, the inflation accelerated, even under conditions of slow growth, with the result that by the end of 1973 the government invoked severe measures to contract the economy and break the inflationary cycle.

As national output has declined, quarter by quarter, in the face of massive inventory liquidations, the rate of inflation has declined. It has been made explicit from the outset that governmental economic policy during this period was conceived and engineered as an instrument for curbing inflation, in the express belief that the public interest required it and that it was preferable to alternative counter-inflationary policies. As the policy has been pursued, it has imposed severe and pervasive hardships, and brought little prospect for price stability. The worst and most pervasive has been the widespread unemployment, which has increased by 4 million in a year and a half to over 9 percent of the labor force. Combined with shortened hours of work and continued inflation, this has resulted in a decline in purchasing power and an erosion of markets for products of business, as consumers and businessmen became increasingly cautious in their spending and investment. Thus expenditures have been depressed, and output and profits depressed even more, as sales have been made out of inventory at reduced prices. The rebates offered by automobile manufacturers, especially Chrysler, are conspicuous examples.

The shrinkage of markets, the decline of output, and the sacrifice of inventories, along with inflationary increases in costs, have taken a heavy toll of business profits. Reported profits for many businesses reached a peak in 1974, then fell by one-third in six months. When the results from the second quarter

of 1975 are in, the decline will probably be even greater, owing to the unprecedented dumping of inventories.

Even so, the counter-inflationary effects have been less than was hoped. As evidence of the fact that inflation is not over, the Labor Department announced just last week that the June increase in retail prices was twice as large as the increase for May. Wholesale prices of crude materials rose at an annual rate of 13 percent in April and 23 percent in May. The question now is whether these large increases will continue and whether fiscal and monetary restraints will be turned on again and further retard the recovery process.

It has to be conceded that this dual recession and threatened energy shortage have affected industries and businesses in an uneven manner. Some industries have enjoyed near-boom conditions, while many others have experienced depression-type sales volumes. Many of the businesses which are most directly affected by the energy crisis are incurring abnormally large operating losses. The cause is not a "management" or an isolated problem; it is at present a common, world-wide economic problem.

Congressional Recognition of Inadequacy of Present Law

In the past, when the Congress found that certain industries had suffered extraordinarily large operating losses which the 3 year back and 5 year forward averaging rule could not adequately

absorb, it provided more appropriate averaging rules. In each such case, the enacted provision was very narrowly drawn, so as to apply to only one industry or one company. In three of the five cases where Congress extended the period for deducting losses, the unusual losses provided for were the result, at least in part, of Government action--either legislative or administrative.

On many occasions in the past, when the Congress enacted or considered such limited legislation, it stated for the record that a more general provision providing flexibility in the loss carry-back mechanism was needed to enable all industries to more effectively average their operating losses. This view was expressed by the Congress in 1967, this Committee expressed the same view in 1974, and these views were expressed when this subject was considered earlier this year.

Clearly, an extension of the net operating loss period is not only sound tax policy, but also good economic policy, since it would provide funds to capital-starved businesses at the time funds are needed and when both business and the economy are struggling to recover. It would thus help restore such companies to full employment and to a taxpayer status.

CRITICAL NEED FOR FUNDS

Required Capital Investments and Limited Available Sources

The dampening effects of the Government's anti-inflationary policy, most particularly as they fall on the automobile industry,

have been aggravated by the impacts of two other sets of government policies: those aimed at conservation of petroleum fuels, and those aimed at environmental protection. These have profoundly altered the markets of the automobile industry. The drive for fuel conservation has dampened the demand by discouraging driving and tilted it toward cars which use less fuel, while at the same time the requirements for engine design to control emissions have added to fuel consumption and to production costs. The effect of all this has been to increase very greatly the requirements for capital to redesign and reengineer the industry's products and retool for production.

The combination of heavy capital requirements and low-profit or profitless operations has produced a capital pinch that is reaching critical severity in many firms. Diminished profits or net losses, in the face of an urgent need for large capital investment, present a harsh dilemma, especially in today's money markets. To raise equity money, a company must demonstrate current or prospective earnings; to raise debt money, a company must show a favorable balance sheet. Either could be very difficult when good years are punctuated by years of recession-induced losses or nominal profits, which depress the prices of equities (often below book value), and restrict the opportunities and stiffen the terms of borrowing.

Poor profit showings restrict access not only to money markets but to the tax incentives which the Congress has provided for investment in productive capacity. Almost all of these--notably investment tax credits and accelerated depreciation--are valuable only to companies with taxable profits. The irony is that the profitable companies are better able to tap the money markets for capital, while those companies to which it would be most helpful because of their limited or intermittent earnings have less in taxable earnings and therefore are less able to benefit from the incentives to investment.

A Full Business-Government Partnership Is Needed

We hear a great deal about the partnership of business and government. From a tax standpoint, the government is a very special type of partner. During profitable years it shares in a business's income; but during loss years, the government's willingness to share immediately in the business's adversity is limited. These have been very tough times for many businesses, and we believe our partnership arrangement with the government should recognize this fact. These hard-hit businesses are asking the government for no more than they would ask of any other partner--to share the business's risks on a current basis, both during "bad" and "good" times.

SUMMARY OF
CORRECTIVE ACTION NEEDED

In justice to companies with intermittent profits and losses, present tax law permits a limited period for averaging profits and losses to soften the impact of loss years on their capital structure. However, losses can be carried forward 5 years but back only 3 years, which has the somewhat perverse effect of providing relief principally not during loss periods, when it is most needed, but in profit years after losses have been overcome and the business has recovered. (The same applies to the carryforward of investment tax credits.)

The basic problem with the present net operating loss provision is that the current three-year carryback period is simply not long enough to absorb the extraordinary business losses which prolonged or extraordinary recessions produce, particularly when a taxpayer has two or more consecutive loss years. Originally enacted in 1918 as a one-year carryback and a one-year carryforward, these provisions were amended nine times until 1958, when the present rule of 3 years back and 5 years forward was enacted. It is fair to speculate that in consistently limiting the carryback period, the Congress has been more concerned with revenue considerations than with sound tax policy.

Since the end of World War II there have been six recessions,

and fewer periods of relatively full employment than were anticipated in postwar economic policy. There were recessions in 1949, 1954, 1958 and 1960. Since 1969 there have been two, separated by less than two years of partial recovery. And the current recession, as we have noted, was compounded by the effects of national energy policies and--as far as the automobile industry is concerned--by legislation and administrative restraints in the interests of environmental protection.

Where the government elects as a matter of policy to deflate the economy as a means of combating inflation, the interests of fiscal justice as well as the public interest in adequate capital formation require some relief for employers whose prospects are jeopardized as a result. This could appropriately be done by allowing a longer carryback so as to permit averaging over longer periods, and to strengthen corporate capital position, when it is most seriously weakened.

Standing in the shoes of bankers or other potential sources of capital and looking to both periods, the past and the future, the three year carryback provision is wholly inadequate. Current losses cannot be carried back adequately because the years 1972 and 1973 were for the most part years of only partial recovery from the 1970-71 recession. Looking forward, the economic outlook is by no means bright enough to offer reasonable prospects of utilizing

the abnormally large loss carryovers, as a capital recovery tool, when capital is most needed. In view of both of these adverse prospects, the hard-hit industries need at least a decade of carryback years, which would allow the abnormal losses of the 1973-1976 period to be offset against the profits of the last half of the 1960's.

Publicity attending the earlier consideration of a longer carryback period created the impression that such amendment would primarily benefit only a few large corporations. This is not correct. It is estimated that a major portion of the benefits of this provision would go to small and medium sized taxpayers. The amendment would be applicable to any business--regardless of size and whether conducted by a sole proprietor, a partnership or a corporation. It is not known exactly how many firms would benefit from this legislation, but it is clear that it would reach into all areas of the economy and all sizes of companies.

PROPOSAL - TEN YEAR PERIOD FOR DEDUCTING LOSSES

In view of the foregoing, it is suggested that the extended period for operating losses be permanently dealt with in this particular tax reform bill. We suggest that the Committee adopt a 10 year carryback period for deducting losses. Chrysler's interest is in the extended carryback period. However, we are aware that

other taxpayers, some represented by the National Small Business Association, are seeking a 10 year loss carryback and carryforward period.

Accordingly, it is suggested that the Congress enact a provision providing for a ten year period which could be used in full either as a 10 year carryback period, or a 10 year carryforward period, or part carryback and part carryforward. The selection of the consecutive 10 year carryback-carryforward period, with respect to any loss year, would be made on an annual basis and would be binding. To facilitate administration by the Treasury Department, the loss for any year could not be carried back to a year prior to the earliest year to which a prior loss was carried under this proposal. As under present law, both carrybacks and carryforwards would have to be taken in the earliest profitable year within the selected 10 year period. The flexible rule proposed here would qualify as permanent tax reform, and would correct the inadequacy of the existing rule of 3 years back and 5 years forward. An extended period of 10 years for deducting operating losses has ample precedent in the loss area in certain situations. Recently, the 10 year period was made the basic rule in the investment credit area, presumably because a decade was considered necessary to achieve a fair averaging under present conditions. A decade would appear to be as appropriate for averaging out operating losses. Moreover, the adoption of such a responsive provision would relieve the Congress from the steady stream of requests for special exceptions.

As was stated, Chrysler's interest is in the extended carryback. It should be emphasized that a 10 year carryback of operating losses would generally represent only a shifting of the loss from a loss carryforward to a loss carryback, thereby providing a current refund of prior year taxes rather than a reduction of future year taxes otherwise payable. The receipt of such taxes would result in an additional benefit to the loss business in that it would improve its financial statements, thereby enhancing its capacity to borrow capital.

Mr. Chairman, as I mentioned earlier, the unprofitable companies derive no current benefit--no benefit at the time they need help--from tax rate reductions, from increased investment tax credits, or from greater depreciation deductions. The particularly hard-hit companies, because they have little or no earnings and pay little or no tax, get no current benefit from the usual capital formation-type tax amendments. I therefore urge this Committee to assist these companies in the recovery of capital by extending the period for deducting operating losses to ten years.

Thank you, Mr. Chairman and members of the Committee.

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July 30, 1975

BEFORE THE COMMITTEE ON WAYS AND MEANS

SUMMARY STATEMENT ON BEHALF OF

THE INVESTMENT COMPANY INSTITUTE

REGARDING CAPITAL LOSS CARRY-OVERS OF

REGULATED INVESTMENT COMPANIES

My name is Robert L. Augenblick. I am President of the Investment Company Institute, 1775 K Street, N. W., Washington, D. C. and appear today on its behalf. The Institute has as its members 389 mutual funds, their investment advisers and principal underwriters, and its member mutual funds have about 8 million shareholders, whose average investment is about $6,000. Mutual funds are known in the Internal Revenue Code as "regulated investment companies." With me today is Edwin S. Cohen, counsel for the Institute.

Mutual funds provide a medium for large numbers of persons to pool their investment resources in a diversified list of securities under professional management. For many years the Internal Revenue Code in Subchapter M has provided "conduit" income tax treatment for these 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 distributions made out of net long-term capital gains, called "capital gain dividends," retain their character as long-term capital gains in the hands of the shareholders.

If the company incurs a net capital loss for any year, it 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 five years and used as an offset against capital gains of the company for that subsequent five year period.

Under the present Internal Revenue Code, individuals are permitted to carry forward net capital losses for an unlimited number of subsequent years. Corporations in general can carry net capital losses of any year to eight other years -- three prior years and five subsequent years. But regulated investment companies can carry over net capital losses only to five other years -- the five subsequent years.

We submit that this five year limitation on regulated investment companies is unfair and inconsistent and we respectfully request that it be changed. Since our surveys indicate that only about one-half of one 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), we think the unlimited capital loss carry-forward rule for individuals should be made applicable to mutual funds.

At the least an eight year carry-over 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 Sub-chapter M. Hence a capital loss carry forward to eight subsequent years should be

permitted at a minimum to mutual funds to equate these companies at least with other corporations; but we respectfully submit that the proper rule is the unlimited carry forward available to individual investors.

A number of mutual funds sustained substantial net capital losses in 1970 and subsequent years, particularly 1973 and 1974, and have not realized sufficient capital gains to use up the loss carry-over. Under the present law the 1970 losses will expire in 1975. 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 five years earlier. The matter is thus of immediate importance to these companies and their shareholders. Accordingly, we urge that the Committee modify the law so that an unlimited period of carry-over is permitted, or at the least the present five-year period is extended to eight years.

I should like to submit for the record a more complete statement concerning this matter, and attach to it a memorandum with respect to an additional amendment, which we propose for the Committee's consideration at the proper time, that would permit mutual funds to be organized to invest primarily in a diversified portfolio of obligations of state and local governments and their political subdivisions, and have the tax-exempt interest on such obligations retain its character as such when distributed to their shareholders.

July 30, 1975

BEFORE THE COMMITTEE ON WAYS AND MEANS

STATEMENT ON BEHALF OF

THE INVESTMENT COMPANY INSTITUTE

REGARDING CAPITAL LOSS CARRY-OVERS OF
REGULATED INVESTMENT COMPANIES

The Investment Company Institute is the national association of the mutual fund industry. Its membership consists of 389 mutual funds, their investment advisers and principal underwriters. Its mutual fund members have over 8 million shareholders 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 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 these 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 five years and used as an offset against capital gains of the company for that subsequent five-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 five years but not carried back to earlier years. In the 1964 Act the five-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 three years in addition to the right of a five 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 eight other years

(three prior and five subsequent years), and individuals have an unlimited carry forward, but regulated investment companies can carry over net capital losses only for five other years -- the five subsequent years.

The Investment Company Institute submits that this five-year limitation on regulated investment companies is unfair and inconsistent and respectfully requests that it be changed. Since our surveys indicate that only about one-half of one 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), we think the unlimited capital loss carry-forward rule for individuals should be the rule applicable to mutual funds.

At the least an eight-year carry-over 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.* Hence a capital loss carry forward to eight

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*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

subsequent years should be permitted at a minimum to equate these companies at least with other corporations, but we respectfully submit that the proper rule is the unlimited carry forward available to individual investors.

Until recent years the difference between the five year limited 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.

The Institute recently made a survey of fifty of its member mutual funds, representing approximately two-thirds of the assets of all mutual fund members of the Institute.

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footnote continued from page 3/
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.

The summary of the results of the survey is:

Fiscal Year Ending In The Following Calendar Years	Dollar Amount of Capital Loss Carried Over by Year (Millions of Dollars)	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 Carry-over at the End of the Most Recent Fiscal Year	1,932.3*	

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 five-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 five years earlier. The matter is thus of immediate importance to these companies and their shareholders, and accordingly we urge that the Committee modify the law so that an unlimited period of carry-over is permitted, or at the least the present five-year period be extended to eight years.

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*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 member mutual funds.

Attached hereto as Exhibit A is the suggested text of an amendment to Section 1212(a) of the Internal Revenue Code which would allow to the regulated investment companies the same unlimited period for capital loss carry overs that is allowed to individuals. Attached as Exhibit B is the suggested text of an alternative form of amendment that would allow to such companies a capital loss carry over for a period of eight years.

EXHIBIT A

SUGGESTED TEXT OF AMENDMENT TO THE INTERNAL REVENUE CODE TO ALLOW TO REGULATED INVESTMENT COMPANIES THE SAME UNLIMITED PERIOD FOR CAPITAL LOSS CARRYOVERS THAT IS ALLOWED TO INDIVIDUALS

Section _____ Capital Loss Carryovers of Corporations.

(a) Capital Loss Carryovers of Regulated Investment Companies. Section 1212(a)(1) of the Internal Revenue Code of 1954, as amended, (relating to capital loss carrybacks and carryovers of corporations) is amended by rewriting subparagraph (B) to read as follows:

[new matter underscored]

"(B) a capital loss carryover to each of the 5 taxable years (10 taxable years to the extent such loss is attributable to a foreign expropriation loss) succeeding the loss year, except that in the case of a regulated investment company (as defined in section 851) it shall be a capital loss carryover to the taxable year succeeding the loss year, and the five-year limitation shall not apply,"

(b) Effective Date. The amendment made by this section shall apply to taxable years ending after January 1, 1975, and to net capital losses incurred in taxable years ending after January 1, 1970.

EXHIBIT B

SUGGESTED TEXT OF ALTERNATIVE AMENDMENT TO THE INTERNAL REVENUE CODE TO ALLOW TO REGULATED INVESTMENT COMPANIES CAPITAL LOSS CARRYOVERS FOR A PERIOD OF EIGHT YEARS

Section _____ Capital Loss Carryovers of Corporations.

(a) Capital Loss Carryovers of Regulated Investment Companies. Section 1212(a)(1) of the Internal Revenue Code of 1954, as amended, (relating to capital loss carrybacks and carryovers of corporations) is amended by rewriting subparagraph (B) to read as follows: [new matter underscored]

"(B) a capital loss carryover to each of the 5 taxable years (10 taxable years to the extent such loss is attributable to a foreign expropriation loss) succeeding the loss year, except that in the case of a regulated investment company (as defined in section 851) it shall be a capital loss carryover to each of the 8 taxable years succeeding the loss year,"

(b) Effective Date. The amendment made by this section shall apply to taxable years ending after January 1, 1975, and to net capital losses incurred in taxable years ending after January 1, 1970.

July 30, 1975

BEFORE THE COMMITTEE ON WAYS AND MEANS

SUPPLEMENTAL MEMORANDUM OF
INVESTMENT COMPANY INSTITUTE
REGARDING A PROPOSAL FOR REGULATED INVESTMENT
COMPANIES INVESTING PRIMARILY IN STATE AND
LOCAL OBLIGATIONS

If the provisions of the federal Internal Revenue Code applicable to the income tax treatment of regulated investment companies and their shareholders were amended to make it practicable for regulated investment companies to be organized to invest primarily in state and municipal bonds, an entirely new and a broader market would be created both for new issues of such bonds as they come on the market and for existing issues. It would also benefit the investor of moderate means by making it feasible for him to invest conveniently in a diversified portfolio of such bonds.*/

Regulated investment companies are usually in corporate form. They are designed to afford to individuals of moderate means the advantages of experienced investment management and

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*/ Such a regulated investment company is to be distinguished from existing fixed municipal bond trusts from which an investor may receive tax-free income on units of the trust he owns. Such trusts do not offer to the investor the advantages of a regulated investment company. For example: (a) the trusts are "fixed" trusts and cannot change their portfolio holdings; (b) trust units are generally priced at high levels, e.g., $1,000 and there may be minimum purchase requirements ($5,000); (c) the market value of the trust units are not reported in daily newspapers and are not readily ascertainable by the investor, and (d) the trusts do not continuously offer new units but are sold on a one-time basis and are therefore not suitable for periodic savings plans.

diversification of investment risk. These companies combine the money of many thousands of people with similar investment objectives and invest it in a portfolio of many different securities which are bought and sold under the management of investment professionals. For his money each investor receives shares in the investment company itself. These shares represent a proportionate interest in all the securities which are owned by the investment company. Investment companies have different investment objectives as stated in their prospectus. Some emphasize growth of capital, some production of income, and some a combination of the two.

There are today hundreds of regulated investment companies, with many millions of shareholders, dedicated to investments in stocks and bonds. Their aggregate assets are in the neighborhood of fifty billion dollars.

Regulated investment companies are predominantly of two types, "open-end" (commonly called a "mutual fund") and "closed-end". Most are mutual funds. There are two principal differences between a mutual fund and a closed-end investment company. First, if a shareholder of a mutual fund wants to dispose of his shares, he need not look for a buyer. He simply tenders his shares back to the fund which redeems them at a price based on their then net asset value. On the other hand, the shares of a closed-end company are not redeemable but are traded between shareholders on a national securities exchange or in the "over-the-counter"

market. Second, virtually all mutual funds continuously offer their new shares to the public, whereas the shares of a closed-end company are issued only once or infrequently, usually through a standard type of securities underwriting.

For many years the federal income tax laws applicable to regulated investment companies have been designed in general 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 investment company.

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 company level -- the income tax is paid by shareholders based on the investment company income distributed to them 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

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*/ Among other conditions the investment company must distribute to its shareholders at least 90% of its income from dividends and interest.

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.

The absence of a statutory provision preserving the exempt status of interest on debt obligations of States and political subdivisions as it passes through the investment company to its shareholders was not a matter of concern when the provisions of Subchapter M of the Internal Revenue Code were enacted in the Revenue Act of 1942. At that time and for many years thereafter, the interest rates on municipal bonds were much lower than those on other bonds. Hence, municipal bonds were not generally attractive to individual investors unless they were in relatively high income tax brackets. In recent years, however, as States, municipalities and other political subdivisions have increased the quantity of their borrowings the interest rate on their obligations has increased to a marked extent. */

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*/ Between 1963 and 1974, for example, the average yield on seasoned Aaa state and local bonds increased from 3.06% to 5.89%. This compares to a rise in federal long-term bonds for the same period of 4.00% to 6.99% and for Aaa corporates of 4.26% to 8.57%. To a married person with taxable income of $16,000 a yield of 5.89% on state and local bonds is equivalent to a yield of 8.18% on taxable obligations; to an unmarried person it is equivalent to a yield of 8.92%.

As a result the interest yield on tax-exempt issues is such that municipal bonds can become desirable investments for persons in the lower income tax brackets. Such persons are, by far, the most numerous group of investors.

1. Obstacles to direct investment in municipal bonds by individual investors of moderate means include:

(a) Municipal bonds are generally issued in denominations of $1,000, a minimum price too high for many small investors maintaining a periodic savings program.

(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 at different interest rates. The average individual investor will usually be "lost" in trying to appraise quality, safety and market price.

(c) Market quotations are not as readily available as in the case of other securities and the large number of municipal bond issues outstanding make the ascertainment of such information a burdensome task.

(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 bonds of less than $10,000 or $20,000 principal amount.

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2. Allowing the "pass through" of the municipal bond interest exemption to shareholders of a regulated investment company is consistent with the purpose and policy of Subchapter M that persons investing via a regulated investment company be placed on substantially the same income tax basis as those persons who have sufficient funds and investment expertise to invest in securities directly.

The present forfeiture of the tax-exempt status of municipal bond interest when it passes through a regulated investment company to its shareholders stifles a new and broader market for municipal bonds by preventing the creation of municipal bond funds which are regulated investment companies. It also deprives the very numerous small individual investors of any realistic opportunity to invest in municipal bonds as part of a savings program.

3. Enactment of a "pass through" rule for regulated investment companies as to tax exempt interest would have the following benefits to the individual investor:

(a) The shares of regulated investment companies are priced at modest levels, generally in the area of $10 to $25 per share. They are suitable, therefore, to periodic savings programs for individuals.

(b) The market values of shares of regulated investment companies are readily ascertainable by the investor, since the net asset values are determined daily and quotations are reported in many daily newspapers throughout the country.

(c) The shares of most regulated investment companies are redeemable by the investment company at the election of the shareholder at a price based on their actual net asset value. The investor may liquidate his interest promptly without delay or difficulty.

(d) The investor of modest means is given the advantage of diversification of investment and expert investment management. Moreover, with these advantages it should be possible to include in an investment portfolio the 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.

4. Accordingly, for the considerations set forth above it is believed that Subchapter M of the Internal Revenue Code should be amended, in the case of regulated investment companies investing primarily in obligations of state and local governments, to eliminate the forfeiture of the tax exempt status of municipal bond interest as it passes through the regulated investment company and is distributed to its shareholders.

Attached hereto is the suggested text of the needed amendments to the federal Internal Revenue Code to permit the establishment of these municipal bond funds.

SUGGESTED TEXT OF AMENDMENTS TO THE INTERNAL REVENUE CODE OF 1954

REGARDING REGULATED INVESTMENT COMPANIES
INVESTING PRIMARILY IN TAX EXEMPT
STATE AND MUNICIPAL BONDS

Sec. __. 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 the excess 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 excluding from gross income under section 103(a)(1) over (ii) its deductions disallowed under section 265 or section 171(a)(2), and"

(b) Dividends Paid Deduction. Section 852(b)(2)(D) 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) (relating to method of taxation of companies and shareholders) is amended by inserting after paragraph (4) the following new paragraph (5):

"(5) EXEMPT-INTEREST DIVIDENDS -- If in the taxable year interest income of the regulated investment company excludable from gross income under section 103(a)(1) exceeds its gross income, such regulated investment 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 forty-five days after the close of the 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 section 265 or section 171(a)(2),

the portion of each distribution which shall be an exempt-interest dividend shall be only that proportion of the amount so designated as the amount of such excess for such taxable year 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."

(d) 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 subsection (e)(23) the following new paragraph:

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

(e) Disallowance of Deductions. Section 265 of such Code (relating to non-allowance 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 this 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), any amount otherwise allowable as a deduction which is allocable to interest (whether or not any amount of such interest is received or accrued) excludable from gross income under section 103(a)(1)."

"(4) INTEREST RELATED TO EXEMPT-INTEREST DIVIDENDS. -- Interest on indebtedness incurred or continued to purchase or carry 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."

"(5) CROSS REFERENCES. --

"(A) For definition of regulated investment company, see section 851(a).

"(B) For definition of exempt-interest dividends, see section 852(b)(5)."

(f) Effective Date. The amendments made by this Act shall apply with respect to taxable years beginning after December 31, 1974.

Statement of Stuart G. Tipton
Senior Vice President, Federal Affairs
Pan American World Airways, before the
Committee on Ways and Means of the
House of Representatives
July 30, 1975

My name is Stuart G. Tipton. I am Senior Vice President, Federal Affairs of Pan American World Airways. I am appearing before you today on behalf of Pan American to urge enactment of the legislative proposal which would permit Pan American to carry its 1970 and 1971 losses back ten years instead of back three years and forward seven.

Pan American is in a critical financial position and has been for the past two years. The situation was brought on by the rapid and drastic increases in jet fuel prices and accentuated by the sharp traffic reduction resulting from the current recession. Prices for jet fuel have increased from approximately 11¢ a gallon in 1973 to the present 38¢ a gallon. Notwithstanding a 12% reduction in operations, our fuel costs rose from approximately $175 million in 1973 to $340 million in 1974 -- a $165 million increase in one year. Passenger traffic on our system is now running about 15% below 1974. This onslaught of adverse influences required Pan American to take very drastic measures in order to stay alive. Our operations were sharply reduced, our fleet was cut down, the older airplanes sold, personnel was cut sharply, and we entered into a series of route suspensions and route swaps all designed to reduce the size of the airline and the level of expenses in order to counteract the effect of high priced fuel. A more detailed statement on this is attached as Attachment 1.

Notwithstanding the steps which have been taken to reduce expense levels, our losses have placed us in a cash bind so that last fall in order to get through our normally lean winter, it was necessary to negotiate a short-term line of credit of $125 million in order to provide enough cash to continue operations. This short-term loan did carry us through the winter and we have been able to pay most of it back. However, the cash shortage, while somewhat ameliorated by the steps I have mentioned, still plagues the Company and will require further short-term line of credit for this winter. This financing is still to be negotiated. The loan which has been under discussion between Pan American and the Government of Iran is still under consideration by officials of that Government and we have no information as to the conclusion which will be reached or the time of decision. Thus, the future of Pan American remains in doubt. The legislation before you is one of the steps designed to help solve our cash crisis. If the legislation were adopted, we would become entitled to a cash refund of $40 million in taxes we paid during past profitable years. Needless to say, any amount obtained under this proposal would immediately be injected into the economy by helping to pay the current capital and operating expenses and to provide continued employment to our 28,000 employees.

The $40 million refund that Pan American would receive would represent a shot of adrenaline to us in our fight to stay alive as America's leading international airline. This would not be easy under the best of circumstances. We are unable to compete on the basis of normal private enterprise principles. On the one hand, we are subject to strict regulation as to routes and fares by our own Civil Aeronautics Board. As a result thereof, we are the only major U.S. flag-carrying airline which does not have any significant route authority within the continental U.S. and are, therefore, unable to share in the relatively profitable intra-U.S. air passenger market. On the other hand, we compete head-to-head with foreign airlines which are subsidized by their respective governments. Most industrial and many developing nations believe it is essential for purposes of their nationalistic image to have an "international air carrier" flying their flag to many of the world's capitals -- even at public expense.

There are many programs under way -- some by the government and some by Pan American under which the company may conquer the adverse influences under which it operates. Last fall the President recognized the serious financial difficulties facing Pan American and the importance of a healthy international U.S. flag air transport system and directed that a strong effort be made to improve the competitive climate in

which Pan American and our other international air carriers operate. The Administration put forward a Seven-Point Action Program under the President's directive (see Attachment 2). However, this program is long term in nature and the Company needs are short term. It is for this reason that we are pressing hard for legislative permission to carry our 1970 and 1971 losses back ten years.

As part of this legislation, Pan American is prepared to reward its employees, who have enthusiastically supported the Company during these troubled times, by contributing nearly $10 million in Pan American stock to an employee stock ownership plan for eventual distribution to the employees upon their retirement. This $10 million worth of stock will not cost the employees a cent and will be in addition to the already generous company stock bonus, disability and retirement plans.

Moreover, Pan American would be required, if it later revokes the extended carryback election, to repay to the Government the entire amount of any net benefit it derives under this proposal. In short, all this proposal would amount to is allowing us to accelerate the time we would otherwise use our losses. Under present law, we would use our losses to reduce our tax liability in the future. In order to be sure that we will have a future, we would prefer to use our losses now by carrying them back against past profits and forego any carryforward of such losses.

This proposed amendment is consistent with the Congressional precedent set in the American Motors case where two years were subtracted from its five-year carryforward period and added to the three-year carryback period.

When the Committee previously considered this proposal, there was concern expressed by some members that the bill would be for the primary benefit of a few large corporations. If any of the members still have that impression, I would like to bring to your attention some estimates which were subsequently developed. It has been estimated that approximately 80% of any refunds which will be obtained under the rearrangement of the averaging period will go to small and medium-sized taxpayers. The proposal would be applicable to any business -- regardless of size and whether conducted by a sole proprietor, a partnership or a corporation.

For the foregoing reasons, I sincerely urge you to adopt this proposal as soon as possible.

Attachment 1
July 30, 1975

PAN AMERICAN WORLD AIRWAYS, INC.

A. The Background of Pan American's Problem

1. Introductory Statement

Pan American's problem is, to a considerable extent, rooted in the failure of the United States Government to recognize the major differences between domestic and international air transportation. The domestic system is wholly subject to the U.S. regulatory scheme and competition is controlled and fair. In the international arena, however, where every nation has an equal voice, there is very much more competition and the ground rules are entirely different. Most foreign airlines are owned and subsidized or otherwise strongly supported by their governments. Unlike the United States, there is little competition between carriers of the same nationality. Capacity and scheduling agreements, as well as pooling, are not only permitted and pervasive, but regarded as desirable.

It is difficult for any unsubsidized U.S. airline to operate profitably against such competition. It is even harder when the U.S. Government -- unlike other governments -- treats its own and foreign national airlines on a basis of impartiality. The challenge to Pan American is especially great, however, because it is the only U.S. international airline without mainland domestic routes.

2. The Profitable 1960s

The international competitive environment developed gradually after the end of World War II, as the United States authorized more and more U.S. airline competition (on the mistaken theory that foreign airlines were not and never would be "real" competitors), as more and more foreign nations sponsored

their own airlines, and as these airlines became stronger and better established, While the seeds of disaster were already planted in the early 1960s, they were obscured by the vast expansion of air traffic that followed the introduction of the jet transport in the late 1950s. Pan American, the leader in ordering and operating jets, benefitted particularly. As a result of its service to Southeast Asia, it also obtained considerable traffic and revenues in connection with the Vietnam war effort.

Until 1969 Pan American earned profits adequate to strengthen itself financially. Very little of these earrings went to stockholders. On the contrary they were plowed back into further development of the airline and its service to the public. It was during this period that Pan American sponsored and placed the first order for the widebodied jumbo jets, the most economical and fuel efficient aircraft in the air today. It was able to do this because of its financial strength.

3. <u>The Turning Point in 1969</u>

By 1969, there was a drastic change. There were more foreign airlines and they were stronger. Charter competition, vigorously supported by U. S. Government policy, became more severe. Fares were unduly depressed because of charter competition and because foreign governments wanted dollars from tourism. And more and more U. S. scheduled airlines, all with domestic route systems, had been authorized to compete, or to compete more extensively, with Pan American. This was especially true to Hawaii and the Pacific, as well as to the Caribbean and South America. Perhaps the most extreme case was the addition of five more airlines to serve Hawaii.

As a result, Pan Am sustained a net loss of almost $34 million in 1969, and an aggregate loss of more than $125 million between 1969 and 1971.* This intolerable situation led to a change in management in March of 1972. While limited in what could be done at that point to affect 1972 results, Pan Am did break even on an operating basis (i.e., before interest) and net loss was reduced from $45.3 million in 1971 to $28.2 million in 1972.

4. The Profit Plan for 1973

The major task and accomplishment in 1972 was to improve Pan Am's efficiency. What appeared to be a realistic plan for 1973 called for at least breaking even, and possibly achieving a small net profit. This came very close to being accomplished. Despite an unanticipated softening of traffic in the summer of 1973, due to the then yet unrecognized recession, Pan Am earned a small net profit as initially reported for the first nine months of the year, as compared with a net loss of $14 million for the same period in 1972.

Then, on top of the fall-off in traffic growth, there came the fuel crisis. The oil embargo led to shortages which disrupted and required reductions of operations. This further reduced revenues and created inefficiency in the use of resources. At the same time, fuel prices began their steep upwards climb. While the price of fuel loaded in the United States was controlled, prices outside the United States (where Pan Am loads more than half) were uncontrolled.

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* Profit and loss figures in this paper are from corporate reports and vary somewhat from reports to the CAB.

As a result of these adverse developments, 1973 was another loss year. Even so, however, the net loss was reduced from $28.2 million in 1972 to $18.4 million in 1973.

Pan American achieved a very high level of efficiency in 1973, even more noteworthy in the light of the fact that its cost per gallon of fuel was well above that of the domestic trunklines.

> Its system cost per revenue ton mile was the lowest of all the trunks.
>
> Its system cost per available ton mile was the third lowest of all the trunks.
>
> Its system revenue load factor was the second highest of the trunks.

Pan American would not have lost money in 1973 if its yield per revenue passenger mile in scheduled service had not been a full cent below that of the domestic trunklines (5.38¢ versus 6.38¢) -- a result of the entirely different and less controlled competitive, economic and political climate in international air transportation. Indeed, at domestic yields, Pan American would have been highly profitable.

B. Facing Up to the Fuel Crisis and the Recession

Responsive to developments in late 1973, Pan Am revised, on a crash basis, its 1974 plan. With a government mandated reduction in fuel usage, soaring fuel prices, and a predictably weak market for international travel, there was no possibility of planning for a profit. The challenge, rather, was to hold down losses as much as possible, and -- with an already badly weakened financial condition -- to survive that loss.

Pan Am sought to cope with the problem on two fronts: direct government assistance, and self help. While we discuss the government assistance efforts first, it should be understood that Pan Am did not just wait for government help but throughout the year made strenuous efforts to achieve the best possible commercial results.

1. Efforts to Obtain Direct Government Assistance

One of the first efforts in 1974, in which Pan Am was joined by TWA, was to seek legislation which would, where appropriate, reimburse U.S. international airlines for fuel cost increases. This effort failed, partly because it was believed by Members of Congress that Section 406(b) of the Federal Aviation Act provided a vehicle for payment of any subsidy which might be appropriate.

In April 1974, therefore, Pan Am petitioned the CAB for subsidy, as did TWA. At approximately this same time an Administration Interdepartment Task Force was established to review these problems. In the absence of any affirmative action, and with a badly deteriorating financial picture, in August 1974 Pan Am filed a further petition with the CAB requesting establishment of a temporary subsidy rate of approximately $10 million a month. On September 18, 1974, the CAB denied this petition, determining that normal hearing procedures should be followed with respect to the underlying petition for subsidy, and instituting an informal investigation into Pan Am's operational and financial practices and activities. Pan Am cooperated fully in this investigation. TWA's petition was dismissed as technically defective (but subsequently refiled).

The CAB's action was, apparently, coordinated with the Administration, for on the same day Secretary of Transportation Brinegar announced that although President Ford had determined that Pan American should not be supported with direct cash subsidy payments, "the importance of a healthy international U. S. flag airline system" required that

> "a strong effort be made to improve the competitive climate in which Pan Am and our other international air carriers operate."

Secretary Brinegar announced a seven point action plan, although it was recognized that the benefits of that plan would not contribute to the solution of Pan American's immediate problems.

a) Fares More in Line with Costs.

"...: realistically we must recognize that as costs go up -- and foreign fuel prices have tripled in the past year -- the carriers must recover these costs in higher ticket prices."

b) Excess Capacity.

Carrier agreements to limit capacity were supported, and there were assurances of "prompt action to correct the excesses" of some foreign carriers.

c) Tariff Integrity.

This was a pledge to clean up illegal price cutting.

d) Fly U. S. Flag.

U. S. citizens were to be "encouraged...to increase their use of U. S. flag airlines."

e) Mail Rate Increases.

The CAB was encouraged to accelerate mail rate adjustments to reflect cost increases.

f) Overseas Discrimination.

There appearing "to be instances where U.S. flag carriers are being discriminated against overseas", the Administration promised "immediate corrective action."

g) Route Restructuring and Service Suspensions on Loss Operations.

The carriers were urged "to consider agreements on overseas route rearrangements, and possibly even mergers", as well as unilateral suspensions of loss operations.

Even before these statements were issued, Pan Am had been working with the Air Transport Association to seek legislation dealing with certain of these subjects. Efforts were intensified, and resulted in the passage of the Fair Competitive Practices Act of 1974, signed by the President in early 1975. While that Act failed to provide for payment to U.S. airlines of the same Universal Postal Union rates that our government pays foreign airlines for the carriage of U.S. international mail, it did require the CAB to take this inequitable situation into account in fixing mail rates for U.S. carriers.

Despite the good intentions of the Administration, implementation of these various programs has faltered. The latest example was the failure to take any action against the massive excess transatlantic capacity operated by KLM.

In the meantime, however, an Interdepartmental Task Force has been established to review U.S. international aviation policy. The comments submitted by Pan Am to this Task Force point out the need for major changes in past policies.

2. Pan American's Self-Help Efforts

These efforts have been vigorous on many fronts and, as indicated earlier, commenced well in advance of the fuel and recession crises that hit in 1973.

a) Personnel Reductions.

Even before 1972 Pan American had begun to reduce the number of its airline employees. Beginning with year-end 1971, the reductions were as follows:

	Airline Employees
December 31, 1971	36,200
December 31, 1972	34,900
December 31, 1973	34,400
December 31, 1974	31,900
April 30, 1975	30,000

This represents a reduction of 17% since 1971.

b) Reduction in Level of Operations.

Pan American reduced its level of operations sharply in 1974 and again in 1975. On the basis of one accepted measure, revenue block hours operated in scheduled service, the reduction from 1973 to 1975 exceeds 20%. However, because of greater reliance on the larger and more efficient Boeing 747 aircraft, the reduction in available seat miles is only slightly more than 10%.

c) Increased Productivity of Aircraft.

Pan American achieved more seats per mile flown through two methods. First, it increased the number of seats in its aircraft. The Boeing 707 could be increased only

moderately, from 140 to 146. In the Boeing 747, however, the seat increase was very substantial -- from 337 to 373. In addition, Pan American increased its relative use of the Boeing 747. The 1975 Plan calls for operation of two-thirds of its seat miles in the Boeing 747, as compared with slightly over 50% in 1972. The significance of this is apparent when it is understood that the Boeing 747 produces two and a half times as many seats, and an even larger multiple of cargo capacity, for about twice the operating expense of the Boeing 707.

d) Increased Fuel Efficiency.

The escalation in fuel prices was, and is, Pan American's greatest single problem. In 1974, with an average cost of 34.4 cents per gallon, Pan American spent $340 million for fuel -- twice as much as it spent in 1973, when it flew 12% more hours. Fuel conservation thus became an extremely important objective and, through numerous changes and refinements in operating procedures, Pan American reduced its 1974 fuel consumption by approximately 50 million gallons.

e) Overall Cost Control.

Perhaps the best measure of the effectiveness of Pan American's cost control efforts, in a period of extraordinary inflation in the United States and abroad. is that operating expense other than fuel increased only 2.2% from 1973 to 1974. Had Pan American's average worldwide fuel cost per gallon been at controlled average domestic levels, it would have had an operating profit of $18 million, instead of an operating loss of $95 million. With domestic fuel prices and domestic yields, Pan American would have earned a substantial net profit in 1974.

f) Capacity Reduction Agreements

Over the last several years Pan American has been a party to a number of agreements with other airlines to limit wasteful excess capacity. Some are still awaiting CAB approval or finalization for submission to the CAB. The service areas involved, at one time or another, include Puerto Rico; Italy; the United Kingdom; Australia; Brazil and Venezuela.

Three airlines most guilty of excess transatlantic operations, however -- KLM, Sabena and SAS -- have rebuffed both Pan American and the U.S. government, and the United States has thus far acquiesced in such action.

g) Route Restructuring

One of Pan American's most important accomplishments, with major long-term profit implications, was a drastic restructuring of its route system. This involved route exchanges, suspensions of loss operations, and efforts to obtain new route authority synergistic with Pan American's route structure. The program has been partly accomplished, and partly awaits government approval.

Suspensions

(i) Even before 1973 Pan American had suspended unprofitable service at several points, including Baghad, Calcutta, Darwin, Hilo and Rangoon.

(ii) In the last six months of 1973, service was suspended at additional unprofitable points: Antigua, Belgrade, Belem, Bergen, Bucharest, Glasgow (passenger only), Entebbe, Freeport, Helsinki, Keflavik, Oslo, Paramaribo, San Pedro Sula, Santa Maria and Stockholm. (Service to Belgrade and Bucharest is being reinstituted this summer).

(iii) In April 1975, when they became a cash drain at the close of the tourist season, Pan American suspended all service to Puerto Rico,

except from Miami and on to the Iberian Peninsula and Rome, as well as its service to the Virgin Islands and certain other unprofitable Caribbean services.

(iv) A proposal to suspend service to Fairbanks, discussed more fully below, is awaiting final CAB action.

Route Swaps and Sales

(i) An initial route swap with TWA, which provided for Pan Am suspension of service to Ireland, and TWA's suspension of Detroit-London and East Africa service, was approved in early 1974.

(ii) In December 1974 Pan American and TWA submitted, and in late January 1975 the CAB approved, a more massive route exchange. TWA withdrew all Pacific service, and all transatlantic service east of Saudi Arabia; it also agreed not to operate to Germany or between Washington and London. Pan American acquired authority to serve Okinawa and Taiwan, and withdrew the following transatlantic services: France, Austria, Portugal, Spain and Casablanca, except for its Miami-San Juan-Iberia Peninsula and Rome service; and service between Los Angeles/Chicago/Philadelphia and London.

(iii) In December 1973, American Airlines agreed to exchange routes from New York/Washington/Dallas-Fort Worth/Chicago to Hawaii and the South Pacific for Pan American's rights between Boston/New York and Bermuda and from New York to Santo Domingo and Barbados. Pending final action by the CAB and the President, American suspended its service from Hawaii to the South Pacific. This agreement has been approved by the CAB and the President.

(iv) Pan American applied to suspend service to Fairbanks operated in connection with its New York/Fairbanks/Tokyo flights in the belief that a rerouting of the New York/Tokyo service via San Francisco (for which Pan American already has authority) would be much more profitable. The CAB denied the Fairbanks suspension application.

New Route Opportunities

Pan Am has been vigorously pursuing opportunities to improve its route system

through new CAB authorizations. The Transatlantic Route Proceeding, involving renewal of temporary transatlantic routes and service to new U.S. gateway cities, has been argued before the CAB. Other pending international route cases which are well-advanced procedurally involve New York-South Africa service via Brazil and service between Saipan and Japan.

Pan Am has also been recommended for a major domestic mainland route, from Los Angeles to Miami and the case has been submitted to the CAB for final decision.

There is also pending an application by Pan Am to carry domestic "fill-up" traffic on flights operated between U.S. cities on international flights, such as the New York-San Francisco-Tokyo service mentioned above.

h) Net Effect of Redeployment of Resources

Without taking into account the new authority sought by Pan American, which has of course not been incorporated in its 1975 Plan, the other route actions described above have resulted in a significant redeployment of Pan American's resources. The shift has been from the unprofitable transatlantic and Caribbean to the more profitable transpacific and Central and South America services, as shown by the following table:

Area Distribution of Available Seat Miles and
Revenue Passenger Miles in Scheduled Service

	1974		1975 Plan	
	ASMS	RPMS	ASMS	RPMS
Atlantic	44%	44%	39%	37%
Pacific	23	22	32	32
Central/South America	13	12	15	16
Caribbean	10	12	5	5
Domestic (Hawaii/Alaska)	10	10	9	10
	100	100	100	100

i) Fare and Rate Increases

Although it was aware that this might further reduce traffic, particularly pleasure travel, in an already shrinking market, Pan American sought to compensate for some of its cost increases by increasing fares and rates. Average yield per passenger mile in scheduled service increased about 16% in 1974, and an increase of about 10% is planned for 1975. Freight yields increased more than 15% in 1974, and are expected to increase another 10% in 1975.

j) Tariff Integrity Efforts

Excess competition and capacity, particularly when combined with economic adversity, lead to extensive rebating and breach of IATA agreements governing commission rates to travel agents. There have been, and are, severe and notorious violations, which have diverted substantial business from Pan American. Pan

American has given notice to IATA that it will not countenance such violations, and has withdrawn from the commission agreement which so many other airlines were violating. It has repeatedly pressed the CAB for more vigorous and effective enforcement, and has urged that legislation be enacted to help deal with this problem.

k) Increased Emphasis on Charter Service

At the same time that Pan American was cutting back on its scheduled service, it increased its charter services which make a significant contribution to overhead. Commercial charter revenues (i.e., excluding military) increased from $57 million in 1972 to $120 million in 1974. In terms of percent of scheduled service passenger and freight revenue, the increase was from 5.0% in 1972 to 9.3% in 1974.

l) Cash Flow Improvement and Financing Efforts

Pan American moved on many fronts to maintain a viable cash position and avoid breach of its various loan agreements. These included the following:

(i) Control of capital expenditures. Pan American reduced its capital expenditure program for 1974 from approximately $100 million to less than $70 million. The 1975 Plan calls for expenditures of approximately $60 million. Capital expenditures were and are being limited to those for which previous commitments had been made or were necessary in the interest of safety, efficiency or environmental improvement.

(ii) Reduction in Fleet Size. Pan Am reduced its fleet size from 154 at the end of 1971 to 127 on May 15, 1975. During 1974 alone nine aircraft (including spare engines) were sold for over $15 million, at a profit of $1.7 million. The program was accelerated in 1975 and between January 1 and mid April an additional 11 aircraft were sold at a price of $31.8 million and a book profit of $11.6 million.

(iii) 1974 Loan Agreement. In order to operate during a period of negative cash flow, the low traffic months of winter and early spring, Pan Am negotiated a line of bank credit for up to $125 million, all of which must be repaid by September 30, 1975. Borrowings under this agreement are secured by a mortgage on certain aircraft and by Pan Am's stock in Intercontinental Hotels Corporation, a wholly-owned subsidiary. At the same time, to obtain certain loan covenant waivers from Pan Am's long-term Institutional Lenders, it had to mortgage to them its other owned aircraft and its 55% stock ownership in the Grand Central Building, Inc., owner of the Pan Am Building in New York.

(iv) Iranian Financing. Because of its heavy loss in 1974, and disappointing results in 1975, Pan Am needs major further financing as promptly as possible. It has, therefore, been negotiating with the government

of Iran for the sale of 55% of its stock in Intercontinental Hotels Corporation for $55 million and a long-term loan of $245 million. As part of the arrangement Iran would receive warrants to purchase 6 million shares of Pan Am's stock -- 13% of Pan Am's outstanding stock. Iran's commitment is conditioned on a one-year extension of the present bank credit agreement, and the retirement of notes held by the Institutional Lenders at a discount. This program has been reviewed and approved in principle by the Administration, but will still require CAB disclaimer of jurisdiction or approval.

m) Merger Explorations

To cure a structural deficiency in Pan American's route system -- its lack of a substantial domestic route network -- it has been engaged in joint reviews of the desirability and feasibility of a merger with American, Eastern and TWA. These studies are close to conclusion, and will hopefully lead to actual merger negotiations with one of these airlines.

C. Results in 1974 and the 1975 Plan

Pan American sustained another substantial loss in 1974, primarily because of the doubling of its fuel expense to $340 million and the decline in traffic. Its operating loss in

airline operations was $95.2 million pre-tax, and its net corporate loss was $81.8 million. It should be noted that most major foreign airlines (e.g., Air France, Alitalia, British Airways, Japan Airlines, KLM) also incurred very substantial losses.

Pan American's 1975 Plan, which incorporates most of the self-help measures described above, contemplates continuing losses but as those measures become increasingly effective, improvements in financial performance can be expected.

D. Key Factors Affecting Pan American's Future

Notwithstanding all that Pan American has already accomplished, much remains to be done before it can return to profitability and rebuild its financial strength.

The single most urgent task is to obtain necessary financing. A memorandum of agreement with Iran, covering $300 million financing described above is now being considered by the Iranian Government. But even if approved, this will not provide Pan American with any cash. A CAB disclaimer of jurisdiction, or approval, will still be required, as well as cooperative action on the part of Pan American's banks and long-term lenders. Administrative support for this effort can be all-important. Failing an agreement with Iran, it will be necessary to arrange alternative financing.

The importance of such financing is two-fold. Not only will it provide funds necessary to maintain Pan Am's cash position and to meet its present obligations, but it will also facilitate negotiations which Pan Am hopes will soon be initiated for a merger with a domestic trunkline. This is an important aspect of the long-term strengthening of the U.S. flag international system and of Pan Am.

Government policy must also play an important role. The Seven-Point Action Plan announced by Secretary Brinegar must be pursued more vigorously. Further, an economically sound and effective U.S. flag international air transport system requires basic changes in U. S. policy. The United States must decide to become a strong advocate of that system, both in terms of policy and negotiating objectives. In the domestic field, government agencies can be impartial as between carriers and assume a judge-like attitude in dealing with the carriers' problems. In the international field, the U.S. must advocate the interests of its carriers. There can be no justification for our government assuming an air of objectivity when its carriers are in a competitive battle with foreign governments.

The United States Government has created so much intra U.S. flag competition that it has hobbled itself in providing support for individual U.S. companies or even one segment of the U.S. industry as opposed to another. It must reduce some of this competition between U.S. carriers so that it will be free to support U.S. carriers vis-a-vis foreign government and carriers.

Government support now, is at best spotty. There is no overall governmental determination that the officers and employees of the U.S. Government are supposed to be advocates of the interests of U.S. air carriers in their dealings with foreign governments. The U.S. must make the support of the U.S. flag system an objective of U.S. foreign policy and not view it, as it does so often now, as a pawn of foreign policy.

U.S. aviation policy must also be directed to making it feasible for U.S. carriers to offer the lowest possible fares and rates. Although the widebodied aircraft are the most efficient transports both in terms of cost per available seat mile and in terms of overall fuel consumptoion, achievement of these efficiencies depends on what laod factors can be attained. Many opportunities for increasing loads were pointed out in Pan American's comments to the Task Force reviewing U.S. international aviation policy. These include the following:

a) The government should adopt that portion of the Seven-point Action Program which contemplates the reduction of excess capacity and excess competition. The government should recognize that, as a practical matter, no carrier faced with excessive capacity and competition can increase its load factor by individual action.

b) In view of the excessive number of airlines already operating international services, combined with the fact that the most cost and fuel efficient aircraft are the widebodies, the U.S. must allow some form of a priori capacity control and schedule coordination. There is no real prospect of reducing the number of airlines significantly.

c) The government should decide that in view of the extent of foreign flag competition, head-to-head competition between American flag carriers is not necessary and should not be authorized in the future.

d) Carriers should be given opportunities to readjust their route structures among themselves. The route restructuring recommendation in the Seven-Point Action Program should be reflected in this new policy determination.

e) The government should change its present inflexible policy against pooling. There are instances where U.S. carriers are placed in a position where the

marketing of their services is not allowed by the economic system of the countries in which they are operating. In that case, pooling should be looked upon with favor by the U.S. Government as it advocates the interests of its carriers. There might be other circumstances such as on some "fifth freedom" sectors where similar conclusions should be reached.

f) The government should recognize that the once-clear distinction between scheduled service and charter service has been so completely eroded by government relaxation of charter rules that there is little left of it. Both supplemental and scheduled carriers are now pursuing the same total market for low-cost transportation. In order to maintain maximum utilization of the capacity of the widebodied aircraft, the government should give scheduled carriers the greatest flexibility in the sale and transportation of groups. This will, at the same time, permit a maximum volume of scheduled service which best serves consumer and national interest needs.

The foregoing is obviously a longer-term program. Pan American is a major national asset and has been for 40 years -- a symbol throughout the world of U.S. strength and technical

competence, a system of transportation and communications in place for use by our government to meet its needs. Unlike other nations, our government has decided not to provide the company with financial help. This being the case, governmental policies should be adopted which will give Pan American a fair opportunity to survive and develop through its own efforts.

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ATTACHMENT 2

PRESS STATEMENT

9/18/74

Secretary of Transportation Claude S. Brinegar today issued the following statement:

After a full review of the situation, President Ford has concluded that it is not now fair to the Nation's taxpayers to ask them to support our U.S. international flag air carriers with direct cash subsidy payments. The issue that prompted this review and decision is the application of Pan American World Airways to the Civil Aeronautics Board for an emergency interim operating subsidy of $10 million a month.

The President, in recognition of the serious financial difficulties facing Pan Am and the importance of a healthy international U.S. flag airline system directed that a strong effort be made to improve the competitive climate in which Pan Am and our other international air carriers operate. Many positive actions are already underway, and others will be started promptly. Not all of these actions can be carried out entirely by the Administration. Most require cooperative action by others, including the CAB and, in some cases, the carriers themselves. I would like to use this occasion to assure the air carriers that the Administration will push hard to obtain this cooperative action.

The near-term action steps include:

1. Fares More in Line with Costs. Fare structures that more closely reflect today's costs should be soon approved by the appropriate organizations. This includes fares of the scheduled carriers and the charter carriers, including those available to the military. Although no one wants to see travel fares go higher, realistically we must recognize that as costs go up -- and foreign fuel prices have tripled in the past year -- the carriers must recover these costs in higher ticket prices.

2. Excess Capacity. Without question the many air carriers, including U.S. flag carriers, that have rights to fly international routes to and from the U.S., are flying excessive passenger capacity relative to today's demands. Recent agreements between U.S. carriers and the Italian and the British carriers for winter capacity reductions are an encouraging step, and we are looking for further progress in prompt agreements with the airlines of France and West Germany. In addition, the state Department has an intensive review underway, working with us and the CAB, to determine which of the foreign carriers are flying capacity to the U.S. that exceeds the rights provided by their bilateral agreements. I have been assured that there will be prompt action to correct the excesses.

3. Tariff Integrity. Together with the CAB and Department of Justice, we are pushing ahead on a program to eliminate, or at least reduce, illegal ticket discounting. As part of this program we are also investigating the roles of the travel agents and tour operators to determine if some form of Federal licensing is needed.

4. Fly U.S. Flag. While U.S. citizens constitute over 60% of those flying overseas to and from the U.S., our flag carriers carry a far smaller share. An equitable balancing of these ratios would add some $200 million a year in new revenues to U.S. flag carriers. Together with the Department of Commerce, and, hopefully, with the cooperation of the Nation's travel agents, we will push a "fly U.S. flag" program to encourage U.S. citizens to increase their use of U.S. flag airlines when they travel and ship abroad.

5. Mail Rate Increases. We are encouraging the CAB to accelerate their actions to adjust international mail rates to reflect today's higher costs.

6. Overseas Discrimination. There appear to be instances where U.S. flag carriers are being discriminated against overseas in terms of excessive landing and other fees. Together with the State Department and the CAB, we are in the process of documenting the flagrant cases. We will seek immediate corrective action.

7. Route Restructuring and Service Suspensions on Loss Operations. We are strongly urging the carriers themselves to consider agreements on overseas route rearrangements, and possibly even mergers, as well as unilateral actions to suspend service to points that have inadequate traffic potential to cover costs. The Administration will do what it can to see that meritorious proposals receive prompt approval.

We believe that the combined impact of these seven steps--steps that, in many ways, are long overdue--will, in time, do a great deal to improve the financial health of all our international flag carriers, including Pan Am. In particular, we believe that these positive and prompt actions by the Adminsitration now provide assurance to the private sector financial institutions that our international flag carriers do have a fine future, and that they deserve their continued financial support--not only in times of growth and good profits, but also in times of losses and short-term setbacks.

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Statement of Stuart G. Tipton
Senior Vice President, Federal Affairs
Pan American World Airways, before the
Committee on Ways and Means of the
U. S. House of Representatives
July 30, 1975

Mr. Chairman, I would like to turn my attention now to a proposal before you which would limit the deductibility of expenses relating to business conventions held abroad. This measure invites retaliation by foreign governments. If we discourage our citizens from meeting in foreign countries they will discourage their citizens from meeting here. This could cost the U.S. over $100,000,000 annually in balance-of-payments. The International Association of Congresses has approved nearly 3,900 international conventions over the next ten years. More than 500 of them are to be held in the United States, which represents the largest percentage of any one nation.

Pan Am would lose a substantial portion of its convention-oriented business threatening us with revenue loss of $23.5 million. In addition, the inevitable retaliatory action by foreign countries could deny us a substantial portion of the $20.3 million we generated in 1974 as foreign-origin convention travel to the United States. Further, we rely on our wholly-owned subsidiary, the Intercontinental Hotel Corporation, operating 75 hotels abroad, to produce convention revenue of some $13 million annually.

The Committee's concern with the elimination of abuses in this area is, of course, justified, but these can be eliminated by vigorous IRS enforcement under existing law of the "ordinary and necessary" test of Section 162 of the Code. A limitation

specifically directed at foreign conventions would not only invite retaliation, but also would eliminate many conventions that are fully justified because of the organizers desire to avoid a controversy with the Internal Revenue Service.

Background Memorandum

Deductibility of Expenses
Attributable to Attending Conventions,
Educational Seminars or Similar Meetings
Outside the United States

In 1974, the Committee on Ways and Means agreed to limit deductions allowable for taxpayers attending conventions, educational seminars or similar meetings outside the United States to the extent that the location was inconsistent with the activities, purposes and functions of such convention, meeting or seminar. This proposal has again surfaced during the current phase of tax reform hearings.

The Internal Revenue Service has been faced with administrative problems resulting from attempts by some individuals to deduct personal vacations as business trips in those situations where a compelling reason cannot be shown for meeting outside the United States. While abuses undoubtedly occur from time to time, the legislative approach suggested would deal a severe blow to legitimate and proper overseas business activities when these activities can be effectively restricted under present law. Severely restricting foreign travel in an attempt to curb these abuses would be both unnecessary and unwise.

Present law permits travel expenses to be deducted only when "ordinary and necessary" in carrying on a trade or business or for the production of income. Current Treasury

Regulations deal specifically with this problem involving business meetings by prohibiting the deduction of expenses unless "there is a sufficient relationship between the taxpayer's trade or business and his attendance at the convention or other meeting so that he is benefiting or advancing the interests of his trade or business." Even more specifically, deduction of expenses is prohibited "if the convention is for political, social, or other purposes unrelated to the taxpayer's trade or business."

These Treasury Regulations enunciate a sound and proper rule which is very clear in its meaning. There is no doubt in the minds of taxpayers or the Internal Revenue Service as to what rules apply. The critical problem is one of enforcement rather than in legislative revision. Indeed, in 1974, the Internal Revenue Service announced (T.I.R. 1275, February 14, 1974) that it had instructed revenue agents and tax auditors to scrutinize deductions for business trips, conventions and cruises which appear to be vacations in disguise. This abuse must be resolved in such situations only, and should not inhibit those normal and customary business activities in which generally taxpayers engage. The Service in its announcement recognized that there are many different factual situations to which the rule may apply, but the test is the same -- where the "primary purpose" of the trip is "personal in nature," no deduction

will be permitted. Whether a trip "is primarily personal depends on the facts in each case." Therefore, "Where there are indications of abuse, the IRS will request lists of the names and addresses of participants," and "taxpayers will be required to substantiate the amount of time spent on business activities." Where the taxpayer cannot substantiate the business nature of the trip, no deduction will be allowed.

Legislative restrictions on foreign travel are not needed to correct abuses, any more than restrictions on domestic travel are needed. The price of travel from New York to London may be no greater than a New York to Hawaii flight, or Miami to Anchorage, particularly considering that foreign travel more often occurs on charter flights. In this light, a Florida vacation is more susceptible to abuse than a business trip to Iceland.

Travel abroad may have equally sound business reasons as does domestic travel. United States exports require meetings abroad, as does maintenance of the billions of dollars of United States investment abroad. Independent technological advances may become available through foreign meetings. The Commerce Department announced on July 28, 1975, that the U. S. had posted a surplus of $1.74 billion in June. This was the fifth monthly surplus in a row. In order to maintain this trade surplus we need to maintain overseas contact with foreign businessmen.

These conventions and seminars directly benefit United States companies. American hotel chains abroad (including Hilton International, ITT-Sheraton, Western-International, Holiday Inn, Hyatt, Loewes, Marriott, and Ramada Inn) would suffer from any curtailment of foreign travel. Many of these facilities were specially built to accommodate meetings and conventions. The aircraft used are predominantly of United States manufacture, whether flown by American flag carriers or others. It is more certainly true that American flag carriers have and will benefit particularly. Pan Am estimates that potential air traffic revenue loss from the proposal would be $25,600,000 and that additional revenue of $13,000,000 from Pan Am's wholly-owned subsidiary, Inter-Continental Hotels Corporation, would be jeopardized. Inter-Continental's 1974 net profit of $5,707,000 was less than half of this figure.

Foreign travel is not a one way street. Increasingly, meetings and conventions are being scheduled in the United States by foreign visitors, a trend which is expected to accelerate in our Bicentennial Year. The British American Chamber of Commerce has noted that the proposed "restrictions on U.S. organizations meeting abroad are likely, in the way of things, to engender an equivalent discouragement of overseas organizations visiting America" with a consequent effect on domestic business.

The proposed restrictions would confuse, rather than enlighten, U.S. taxpayers. Taxpayers know now that travel, whether foreign or domestic, is not deductible unless it is undertaken for business rather than personal reasons. This would continue to be the case. Conscientious taxpayers, aware that Congress had passed a law with respect to foreign travel only, would tend to stay in the United States. But those taxpayers who now deduct personal travel as "business expenses" would still be able to invent spurious business reasons for their trips. The Treasury has stated that in determining whether travel is personal or business "depends upon the facts in each case," and this would still be the case.

The solution is not to change the language of the rule, thereby discouraging legitimate foreign travel with its benefits for U.S. exports, U.S. investments abroad, U.S. flag carriers, and the ability of the U.S. to obtain reciprocal travel by foreigners. The solution is vigorous enforcement of existing law in factual situations where abuse is real. The Internal Revenue Service should continue to effectively enforce through its audit program, current limitations on such travel. Moreover, examination of returns is not the only remedy. In the past, tax forms have been revised requiring taxpayers to answer pertinent questions

before an exemption or other deduction could be claimed. This step could be utilized in this area and bring home to taxpayers the requirements for claiming the deduction. This would be a more effective way of uncovering abuses in foreign travel than a legislative approach.

In summary, any legislative proposal would discourage legitimate foreign travel and reciprocal travel to the U.S. by foreigners. Present law establishes a clear and proper rule prohibiting the deduction of personal travel as a business expense and will continue to encourage U.S. exports, maintain U.S. investment abroad, and the survival of our sorely pressed U.S. flag carriers in competition with subsidized foreign lines.

Statement of Joseph P. Smyth
Senior Vice President Marketing
Intercontinental Hotels Corporation
before the Committee on Ways and Means
U. S. House of Representatives
July 30, 1975

Certain amendments to the Internal Revenue Code are currently being considered by the Committee on Ways and Means. The enactment of these amendments, I believe, would be an unfortunate and serious mistake. It is my understanding that this legislation which would disallow tax deductibility for traveling expenses incurred by businessmen and professionals in attending conventions held outside the United States is intended to preclude certain "junketeering", "vacations in disguise", and similar abuses.

Intercontinental Hotels Corporation, a Delaware corporation established in 1946, which (with our subsidiaries) operates and/or represents a group of 75 first class hotels, comprising some 28,000 rooms and located (with one exception) outside the Continental United States. Obviously, the enactment of this legislation would have negative effects on our company's business, on that of our parent company, Pan American World Airways, Inc., and on that of our principal competitors engaged in international hotel operations most of which companies are U.S.-based and U.S.-owned corporations. The leaders of these organizations have already made their feelings on this matter known to the Committee. There is little doubt that the enactment of these measures would add to the already widely publicized plight of the U.S.-flag carriers. And it is only natural for me to strongly oppose any legislation which will make it more difficult to attract customers to our hotels and to our parent company's aircraft.

However, in my judgment, it is perhaps more significant to oppose the proposed legislation on the grounds of its discriminatory aspects, its potential interference with international trade and commerce, its adverse affects on international understanding and goodwill, and its conceivable failure to effectively do the job it sets out to do.

The U. S.-generated meeting and convention market is a 7-billion dollar industry. According to our market studies and experience, only approximately 3% of this amount ($200 million) is spent on meetings outside the United States. If there are substantial current abuses in conventioneering expense account deductions, surely they cannot all be related to this relatively small segment of the market. Indeed, if these abuses are in fact widespread, it is quite conceivable that those related to conventions held in the U. S. are greater than the total $200 million spent overseas.

A large number of overseas conventions and business meetings take place in hotels controlled by U. S. corporations. These properties have been constructed, and if business warrants, will continue to be constructed, and furnished with predominately U. S.-source building materials, furnishings and equipment. The aircraft which carry these travelers to their overseas conventions and business meetings are almost without exception of U. S. manufacture. An abrupt change in the convention-going habits of U. S. residents, which may be expected to follow enactment of the proposed legislation, can be expected to bring about an equally abrupt change in the development plans and capital investment and procurement activities of all those companies engaged in the

various aspects of the international travel industry.

This proposed legislation would seem to say that it is contrary to the American public policy and interest for convention and business meeting dollars to be spent overseas: one must do all his conventioneering and business meeting in the U. S. Such an arbitrary and discriminatory policy is unworthy of a great nation. It is unrealistic in a modern world where such petty barriers to the free movement of people, the interchange of ideas, and the stimulation of international trade and understanding are inconsistent with a progressive foreign policy. It invites quid-pro-quo retaliation from both developed and developing nations - most of them "friendly" - whose economies are tourism-intensive . . . all this at a time when the U. S. Department of Commerce is becoming increasingly aware of and is increasing its expenditure to promote tourism to the U. S. A.

HR1040 and the companion legislation would, if enacted, represent a patent example of the very kind of discrimination which this country has been urging other governments not to adopt. This has nothing to do with the issue of what business expenses should or should not be deductible. The point is that the same principals should be applicable whether the location is in this country or outside.

If there is in fact (and one assumes that this has first been objectively established) abuse of the spirit of the Internal Revenue Act by some individuals who because of their business or professional connections or status are permitted to combine convention going with vacationing - whether in this country or overseas - with a resulting loss in tax revenues, is it not within the authority of the Internal Revenue Service to lay down guidelines, excluding the vacation aspects from the deductible costs involved? If it is not, then may I respectfully suggest that the Congress give attention to the establishment of such guidelines or give such authority to the IRS, rather than make legislation outlawing overseas meetings the law of the land.

Summary of Testimony

KURT M. SWENSON

on

CAPITAL FORMATION AS IT RELATES TO
THE CARRYFORWARD AND CARRYBACK OF
NET OPERATING LOSSES

July 30, 1975

1. Strongly supports H.R. 8737 which would extend carryback of net operating losses 5 additional years in exchange for surrendering right to 5-year carryforward.

2. History of The John Swenson Granite Company, Inc.

The company was successful for many years (since 1883) until tariff reductions beginning in the mid-1960's caused crippling competition from imported granite. As a result, operations were curtailed, number of employees greatly reduced, level of indebtedness overextended, plant became run down and working capital unavailable.

3. The Company's Current Situation.

The demand for its granite is again high and it is expected 1975 will produce a reasonable operating profit. But years of operating losses have hurt cash position, payables are badly out of line, machinery and equipment in bad need of repair or replacement and quarries need development.

4. The Need for H.R. 8737.

The company is in great need of capital. Normal sources are unavailable to it; after bank sources have been exhausted, a small closely-held corporation has nowhere to turn. A recoupment of taxes paid in earlier profitable years is the one important remaining source of working capital available.

5. Tax Reduction Act of 1975 and Proposed Similar Relief of Absolutely No Benefit to John Swenson Granite Company, Inc. and Other "Loss" Taxpayers.

Investment tax credits, depreciation changes, increases in the surtax exemption, reduction in rates are of no benefit whatsoever to a taxpayer which has been suffering losses. The unfortunate position of these loss companies is exacerbated vis-a-vis those companies who have had successful years during 1970 through 1975 and who are being benefited by the recent rate reductions and other economy-stimulating reforms. Fairness alone requires that something be done for these loss companies--something designed to again make them profitable and a plus factor in the economy's recovery.

CAPITAL FORMATION AS IT RELATES TO CARRYFORWARD AND CARRYBACK OF NET OPERATING LOSSES

Statement of Kurt M. Swenson,
Executive Vice President,
The John Swenson Granite Company, Inc.
Concord, New Hampshire,
In Support of H.R. 8737
Before the House Ways and Means Committee

July 30, 1975, Washington, D. C.

Mr. Chairman, Members of the Committee:

My name is Kurt M. Swenson, of Hopkinton, New Hampshire, and I appear before you in my capacity as the Executive Vice President of The John Swenson Granite Company, Inc. of Concord, New Hampshire. With your indulgence, I would like to briefly outline for you the history of our company and then explain our strong support of House Bill 8737 recently introduced by Representative Burke of Massachusetts whereby, among other things, a taxpayer would be entitled to elect to carryback its losses an additional five years in excess of the carryback period it is currently permitted.

HISTORY OF THE JOHN SWENSON GRANITE COMPANY, INC.

1. Early History.

The John Swenson Granite Company, Inc. is a small business located in Concord, New Hampshire. It was founded by my great grandfather, John Swenson, in 1883 in Concord. The business began as a granite polishing operation which polished granite for use in the monumental business. By 1900, John Swenson had bought a gray granite quarry and a manufacturing plant at the

company's current location in Concord. The company quarried and manufactured gray granite for use in the monumental industry.

By 1915, John Swenson's only three sons, John, Guy and Omer, had joined him in the business and it began to expand. After John Swenson's death in 1918, the three sons continued the business as a partnership. Primarily because two of the sons had college backgrounds in architecture, the company began to expand its manufacturing capacity into the manufacture of finished granite for use in buildings. The company successfully survived the Depression and in the 1930's, provided the granite for the Waldorf Astoria in New York and other buildings in New York, Philadelphia and Washington. As the company's expansion continued, it phased completely out of the monumental business and concentrated in the business of manufacturing finished granite for use in buildings.

During the Second World War, the company converted its entire productive capacity to the production of anti-submarine nets and to the reconditioning of rockets for the war effort. All of the Swensons who were physically able joined the armed forces.

2. Post-War History.

After the Second World War, the company incorporated and the sons of the three owners, the third generation of Swensons, began to enter the firm. Both John and Omer Swenson's only sons became active in the business in the 1940's, and two of Guy Swenson's three sons joined the business in the 1950's.

During the post-war period and through the early 1960's, the company grew and prospered. It became the second largest supplier of building granite in the United States. It quarried and/or fabricated the granite for the CBS Building and the Seagrams Plaza in New York, the Dupont-Brandy Wine Building in Wilmington, Delaware, the Pittsburgh National Bank, the Michigan Bell Telephone Headquarters, and hundreds of other buildings throughout the United States. In Washington, our granite can be found in numerous places and applications, including the Rayburn Office Building, the Hirshhorn Museum, and the Tomb of the Unknown Soldier. From 1945 to 1965, the company never lost money and paid millions of dollars of taxes to the United States government. In the company's three most profitable years in the 1960's, the company paid the United States government approximately $800,000 in Federal income taxes for those years alone.

The company bought additional quarries in the post-war period and now owns seven different granite quarries in the states of Maine, New Hampshire and Vermont, representing six different colors of granite ranging from gray to black. In terms of the Concord area, the company was one of the top employers in the Concord area, employing between 100 and 170 employees during the 1960's. The company was one of the largest city, state and federal taxpayers in the City of Concord, New Hampshire.

3. Current History - 1965-1975.

As a result of the Kennedy Round Tariff Reductions, the impact of competition from imported building granite began to severely erode the company's earnings beginning in 1965. Many of the building granite manufacturers in the United States have gone bankrupt or withdrawn from the building granite business from 1965 through 1975. Despite what was, for a company of our size, a massive investment from 1965 through 1972 of over $1,000,000 to install and update machinery and equipment to meet this competition, and despite diversification into the granite curb business and re-entry into the monumental business, the company suffered staggering losses from 1966 through 1974 which brought it to the brink of bankruptcy in late 1973.

When I became Chief Executive Officer of the corporation late in 1973, I was forced to lay off over one-half of the employees of the company, including over one-half of the management personnel, and shut down the company's operation in order to preserve cash. For those employees in the building granite division, this was a permanent lay off and shut down of plant facilities. While the impact of laying off 40 to 50 people may be minimal by national standards, it is not minimal by community standards in Concord, New Hampshire. Moreover, unlike an executive in a large corporation laying off 5,000 or 10,000 employees, the employees laid off were ten to twenty year employees of the company who the management knew on a first-name basis.

Ultimately, in February of 1974, the company entered into a purchase and sale agreement for the sale of its building granite division for a fire sale price, and on the closing of that agreement in the Spring of 1975, lost over $100,000 on a book value basis, not even considering the fair market value of the land, building and equipment involved.

The company now has an employment level of approximately 40, including both management and union members, and sales of about $1,000,000, a level of approximately 25% of those in the early 1960's. We have retained our quarries and now sell our granites primarily to monumental manufacturers and as granite curb and other quarry products. We sell some rough granite blocks to the purchaser of our building granite manufacturing assets.

In the Summer of 1974, the company petitioned the then United States Tariff Commission for a qualification for Trade Adjustment Assistance under the Trade Expansion Act of 1962. We were successful in the petition and became the first granite company qualified under the 1962 Act. I would note that we joined a select few who had qualified under the stringent qualifications of the 1962 Act which required our company to show that we were injured "in major part" (as opposed to the less stringent test in the 1974 Act) by increased "quantity" (as opposed to the dollar value of that quantity) of imported products.

I have two purposes for raising the Tariff Commission's decision. The first is to illustrate that the predicament of The John Swenson Granite Company, Inc. was not brought about by mismanagement, but by circumstances over which a small company like The John Swenson Granite Company, Inc. had no control. The company and our industry did not participate in or fight the Kennedy Round Tariff Reductions in the rate on imported granite. The dramatic increase in imports to almost 50% of our market was a circumstance not foreseen by our company nor any other company in the building granite business. Perhaps some would say the company stayed in the building granite business too long, but I attribute this to the transmission of tradition in the Swenson family that quality, hard work, perseverance and honesty can overcome any economic set back. The company had managed to overcome depressions and World Wars in its over eighty years of business, and assumed that it could overcome the imports. It could not.

The second reason that I raise the issue of the Tariff Commission is that, pursuant to the decision of the Tariff Commission, we submitted a Trade Adjustment Assistance proposal to the Commerce Department for assistance. The management, management consultants and our accountants, determined very carefully the amount of dollars that were necessary to get the company back where management and its consultants thought the company should be, and the total dollars required was in the vicinity of $900,000. Since the Commerce Department

can provide only debt financing, debt financing in that amount had a substantial adverse impact on the level of indebtedness of the company and raised substantial problems with management in determining whether it could be repaid. With considerable trepidation, however, management submitted a request of $900,000 in debt financing on the basis that we should at least honestly show what we believed to be necessary in terms of actual dollars to revitalize the company from the blow suffered at the hands of imports.

Suffice it to say that at the present time, management has reduced its request for financial assistance from the Commerce Department to a realistic level of debt financing in the area of $300,000. This obviously does not obviate the need for the additional capital. Even this lesser amount of debt financing has not been approved by the Commerce Department, even though our proposal for assistance was submitted over seven months ago and we badly need the capital at this point in time. The other assistance available from the Commerce Department (aside from technical assistance) is an extension of the loss carryback provisions from three years to five years. This does our company absolutely no good as we are not able to pick up any benefits from that extension under current law.

4. <u>The Company's Current Situation</u>.

The company today faces a high demand for its granite, a development that we are delighted with. We have essentially sold out the available production of our existing capacity for

the remainder of 1975. We have been able to produce a reasonable operating profit for the past four months and expect the year to end with a reasonable operating profit. We are, therefore, viable, and the demand for our product is growing. However, years of operating losses have seriously hurt our cash position and our payables are badly out of line, creating unusually high demands on our cash by trade creditors. Our machinery and equipment badly needs updating, maintenance, repair or replacement. Our quarries need development if we are to continue to supply our customers with granite to meet their current needs, as well as to meet the expanding demand in the future. All of this requires capital, capital we do not have and do not have access to.

THE NEED FOR HOUSE BILL 8737

1. The Need for Capital.

I believe that all of the participants of this particular panel are here today to discuss the need for substantial influx of capital into both small and large businesses in order to permit them to survive and grow. I know our company doesn't need any additional debt, and we can't obtain it from conventional sources in any event. We have plenty of debt as it is. What we need is an influx of capital. The question that The John Swenson Granite Company, Inc. faces is how do we get the capital.

It is so ironic and unexpected for me to be sitting here today on a panel with Lockheed, Pan American Corporation,

Chrysler Corporation and the Investment Company Institute.

I assume most of you said "who or what is The John Swenson Granite Company, Inc.?" when you saw the list of participants on the panel. The only reason I am here is because I learned of this hearing and its possible benefit for us from the Washington attorney who handled our Tariff Commission case. Without that personal contact, I would not have even known about this hearing, let alone submitted a request to participate in it.

Frankly, when I learned I had in fact been given an opportunity to come here today to testify before you, I seriously considered simply submitting a statement because I had a great deal of difficulty justifying the expenditure of our very precious cash to come here. From my experience before the Tariff Commission, I was concerned and continue to be concerned about delays in action and modifications to the proposal which would leave our company on the outside looking in, as seems often to be the case with small business. I decided, however, that perhaps by coming here and explaining to you our problem, you would keep it in mind in your consideration of House Bill 8737 and, in fact, perhaps keep small business in mind throughout your considerations of tax reform and relief.

I can honestly say that I think I have learned a great deal about small business in the approximate one and one-half

years since I took a leave of absence from the practice of corporate law to become Chief Executive Officer of The John Swenson Granite Company, Inc. I hope that as a result of my testimony, you will have a better understanding of those problems, particularly as they relate to at least our company. If there is anyone here who does not think small business is in trouble, I invite them to review the transcripts of testimony before the International Tariff Commission concerning tariff reductions. Hundreds of small businesses, as well as big businesses, testified at those hearings, which were held all over the country, as I did in Boston, Massachusetts. I was amazed and even shocked at the number of businesses and industries, ranging from a sardine business in Maine to the textile industry, that faced the same problem. Sooner or later, the ever-present conflicts between balance of payments, employment level and consumer prices must be brought into a meaningful balance. One way to achieve this balance, I believe, is to assure that capital is available to businesses to permit it to adjust to competitive market conditions over which I feel the small businessman has little or no control.

The presence of these large firms here today should magnify for you the problem faced by small business. Big business has traditionally utilized the bond markets, secondary issues of its common stock, or merger with cash-rich financial partners to obtain capital. If these markets are either not available to big business or unattractive to big business,

imagine the effect on a small business. A small closely-held corporation essentially has access to none of these capital markets or financial partners anyway, particularly a small business that has been dealt a crushing blow and is attempting to regain its feet. Where does a small business go to get capital after bank sources have been exhausted. What invester is going to invest in The John Swenson Granite Company, Inc. at this stage of the game when the return on other investments is considerably more attractive at equal, or more likely, lower risk.

2. Justification for the Extension of the Tax Carry-Back Period.

The points raised in the foregoing section, I believe, illustrate for our company the absolute necessity that the net operating loss carryback period be extended to permit not only our company, but other companies in similar situations, to recoup money they have actually paid in Federal taxes. As I indicated previously, we paid $800,000 in taxes for three years alone in the mid-sixties. I am here to ask that you permit us to carry back our losses to recover some or all of that money paid to the Treasury in order to increase our employment, increase our efficiency by capital investment, and increase our profitability. I suggest that our company will pay back those dollars refunded to us in the form of taxes, as well as additional tax dollars from us and from others. I will leave it to the economists to determine the possible

multiplier effect of such a refund, but the impact in terms of investment and return of tax dollars significantly exceeds the amount of the refund.

Some companies may benefit from the tax loss carry-forward provisions either because they can shield high profits in succeeding years from taxes, or they can attract a financial partner looking for tax losses to offset profits, assuming they can meet the stringent pooling requirements now in effect. The John Swenson Granite Company, Inc. could not possibly make enough money in the next eight years, let alone five years, to take advantage of its $750,000 of tax loss carryforwards. Some $200,000 in available tax loss carryforwards have already been lost by our company, and an additional $85,000 expires this year. The prospect of a financial partner, assuming we desire one, is remote, if non-existent, on any reasonable basis. We would obviously elect to receive the entire refund, and if our projections hold true, in the absence of carryforwards, we would immediately begin paying corporate taxes in the year 1975 and increase withholding taxes as a result of increased employment in the year 1976. Obviously, the effect of a refund would have a significant positive impact in the Concord area in terms of employment, paying of payables, and purchases of machinery and equipment.

3. Absence of Relief to The John Swenson Granite Company, Inc. from Recent Tax Reductions.

All of the tax reduction items made by Congress last year have done our company absolutely no good since we have more tax

loss carryforward than we need. Investment tax credits, depreciation changes, increases of the surtax exemption, and other tax reduction measures do us absolutely no good in the short term. The only way we can be helped is by extending the number of years allowable for the tax loss carryback, thereby permitting us to recover taxes paid to the Treasury in prior years to offset the substantial losses in recent years.

We cannot take advantage of any of the recent tax reductions in effect, nor could we take advantage of any further tax reductions or credits that Congress may enact, at least for the next three years. I suggest that this puts our company in an extremely unfair relative position to those companies who have had successful years from 1970 through 1975 and are able to obtain the benefits of these reductions through lesser tax payments.

I know of other companies in New Hampshire in relatively the same position as ours, and certainly a careful analysis would develop hundreds of small businesses like ours who desperately need the positive impact of tax relief but have not obtained any benefits from the recent tax reductions. We think we are at least as deserving of tax relief, and certainly in as much need, as other businesses who enjoy the benefits of the recent tax reduction. An extension of the period for carrying back net operating losses provides a reasonable vehicle for that relief, particularly since Congress has already recognized that a company should be able to carry forward or carry back its

losses. What The John Swenson Granite Company, Inc. seeks is not a radically new proposal, but simply extending the coverage of an existing provision to assist small businesses such as ours in obtaining the necessary capital to return their businesses to normal levels of employment, efficiency and profitability.

Thank you.

Kurt M. Swenson

Kurt M. Swenson, Executive Vice President of The John Swenson Granite Company, Inc.

Summary

of the testimony of

MICHAEL WARIS, JR.

on

CAPITAL FORMATION AS IT RELATES TO
THE CARRYFORWARD AND CARRYBACK OF
NET OPERATING LOSSES

July 30, 1975

1. On behalf of small and medium size businesses, both individual and corporate, which have suffered severe operating losses during the past 5 years, I urge enactment of H.R. 8737 as a source of badly needed capital formation. H.R. 8737 would:

a. Permit net operating losses to be carried back for 5 more years in exchange for giving up 5 carryforward years, thus generating tax refunds to provide this greatly needed capital, and

b. Close the loophole of buying and selling loss carryforwards.

2. The Tax Reduction Act of 1975, and proposed further rate reductions, investment tax credit amendments and depreciation reforms do absolutely nothing for companies which have suffered losses during the recession. Only taxpayers earning income benefit from these changes. Loss companies have been completely bypassed or overlooked. Fairness, as well as sound tax policy, indicates that loss carrybacks should be liberalized to provide hard-hit taxpayers with this source of capital--in effect funded out of their own prior tax overpayments.

3. This is not a "big corporation" or "private interest" proposal. On the contrary, it is estimated that 75% to 80% of the refunds would go to hundreds of small and medium size companies.

4. This proposal is a mere rearrangement of the number of years over which losses and income can be averaged; it is <u>not</u> an enlargement of the period of years over which such averaging can take place.

5. Nine Committee-invited economists testified a few months ago that this proposal would more effectively and efficiently work to stimulate the economy than any other aspect of tax reduction, tax rebate or tax reform considered by the Committee to date.

Statement of

MICHAEL WARIS, JR.

before the

Committee on Ways and Means
U. S. House of Representatives
Hearings on Tax Reform
July 30, 1975

regarding

CAPITAL FORMATION AS IT RELATES TO
THE CARRYFORWARD AND CARRYBACK OF
NET OPERATING LOSSES

Mr. Chairman and members of the Committee, I am Michael Waris, Jr., a member of the law firm of Baker & McKenzie. I appear on behalf of a number of small and medium size companies which have suffered severe net operating losses over the last five years of economic decline and recession. The names and a brief profile of each are attached to this statement.

The difficulty of raising capital, which so many profitable taxpayers are currently having, is greatly magnified in the case of these "loss companies." Their lines of credit are even more fully extended. Their stock at present is not an attractive investment. Improvements in the investment tax credit, depreciation liberalization rate reductions and similar tax reforms will not help these companies. Such tax reforms presuppose taxable income and completely disregard those taxpayers who have suffered losses.

The refund of taxes which these companies in effect overpaid in earlier profitable years is the only real source of capital available to them today.

Therefore, I urge the Committee to act favorably on Mr. Burke's bill, H.R. 8737, which would produce such tax refunds by permitting losses to be carried back five additional years--in exchange, however, for giving up five carryforward years. In other words, the averaging period of present law would not be enlarged--the order in which loss and profit years are matched against each other would simply be rearranged. Eighteen members of this Committee previously voted in favor of this proposal.

In the short time alloted I would like to make three basic points:

1. It is very important to have clearly in mind that an estimated 75% to 80% of the benefits of the proposal would go to small and medium size companies. Or to put it another way--the taxpayers who will obtain the great bulk of the benefit from this amendment will be numerous companies other than Chrysler, Pan Am and Lockheed. This point seems to have become completely obscured when this matter was last before this Committee. Perhaps it is more newsworthy to single out larger, better known

taxpayers--but it is unfortunate that the case of the smaller taxpayer is neglected in the process.

2. It is also important to remember that we are talking about losses. H.R. 8737 does not seek a new deduction, new credit or other new tax break. It does not ask that other taxpayers subsidize these loss companies. All that it asks is that a taxpayer who has suffered an extraordinary operating loss be allowed to use such loss in a manner which will most effectively enable it to again become a profitable taxpayer. Certainly a large business loss is not an occurrence which can be called a tax-saving maneuver, a tax shelter, or a tax gimmick. Operating losses are not planned; they, like flood and drought to the farmer, are disasters to the businessman.

Therefore, to look upon a provision which would extend the period for carrying back losses--at the expense of giving up the right to carry losses forward--as some sort of tax bonanza completely mystifies me. It should not matter whether the largest company or the smallest proprietorship is involved. The principle is the same: Business losses should be fully deductible--and in a manner which will be most

beneficial to the individual taxpayer and the country as a whole.

3. This leads me to my last point: Making the loss carryback rules a more efficient part of our Federal tax system.

One important function of that system is to foster stability by taking funds out of the economy when it is overheated and by putting them back during a period of recession. However, if operating losses cannot be offset against earlier profits, the tax system can have just the opposite effect.

For example, typical of a great many New England shoe companies, take the case of a small shoe manufacturer who, after 25 years of profits (which have been subjected to full taxation), incurs net operating losses in the past few years. By 1975, his working capital is badly depleted. His suppliers are demanding cash on delivery. His bank refuses to increase his accounts receivable loan. He has nowhere to turn for more operating capital.

From a sales standpoint, however, his recession is over. Customers are once again eager to buy--but they need the customary 90 days credit. He cannot provide it so he restricts his business by taking only orders which will be paid within 30 days after delivery.

Because he has been unable to carry his recent losses back further than 3 years he has not gotten a refund of taxes paid in the past. Without these funds he must hold his business in check at the very time when the country needs it to expand. In this way the present 3-year carryback rule is really inhibiting the economy's recovery.

To give the most ailing of our taxpayers a shot in the arm which will, in turn, be plowed right back into the economy to help lick the recession--the Committee should act favorably on H.R. 8737. This is not merely the view of an advocate interested in his clients' cause--it is also the conclusion unanimously shared by 9 of the country's leading economists who testified before this Committee, at the Committee's invitation, only a few short months ago.

PROFILES OF
SELECTED SMALL AND MEDIUM SIZE COMPANIES
WHICH WOULD BENEFIT FROM THE ENACTMENT OF H.R. 8737

	NAME	LOCATION	BUSINESS	NUMBER OF EMPLOYEES	ANTICIPATED REFUND	ANTICIPATED USE OF FUNDS
1.	American Girl Fashions, Inc.	Ware, Massachusetts	Women's shoe producer	2000 in 1966 200 today	$3,000,000	working capital
2.	Bernie Shoe Co.	Haverhill, Massachusetts	Women's shoe producer	170 in 1966 100 today	$ 25,000	payroll and supplies
3.	Joseph Weiss & Sons, Inc.	Brooklyn, New York	Granite fabricator	20 today	$ 35,000	new equipment
4.	Ampex Corporation	Redwood City, California	video and audio recording and playback equipment	13,000 in 1969 10,000 in 1975	$9,300,000	working capital
5.	Dover Shoe Mfg. Co.	Somersworth, New Hampshire	Women's shoe producer--inactive pending a change in the economy and additional working capital	200--presently laid off	$ 200,000	working capital to reestablish business
6.	The Bibb Company	Macon, Georgia	Textile manufacturer	9000 in 1968 5000 today	$3,000,000	equipment and supplies

(These corporations are representative of the type of small and medium size companies which would benefit from the enactment of H.R. 8737. A more detailed description of each is attached.)

MEMORANDUM

DATE: JULY 30, 1975

RE: H. R. 8737

AMERICAN GIRL FASHIONS, INC. (FORMERLY CONSOLIDATED NATIONAL SHOE CORPORATION), WARE, MASSACHUSETTS

PROFILE OF A COMPANY WHICH WOULD BENEFIT FROM AN EXTENSION OF THE NET OPERATING LOSS CARRYBACK PERIOD

Among the companies which would benefit from an extension of the net operating loss carryback period would be American Girl Fashions, Inc., operating in Massachusetts, Maine and New Hampshire.

American Girl Fashions, Inc. was originally founded in Lynn, Massachusetts in 1917 as a women's shoe manufacturer. Over the years it expanded its operations until in 1968 it was a large publicly held company, with numerous factories and over 2,000 employees.

In 1969 it began to suffer losses, however, and has recently been forced to file a petition under Chapter 11 of the Bankruptcy Laws in order to permit it to reorganize its affairs. Many of its plants have been closed. Employment has declined from over 2,000 in 1968 to approximately 200 at the present time.

Under existing law, American Girl is not able to offset its recent substantial losses ($12 million in the past five years) with previous profits. However, if H.R. 8737 is enacted, permitting corporations to carry their losses back for an additional five-year period, American Girl would receive an immediate refund in the neighborhood of $3 million from taxes previously paid. These funds would be promptly put to use for the purchase of additional materials and payroll, and would materially assist in the recovery of this substantial New England employer and taxpayer.

MEMORANDUM

DATE: JULY 30, 1975

RE: H. R. 8737

BERNIE SHOE COMPANY, HAVERHILL, MASSACHUSETTS

PROFILE OF A COMPANY WHICH WOULD BENEFIT FROM AN EXTENSION OF THE NET OPERATING LOSS CARRYBACK PERIOD

The Bernie Shoe Company is a small owner-operated Massachusetts shoe manufacturer which was founded in 1946 in Haverhill, Massachusetts. Over the years it grew and prospered, earning profits and paying federal income taxes. By 1966 it employed nearly 170 workers and its sales had risen to over $1.5 million.

Since 1970, however, it has incurred losses which, although not large by big company standards, are substantial for it. In recent years it has cut back its operation in part because of the lack of working capital. At the present time it has only about 100 employees, a decrease of 40 percent since 1966.

Under existing law Bernie Shoe Company is not able to carry its present losses back far enough to fully match them up with earlier profits, and accordingly, it has net operating losses which it is not able to use. However, if

legislation is enacted permitting corporations to carry their losses back an additional five years, Bernie Shoe Company will offset its current losses against earlier profits, and will receive an immediate refund in the neighborhood of $25,000. The funds received by this small company will be promptly put to use for the purchase of additional materials and to meet payroll.

MEMORANDUM

DATE: JULY 30, 1975

RE: H.R. 8737

JOSEPH WEISS & SONS, INC., BROOKLYN, NEW YORK

PROFILE OF A COMPANY WHICH WOULD BENEFIT FROM AN EXTENSION OF THE NET OPERATING LOSS CARRYBACK PERIOD

Joseph Weiss & Sons, Inc. is a small owner-operated New York granite and marble fabricator which was founded in 1952 in Brooklyn. The company made moderate profits for the first twenty years of its existence and paid substantial amounts in Federal income taxes.

Since 1973, however, this company has incurred large losses which have depleted its working capital. Under existing law it is not able to carry these current losses back far enough to fully offset them against previous profits. If H.R. 8737 is enacted, however, it will be permitted to carry its losses back an additional five years, thereby providing it with an immediate refund in the neighborhood of $35,000.

The funds received by the company will be used to replenish its working capital and to provide for new equipment.

MEMORANDUM

DATE: JULY 30, 1975

RE: H. R. 8737

AMPEX CORPORATION, REDWOOD CITY, CALIFORNIA

PROFILE OF A COMPANY WHICH WOULD BENEFIT FROM AN EXTENSION OF THE NET OPERATING LOSS CARRYBACK PERIOD

Among the companies which would benefit from legislation extending the period for carrying back net operating losses is Ampex Corporation. This company was founded in 1944 with 20 employees and had grown to a high point of over 13,000 employees in 1969; its present employment is approximately 10,000. It has been an important source of economic activity in the Redwood City, California area, as well as Los Angeles, Colorado Springs, Colorado, and Opelika, Alabama, where manufacturing plants are located. The company has contributed significantly to technology in the fields of communications (video and audio magnetic recording/playback equipment), peripheral computer equipment, rapid access data storage/retrieval, and magnetic instrumentation recording. Its products are employed extensively in the fields of broadcasting (both television and radio), industry, education and government.

During the 1971 and 1972 fiscal years of Ampex, the television broadcasting industry was badly depressed, not only because of general economic conditions but also by

reasons of conditions peculiar to the industry. In addition, there were problems regarding markets for other lines of Ampex products. As a result, Ampex for these two taxable years had net operating losses totaling $96,000,000. These losses served as a basis for recovering all of the taxes paid in the preceding three years, and there still remained approximately $68,700,000 of losses to carry forward. Even taking into account the fact that the company has accomplished a turnaround, it is still far from certain that utilization of the net operating loss carryover can be effectuated in the normal course of business prior to expiration of the loss utilization period under current law. If H.R. 8737 is enacted, however, permitting taxpayers to carry their losses back an additional five years, Ampex Corporation will receive a refund of taxes of approximately $9,300,000. This would enable the company to increase its working capital and reduce its long-term indebtedness.

MEMORANDUM

DATE: JULY 30, 1975

RE: H. R. 8737

DOVER SHOE MFG. CO., SOMERSWORTH, NEW HAMPSHIRE

PROFILE OF A COMPANY WHICH WOULD BENEFIT FROM AN EXTENSION OF THE NET OPERATING LOSS CARRYBACK PERIOD

Dover was founded in Dover, New Hampshire in 1934 as a producer of low and medium priced women's footwear. Over the years it grew, prospered and paid substantial Federal taxes on earned income. In 1969 it moved unto a new ultra-modern one-story plant in Somersworth, New Hampshire.

In the late 1960's and early 1970's, Dover began to be overwhelmed by competition from low-priced imported women's shoes, made even more competitive by constantly decreasing tariffs. Dover's sales and production decreased and it incurred heavy losses.

Before Dover could make the necessary changes in its operations to become profitable again, the recession struck. Being unable to carry its current losses back for more than three years, Dover was unable to obtain refunds of taxes previously paid. In a short time it became desperately short of working capital. Rather than continue a deteriorating situation, Dover made an arrangement to pay off its creditors and ceased manufacturing operations.

Its more than 200 employees were laid off and the company now awaits an opportunity to get back on its feet.

MEMORANDUM

DATE: JULY 30, 1975

RE: H. R. 8737

THE BIBB COMPANY, MACON, GEORGIA

PROFILE OF A COMPANY WHICH WOULD BENEFIT FROM AN EXTENSION OF THE NET OPERATING LOSS CARRYBACK PERIOD

Among the companies which would benefit from legislation extending the period for carrying back net operating losses is The Bibb Company, a southern textile manufacturer. This company made a profit in every year from 1911 to 1968, and in the period from 1941 to the present, it has paid $66 million in income taxes.

In 1969, it began suffering losses, at first because of intense import competition, and later because of the recession. As a result, it has been forced to close a substantial portion of its plants. Since this company is one of the largest employers in the State of Georgia, the resulting lay off of 45 percent of its labor force (approximately 4,000 employees) has had a significant effect upon the state's economy.

The recent losses have also had a disastrous effect on the company's stockholders. No dividends have been paid since 1968, and the market price of the company's stock has declined by 84 percent since 1966.

The company has suffered cumulative tax losses in the past four years of $20 million, and under existing law it is unable to fully offset these losses against previous profits. If H.R. 8737 is enacted permitting corporations to carry losses back for five additional years, the company will obtain an immediate refund of approximately $3 million from taxes paid during earlier periods. These funds will be used to replenish badly depleted working capital so that more supplies can be purchased and more employees put back to work.

STATEMENT OF
RICHARD A. FRELING
BEFORE
THE COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
TAX REFORM HEARINGS

July 30, 1975

My name is Richard A. Freling, and I am a partner in the law firm of Jenkens & Gilchrist, Dallas, Texas. I am appearing before the Ways and Means Committee (the "Committee") as an invited witness, and I hope that this statement and my oral commentary will be of use to the members in analyzing various current proposals for amendment of the provisions relating to the carryback of net operating losses. I began my inquiry with no preconceived notions about the efficacy of the proposals, and my objective throughout will be to present the issues as impartially as my experience and personal predilections will permit. In view of the financial crises which beset the corporations urging this legislation and the impact upon their employees and the economy generally, the proposals obviously warrant the most careful scrutiny.

I believe that it is important in evaluating these proposals to differentiate between those aspects which are premised on abstract tax policy, those which are designed to provide special relief or incentives for particular

recession beleaguered industries, and those which seemingly are motivated by other considerations. The distinctions often blur, and in some respects there may be a confluence of all three factors; however, there are discernable differences which, if kept in focus, could be meaningful in testing the proposals against their avowed objectives.

Evolution of the Net Operating Loss Offset Provisions

The evolution of the net operating loss provisions of the Internal Revenue Code (the "Code") and its predecessor statutes represents a continuous effort by Congress to reconcile the exigencies of business with a tax system founded upon an annual accounting concept and the practicalities of tax administration. The annual accounting concept is arbitrary, and the Code is replete with individualized efforts to ameliorate the harsh and capricious characteristics of that concept or to preclude various abuses which it also engenders. The net operating loss offset provisions are but one example.

The operating loss carryback and carryforward were first introduced by section 204 of the Revenue Act of 1918, which permitted the net losses sustained in one year to be claimed as a deduction against income of the prior taxable year and then against the income of the succeeding taxable

year. The report of the Senate Finance Committee indicated that a system of taxation based upon the annual accounting concept had as its chief merit simplicity of administration, but, the Report stated, ". . .it does not adequately recognize the exigencies of business, and, under our present high rates of taxation, may often result in grave injustice."[1] The rates have changed but not the sentiment! Since those balmy days, the statutory period for carryback and carryforward of net operating losses has been amended no less than sixteen times.[2] The last general amendment to the Code occurred in 1958,[3] and this established the three-year carryback, five-year carryforward with which we are so familiar today. However, of the sixteen amendments, six carved out special exceptions for selected industries or, in one case, a particular corporation.[4]

Therefore, it is evident that Congress has not viewed the rules pertaining to the carryback and carryforward of net operating losses as either sacrosanct or immutable. To the contrary, generic changes were made whenever Congress determined that its policy objectives were inadequately served by the then existing rules, and special relief provisions were enacted when the circumstances so warranted.

Philosohical Objectives of the Carryback and Carryforward Provisions

What are (or were) the objectives which Congress apparently hoped to accomplish? Broadly stated, the carryback and carryforward of net operating losses over a nine-year period is a crude mechanism for income averaging. More specifically, the backward-forward offset philosophy has been justified on several grounds:

(1) To preclude the imposition of what is tantamount to an income tax on capital rather than income;

(2) To reinforce tax neutrality by permitting industries or businesses with wide cyclical swings to level their incomes, thereby facilitating competition for investment capital with others whose earnings' levels are more stable or predictable;

(3) To provide a countercyclical effect by stimulating investment in periods of recession or financial difficulty; and

(4) To encourage the entry of risk or venture capital into the marketplace.

The attainment of these objectives is inextricably related to the length of the offset period. Significantly, both the Treasury Department and the Internal Revenue Service have undertaken studies in the past to analyze the business

cycle and the experience of selected businesses over a given period of time in absorbing their net operating losses against past or future profits.[5] It appears that Congress has been responsive to that logic.

Thus, there is no compelling reason why Congress should now repudiate a further change in the period for which net operating losses may be carried back or carried forward if extant knowledge about the contemporary business cycle or the financial misfortunes of important industries or major segments of our economy demonstrates that the present rules are inadequate to accomplish the basic objectives. Surely, there is nothing repugnant about a tax system which says that a taxpayer who bears his tax burden in a good year may recoup all or a portion of those taxes in a bad year.

In theory, lifetime (or period of existence) averaging, both backwards and forwards, has legitimate appeal, but we know that politically and administratively such a radical concept is not feasible; nor might it be desirable if the erosion of Federal revenues and the attendant impact on the budget and fiscal policy was too severe. Accordingly, the authentic and limited issues are as follows: should the carryback period be extended, should the carryforward period be extended, and in either case for how long and under what conditions.

General Comparison of the
Carryback and the Carryforward

The net operating loss carryback and carryforward appeared in 1918 on an equal plane, but the carryback soon lost favor to the carryforward and that trend has essentially continued.[6] Each has its advantages and disadvantages, and a comparison may anchor in better perspective the issues with which the Committee is confronted. There are several points for comparison:

(1) The carryback results in an immediate infusion of cash for the business enterprise at a time most closely proximate to the period of financial loss, whereas the carryforward requires the business enterprise to "bet on the come."

(2) In that sense, the carryback may provide a greater stimulation for current investment since it represents a mechanism for internal regeneration of capital. The production of future income to absorb a carryforward necessarily entails the further utilization of existing capital, debt financing or the attraction of new capital.

(3) Based on that rationale, the carryback may be deemed to have a somewhat greater countercyclical effect than the carryforward, but prior studies have suggested that the countercyclical

effect of either may not be significant on a nationwide basis.

(4) However, the Report prepared by the Treasury Department in connection with Revenue Revisions of 1948 suggested that the problem in a depression is not a shortage of funds for investment, but the lack of profit expectations. Studies had indicated that in periods of low economic activity there was excessive rather than deficient business liquidity. It is by no means clear that this is true today when recession and inflation coexist.

(5) It has been alleged that the carryback places new enterprises at a disadvantage in the competitive market, because an existing enterprise could finance expansion or the development of new products with the refund obtained from a carryback of programmed "start-up" losses, whereas a new enterprise must rely solely on the carryforward to recoup its invested capital.

(6) The carryback is much more cumbersome to deal with administratively, and if extended for an unlimited or extremely lengthy period could result in an administrative and record-keeping nightmare.

The carryforward embodies little of these difficulties.

(7) The carryback may complicate the compromise and settlement procedures which are essential to effective administration of the tax laws, but the impact of this factor must be deemed negligible.

(8) The carryback has the distinct attribute of certainty while the effect of a carryforward is essentially speculative. This dichotomy is recognized by Accounting Principles Board Opinion No. 11, which attempts, in part, to deal with carrybacks and carryforwards from a financial accounting standpoint. Carrybacks are treated in accordance with the fundamental accounting concept of matching revenue and expense. Thus, the tax effects of a carryback are included in the results of operations in the loss period since realization of the benefits is assured. Carryforwards, however, are treated differently. The existence of a carryforward indicates that the business enterprise has experienced operating losses which have already exhausted the benefits of the carrybacks and which can be realized only in the future. Since realization of the carryforward benefits is generally not assured,

the tax effects are not recognized in the results of operations until actual realization. The Accounting Principles Board apparently regards this as a departure from the "matching" concept in favor of the conservative accounting principle that items should be recognized in operations only if they are reasonably certain. Consistently, there is an exception which permits current recognition in the loss period where realization of the carryforward benefits is assured beyond any reasonable doubt, and this standard is deemed to be satisfied when both of the following conditions exist:

(a) The loss results from an identifiable, isolated and nonrecurring cause and the company either has been continuously profitable over a long period or has suffered occasional losses which were more than offset by taxable income in subsequent years; and

(b) Future taxable income is virtually certain to be large enough to offset the loss carryforward and will occur soon enough to provide realization during the carryforward period.

It seems highly unlikely that many business enterprises will be able to meet these standards. Thus, the net operating losses in excess of the amount that can be absorbed by the carryback will further deepen the "loss per share" in the loss period, and the recoupment through the carryforward in a subsequent year will doubtless be characterized as an extraordinary credit. Extension of the carryback period would resolve this problem to some extent, since the number of occasions when a business enterprise would exhaust the carryback period and be compelled to rely upon the carryforward presumably would be diminished.

(9) The carryback is not the raison d'etre for trafficking in loss corporations, so an extension of the carryback period should have little or no adverse effect. Conversely, the extension of the carryforward period would compound the problem. The pending expiration of the carryforward period unquestionably is a disincentive to a struggling business, and sometimes is the motive for tax-oriented deals designed solely to anticipate income. Although these are legitimate reasons for extending the carryover period, any such extension will

multiply the opportunities for abuse so evident in the classified sections of financial and trade journals unless correlative measures are adopted to inhibit those practices.

There may be other relevant bases for comparison, but those described above were most visible in the legislative history. Perhaps they do not prove much in the abstract, except that it is perplexing to determine whether from the standpoint of long-range tax policy the carryback or carryforward is preferable and that Congress has struggled with the concepts. The comparison does suggest that abrupt changes would probably be inadvisable, and that cautious balancing between the two is more likely to achieve a broad-scale equitable result. Assuming that a choice has been made about the direction (or directions) of the net operating loss effect, the next critical question is the length of the applicable period.

Observations With Respect to the Length of the Carryback or Carryforward Period

As I stated previously, income averaging which moved on some continuum has theoretical appeal, but it is neither politically feasible nor realistic. Consequently, limits have been selectively imposed on the carryback and carryforward periods from time to time for reasons which Congress

deemed expedient. Those reasons are not readily discernable in each instance from the legislative history, but it would seem that some of the appropriate considerations should be as follows:

(1) The aggregate period over which the net operating loss may be carried back and carried forward should parallel the business cycle, since that equation would achieve the primary objectives described previously. Obviously, economic forecasting is not an exact science, but the closer the approximation to economic reality the more likely that the offset period will result in the implementation of abstract tax policy and not selective incentive to or relief for particular segments of our economy which would be vulnerable to claims of special interest legislation. However, the determination is complicated by the fact that the business cycle is not the same for all industries. I am not an economist and I tred these waters only with the greatest trepidation, but it is my understanding[7] that there are at least three distinct types of business cycles: a relatively short-term trade cycle which reflects fluctuations in inventory accumulation; a capital goods

cycle for capital intensive industries which reflects the demand for facilities and production equipment; and an industry cycle which reflects characteristics unique to a particular industry. It would seem that the present nine-year offset period may be adequate to accommodate the recoupment of losses in the trade cycle, but the capital goods cycle and the cycle in certain industries (such as construction) almost certainly extend for longer periods. Moreover, in the contemporary situation we are dealing with forces beyond those traditionally associated with fluctuations in the business cycles and which are having a profound effect on the structure of the international economy.[8] In some industries, the changes may be so radical or of such grave significance that the constituent corporations will require massive infusions of capital and a longer recovery period to adjust to the evolving competitive markets.

Because of the importance of the capital intensive industries to our economy and our society it would be plausible therefore to weight the offset period in favor of the estimated capital goods cycle. Stated simply, I would rather see the offset period

be a little too long than too short if that is necessary to assure that our inaccurate methods of measurement do not short-change important segments of our economy in their opportunities to replenish capital.

(2) Testimony before the Committee and the Senate Finance Committee in connection with the Tax Reduction Act of 1975 suggested that certain industries and corporations have experienced catastrophic losses which are the product of aberrational conditions that transcend the normal business (or capital goods) cycle. Thus, their representatives have proposed an extension of the carryback period which they believe is necessary to facilitate recoupment of their losses at a time when the funds are most needed. However, a threshold question is whether these provisions of the income tax law are the most desirable legislative mechanism to accomplish that purpose. This is one of the areas where the legislative history of the net operating loss offset provisions indicates a "mixed bag" of Congressional motives. Efforts have clearly been made to correlate the offset period with the business cycle, but it is equally clear that special attention has been focused

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on more specific objectives -- encouraging investment or assisting particular industries or categories of taxpayers. Thus, there certainly is precedent if Congress should again choose to legislate in this area.

(3) If the net operating loss offset period is extended beyond the appropriate business cycle in order to provide specific relief, should conditions be imposed which will assure that the beneficiaries of the extension will utilize the benefits to fulfill that purpose? For example, if the carryback period is extended to stimulate business expansion or assist selected industries which are on the financial ropes, that purpose would not be served if the corporate beneficiary chose to distribute the benefits to its shareholders as a dividend or to "cash out" by liquidating entirely. Therefore, it would seem logical to require that the corporation remain in business for some stated period and that the benefits be reinvested or "plowed back" into operations. If the corporate beneficiary failed to comply with these requirements, the benefits would be reversed or "recaptured". On the other hand, if the extension of the total offset period is designed

solely to equate with the business cycle, there might logically be no prerequisites other than the realization of a sufficiently large net operating loss.

(4) The longer the offset period the more remote the parameters are from the year in which the loss is incurred. One ramification is that the effect on Federal revenues and fiscal policy will be more unpredictable. Another ramification is the greater likelihood that the shareholders of the corporation in the profitable years when tax is paid or in the year the net operating loss is incurred will change by the time the benefits of the extended offset period are realized.

(5) Manifestly, the estimated revenue cost of any change and the relationship thereof to current fiscal policy must be considered.

(6) Finally, the practical and administrative problems engendered by an extension of the offset period should be taken into account.

Again, there may be other considerations, but these seemed to be the most revealing. There is a great temptation in addressing these questions to resort to generalizations or shibboleths, but the hard decisions will not go away. In the

final analysis, Congress must identify its objectives and determine the period over which net operating losses may be carried back or forward consistent with those objectives.

Relationship of the Net Operating Loss Carryback and Carryforward to Capital Formation

In my opinion, the tax laws should encourage capital formation. There is a concensus that the United States is now or will in the next decade be confronting an impaired capital market which will make it difficult to replenish or accumulate the capital indispensable to support an expanding labor force, technological improvements or adaptations (particularly in the energy and environmental areas), and the anticipated growth in the demand for goods and services. Secretary Simon, in his statement to this Committee on July 8, 1975, synthesized the urgency for capital formation and the complex interrelationship between capital formation, fiscal policy and our tax laws.

Concommitantly, ours is essentially a self-assessment system of taxation which is dependent upon acceptance by the general citizenry. It is also imperative, therefore, that the tax laws be simplified and reform measures enacted to assure that the tax burden is equitably shared in a manner consistent with National policy. This requires Congress to draw and monitor continually a carefully conceived balance

between the tax imposed on the fruits of labor and the tax imposed on the fruits of capital investment. I do not underestimate the importance of that process, which may be the key to making the system work. However, if the balance is upset, if the investment of capital is inhibited by a bias in our tax laws so that the private sector is unwilling to (or incapable of) supplying the capital necessary to fuel the multiple facets of our economy, we will inexorably witness further intervention by government. And that, in turn, will surely lead to further management of the economy and incursions on the free market system.

Instead, our tax laws should encourage capital formation and the participation by the private sector in the dynamics of economic and social change.

I stated at the beginning that one of the fundamental purposes of the net operating loss offset provisions was to preclude the imposition of what would be tantamount to an income tax on capital. Thus, these provisions have a direct relationship to capital formation, and their modification to reflect current economic reality should be a relatively innocent method of pursuing that objective within our tax laws.

Recommendations

Based upon my analysis of the historical purposes of the net operating loss offset provisions, I would recommend that the Committee consider the following:

(1) Unless the econometric information is already available, the Committee should request the Staff of the Joint Committee or the Treasury Department to prepare a report the scope of which would be as follows:

(a) Analyze the business cycles (particularly the trade and capital goods cycles) operative in the United States today;

(b) On the basis of assumptions deemed appropriate, seek to predict or forecast changes in the business cycle over some selected future period;

(c) Determine whether or not the present nine-year offset period roughly parallels the business cycles and has been adequate to permit recoupment of losses generally in the period 1960-1975; and

(d) Identify aberrational or unusually extreme periods of loss which have been experienced by particular segments of our

economy and which may therefore warrant special attention.

(2) There is no magic in the present offset period. If it is determined that the present offset period is inadequate to assure reasonable recoupment of losses by a major segment of our corporate economy, the period should be extended. A modest extension without substantial revision of existing law would necessitate only the equalization of the carryback and carryforward periods at five years, thereby extending the aggregate offset period to eleven years. If this period is not of sufficient duration to accommodate fluctuations within the estimated capital goods cycle -- which should be the dominant consideration -- the offset period should be extended further. Since the extension would be designed to have general application in order to implement abstract tax policy concerning the fundamental objectives of the offset provisions, I would see no justification for coupling the extension to special conditions, such as "plow back" or continuity of business enterprise rules. Congress has not seen fit to do so in the past, and there would seem no reason for doing so now. However, if the carryforward

period is extended (or perhaps even if it is not), I would recommend that additional measures be adopted to prevent abuses in the sale or reorganization of loss corporations.

(3) Whether or not the aggregate offset period is extended, Congress must decide whether it is appropriate to alter the existing relationship between the carryback and the carryforward. As the previous comparison between the two demonstrates, the choice is a tough one, and there is a simple elegance in preserving the existing relationship or at least placing them in equilibrium. This could be accomplished with no major revisions to the statute. On the other hand, the translation of the aggregate offset period entirely into a carryback (i.e., elimination of the carryforward) would be an abrupt and radical departure from present policy and procedure, and it would be difficult to predict the long-range effects on the economy. Furthermore, that alternative probably would not be acceptable or appropriate for many business enterprises (certainly those that were new or in their infancy), so the exclusive carryback would have to be elective. The presence of

an election autmatically raises peripheral but important questions: should the election be revocable and upon what conditions, should a taxpayer be entitled to more than one election, how should subsequent loss years be handled, etc. The transitional and procedural problems entailed in "electing in" and "electing out" would be highly complex, and the election could be something of a sporting event if the conditions imposed made the ultimate result unpredictable. I see no justification for taking these risks as a matter of abstract tax policy. On the other hand, an extended carryback may be the most expedient method of providing special relief in the form of an immediate infusion of cash, and that leads to the next point.

(4) If the report demonstrates that particular industries or segments of our economy have suffered extraordinary losses or are the captives of an aberrational business cycle, Congress should determine whether or not as a matter of National policy they should be provided special relief and whether that relief should be facilitated through the tax laws. The tax laws have, of course, been utilized countless times in the past for similar purposes,

and so long as that is an inherent characteristic of the system I personally find nothing objectionable in using the carryback provisions as the mechanism for accomplishing the special relief -- if the need is demonstrable and urgent. Since the extension of the carryback would, by hypothesis, have only limited and not universal application, it should be available only by special election. The special election should be designed to assure that the purposes of the extended carryback would be fulfilled by requiring --

(a) reinvestment or "plow back" in the business operations (including repayment of government guaranteed or other debt incurred for business purposes) of any refund obtained through the special election; and

(b) continuation in business for some prescribed minimum period.

If the electing corporation failed to comply with either or both of these conditions, the refund benefits theretofore obtained would be recaptured. The amendment approved by the Senate, but eliminated by the Conference Committee, in connection with the Tax Reduction Act of 1975 was deficient, in my

judgment, in that it did not address that question. On the other hand, if the need is there and the extended carryback is a "one-shot" election, there may be no reason to impose other conditions, such as a waiver of future carryforwards and other transitional rules which unduly complicate the legislation. The proposed waiver of future carryforwards as the "price" for an extended carryback transforms the refund into something which has some characteristics of a loan that would be "repaid" out of increased taxes during the subsequent carryover period. Of course, to the extent that the extended carryback results in the utilization of losses that otherwise would have been "lost" under the present period, the "loan" is tantamount to a permanent refund. Finally, if the special relief measure were accompanied by a general extension of the offset period, as suggested before, the justification for making the extended carryback a continuous option might evaporate.

(5) I also see no justification for tying the extended carryback to a contribution by the corporation to an employee stock ownership or other employee benefit plan. I personally believe that the ESOP has great potential as a device for

developing wider participation by the labor force in corporate ownership, but that subject should be encouraged independently by Congress.

Conclusion

I am grateful to the Committee for this opportunity to be a part of this important legislative process.

FOOTNOTES

1. Sen. Rep. No. 617 (65th Cong., 3d Sess., 1918).

2. The follosing chart depicts the various changes in the net operating loss carryback and carryover provisions:

Act	Section	Carryback	Carryover
1918	204	1	1
1921	204	0	2
1924	206	0	2
1926	206	0	2
1928	117	0	2
1932	117	0	1
1933	218	0	0
1939	23(s), 122	0	2
1942	23(s), 122	2	2
1950	23(s), 122	1	5
1951	23(s), 122	2	3
1954	172	2	5
1958	172	3	5
1962	(a)172(b)(1)(A)(ii)	5	5
	(b)172(b)(1)(C)	3	7
1964	(c)172(b)(1)(D)	0	10(15)
1967	(d)172(b)(1)(E)	5	3
	172(b)(3)(E)		
1969	(e)172(b)(1)(F)	10	5
	(f)172(b)(1)(G)	10	5

(a) Special provision applicable to certain businesses which have been injured by imports as a result of the Trade Expansion Act of 1962.
(b) Special provision applicable to regulated transportation corporations.
(c) Special provision applicable to foreign expropriation losses other than those attributable to Cuba. A 1971 amendment permits Cuban losses to be carried over 15 years.
(d) Special relief measure designed for American Motors Corp., which expired with the taxable year ended December 31, 1968.
(e) Special provision applicable to certain financial institutions.
(f) Special provision applicable to a Bank for Cooperatives (chartered pursuant to §2 of the Farm Credit Act of 1933).

3. Pub. L. No. 85-866, §203(a) substituted "1957" for "1953", and "3" for "2" in ¶(1) of §172(b).

4. See note 2, supra.

5. Treasury Tax Studies prepared in connection with the Revenue Revisions of 1948, Hearings before the Committee on Ways and Means, p. 3783 (1947-48).

6. Only once since the Revenue Act of 1918 have the carry-forward and carryback been of equal length. A 2-year carryback and carryover was permitted under §122 of the 1939 Code as amended by §153 of the Revenue Act of 1942.

7. Discussions with Dr. Richard B. Johnson, Director of the Southwestern Graduate School of Banking, Dallas, Texas.

8. For instance, one need only consider the following: (i) the phenomenon of worldwide inflation and depression co-existing; (ii) the strains exerted in recent years upon the world monetary system; (iii) the impact and yet unpredictable effect of the energy crisis and efforts to "recycle" the petro-dollars; (iv) the presaged crises associated with uncontrolled population growth; (v) the threat of selected embargoes on a worldwide basis of scarce but essential raw materials; (vi) the growing interconnection between national and world economics; and (vii) the "future shock" of rapid technological change.

STATEMENT OF DR. DAVID K. ANDREWS, PRESIDENT OF THE AMERICAN ASSOCIATION OF PRESIDENTS OF INDEPENDENT COLLEGES AND UNIVERSITIES BEFORE THE HOUSE WAYS AND MEANS COMMITTEE ON JULY 30, 1975

I am David K. Andrews and am President of Principia College, a private independent college in Elsah, Illinois. I also am President of the American Association of Presidents of Independent Colleges and Universities.

We are gravely concerned about the minimum tax proposals now being considered by the Ways and Means Committee, as those proposals would affect charitable gifts to colleges, universities and other exempt institutions. Subjecting charitable gifts to any form of minimum tax would decrease charitable contributions on which we rely for our very existence.

Over two-thirds of the member colleges and universities of the American Association of Presidents of Independent Colleges and Universities receive either no government financial assistance or assistance in amounts of less than 2% of their annual budgets. We exist on charitable giving. We urge--indeed we implore--Congress not to strike a death blow to independent higher education by removing any of the existing incentives for charitable giving.

In connection with the testimony of the American Association of Presidents of Independent Colleges and Universities and the other 29 organizations and groups of organizations which have consolidated their testimony, we have submitted a

detailed statement of our position which shows that the charitable contribution deduction is not a loophole and that a reduction of current tax incentives to charitable contributors would reduce charitable gifts, resulting in decreased services to the general public.

Our statement also details how our institutions would be adversely affected by subjecting charitable contributions to the various types of minimum tax now being considered by the Committee.

We are pleased that Treasury Secretary William Simon in his July 8th testimony before this Committee said that in view of the dire financial position in which inflation has left so many public charities, the Treasury now believes charitable contributions should not be subject to the minimum tax--and that Treasury supports the decision this Committee made last year not to subject charitable gifts to any type of minimum tax.

Thank you for this opportunity to present our views. We ask that any new tax law continue the long established and essential tax incentives to charitable giving which undergird our nation's educational, religious, hospital, health, social welfare and other charitable organizations.

STATEMENT REGARDING MINIMUM TAX AND ALLOCATION OF ITEMIZED DEDUCTIONS BETWEEN TAXABLE AND NON-TAXABLE INCOME PROPOSALS AFFECTING TAX TREATMENT OF CHARITABLE CONTRIBUTIONS TO TAX-EXEMPT INSTITUTIONS

Presented to: Committee on Ways and Means, United States House of Representatives

Honorable Al Ullman, Chairman

Submitted by:

American Association of Presidents of Independent Colleges and Universities. Presidents of 102 colleges and universities belong to the Association. (List annexed as Exhibit "A").

National Association for Hospital Development. Members are executives of over 600 hospitals located nationwide and charged with obtaining funds from the private sector to meet hospital needs. (List annexed as Exhibit "B").

National Association of Independent Schools. An association of 850 independent elementary and secondary not-for-profit schools. (List annexed as Exhibit "C").

National Board of Young Men's Christian Associations. The Board is the legal corporate entity of the National YMCA movement. Locally incorporated YMCA's throughout the United States total about 1,900.

48 New York colleges and universities. (List annexed as Exhibit "D").

The Christian and Missionary Alliance, a church denomination serving as a missionary - sending organization with over 900 missionaries. The United States constituency is represented by over 1,200 local church groups. The Christian and Missionary Alliance operates three colleges, four retirement centers and four convalescent and nursing homes. (List annexed as Exhibit "E").

(List continued on next page)

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The Church of the Nazarene, a church denomination serving both the United States and Missionary fields with about 600 missionaries and 7,473 ministers in the United States. The United States constituency is represented by 7,427 congregations with a membership of 430,128 and Sunday School enrollment totalling 1,175,212 and 68 Districts. The Church of the Nazarene operates 8 liberal arts colleges, one Bible college, and one Seminary. (List annexed as Exhibit "F").

General Council of the Assemblies of God, a church denomination serving both the United States and foreign fields with nearly 1,900 ministers. The United States constituency is represented by 8,920 churches with a membership of almost 5 million. The General Council operates 27 colleges.

Alfred University, Alfred, New York.

Beloit College, Beloit, Wisconsin.

Carleton College, Northfield, Minnesota.

Carnegie-Mellon University, Pittsburgh, Pennsylvania.

Choate Rosemary Hall, Wallingford, Connecticut.

Clark University, Worcester, Massachusetts.

College of the Holy Cross, Worcester, Massachusetts.

Doane College, Crete, Nebraska.

Drexel University, Philadelphia, Pennsylvania.

General Conference of Seventh-day Adventists, Washington, D. C.

Hendrix College, Conway, Arkansas.

Holy Cross Hospital, Fort Lauderdale, Florida.

(List continued on next page)

Knox College, Galesburg, Illinois.

Lafayette College, Easton, Pennsylvania.

LeTourneau College Fund, Longview, Texas.

Middlebury College, Middlebury, Vermont.

Millikin University, Decatur, Illinois.

Mount Holyoke College, South Hadley, Massachusetts.

Mayo Foundation, Rochester, Minnesota. A charitable corporation dedicated to medical practice, medical education and medical research.

Northfield Mount Hermon School, East Northfield, Massachusetts.

University of Notre Dame, Notre Dame, Indiana.

Smith College, Northampton, Massachusetts.

The Society for the Propagation of the Faith, New York City.

Westmont College, Santa Barbara, California.

Worcester Polytechnic Institute, Worcester, Massachusetts.

World Literature Crusade, Chatsworth, California.

Oral testimony by:

Conrad Teitell, member, Prerau & Teitell, New York City.

Dr. David K. Andrews, President, American Association of Presidents of Independent Colleges and Universities, and President, Principia College, Elsah, Illinois.

Dr. Dallin H. Oaks, Secretary, American Association of Presidents of Independent Colleges and Universities, and President, Brigham Young University, Provo, Utah.

Dated: June 30, 1975

SUMMARY OF TESTIMONY

I. THE TAX LAWS SHOULD CONTINUE TO ENCOURAGE SUPPORT OF CHARITABLE ORGANIZATIONS BY CONCERNED CITIZENS.

Public charities perform a vital role in our society and the public would be adversely affected by enactment of proposals removing or reducing tax incentives to contributors. The history of our tax laws shows ever increasing tax incentives to supporters of charitable organizations which benefit the public. Now is not the time to reverse that trend.

The charitable deduction is not a loophole. It differs from other deductions and tax preferences in that it is not economically motivated. Other deductions redound to the individual taxpayer's benefit. Charitable contributions are voluntary and redound to the benefit of our nation. Any reduction of current incentives to charitable contributions would, in effect, be an indirect tax on publicly supported charitable organizations.

[See pages 8-11]

II. THE FOLLOWING PROPOSALS WOULD ADVERSELY AFFECT PUBLICLY SUPPORTED CHARITABLE ORGANIZATIONS AND THE PUBLIC THEY SERVE AND SHOULD NOT BE ENACTED.

A. Minimum tax.

Any proposal which would subject the appreciation element in a charitable gift of appreciated property to the 10% or other minimum tax is opposed.

[See pages 12-13]

B. Limit on tax preferences.

Any proposal which would include appreciation on property contributed to charity in a "limit on tax preferences" rule is opposed.

[See pages 13-14]

C. Minimum taxable income.

Any proposal which would subject charitable contributions to the Administration's Minimum Taxable Income (MTI) proposal is opposed.

[See pages 14-19]

D. Allocation of deductions.

Any proposal which would include the charitable deduction as one of the deductions to be allocated between taxable and non-taxable income under any allocation of deductions rule or include the appreciation in contributed property as a tax preference which would cause deductions to be allocated under that rule is opposed.

[See pages 19-20]

III. CONCLUSION.

The charitable deduction is unique. It is society that benefits the most by the tax law's encouragement of charitable gifts, not individual donors.

[See pages 21-22]

TESTIMONY

Mr. Chairman and Members of the Committee:

I am Conrad Teitell, a member of the New York City law firm of Prerau & Teitell, and appear before you in the capacity of special counsel to a number of charitable organizations which have the same general interests and have consolidated their testimony so as to conserve the Committee's time.

The organizations on whose behalf I appear are:

The American Association of Presidents of Independent Colleges and Universities; the National Association for Hospital Development; the National Association of Independent Schools; the National Board of Young Men's Christian Associations; 49 New York colleges and universities; The Christian and Missionary Alliance; The Church of the Nazarene; Alfred University; Beloit College; Carleton College; Carnegie-Mellon University; Choate Rosemary Hall; Clark University; College of the Holy Cross; Doane College; Drexel University; the General Conference of Seventh-day Adventists; the General Council of the Assemblies of God; Hendrix College; Holy Cross Hospital; Knox College; Lafayette College; LeTourneau College Fund; Middlebury College, Middlebury, Vermont; Millikin University; Mount Holyoke College; the Mayo Foundation; Northfield Mount Hermon School; the University of Notre Dame; Smith College; The Society for the Propagation of the Faith; Westmont College; Worcester Polytechnic Institute; and World Literature Crusade.

We thank you for this opportunity to present our views and support your efforts to make our tax laws more equitable.

I. THE TAX LAWS SHOULD CONTINUE TO ENCOURAGE SUPPORT OF CHARITABLE ORGANIZATIONS BY CONCERNED CITIZENS.

First and foremost, the charitable contribution deduction is not a loophole. It differs from other deductions and tax preferences in that it is not economically mandated. Other deductions redound to the individual taxpayer's benefit. A donor is economically ahead by not making a charitable gift because the tax savings are smaller than what he parts with. Charitable contributions are voluntary and redound to the benefit of our nation.

A reduction of current tax incentives to charitable contributors would reduce charitable gifts and result in decreased services to the general public. Reduced tax incentives would, in effect, be indirect taxes on publicly supported charitable organizations.

Schools, hospitals, churches, health, social welfare and other publicly supported charitable organizations perform a vital role in our nation. If the services rendered to the general public by charitable institutions were to be diminished because of reduced private support, the public would suffer immeasurably. The importance of the services to the nation rendered by the institutions

represented at these hearings need not be reviewed. They are well known and we stand on our record of serving our communities, states and the nation. We do emphasize that if our services to the general public are to continue and expand to meet new needs, tax incentives to those who support worthy charitable organizations should be increased, not decreased.

Historical, philosophical and practical reasons why current tax benefits for donors should be continued. In no country is private philanthropy as important a part of the national character as in the United States. The inception early this century of our federal tax laws encouraged rather than curbed the generosity of Americans. Since 1917 the government has stimulated private voluntary support by granting tax deductions to those who give to schools, churches, hospitals, health, social welfare and other publicly supported charitable organizations.

Congress has continually increased the tax incentives for charitable giving, starting out with a 15% ceiling on charitable gifts and increasing it over the years to the present 50% of adjusted gross income (contribution base) ceiling -- with a 5 year carryover for any "excess".

The government has practical reasons for encouraging voluntary financial support. We need the services provided by schools, churches, hospitals, health organizations and other charities. If support for their work does not come from private sources, from where will it come?

Charitable contributions by concerned citizens have enabled educational institutions to maintain freedom of academic inquiry. They have insured separation of church and state. Voluntary charitable contributions have offered the means of maintaining the historical balance between government services and voluntary initiatives, the antithesis of a totalitarian society. The charitable contribution deduction enables our citizens to participate in making decisions, rather than concentrating further power in the hands of the government.

The increased tax incentives for charitable gifts over the years has resulted in expansion and development of charitable organizations which now more than ever depend upon private philanthropic support.

A vast corps of volunteers give not only their money but also their time to charitable organizations. If our private institutions become government institutions, much of this volunteer time is likely to be lost.

The Congress has stated on many occasions that the government is compensated for any loss of revenue by its relief from financial burdens which otherwise would have to be made by appropriations from public funds and by the benefits resulting from promotion of the general welfare.

As the Treasury itself has said: "Private philanthropy plays a special and vital role in our society. Beyond providing for areas into which government cannot or should not advance (such as religion), private philanthropic organizations can be uniquely qualified to initiate thought and action, experiment with new and untried ventures, dissent from prevailing attitudes and act quickly and flexibly.

"***In doing so they enrich the pluralism of our social order***" (Treasury Report on Private Foundations, Committee on Ways and Means, U. S. House of Representatives, Washington: U. S. Government Printing Office, February 2, 1965, P. 5.).

II. THE FOLLOWING PROPOSALS WOULD ADVERSELY AFFECT PUBLICLY SUPPORTED CHARITABLE ORGANIZATIONS AND THE PUBLIC THEY SERVE AND SHOULD NOT BE ENACTED.

A number of proposals affecting charitable contributions have been made regarding the minimum tax, minimum taxable income (MTI), allocation of deductions and limit on tax preferences. If enacted, they would reduce essential tax incentives to charitable giving.

The Committee has not announced the specific proposals it is now considering. So that our views will be available, we comment on the major proposals made: (1) during consideration of the Tax Reform Act of 1969; (2) at the House Ways and Means Committee tax reform hearings in 1973; and (3) during tax reform deliberations of the House Ways and Means Committee in 1974.

A. The Minimum Tax. Proposals have been made which would subject to the minimum tax the appreciation element in charitable gifts of long-term appreciated securities, real estate and tangible personal property for a "related" use to schools, hospitals, churches, health organizations and other publicly supported charities. These proposals are made even harsher when coupled with other proposals which would lower the present $30,000 plus regular taxes paid floor and increase the present 10% minimum tax rate.

Gifts of appreciated property are a major source of support for most publicly supported charitable organizations. The tax treatment of appreciated property gifts was thoroughly considered by Congress in connection with the Tax Reform Act of 1969 and reflects an evident purpose to retain tax incentives for these gifts. We strongly urge that current law remain unchanged; otherwise a major source of charitable support would be drastically decreased. Thus, charitable gifts of appreciated property should not be subject to the current or any revised minimum tax provision.

B. Limit on tax preferences ("LTP"). Under one proposal, a 50% ceiling would be imposed on an individual's total income which can enjoy tax preferred status.

Tax preferences could include:

(1) Appreciation on property contributed to charity.

(2) One-half of net long-term capital gains.

(3) Tax-exempt interest on state and local bonds.

(4) The excess of accelerated depreciation over straight line depreciation.

(5) Certain farm losses.

We oppose the inclusion of appreciation on contributed property in LTP because it would substantially decrease charitable gifts.

C. The Administration's minimum taxable income (MTI) proposal.

The MTI proposal would for the following reasons substantially decrease support from major contributors on whom we rely for a large part of our private support.

1. The MTI proposal would abolish the fifty percent of adjusted gross income ceiling on the income tax charitable deduction and, in effect, substitute a fifty percent of adjusted gross income ceiling for the total of all deductions (charitable, medical expenses, interest, taxes, etc.). Thus, if an individual makes charitable gifts equal to fifty percent

of his adjusted gross income and has other itemized deductions of thirty-five percent, in effect, the ceiling on his charitable contribution deduction would be fifteen percent of his adjusted gross income.

2. The MTI proposal would abolish the five year carryover for gifts by donors who are subject to MTI.

3. The MTI proposal could have a retroactive effect and disallow deductions for charitable gifts made before enactment of MTI and being carried over into MTI years.

4. The MTI proposal would affect even those who have no so-called tax preferences. For example, consider the case of a donor who has ordinary income of $100,000 and no tax preferences. Assume his adjusted gross income is also $100,000 and he has $3,000 in personal exemptions. His cash gifts for the year to colleges, universities and other publicly supported charities total $50,000. His itemized deductions for interest, taxes, etc., total $30,000.

Under current law, his taxable income would be $17,000 ($100,000 adjusted gross income, minus $50,000 charitable contribution deduction, minus $30,000 deduction for interest, taxes, etc., minus $3,000 personal exemption).

Under MTI, his adjusted gross income and expanded adjusted gross income (EAGI) would be $100,000 (because he has no tax preferences). From that subtract $3,000 for personal exemptions, subtract $10,000 and divide by two. His minimum taxable income would be $43,500 and he would be required to pay tax on $43,500 (instead of tax on $17,000 as under current law). In effect, $26,500 in charitable contribution deductions would be disallowed. The proposal would, in the example, impose a 23.5% ceiling on cash contributions. If the donor's non-charitable deductions were greater than $30,000, the charitable deduction would be reduced even more.

5. Colleges, universities and other publicly supported charities depend heavily on leadership gifts. The MTI proposal would adversely affect contributions from those whose gifts

inspire others to contribute. Thus, there would also be decreased gifts from those not subject to MTI.

6. Individuals subject to MTI, or potentially subject to MTI, would likely not make their gifts during the year, but would wait until the end of the year to plan their gifts. Thus, gifts would be delayed or not made at all.

We do not believe that the charitable contribution deduction should be lumped with other deductions in the MTI proposal. Other deductions differ from the charitable contribution which is voluntary. It benefits not the taxpayer, but the general public. Congress, as recently as 1969, increased the ceiling from thirty to fifty percent of adjusted gross income for charitable gifts to publicly supported charities. Congress determined that tax encouragement should be increased to those who support colleges, universities and other public charities.

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When former Secretary of the Treasury, George Shultz, testified in 1973 before the House Ways and Means Committee on the Administration's tax reform proposals, he urged the Congress to "do nothing which will jeopardize the vitality of our voluntary charities, which depend heavily on gifts and bequests". He then went on to say: "These organizations are an important influence for diversity and a bulwark against over reliance on big government. The tax privileges extended to these institutions were purged of abuse in 1969 and we believe the existing deductions for charitable gifts and bequests are an appropriate way to encourage those institutions. We believe the public accepts them as fair."

We are deeply concerned, however, that the Administration's Minimum Taxable Income (MTI) proposal as it relates to charitable contributions is inconsistent with former Secretary Shultz' fine statement. The MTI proposal would, for the reasons just discussed, substantially decrease support from major contributors on whom we rely for a large part of our private support.

We request that charitable contributions not be subject to MTI -- thus retaining the current fifty

percent of adjusted gross income ceiling, with a five year carryover for any gifts which exceed the ceiling.

D. Allocation of deductions (including charitable contribution deductions) between taxable and non-taxable income. A donor's non-business itemized deductions would be allocated between his taxable and non-taxable income, with only the part allocable to taxable income allowed as deductions. The deductions affected could include charitable contributions, interest, taxes, casualty losses, medical expenses, etc. Tax preferences which could cause expenses to be allocated: (a) appreciation on property contributed to charity; (b) tax-exempt interest from state and local bonds; (c) one-half of net long-term capital gains.

Example 1. Donor has $90,000 in taxable salary and $10,000 of non-taxable municipal bond income. His total income is $100,000. Since 10% of his income is not taxed, he must reduce his itemized deductions (charitable contributions, interest, taxes, medical expenses, etc.) by 10%. Thus, if his itemized deductions total $20,000, he can only deduct $18,000.

Example 2. Facts are the same as in Example 1, except instead of having $10,000 in municipal bond income, donor makes a charitable gift of property which has $10,000 of appreciation. The appreciation on the property gift would be treated under one proposal as non-taxable income (just as if donor had $10,000 in municipal bond income). Because of his generosity, donor must reduce not only his charitable deductions by 10%, but also his deductions for taxes, interest, medical expenses, etc.

Two edged sword. The allocation of deductions proposal as it applies to charitable gifts has two aspects:

Aspect 1. By including the charitable contribution deduction in the itemized deductions to be allocated between taxable and non-taxable income, it reduces the charitable deduction.

Aspect 2. By considering the amount of appreciation on property contributed to charity as non-taxable (tax preferred) income, it reduces donor's charitable deduction as well as his other itemized deductions.

We oppose this proposal because it would substantially decrease charitable gifts.

III. CONCLUSION

Among all of the deductions the charitable deduction is unique. It is society that benefits the most by allowing charitable deductions, not individual donors. Donors would benefit more economically by not making charitable gifts.

Current news abounds with articles concerning the inadequacy of the financial resources of all types of charitable organizations. Never in our history have charitable organizations found themselves in comparable circumstances -- in which they are unable to carry on assigned roles without using and depleting endowment and obtaining additional current contributions.

It is no answer to suggest that direct government funding will substitute for funds lost through reduction of tax incentives or taxes on property passing to charity. Funds siphoned off in general revenues reach the public through the charitable stream in the most remote sense, if at all. Reducing current tax incentives would reverse the objective of less, rather than more, government intervention.

Mr. Chairman and members of the Committee, thank you again for this opportunity to present our views. We ask that any new tax law continue the long-established and essential tax incentives to charitable giving which undergird our nation's educational, religious, hospital, health, social welfare and other charitable organizations.

We are aware of the time pressures and heavy work load of the Committee and have made our remarks as brief as possible. If the Committee wishes amplification on any point, we would appreciate the opportunity to submit a supplemental statement. We are available, if it is the Committee's pleasure, to meet with members of the Committee's staff.



AAPICU

American Association of Presidents of
Independent Colleges & Universities

EXHIBIT "A"

College	Location	President
Albion College	Albion, Mich.	Dr. Bernard T. Lomas
American Grad. School of Internat'l Mgt.	Glendale, Ariz.	Dr. William Voris
Andrews University	Berrien Springs, Mich.	Richard Hammill
Augustana College	Sioux Falls, S.D.	Dr. Charles L. Balcer
Averett College	Danville, Va.	Dr. Conwell A. Anderson
Baptist College at Charleston	Charleston, S.C.	Dr. John A. Hamrick
Beloit College	Beloit, Wis.	Dr. Miller Upton
Benjamin Franklin Univ.	Washington, D.C.	Mrs. C. A. Kennedy
Berry College	Mount Berry, Ga.	Dr. John R. Bertrand
Biola College	La Mirada, Ca.	Dr. J. Richard Chase
Brigham Young University	Provo, Utah	Dr. Dallin H. Oaks
Butler University	Indianapolis, Ind.	Dr. Alexander E. Jones
California Inst. of the Arts	Valencia, Calif.	Robert J. Fitzpatrick
Calvin College	Grand Rapids, Mich.	Dr. William Spoelhof
Campbell College	Buies Creek, N.C.	Dr. Norman A. Wiggins
Central Methodist College	Fayette, Mo.	Dr. Harold P. Hamilton
Chowan College	Murfreesboro, N.C.	Dr. Bruce E. Whitaker
Cleary College	Ypsilanti, Mich.	Lynn Brenneman
College of Insurance	New York, N.Y.	Dr. A. Leslie Leonard
College of Mt. St. Joseph	Mount St. Joseph, Ohio	Dr. Robert E. Wolverton
College of Notre Dame	Belmont, Calif.	Sister Catharine Julie Cunningham
Colorado Women's College	Denver, Colo.	Dr. Dumont F. Kenny
Detroit Institute of Tech	Detroit, Mich.	Dr. Dewey F. Barich
Divine Word College	Epworth, Iowa	Rev. Louis J. Luzbetak
Dropsie University	Philadelphia, Pa.	Dr. Abraham I. Katsh
Duke University	Durham, N.C.	Terry Sanford
Earlham College	Richmond, Ind.	Dr. Franklin W. Wallin
East Texas Baptist College	Marshall, Tex.	Dr. Howard C. Bennett
Flagler College	St. Augustine, Fla.	Dr. William L. Proctor
Fort Lauderdale University	Fort Lauderdale, Fla.	Dr. Stanley J. Drake
Franklin Pierce College	Rindge, N.H.	Dr. Frank S. DiPietro
Friends University	Wichita, Kans.	Dr. Harold C. Cope
Gardner Webb College	Boiling Springs, N.C.	E. Eugene Poston
Grace Bible College	Wyoming, Mich.	Dr. John T. Dean
Grove City College	Grove City, Pa.	Dr. Charles S. MacKenzie
Hanover College	Hanover, Ind.	Dr. John E. Horner
Hebrew Union College	Cincinnati, Ohio	Dr. Alfred Gottschalk
Hillsdale College	Hillsdale, Mich.	Dr. George C. Roche III
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Helena
Indian Springs School
Huntsville
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Mobile
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St. Paul's Episcopal Day School
University Military School
Montgomery
Montgomery Academy
Tuscaloosa
Tuscaloosa Academy

ARIZONA

Mayer
Orme School
Phoenix
Phoenix Country Day School
Rimrock
Southwestern Academy
Arizona Campus
Scottsdale
Judson School
Sedona
Verde Valley School
Tucson
Fenster School
Green Fields School
Treehaven School

CALIFORNIA

Avalon
Catalina Island School
Carlsbad
Army and Navy Academy
Carpinteria
Cate School
Claremont
Foothill Country Day School
Webb School of California
Corona del Mar
Harbor Day School
Corte Madera
Marin Country Day School
Danville
The Athenian School
Del Mar
San Diego Military Academy
Hillsborough
Crystal Springs School
Idyllwild
Desert Sun School
La Canada
Flintridge Preparatory School
La Jolla
The Bishop's Schools
La Jolla Country Day School
Long Beach
Progress School
Los Angeles
John Thomas Dye School
Marlborough School
The Mirman School
Westlake School
Los Olivos
Dunn School
Midland School
Menlo Park
Menlo School
Monterey
Santa Catalina School
The York School
North Hollywood
Harvard School
Oakwood School
Oakland
College Preparatory School
The Head-Royce Schools
Anna Head School
The Royce School
Ojai
Ojai Valley School
Thacher School
Pacific Palisades
St. Matthew's Parish School
Palm Springs
Palm Valley School
Palo Alto
Castilleja School

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Palos Verdes Peninsula
Chadwick School
Pasadena
The Chandler Schools
Mayfield High School
Polytechnic School
Westridge School
Pebble Beach
Robert Louis Stevenson School
Ross
The Katharine Branson and
Mount Tamalpais Schools
Sacramento
Sacramento Country Day School
San Anselmo
San Domenico School for Girls
San Diego
Francis W. Parker School
San Francisco
Cathedral School for Boys
The Hamlin School
Katherine Delmar Burke School
Lick-Wilmerding High School
Schools of the Sacred Heart
Broadway Elementary School
Broadway High School
Stuart Hall School for Boys
Town School for Boys
San Marino
Southwestern Academy
Santa Barbara
Laguna Blanca School
Santa Monica
St. Augustine-by-the-Sea Episcopal
School

COLORADO

Canon City
The Abbey School
Carbondale
Colorado Rocky Mountain School
Colorado Springs
Colorado Springs School
Fountain Valley School
Denver
Graland Country Day School
Randell-Moore School of Denver
Englewood
Colorado Academy
Kent-Denver Country Day School
Steamboat Springs
Whiteman School

CONNECTICUT

Avon
Avon Old Farms School
Cheshire
Cheshire Academy
Cornwall
Marvelwood School
Danbury
Wooster School
East Haddam
Becket Academy
Fairfield
Fairfield Country Day School
Unquowa School
Farmington
Miss Porter's School
Greens Farms
Greens Farms Academy
Greenwich
Brunswick School
Convent of the Sacred Heart
Daycroft School
Greenwich Academy
Greenwich Country Day School
Whitby School
Hamden
Hamden Hall Country Day School
Hartford
Institute of Living School
Kingswood-Oxford School
Oxford Campus
Watkinson School
Kensington
Mooreland Hill School
Kent
Kent School
Lakeville
Hotchkiss School
Indian Mountain School
Litchfield
Forman School
Madison
The Country School
Middlebury
Westover School
Middlefield
Independent Day School

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Milford
Milford Academy

New Canaan
New Canaan Country School

New Haven
Foote School
Hopkins Grammar Day Prospect Hill School

New London
The Williams School

New Milford
Canterbury School

Pomfret
Pomfret School
Rectory School

Rowayton
The Thomas School

Salisbury
Salisbury School

Simsbury
Ethel Walker School
Westminster School

South Kent
South Kent School

Stamford
King School
Long Ridge School
Low-Heywood School

Stonington
Pine Point School

Suffield
Suffield Academy

Wallingford
Choate/Rosemary Hall

Washington
The Gunnery
Rumsey Hall School
Wykeham Rise School

Waterbury
Saint Margaret's-McTernan School

Watertown
Taft School

Westbrook
Oxford Academy

West Hartford
Kingswood-Oxford School
Kingswood Campus
Renbrook School

Windsor
Loomis-Chaffee School

DELAWARE

Hockessin
Sanford School

Middletown
Broadmeadow School
St. Andrew's School

Wilmington
Tatnall School
Tower Hill School
Wilmington Friends School

DISTRICT OF COLUMBIA

The Academy of the Washington Ballet
Beauvoir
Georgetown Day School
Georgetown Visitation Preparatory School
Maret School
National Cathedral School
St. Albans School
Sheridan School
Sidwell Friends School

FLORIDA

Boca Raton
Saint Andrew's School of Boca Raton

Clearwater
Saint Paul's School

Delray Beach
Gulf Stream School

Fort Lauderdale
The Mills School
Pine Crest School

Indian Rocks Beach
Cottingham School

Jacksonville
Bartram School
Bolles School
Jacksonville Episcopal High School
John Carroll Institute
Riverside Presbyterian Day School
Southside Country Day School

Miami
Carrollton School for Girls
Ransom-Everglades School

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Page 4

Orange Park
St. Johns Country Day School
Palm Beach
Palm Beach Academy
Palm Beach Day School
Tallahassee
Alfred B. Maclay, Jr., Day School
Tampa
Berkeley Preparatory School
Independent Day School
Vero Beach
St. Edward's School

GEORGIA

Athens
Athens Academy
Atlanta
The Arlington Schools
Holy Innocents' High School*
Lovett School
Marist School
Pace Academy
Trinity School
The Westminster Schools
Augusta
Augusta Preparatory School
College Park
Woodward Academy
Columbus
Brookstone School
Keysville
Boggs Academy
Mount Berry
Berry Academy
Rome
Darlington School
Savannah
Savannah Country Day School

GUAM

Agana
St. John's Episcopal Preparatory School

HAWAII

Honolulu, Oahu
Hanahauoli School
Hawaii School for Girls
Iolani School
The Kamehameha Schools
Punahou School
Kamuela, Hilo
Hawaii Preparatory Academy
Makawao, Maui
Seabury Hall

ILLINOIS

Chicago
Academy of the Sacred Heart
Anshe Emet Day School
Francis W. Parker School
Harris School
The Latin School of Chicago
Downers Grove
Avery Coonley School
Elgin
Elgin Academy
Evanston
Roycemore School
Lake Forest
Lake Forest-Ferry Hall Academy
Lake Forest Country Day School
Woodlands Academy of the Sacred Heart
Rockford
Keith Country Day School
Wilmette
Loyola Academy
Winnetka
North Shore Country Day School

INDIANA

Culver
The Culver Educational Foundation
Evansville
Evansville Day School
Howe
Howe Military School
Indianapolis
Park-Tudor School
La Porte
La Lumiere School
South Bend
The Stanley Clark School

IOWA

Bettendorf
St. Katharine's/St. Mark's School

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Page 5

KANSAS

Wichita
Wichita Collegiate School

KENTUCKY

Frankfort
Capital Day School
Goshen
St. Francis School
Lexington
Lexington School
Sayre School
Louisville
Kentucky Country Day School
Louisville Collegiate School
Versailles
Margaret Hall School

LOUISIANA

Baton Rouge
Episcopal High School*
Metairie
Metairie Park Country Day School
St. Martin's Protestant Episcopal School
New Orleans
Isidore Newman School
Louise S. McGehee School
Trinity Episcopal School
Shreveport
Southfield School

MAINE

Bath
Hyde School
Bethel
Gould Academy
Fryeburg
Fryeburg Academy
Hebron
Hebron Academy
Hinckley
Hinckley School
Kents Hill
Kents Hill School
Portland
Waynflete School
South Berwick
Berwick Academy
Vassalboro
Oak Grove-Coburn School
Yarmouth
North Yarmouth Academy

MARYLAND

Annapolis
The Key School
Arnold
Wroxeter-on-Severn School
Baltimore
Boys' Latin School
Bryn Mawr School
Calvert School
Friends School
Gilman School
Roland Park Country School
Samuel Ready School
Bethesda
Country Day School of the Sacred Heart
Holton-Arms School
Landon School
Brooklandville
Park School of Baltimore
Saint Paul's School
Saint Paul's School for Girls
Centreville
The Gunston School
Chestertown
Kent School
Colora
West Nottingham Academy
Easton
The Country School, Inc.
Garrison
Garrison Forest School
Gibson Island
Gibson Island Country School
Glencoe
Oldsfields School
Glenelg
Glenelg Country School
McDonogh
McDonogh School
North East
The Tome School
Olney
St. John's Parish School

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Owings Mills
Valley School
Potomac
School of the Holy Child
Rockville
Georgetown Preparatory School
Green Acres School
St. James
Saint James School
Severna Park
Severn School
Silver Spring
Town and Country Day School
Stevenson
St. Timothy's School

MASSACHUSETTS

Andover
Phillips Academy
Pike School
Arlington Heights
Saint Anne's School
Ashburnham
Cushing Academy
Belmont
The Arlington School
Belmont Day School
Belmont Hill School
Beverly
Shore Country Day School
Boston
Commonwealth School
Newman Preparatory School
Thompson Academy
Winsor School
Boylston
Shepherd Knapp School
Braintree
Thayer Academy
Brookline
Dexter School
Park School
Byfield
Governor Dummer Academy
Cambridge
Buckingham Browne & Nichols School
Cambridge Friends School
Manter Hall School
Shady Hill School
Chestnut Hill
Beaver Country Day School
Brimmer & May School
Chestnut Hill School
Concord
Brooks School of Concord
Concord Academy
Fenn School
Middlesex School
Nashoba Country Day School
Dedham
Dedham Country Day School
Noble & Greenough School
Deerfield
Bement School
Deerfield Academy
Eaglebrook School
Dorchester
Boston College High School
Dover
Charles River School
Easthampton
Williston-Northampton School
East Northfield
Northfield Mount Hermon School
Fitchburg
Applewild School
Great Barrington
Simon's Rock
Greenfield
Stoneleigh-Burnham School
Groton
Groton School
The Lawrence Academy at Groton
Hingham
Derby Academy
Lenox
Berkshire Country Day School
Cranwell School
Foxhollow School
Lexington
Lexington Christian Academy
Lincoln
The Carroll School
Manchester
Brookwood School
Marblehead
Tower School
Marion
Tabor Academy

(continued)
Page 7

Marlborough
Hillside School
Migton
Milton Academy
Natick
Walnut Hill School
Newton
Country Day School of the Sacred Heart
St. Sebastian's Country Day School
Northampton
Smith College Campus School
North Andover
Brooks School
North Dartmouth
Friends Academy
Pittsfield
Miss Hall's School
Sheffield
Berkshire School
Southborough
Fay School
Saint Mark's School
South Hamilton
Pingree School
South Yarmouth
Trinity School of Cape Cod
Springfield
MacDuffie School for Girls
Watertown
Palfrey Street School
Wellesley
Dana Hall School
Tenacre Country Day School
Weston
Cambridge School of Weston
The Meadowbrook School of Weston
Rivers Country Day School
West Newton
Fessenden School
West Roxbury
Roxbury Latin School
West Stockbridge
Stockbridge School
Wilbraham
Wilbraham & Monson Academy
Williamstown
Pine Cobble School
Winchendon
Winchendon School
Worcester
Bancroft School
Worcester Academy

MICHIGAN

Birmingham
Detroit Country Day School
Bloomfield Hills
Academy of the Sacred Heart
Bloomfield Country Day School
The Cranbrook Schools
Brookside School
Cranbrook School
Kingswood School
Roeper City & Country School
Detroit
Friends School in Detroit
Glen Arbor
The Leelanau School
Grosse Pointe Woods
University-Liggett School
Interlochen
Interlochen Arts Academy
Oxford
Kingsbury School

MINNESOTA

Duluth
Duluth Cathedral High School*
Fairbault
The Bishop Whipple Schools
Saint James School
St. Mary's Hall
Shattuck School
Hopkins
Blake Schools
Lower School-Blake
Middle School
Minneapolis
Breck School
Blake Schools
Upper School
St. Paul
Saint Paul Academy & Summit School
St. Thomas Academy

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Page 8

Wayzata
Blake Schools
Lower School-Highcroft

MISSISSIPPI

Vicksburg
All Saints' Episcopal School

MISSOURI

Kansas City
Barstow School
Pembroke-Country Day School
Sunset Hill School

Mexico
Missouri Military Academy

St. Louis
Community School
John Burroughs School
Mary Institute
The Principia School
Rohan Woods School
Rossman School
Saint Louis Country Day School
Thomas Jefferson School
Villa Duchesne
Whitfield School

NEBRASKA

Omaha
Brownell-Talbot School

NEW HAMPSHIRE

Andover
Proctor Academy

Canaan
Cardigan Mountain School

Concord
St. Paul's School

Dublin
Dublin School

Exeter
Phillips Exeter Academy

Littleton
The White Mountain School-St. Mary's

Manchester
Derryfield School

Meriden
Kimball Union Academy

New Hampton
New Hampton School

Plymouth
Holderness School

Tilton
Tilton School

Wilton
High Mowing School

Wolfeboro
Brewster Academy

NEW JERSEY

Atlantic City
Atlantic City Friends School

Bernardsville
Gill/St. Bernard's School

Blairstown
Blair Academy

Bridgeton
St. John's Day School

Burlington
St. Mary's Hall/Doane Academy

Chester
Garland School

Elizabeth
Pingry School
Vail-Deane School

Englewood
The Dwight & Englewood Schools
Elisabeth Morrow School

Far Hills
Far Hills Country Day School

Hightstown
Peddie School

Lawrenceville
Lawrenceville School

Livingston
Newark Academy

Mendham
St. John Baptist School

Montclair
Montclair-Kimberley Academy

Moorestown
Moorestown Friends School

Morristown
Delbarton School
Morristown-Beard School
Peck School

Mountain Lakes
The Wilson School

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North Plainfield
Mount Saint Mary Academy
Pennington
Pennington School
Pine Beach
Admiral Farragut Academy
Plainfield
Hartridge School
Wardlaw Country Day School
Pottersville
The Purnell School
Princeton
Chapin School
Columbus Boychoir School
The Hun School of Princeton
Princeton Day School
Stuart Country Day School of the Sacred Heart
Rumson
Rumson Country Day School
Saddle River
Saddle River Country Day School
Short Hills
Far Brook School
Pingry School
Lower School
Somerset
Rutgers Preparatory School
Summit
Kent Place School
Oak Knoll School of the Holy Child
Tenafly
The Center for Open Education

NEW MEXICO

Albuquerque
Albuquerque Academy
Sandia School
Santa Fe
Santa Fe Preparatory School

NEW YORK

Albany
Albany Academy
Albany Academy for Girls
Saint Agnes School
Amenia
Barlow School
Bedford
Rippowam-Cisqua School
Upper School
Brewster
Green Chimneys School
Brooklyn
Adelphi Academy
Berkeley Institute
Brooklyn Friends School
Packer Collegiate Institute
Polytechnic Preparatory Country Day School
St. Ann's Episcopal School
Buffalo
Buffalo Seminary
Elmwood-Franklin School
Nichols School & Nottingham Academy
Congers
Rockland Country Day School
Cornwall-on-Hudson
New York Military Academy
Storm King School
DeWitt
Manlius Pebble Hill School
Dobbs Ferry
The Masters School
East Islip
Hewlett School
Forest Hills
Kew-Forest School
Garden City
Cathedral School of St. Mary
St. Paul's School
Waldorf School of Adelphi University
Garrison-on-Hudson
Malcolm Gordon School
Glen Head
Green Vale School
Hewlett
Lawrence Country Day School
Hoosick
Hoosac School
Jackson Heights
Garden School
Katonah
Harvey School
Lake Placid
North Country School
Northwood School

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Locust Valley
Friends Academy
Portledge School
Loudonville
Saint Gregory's School
Lynbrook
Academy of Lynbrook
Millbrook
The Dutchess School
Millbrook School
Mt. Kisco
Rippowam-Cisqua School
Lower School
New Lebanon
Darrow School
New Rochelle
Thornton-Donovan School
New York City
Allen-Stevenson School
The Baldwin School of New York City
Barnard School for Girls
Birch Wathen School
Brearley School
Browning School
Buckley School
Calhoun School
Cathedral School
Chapin School
The Choir School of St. Thomas Church
Collegiate School
Columbia Grammar and Preparatory School
Convent of the Sacred Heart
Dalton School
The Day School
Ethical Culture Schools
Fordham Preparatory School
Friends Seminary
Grace Church School
Hewitt School
The Horace Mann-Barnard School
Lenox School
Little Red Schoolhouse, Inc.
Little Red Schoolhouse
Elisabeth Irwin High School
McBurney School
Marymount School
Nightingale-Bamford School
Professional Children's School
Rhodes School
The Riverdale Country School
Rudolf Steiner School
St. Bernard's School
Saint David's School
St. Hilda's & St. Hugh's School
St. Luke's School
Spence School
Town School
United Nations International School
Walden School
Old Westbury
School of the Holy Child
Oyster Bay
East Woods School
Pawling
Trinity-Pawling School
Peekskill
St. Mary's & St. John's School
Poughkeepsie
Oakwood School
Poughkeepsie Day School
Rochester
The Allendale and The Columbia Schools
Harley School
Roslyn
Buckley Country Day School
Rye
Rye Country Day School
St. James
Harbor Country Day School
Knox School
Scarborough-on-Hudson
Scarborough Day School
Snyder
Park School of Buffalo
South Wales
Gow School
Staatsburg
Anderson School
Staten Island
Staten Island Academy
Stony Brook
Stony Brook School
Tarrytown
Hackley School
Troy
Emma Willard School
Tuxedo Park
Tuxedo Park School

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Wallkill
Mohonk Cragsmoor School
White Plains
Windward School
Woodmere
Woodmere Academy
Yonkers
Halstead School

NORTH CAROLINA

Arden
Christ School
Asheville
Asheville Country Day School
Asheville School
St. Genevieve/Gibbons Hall School
Charlotte
Charlotte Country Day School
Durham
Durham Academy
Goldsboro
Wayne Country Day School
Oak Ridge
Oak Ridge Academy
Raleigh
Ravenscroft School
Wilmington
Cape Fear Academy
Winston-Salem
Salem Academy
Summit School

OHIO

Bath
Old Trail School
Canton
Canton Country Day School
Cincinnati
Cincinnati Country Day School
The Seven Hills Schools
Doherty School
Lotspeich School
Seven Hills School
Cleveland
Hathaway Brown School
Laurel School
University School
Cleveland Heights
Beaumont School for Girls
Columbus
Columbus School for Girls
Dayton
Miami Valley School
Gahanna
Columbus Academy
Gates Mills
Gilmour Academy
Hawken School
Upper Campus
Hudson
Western Reserve Academy
Lyndhurst
Hawken School
Lower Campus
North Ridgeville
Lake Ridge Academy
Toledo
Maumee Valley Country Day School

OKLAHOMA

Oklahoma City
Casady School
New World School
Westminster Day School
Tulsa
Holland Hall School

OREGON

Portland
Catlin Gabel School
Oregon Episcopal Schools
St. Helen's Hall/Bishop Dagwell Hall

PENNSYLVANIA

Allentown
The Swain Country Day School
Bethlehem
Moravian Academy
Bryn Athyn
Academy of the New Church
Bryn Mawr
Baldwin School
Shipley School
Fort Washington
Germantown Academy
Harrisburg
Harrisburg Academy

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Haverford
Friends School
Haverford School
Jenkintown
Abington Friends School
Kennett Square
Upland Country Day School
Kingston
Wyoming Seminary & Day School
Lahaska
Buckingham Friends School
Lancaster
Lancaster Country Day School
Ligonier
Valley School of Ligonier
Lititz
Linden Hall School for Girls
Malvern
Phelps School
Meadowbrook
Meadowbrook School
Mercersburg
Mercersburg Academy
Merion
Episcopal Academy
Merion Mercy Academy
New Bloomfield
Carson Long Institute
New Hope
Solebury School
Newton Square
Charles E. Ellis School
Newtown, Bucks Co.
George School
Newtown Friends School
Paoli
Church Farm School
The Vanguard Schools
Pennsburg
Perkiomen School
Philadelphia
Academy of the Assumption-Ravenhill
Chestnut Hill Academy
Friends' Central School
Friends Select School
Germantown Friends School
Germantown-Stevens Academy*
Girard College
Lankenau School
Penn Center Academy
St. Joseph's Preparatory School
Springside School
William Penn Charter School
Pittsburgh
Ellis School
Fox Chapel Country Day School
St. Edmund's Academy
Shady Side Academy
Winchester-Thurston School
Pottstown
Hill School
Wyndcroft School
Rose
Ellis School
Fox Chapel Country Day School
St. Edmund's Academy
Shady Side Academy
Winchester-Thurston School
Pottstown
Hill School
Wyndcroft School
Rosemont
Agnes Irwin School
Booth School
Saltsburg
Kiskiminetas Springs School
Scranton
Scranton Preparatory School
Sewickley
Sewickley Academy
Wayne
Valley Forge Military Academy
Westtown
Westtown School
Wynnewood
Montgomery Country Day School
York
York Country Day School

PUERTO RICO

Fajardo
Fajardo Academy
Hato Rey
Caribbean Consolidated Schools
Santurce
Escuelas Las Nereidas
St. John's School

RHODE ISLAND

Barrington
St. Andrew's School
East Greenwich
Rocky Hill School

(continued)
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East Providence
Gordon School
Providence Country Day School
Newport
St. George's School
Portsmouth
Portsmouth Abbey School
Providence
Lincoln School
Mary C. Wheeler School
Moses Brown School

SOUTH CAROLINA

Aiken
Aiken Preparatory School
Charleston
Porter-Gaud School
Greenville
Christ Church Episcopal School
Spartanburg
Spartanburg Day School

TENNESSEE

Bell Buckle
Webb School
Chattanooga
Baylor School
Bright School
Girls' Preparatory School
McCallie School
Knoxville
Webb School of Knoxville
Memphis
The Hutchison School
Lausanne School
Memphis University School
Presbyterian Day School
Saint Agnes Academy
St. Mary's Episcopal School
Nashville
David Lipscomb Elementary & High Schools
Ensworth School
Harpeth Hall School
Montgomery Bell Academy
St. Andrews
St. Andrew's School
Sewanee
The Sewanee Academy

TEXAS

Austin
St. Stephen's Episcopal School
Bryan
The Allen School
Dallas
Greenhill School
Hockaday School
St. Mark's School of Texas
Denton
Selwyn School
Fort Worth
Fort Worth Country Day School
Trinity Valley School
Galveston
Trinity Episcopal School
Harlingen
Marine Military Academy
Houston
Kinkaid School
St. John's School
Midland
Trinity School of Midland
San Antonio
Saint Mary's Hall
Texas Military Institute
San Marcos
San Marcos Baptist Academy
Texarkana
St. James Day School

UTAH

Mount Pleasant
Wasatch Academy
Salt Lake City
Rowland Hall-St. Mark's School

VERMONT

Craftsbury Common
Sterling
Putney
Putney School
St. Johnsbury
St. Johnsbury Academy
Saxtons River
Vermont Academy
South Woodstock
Woodstock Country School

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VIRGINIA

Alexandria
Ascension Academy
Episcopal High School
St. Agnes School
Saint Stephen's School

Boyce
Powhatan School

Charlottesville
St. Anne's-Belfield School

Chatham
Chatham Hall
Hargrave Military

Christchurch
Christchurch School

Dyke
Blue Ridge School

Fork Union
Fork Union Military Academy

Fort Defiance
Augusta Military Academy

Front Royal
Randolph-Macon Academy

Greenway
Madeira School

Leesburg
Loudoun Country Day School

Lynchburg
Seven Hills School
Virginia Episcopal School

McLean
Potomac School

Middleburg
Foxcroft School
Hill School

Newport News
Hampton Roads Academy

Norfolk
Norfolk Academy
Norfolk Collegiate School

Orange
Grymes Memorial School

Petersburg
Bollingbrook School

Richmond
The Collegiate Schools
St. Catherine's School
St. Christopher's School

Roanoke
North Cross School

Staunton
Stuart Hall

Tappahannock
St. Margaret's School

Warrenton
Highland School

Waynesboro
Fairfax Hall

Woodberry Forest
Woodberry Forest School

VIRGIN ISLANDS

St. Croix
Good Hope School
St. Croix Country Day School
St. Dunstan's Episcopal School

St. Thomas
All Saints Cathedral School
Antilles School

WASHINGTON

Seattle
The Bush School
Lakeside School

Spokane
St. George's School

Tacoma
Annie Wright School
Charles Wright Academy

WEST VIRGINIA

Wheeling
Linsly Military Institute
Wheeling Country Day School

WISCONSIN

Beaver Dam
Wayland Academy

Delafield
St. John's Military Academy

EXHIBIT "D"

STATE OF NEW YORK INSTITUTIONS

ALFRED UNIVERSITY
Alfred, N.Y. 14802

CANISIUS COLLEGE
Buffalo, N.Y. 14208

CLARKSON COLLEGE OF TECHNOLOGY
Potsdam, N.Y. 13676

COLGATE ROCHESTER DIVINITY
SCHOOL/Bexley Hall/Crozer
Rochester, N.Y. 14620

COLGATE UNIVERSITY
Hamilton, N.Y. 13346

COLLEGE OF NEW ROCHELLE
New Rochelle, N.Y. 10801

CORNELL UNIVERSITY
Ithaca, N.Y. 14850

DOWLING COLLEGE
Oakdale, L.I., N.Y. 11769

D'YOUVILLE COLLEGE
Buffalo, N.Y. 14201

EISENHOWER COLLEGE
Seneca Falls, N.Y. 13148

ELMIRA COLLEGE
Elmira, N.Y. 14901

COLLEGE OF WHITE PLAINS
White Plains, N.Y. 10603

HAMILTON COLLEGE
Clinton, N.Y. 13323

HARTWICK COLLEGE
Oneonta, N.Y. 13820

HOBART & WILLIAM SMITH COLLEGES
Geneva, N.Y. 14456

IONA COLLEGE
New Rochelle, N.Y. 10801

ITHACA COLLEGE
Ithaca, N.Y. 14850

KEUKA COLLEGE
Keuka Park, N.Y. 14478

KIRKLAND COLLEGE
Clinton, N.Y. 13323

LEMOYNE COLLEGE
Syracuse, N.Y. 13214

MANHATTAN COLLEGE
Bronx, N.Y. 10471

MANHATTANVILLE COLLEGE
Purchase, N.Y. 10577

MARIST COLLEGE
Poughkeepsie, N.Y. 12601

MILLS COLLEGE OF EDUCATION
66 Fifth Avenue
New York, N.Y. 10011

MOUNT ST. MARY COLLEGE
Newburgh, N.Y. 12550

NAZARETH COLLEGE OF ROCHESTER
Rochester, N.Y. 14610

NIAGARA UNIVERSITY
Niagara University, N.Y. 14109

PACE COLLEGE
New York, N.Y. 10038

PAUL SMITH'S COLLEGE
Paul Smith, N.Y. 12970

PRATT INSTITUTE
Brooklyn, N.Y. 11205

RENSSELAER POLYTECHNIC INSTITUTE
Troy, N.Y. 12181

ROCHESTER INSTITUTE OF TECHNOLOGY
Rochester, N.Y. 14623

ROSARY HILL COLLEGE
Buffalo, N.Y. 14226

RUSSELL SAGE COLLEGE
Troy, N.Y. 12180

ST. BERNARD'S SEMINARY
Rochester, N.Y. 14612

ST. BONAVENTURE UNIVERSITY
St. Bonaventure, N.Y. 14778

ST. JOHN FISHER COLLEGE
Rochester, N.Y. 14618

ST. LAWRENCE UNIVERSITY
Canton, N.Y. 13617

SARAH LAWRENCE COLLEGE
Bronxville, N.Y. 10708

SIENA COLLEGE
Loudonville, N.Y. 12211

SKIDMORE COLLEGE
Saratoga Springs, N.Y. 12866

SYRACUSE UNIVERSITY
Syracuse, N.Y. 13210

UNION COLLEGE & UNIVERSITY
Schenectady, N.Y. 12308

UNIVERSITY OF ROCHESTER
Rochester, N.Y. 14627

UTICA COLLEGE OF SYRACUSE UNIV.
Utica, N.Y. 13502

VASSAR COLLEGE
Poughkeepsie, N.Y. 12601

WAGNER COLLEGE
Staten Island, N.Y. 10301

WELLS COLLEGE
Aurora, N.Y. 13026

EXHIBIT "E"

THE CHRISTIAN AND MISSIONARY ALLIANCE

Graduate School: Alliance School of Theology and Missions
Nyack, New York

Colleges:

Nyack College, Nyack New York
St. Paul Bible College, Bible College, Minnesota
Simpson College, San Francisco, California
Toccoa Falls Bible College, Toccoa Falls, Georgia
(affiliated)

Retirement Centers:

Suppes Memorial Home, Glendale, California
Shell Point Village, Fort Myers, Florida
The Alliance Home, Carlisle, Pennsylvania
The Alliance Home of DeLand, DeLand, Florida

Convalescent and Nursing Homes:

Alliance Convalescent Hospital, Glendale, California
Alliance Nursing Center, DeLand, Florida
The Alliance Village, McAllen, Texas
Nursing Pavilion, Shell Point Village, Fort Myers, Florida

Missionary Homes:

Headquarters Missionary Home, New York, New York
Nyack Missionary Cottages, Nyack, New York
Seymour Home, Vermilion, Ohio
Glendale Alliance Center, Glendale, California

EXHIBIT "F"

CHURCH OF THE NAZARENE -- RELATED COLLEGES

COLLEGES:

1. Bethany Nazarene College
   Bethany, Oklahoma

2. Eastern Nazarene College
   Wollaston, Massachusetts

3. Mid-America Nazarene College
   Olathe, Kansas

4. Mount Vernon Nazarene College
   Mount Vernon, Ohio

5. Northwest Nazarene College
   Nampa, Idaho

6. Olivet Nazarene College
   Kankakee, Illinois

7. Pasadena College
   Pasadena, California

8. Trevecca Nazarene College
   Nashville, Tennessee

Bible College

Nazarene Bible College
Colorado Springs, Colorado

Seminary

Nazarene Theological Seminary
Kansas City, Missouri

SUMMARY OF TESTIMONY

by

John T. Connor, Chairman of Allied Chemical
Corporation and Chairman of the Board of Directors
of the Council for Financial Aid to Education

There is an urgent need for more voluntary support, not less, of higher education.

Voluntary support of higher education is jeopardized by various legislative proposals which would reduce or eliminate tax incentives for gifts for this purpose. Proposals relating to minimum tax and allocations of deductions are of particular concern.

The most recent Survey of Voluntary Support of Education conducted by the Council for Financial Aid to Education shows a decrease in educational giving by living donors in excess of 8% in 1973-74. This decrease is attributable to the prolonged and deep decline in the securities markets. Any weakening of the tax incentives for educational and charitable giving is likely to result in further decreases.

Existing tax incentives for voluntary support of higher education must be maintained and, to the extent not incompatible with other objectives, be expanded.

Mr. Chairman and Members of the Committee:

I am John T. Connor, Chairman of Allied Chemical Corporation and Chairman of the Board of Directors of the Council for Financial Aid to Education.

I appreciate this opportunity to appear before you as an individual deeply concerned about the financial viability of our colleges and universities. I am especially concerned about the likelihood that private, voluntary financial support of our institutions of higher education will be reduced substantially as a result of legislation that would weaken tax incentives of individuals and corporations to make gifts and grants to the colleges of their choice.

As previously indicated by President Edmund J. Bolling of the University of Tennessee, the voluntary support of higher education is a critical factor in the financial structure of both public and private institutions; the urgent need, therefore, is for more voluntary support, not less. Yet the incentives for voluntary giving to education are in danger of being seriously weakened by various legislative proposals that would directly or indirectly impinge on the way in which the contributions deduction operates.

Of particular concern are proposals relating to minimum tax and allocation of deductions which reduce, if not eliminate, the tax incentives for educational and charitable giving.

Deductions for charitable contributions should not be treated the same as other personal deductions. Charitable deductions result from voluntary and discretionary decisions on the part of the taxpayer which are not motivated by personal financial gain. Other deductions normally provide the taxpayer with some tax relief for involuntary expenditures or provide him with a partial offset to some expenses for which he receives a benefit. Charitable contributions constitute a voluntary transfer of income from the taxpayer to non-profit organizations, organizations which perform vital and essential services to our society. The voluntary support of higher education is an income transfer of precisely this kind, since our colleges and universities are providing educational, research, and other public service functions of immeasurable value to the nation. In sum, the contributions deduction is not a tax shelter, not a tax avoidance "gimmick," not a loophole; rather it is an incentive to taxpayers to increase the allocation of their incomes to activities that are very much in the national interest.

Taxpayers do react to such incentives and are sensitive to the charitable deduction and to economic circumstances when they make their decisions about voluntary giving. This is especially true of voluntary giving to educational institutions. An authoritative source of information in this area is the Survey of Voluntary Support of Education conducted by the Council for Financial Aid to Education for the past 20 years. This annual Survey is now co-sponsored by the Council for Advancement and

Support of Education and the National Association of Independent Schools. The most recent Survey, covering the academic year 1973-74, is submitted to this Committee at this time as evidence of the amounts, sources, and purposes of the voluntary support of educational institutions, and as evidence of the sensitivity of certain groups of donors to incentives for providing such support. Although the Survey includes information from only about a thousand colleges and universities, the institutions represented account for approximately 85% of the voluntary support received by all 2,800 colleges and universities in this country.

I should like to call to the attention of this Committee the chart on page 4 and Table 1 on page 5 of this Survey. The two categories of individual donors, alumni and non-alumni, reduced their educational support in 1973-74. Since the two categories of individual donors taken together account for about half of the total amount of voluntary support, the 6% decrease in 1973-74 was a matter of consequence. These figures include educational bequests, and since bequests increased nearly 4.5% in 1973-74, the decrease in educational giving by living donors was in excess of 8%. The Survey also reveals that nearly all of this decline was accounted for by reduced giving for capital purposes, including endowments. Since capital support is provided primarily by large contributions in the form of appreciated property, it is believed that the decrease was due to the prolonged and deep decline in the securities markets during 1973 and 1974.

Such sensitivity to the economic climate by major contributors to the institutions of higher education is, I believe, illustrative of the way in which individuals react to changes in their incentives to give. There is no doubt in my mind that they would react in a similar way to any weakening of the tax incentives for educational and charitable giving. Indeed, it is my understanding that some of the studies of the soon to be published Filer Commission demonstrate this in convincing fashion.

The Committee for Economic Development issued in October 1973 a policy statement titled, The Management and Financing of Colleges. One of their recommendations is:

> "We urge that the existing tax incentives for voluntary support of higher education be maintained and, to the extent not incompatible with other objectives, expanded in order to strengthen the base of financial support of all colleges and universities."

I endorse fully this statement. More specifically, I respectfully urge this Committee, in considering various proposals for a minimum tax, to exclude the charitable contributions deduction from such legislation, so that the existing tax incentives for voluntary philanthropy are preserved.

Summary of Testimony

of the

American Council on Education

Before the Ways and Means Committee

July 30, 1975

I. Introduction

The American Council on Education and the associations of colleges and universities joined with it in this testimony represent virtually all of the accredited public and private nonprofit colleges and universities in the country.

II. General

The financial plight of these institutions of higher learning has become even more critical since the American Council on Education's testimony before this Committee in April of 1973. In fact, a number of the small liberal arts colleges which are especially dependent on private gifts and bequests have closed, merged or been absorbed into public institutions. The ACE's surveys (one of which is just being completed) demonstrate that private sources are essential to private institutions of higher education and crucial to the quality of education provided by many public schools and colleges. Independent studies about to be released confirm that the charitable contribution deduction for estate, income and gift tax purposes provides a substantial incentive to giving, and that any loss in revenue to the Government is more

than offset by the increase in giving thus engendered for the support of activities which, in most cases, otherwise, would have to be borne by government.

III. Specific Recommendations

1. Minimum Taxable Income -- The Council endorses the recommendation of the Secretary of the Treasury Simon that the charitable contribution deduction for income tax purposes be entirely without the scope of any provision which the Committee may adopt with respect to the imposition of a minimum tax on all individuals. This should be the case whether the change is in the form of a modified preference tax, an alternate tax on economic income or other.

2. Declaratory Judgment in the Case of Tax Exempt Organizations -- The Council strongly urges the adoption of a provision giving institutions whose claim for exemption under IRC Section 501(c)(3) or classification under IRC Section 509(a) has either been denied or revoked access to the courts for a declaratory judgment as to their status. As a practical matter, in most cases such access is now denied.

3. Scholarships and Fellowships -- The Council urges that the Committee establish statutory guidelines whereunder the loan forgiveness provisions of certain Federal and state and other programs of support for students will be considered nontaxable scholarships.

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The following associations join in this statement:

AMERICAN ASSOCIATION OF COMMUNITY AND JUNIOR COLLEGES

AMERICAN ASSOCIATION OF STATE COLLEGES AND UNIVERSITIES

ASSOCIATION OF AMERICAN COLLEGES

ASSOCIATION OF AMERICAN UNIVERSITIES

ASSOCIATION OF JESUIT COLLEGES AND UNIVERSITIES

COUNCIL FOR AMERICAN PRIVATE EDUCATION

COUNCIL FOR THE ADVANCEMENT AND SUPPORT OF EDUCATION

NATIONAL ASSOCIATION OF STATE UNIVERSITIES AND LAND-GRANT COLLEGES

NATIONAL CATHOLIC EDUCATIONAL ASSOCIATION

NATIONAL COUNCIL OF INDEPENDENT COLLEGES AND UNIVERSITIES

Mr. Chairman and Members of the Committee:

I am Edward J. Boling, President of the University of Tennessee. With me is Professor Julian Levi of the University of Chicago, Chairman of the American Council on Education's Committee on Taxation.

We are very grateful for this opportunity to appear before you on behalf of America's colleges and universities and its privately supported elementary and secondary schools. We are authorized to speak for the associations, noted on the cover sheet of this testimony, whose memberships include virtually all of the accredited, public and private, nonprofit colleges and universities, and a majority of independent schools in the country. While we are speaking for colleges and universities, public and private, and associations of such institutions, what we are really talking about are some 9 million students served by those institutions.

When we appeared before this Committee in April of 1973, we called your attention to the then critical financial plight of colleges and universities and noted that this had resulted in a substantial curtailment of programs and limitation of activities. Unfortunately, the situation has not improved. State institutions continue to face increasing competition for funds. Private institutions, large and small, continue to incur substantial operating deficits. One single factor--the increase in energy costs--shattered the expectations of many to balance their budgets. The one bright hope we then saw for the future--increased philanthropic support--has not been realized. In fact, in the year just ended, for the first time in many years, there was no overall increase in contributions and bequests to institutions of higher education. In the same period, the expenses of providing education have substantially increased. Moreover, colleges and universities, public and private, fortunate enough to realize income from endowment sources, have seen that income sharply reduced in many instances.

As an inevitable result, the crucial share of support which institutions of higher education receive from private gifts and bequests (and the income from those contributions which are funneled into endowment) has been reduced.

In 1973, we called your attention to the critical condition of many small liberal arts colleges and universities which have traditionally played such an important role in the training of our young. In studies submitted with our presentation, projections indicated that continuing deficits would necessitate the invasion of endowment assets so as to exhaust them within a relatively short period. Under the conditions which have since prevailed, those projections appear to have been optimistic. In fact, since January 1970, approximately 77 private colleges and universities have either closed, merged, or been absorbed by the public college and university system.

Other than the fact that overall contributions to institutions of higher education did not increase in the 1973-74 year, there are few material changes in the patterns of giving to colleges and universities. The most significant characteristics of gifts to colleges and universities are

-- About 75 percent of the private voluntary support of colleges and universities continues to be produced by large gifts (those in excess of $5,000).
-- Large individual gifts of property continue to be of great importance to education institutions.
-- Higher education receives nearly half of its voluntary support from individual gifts, divided almost equally between alumni and nonalumni. (For economic reasons, apparently, individual gifts declined in the 1973-74 year.)

-- Over 50 percent of the large gifts from individuals are received in the form of property, primarily securities and real estate. (Again, economic conditions resulted in a reduction of gifts of this kind although, in the case of some small private institutions, gifts of property continued to account for 70 to 80 percent of the gifts from individuals.)

-- Gifts from private foundations continue to be an important source of support, amounting to approximately one fourth of the dollar support.

-- Bequests are an increasingly important source of support for educational institutions, amounting to 32.2 percent in 1973-74.

-- Despite the drop resulting from the uncertainty created by the changes made in the Tax Reform Act of 1969, deferred gifts account for approximately 7 percent of all contributions to colleges and universities.

-- According to the survey data, the public institutions' share of the gift dollar, which rose markedly from 1963 to 1971, now accounts for approximately 22 percent of all gifts to higher education.

The American Council on Education has just completed a third in-depth analysis of voluntary support of American colleges and universities showing the patterns of giving to those institutions in the 1973-74 fiscal year. The results of this study are being tabulated, and we expect to make them available to your staff during the August recess. Based on preliminary data, we can make the following observations:

-- In the 1973-74 fiscal year, alumni contributed a total of $402,667,513 in 2,602,458 gift transactions. Of this amount,

$145,362,274 or 36 percent of the total raised originated in 2,595,831 transactions; each for less than $5,000. At the same time, $257,305,239 or 63 percent of the total contributed was represented by only 6,627 transactions; each for more than $5,000. Thus 0.2 percent of all of the gift transactions (those over $5,000 each) account for 63.9 percent of all gifts received from alumni.

-- The same pattern is found in the 1973-74 fiscal year for nonalumni giving.

-- In the 1973-74 fiscal year, nonalumni contributed a total of $393,715,032 in 720,680 gift transactions. Of this amount $86,859,527 or 22.0 percent of the total raised originated in 712,817 transactions; each for less than $5,000. At the same time, $306,855,505 or 77.9 percent of the total contributed was represented by only 7,863 transactions; each for more than $5,000. Thus 1.1 percent of all of the gift transactions (those over $5,000 each) account for 77.9 percent of all gifts received from nonalumni.

-- The reliance of higher education upon the generosity of the large contributor has been demonstrated in previous studies for the 1962-63 fiscal year (Patterns of Giving to Higher Education) and again for the 1970-71 fiscal year (Patterns of Giving to Higher Education II.)

-- Of the $564,160,744 contributed by alumni and nonalumni for both current and capital purposes in transactions of $5,000 or more, $229,296,272 or 46.64 percent were in the form of securities, $32,190,459 or 5.71 percent in the form of real estate and $30,566,862 or 5.42 percent in the form of other property.

Private sources of support are essential to the continued existence of private institutions of higher education and crucial to the quality of education provided by many public institutions. For that reason, we urge this Committee, in considering modification of the tax laws at this critical time, to carefully weigh the potential effect of any modification on charitable and educational institutions, particularly those which like private colleges and universities perform functions that would otherwise have to be financed for the most part by direct public budget outlays. In fact, we would hope that the Committee could find ways to encourage charitable contributions and bequests which are so essential to the continuation of the system of education. We feel certain that each member of this Committee is sensitive to the critical condition of colleges and universities and supportive of the crucial role which they play in the life of this nation. On the other hand, we are genuinely fearful that, in making changes, which for other reasons may seem justified, Congress may, inadvertently, significantly damage the incentives to giving which are so important to the continued private support of all charities.

As a result of reforms enacted in 1969, a donor cannot incur financial benefit for himself or his family by means of a gift or bequest. The personal satisfaction that may accrue to a donor as a result of his directing a contribution to a recognized charity is small in comparison to

the benefits which the charity and, directly and indirectly, the public receive. With this in mind, we trust the Committee will give serious consideration to the potential detriment to private support that could result from particular changes, especially where the increases in tax revenues to the Federal government are minimal in comparison with the losses to educational institutions.

In this connection, we would call the Committee's attention to the fact that the Commission on Private Philanthropy and Public Needs is completing a 2-year study of all aspects of philanthropy and philanthropic organizations in the United States. One of the Commission's most important acts was to sponsor the first comprehensive examination, based on econometric analyses, of the role which the Federal tax laws play in encouraging contributions and bequests. Although the results of these studies by Professor Martin Feldstein at Harvard and others are not in final form, the preliminary drafts confirm for the first time the significant role that the charitable contribution deduction plays in encouraging donations and, in the process, refute prior suggestions to the contrary. These studies show that the income and estate tax deductions for charitable gifts are indeed "efficient" in that for every dollar of tax revenue foregone by the Treasury, substantially more than a dollar is gained by the beneficiary charitable institutions. In the case of gifts of property and bequests, the benefits to charity resulting from the deduction are even more important.

We would now like to make specific comments on those subjects that are to be dealt with in the first phase of this Committee's deliberations, recognizing that the charitable contributions including gifts of appreciated

property to public charities, tax exempt institutions and estate and gift tax laws have been reserved for the deliberations which this Committee will begin in November.

Minimum Taxable Income

One proposal before this Committee that could have an adverse effect on support of public charities is the proposal reintroduced by the Secretary of the Treasury to impose a minimum tax on all individuals regardless of the validity of claimed deductions and exclusions if these result in an individual of substantial wealth paying little or no income taxes for a particular year. We understand the reasons for such a proposal. However, we believe that any examination of this problem requires a careful consideration of the nature of each deduction or exclusion. In particular, we urge that any proposal that the Committee adopts not impinge upon the charitable contribution deduction. A charitable gift is, unlike other deductions, the result of a voluntary decision, which may be made or not made at will. Imposing an additional or alternate tax on charitable gifts would, in our opinion, work a substantial reduction of contributions at little, if any, gain in revenue. These considerations apparently led the Committee to place charitable deductions entirely outside the scope of the provisions of a similar proposal for an alternate tax on economic income, made in connection with the drafted 1974 Tax Reform Act. We were very gratified to note that Secretary Simon, in presenting the Treasury's recommendations at the outset of this hearing, stated that although "the Treasury (was) opposed to that modification last year, we are now persuaded, in view of the dire financial position in which inflation has left so many private charities, that the Committee decision was appropriate and we support it."

We respectfully urge that, in considering the proposals with respect to modification of the present preference income tax or substituting an alternate tax on economic income, the Committee treat the charitable contribution separately so that no direct or indirect tax is imposed on such contributions. Only by following such a course can the Committee be responsive to the recommendations of the Honorable George P. Shultz, then Secretary of the Treasury, in his testimony before this Committee in April of 1973, namely, that it

> "do nothing which will jeopardize the vitality of our voluntary charities, which depend heavily on gifts and bequests. These organizations are an important influence for diversity and a bulwark against over-reliance on big government. The tax privileges extended to these institutions were purged of abuse in 1969 and we believe the existing deductions for charitable gifts and bequests are an appropriate way to encourage those institutions. We believe the public accepts them as fair." ("Proposals for Tax Change," Department of the Treasury, April 30, 1973, page 72.)

Declaratory Judgments in the Case of Tax Exempt Organizations

We strongly support the proposal that there be provision for declaratory judgments in the case of a wide range of questions involving tax exempt organizations. On the recommendation of this Committee, Congress has already adopted a similar rule with respect to the Federal tax status of pension plans. The problem is even more critical in the case of the determination of the exempt status of a charitable organization. Denial or revocation of exemption is quite clearly an irreparable injury. However, the Supreme Court has reluctantly concluded that the antiinjuntion statute (26 U.S. Code 7421(a)) denies an organization claiming exemption access to the courts in the event of an adverse Internal Revenue Service decision unless it can establish that "under no circumstance could the Government ultimately prevail" in its conclusion. (Bob Jones University v. Simon, et al., 416 U.S. 725 (1974)). In the dissenting opinion in a companion case,

Mr. Justice Blackmun succinctly documents the lack of any real remedy for such an institution. (Alexander v. "American United," Inc., 416 U.S. 752 (1974)).

The Court itself, in effect, called upon Congress to remedy this situation noting the "harshness" of the present law (Bob Jones, supra). We earnestly urge that the Committee respond by providing such institution with an opportunity to have their day in court by means of a declaratory judgment with respect to the determination not only of their status as an exempt institution but the character of that status, namely, as a publicly supported or private charity.

Scholarships and Fellowships

The Committee has listed the tax treatment of scholarships and fellowships as an item for consideration in this phase of its hearings, calling special attention to problems with respect to cancellation of indebtedness under student loan programs. In its deliberations on the proposed 1974 Tax Reform Act, the Committee recognized the problems which have developed with respect to loan forgiveness and, indeed, Congress has passed a specific moratorium on the Internal Revenue Service's attempt to collect tax on the forgiveness of loans with respect to one Federal program. (P.L. 93-483 (1974)).

The treatment of this issue by the Internal Revenue Service demonstrates the distressing difficulties which colleges and universities may face in this area. For a number of years, the Internal Revenue Service held in ruling letters to the Federal agencies involved in loan forgiveness programs that the forgiveness constituted a scholarship or fellowship which was excludable from gross income. In June of 1973, the Service published a ruling to the contrary in connection with one specific program. (Revenue Ruling 73-256).

Ultimately, it modified the decision in part by advising that it would not impose that ruling retroactively. (Revenue Ruling 74-540). However, that advice relates only to that particular program. There is a wide range of loan forgiveness plans under Federal and state laws, as well as a few in connection with the private scholarship programs. We submit that the original Internal Revenue Service action was correct and urge the Committee to establish statutory guidelines under which student loan programs will be treated as excludable grants under Section 117.

In this connection, we would note that this experience with respect to the loan forgiveness program is only one of many similar problems faced by the colleges and universities in the administration of their scholarship and fellowship programs. Colleges and universities provide a major source of grant funds which make it possible for disadvantaged young people to attend institutions of higher education. Taking account of the statute, the regulations, decided cases, private and, in some cases, published rulings of the Internal Revenue Service, these institutions have treated a wide range of grants as coming within the purview of Section 117 and, therefore, not subject tc withholding requirements either with respect to income tax or social security (FICA). Such institutions will be faced with substantial liabilities if the Internal Revenue Service adopts the position that payments under one or more of the programs represent taxable stipends as it did in the case of the loan forgiveness program.

A claim for withholding of income and social security taxes once finally asserted by the Internal Revenue Service may not be appealed to the Tax Court but must be paid and redress sought only through a refund suit. This circumstance is a nightmare for college and university administrators who may expose their institutions to substantial liability in the exercise of

of prudent and proper judgment. For this, reason, we earnestly urge that the Committee consider providing a ready access to the Tax Court for a determination of the status of payments as scholarship or fellowship grants under Section 117, limited solely to the issue of whether or not the institution is required to withhold income and social security taxes.

Oral Statement of

Chancellor Willis M. Tate,
SOUTHERN METHODIST UNIVERSITY
Dallas, Texas

On behalf of

SOUTHERN METHODIST UNIVERSITY, Dallas, Texas
and the Board of Governors and the Board of Trustees
of SOUTHERN METHODIST UNIVERSITY

Mr. Chairman, and Members of the Committee:

I am Willis M. Tate, Chancellor of Southern Methodist University, Dallas, Texas 75275, and a member of its Board of Governors.

SMU was founded in 1911 with two buildings, 706 students, a faculty of 35 and an endowment of $279,178. Today SMU inventories more than 80 buildings, a faculty of nearly 500 full-time with 382 employed on a part-time basis. Our endowment is approximately 49 million dollars and our student enrollment averages above 10,000 in the past few years. Our data is typical and representative of many other independent colleges and universities. And like so many other independent institutions, we rely heavily on gifts from our alumni, friends, businesses and foundations.

It is interesting to note that our growth and development in some ways parallels the encouragement the Federal government has provided through tax incentives for making charitable gifts. Congress provided a contribution deduction with a 15% ceiling on gifts in 1917, and increased it over the years to the present 50% of adjusted gross income ceiling, with a five year carry-over of any excess, providing a substantial incentive for our growth and development.

There is a practical reason for the government to encourage voluntary financial support for charitable uses, for these charities have operated substantially for the public good.

Congress has reaffirmed on many occasions that the Federal Treasury is compensated for any loss in revenue, through relief from the financial commitment which would have to be made by appropriations from public funds to achieve the benefits produced by charitable organizations.

The most important incentive you have at your disposal, to help insure the continued stability of the charitable organization is that which is provided through the charitable contribution deduction.

In our supplemental statement we have detailed out the history of our gift income for the past 10 years in Appendix A, and outlined our cost of operations, with attention drawn to tuition and fees in Appendix B.

A substantial portion of our gift income is in the form of property, principally securities, which represent approximately 75% of our gifts, and the preponderance of the donated securities

are appreciated in value over the donor's cost basis.

Our future ability to withstand substantial deficits will depend heavily on a public which is willing to voluntarily share their fortunes with us to insure our future. Deficits illustrated in Appendix B of our supplemental statement have largely been off set through expenditure from reserve funds, and realization of capital appreciation on our investments. Our reserves are now substantially depleted, therefore we must depend even more on the charitable gift. It is therefore apparent that the tax laws must encourage support of charitable organizations.

If incentives for making gifts are going to be reduced, then the public should be made aware of the fact, and informed as to what plans there are to replace the services provided by our independent universities and colleges.

TAXABLE AND NON-TAXABLE INCOME ALLOCATIONS:

The proposal requiring the inclusion of the charitable contribution deduction in the itemized deductions along with others to be allocated is illogical. The charitable contribution deduction is unique in that it rises from a donor's voluntary act and the benefit inures to the

charitable organization.

The allocation of deduction proposal would decrease support from major contributors because the allocation will reduce the charitable contribution deduction and in effect tax the donor on that which he has given away.

Limiting the requirement to allocate only the value of appreciation on the donation of appreciated property will have substantially the same effect.

We oppose this proposal because it would substantially decrease charitable gifts.

MINIMUM TAXABLE INCOME PROPOSAL:

The minimum taxable income proposal would effectively abolish the 50% of adjusted gross income ceiling on the income tax charitable contribution deduction, and in effect, substitute a ceiling for the total of all deductions, whether they be charitable, medical, interest deductions, taxes, etc. Thus, if an individual so plans his giving, as some do, to fund a charitable project up to the 50% limitation each year, and his adjusted gross income has other itemized

deductions, the ceiling on his contribution deduction would be reduced. Such a donor would then reduce his annual support to that which is allowable as a deduction. The five year carry-over would be abolished, and indeed the carry-over from previous years from gifts made before the enactment of MTI could result in a retroactive disallowance of deductions.

We do not believe that the charitable contribution deduction should be included with other deductions in the minimum taxable income proposal, and endorse the testimony of Treasury Secretary Simon made before this committee when he recommended his support of the Committee's decision to place the charitable contribution deduction entirely outside the scope of the provision for MTI.

Mr. Chairman and members of the Committee, I want to extend to you the deep thanks on behalf of SMU, its Board of Governors and Board of Trustees for this opportunity to present our view. More importantly, however, because our essential business is the education of young men and women, we hope that you will do nothing that will impair the opportunity they have, both in private and public institutions of higher learning of persevering in an inquiry just as far as their talent and ability will allow, under the guidance of a viable and thriving independent educational enterprise.

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STATEMENT OF CHANCELLOR WILLIS M. TATE
presented on behalf of SOUTHERN METHODIST UNIVERSITY
and the BOARD OF GOVERNORS and BOARD OF TRUSTEES
of SOUTHERN METHODIST UNIVERSITY, Dallas, Texas.

I. INTRODUCTION:

A. Mr. Chairman, and members of the Committee:

I am Willis M. Tate, Chancellor of Southern Methodist University, Dallas, Texas and a member of its Board of Governors.

I am very grateful for this opportunity to appear before you on behalf of Southern Methodist University and its Board of Governors and Board of Trustees. The membership of each Board has been provided to the Committee staff in our request to appear before you today.

B. Southern Methodist University was founded in 1911 and enrolled its first students in 1915. At its opening session the University had two buildings, 706 students, a faculty of 35 and an endowment of $279,178 on a 700 acre campus.

II. HISTORY OF FINANCIAL SUPPORT:

A. The University was founded and established by a commission of the Methodist Church when the citizens of Dallas raised $300,000 to build the first building and donated over 700 acres, which provided

the land and the original endowment. At that time, even in our early years, 100 citizens of Dallas gave $1,000 or more to the founding of the fledgling University. A gift of $111,500 from the General Education Board, founded by John D. Rockefeller, was of utmost importance in insuring the success of the new University.

B. Today Southern Methodist University inventories more than 80 buildings in its physical plant, some 60 of which were constructed since World War II, a faculty of nearly 500 employed full-time, with 382 employed on a part-time basis, an endowment fund of nearly 49 million dollars and a student enrollment that has averaged above 10,000 in the past few years. Southern Methodist University is now one of the largest independent universities in the combined South and Southwestern geographic areas of the United States, although it is considered moderate in size when compared with other major institutions of similar academic scope. Our total annual budget for the 1975-76 academic year is $36,215,000. The accomplishments of Southern Methodist University are in large measure achievements of the free enterprise system.

The reasons for this data on Southern Methodist University is to familiarize you with our specific institution. This data is however, typical and representative of other independent colleges and universities.

As an independent institution, SMU must rely heavily on gifts. We obtain our operating funds from tuition and fees paid by our students, income from investments, and (importantly), annual contributions from alumni, business firms, friends and foundations. In a unique adventure designed to supply SMU's growing budget with vital operating capital, the citizens of Dallas including alumni and non-alumni and business firms annually contribute more than $700,000 to the University's unrestricted resources.

III. CURRENT FINANCIAL SUPPORT:

A. It is interesting to note that a parallel may be drawn between the increasing financial support received from the private sector for Southern Methodist University on the one hand, and the encouragement the Federal government has provided through tax incentives for making charitable gifts, on the other. Congress provided a contribution deduction with a 15% ceiling on charitable gifts in 1917, and increased it over the years to the present 50% of adjusted gross income ceiling, with a five year carry-over of any excess, thereby providing a substantial incentive for our growth and development through support from the private sector.

There is a practical reason for the government to encourage

voluntary financial support for charitable uses. These increased tax incentives for charitable giving over the years has resulted in the expansion and development of charitable organizations, including independent universities which serve the public good.

The Congress has reaffirmed on many occasions that the Federal Treasury is compensated for any loss in revenue, through its relief from the financial commitment which would otherwise have to be made by appropriations from public funds to achieve the benefits produced by charitable organizations which promote the public welfare. The most important incentive you have at your disposal, to help insure the continued stability of the charitable organization is that which is provided through the charitable contribution deduction. As the honorable George P. Schulz, Secretary of the Treasury has said in testimony before this Committee in April 1973, "We urge you to do nothing that would jeopardize the vitality of our voluntary charities which depend heavily on gifts and bequests...we believe the existing deductions for charitable gifts and bequests are an appropriate way to encourage those institutions. We believe that the public accepts them as fair."

B. Private contributions to SMU including contributions to capital purposes and current restricted and unrestricted support, is

detailed in the Appendix A to this report for your information. We can see that the current levels of support realized from the private sector by Southern Methodist University in the past 10 years has provided a substantial resource without which this University could not hope to function. The costs of operations detailed in this statement as Appendix B, illustrates our annual budget for current operations showing an increasing spread between our sources of revenue and the costs of operations. This spread must be filled by increased support from individuals, businesses and foundations.

IV. THE NATURE OF FINANCIAL SUPPORT:

The nature of the current trends of financial support detailed in Appendix A of this report illustrates that our gift income is directed to 2 main areas including (1) cash for operations, and (2) cash for capital purposes. Sources of this support are also detailed. In the past ten years contributions have provided nearly 75 million dollars. A substantial portion of our gifts are in the form of property of which approximately 75% is appreciated property, and principally in the form of securities.

This gift income has permitted the University to largely absorb

the increasing cost of operations up to the present. Our future ability to withstand substantial deficits will depend to an even greater degree on a public which is willing to voluntarily share their fortunes with us to insure our future.

In this regard, it is apparent that the tax laws must continue to encourage support of charitable organizations by private citizens. The charitable contribution deduction remains an important incentive for private giving for the public good. A reduction of current tax incentives for charitable contributors would reduce charitable gifts. This would result in decreased services to the general public, provided by charitable institutions and would come at a time when charitable organizations and certainly Southern Methodist University are finding it increasingly difficult to operate without deficits each year in the face of spiraling costs of operations, and in some cases, reduced income from endowment and a hesitancy to further substantially increase tuitions and fees charged to our students (see Appendix B). If these incentives are going to be reduced, then the public should be made aware of the fact, and informed as to what plans there are to replace the services provided by our independent universities and colleges.

I would now like to comment on two subjects which are to be dealt with in this phase of the Committee's deliberations which we feel would have an adverse affect on the support received by Southern Methodist University.

V. TAXABLE AND NON-TAXABLE INCOME ALLOCATIONS:

Much like the minimum taxable income proposal is the proposal that would require the inclusion of the charitable contribution deduction in the itemized deductions along with others to be allocated between taxable and non-taxable income.

If the charitable contribution deduction is going to be lumped with a donor's other non-business itemized deductions, it along with other itemized deductions would be allocated between his taxable and non-taxable income with only the part allocable to taxable income allowed as a deduction. It is illogical to lump the charitable contribution deduction along with other itemized deductions, such as interest, taxes, casualty losses, medical expenses and so forth, in making this allocation. The charitable contribution deduction is unique in that it rises from a donor's voluntary act and the benefit inures to the charitable organization.

The allocation of deduction proposal would substantially decrease support from major contributors on whom we rely for a large part of our support because the allocation between taxable and non-taxable income will reduce the charitable contribution deduction and in effect tax the donor on that which he has given away. If we limited the allocation between taxable and non-taxable income, even to only the value of appreciation on contributed appreciated property, then the effect would be the same. It would reduce the donor's charitable contribution deduction as well as his other itemized deductions.

We oppose this proposal because it would substantially decrease charitable gifts.

VI. MINIMUM TAXABLE INCOME PROPOSAL:

The administration's minimum taxable income proposal would substantially decrease support from major contributors because it would effectively abolish the 50% of adjusted gross income ceiling on the income tax charitable contribution deduction, and in effect, substitute a ceiling for the total of all deductions, whether they be charitable, or medical, deductions for interests, taxes and so forth. Thus, if an individual in planning a large commitment to the institution for a specific program or project of his choice, so plans his

giving, as some do, to fund a project up to the 50% limitation each year of his adjusted gross income, and his adjusted gross income has other itemized deductions, the ceiling on his contribution deduction would be reduced. Such a donor would then reduce his annual support for a large program to that which is allowable as a deduction. In addition, the minimum taxable income proposal would have the effect of abolishing the five year carry-over for gifts by donors who are subject to the minimum taxable income. Indeed the minimum taxable income proposal could result in a retroactive disallowance of deductions for charitable gifts made before enactment of the minimum taxable income and now being carried over into minimum taxable income years.

Southern Methodist University and other universities depend very heavily on leadership gifts. The minimum taxable income proposal will adversely affect leadership gifts which often inspire others to make contributions. And it is a well understood truism that securing the first large leadership gift in a development campaign seeking funds for special purposes and projects is an extremely important ingredient in the success or failure of a development campaign.

We do not believe that the charitable contribution deduction should be included with other deductions in the minimum taxable income proposal. And in so stating, we want to endorse the testimony of Treasury Secretary Simon in his July 8th testimony before this Committee when he recommended his support of the Committee's decision to put the charitable contribution deduction entirely outside the scope of the provision for minimum taxable income. His testimony is an acknowledgment of the problem faced by charitable organizations who are facing difficult financial positions caused by inflation and in some cases reduced income from investments. We support his testimony and we urge this Committee's final decision to reflect that regard.

Mr. Chairman and members of the Committee, I want to extend to you the deep thanks on behalf of Southern Methodist University, its Board of Governors, and Board of Trustees for this opportunity to present our view. More importantly, however, because our essential business is the education of young men and women, we hope you will do nothing that will impair the opportunity they have both in private and public institutions of higher learning of persevering in an inquiry just as far as their talent and ability allow under the guidance of a viable and thriving independent educational enterprise.

APPENDIX A

RECORD OF GIFTS AND GRANTS TO SOUTHERN METHODIST UNIVERSITY
1965 - 1975

Year	Total Support	Current Operations	Capital Purposes	Corp. & Bus.	Religious Denomina-tions	Alumni	Other Individuals	General Welfare Foundations	Other Groups & Sources	Bequests	Annuities, Life Contracts, Insurance
1965-66	4,785,849	1,832,354	2,953,495	182,113	387,183	300,526	1,141,247	2,742,184	32,596	-0-	-0-
1966-67	4,132,785	1,965,246	2,167,539	831,737	330,625	320,365	1,649,338	926,918	73,802	-0-	-0-
1967-68	4,899,951	1,999,787	2,900,164	391,479	517,817	437,227	2,329,634	1,119,042	104,752	-0-	-0-
1968-69	6,320,828	2,469,366	3,851,462	616,599	349,891	645,248	1,611,751	2,439,609	657,730	118,674	544,867
1969-70	9,346,165	3,413,577	5,932,588	826,196	577,247	1,227,388	1,812,739	3,806,055	1,096,540	-0-	13,043
1970-71	6,915,926	3,807,049	3,108,877	1,093,562	436,585	1,846,763	1,051,563	1,782,352	705,101	10,000	-0-
1971-72	10,909,631	3,482,581	7,427,050	869,521	490,760	4,331,716	2,217,839	2,232,088	767,707	931,066	4,758,000
1972-73	8,809,415	4,255,324	4,554,091	1,080,833	526,885	2,215,446	1,312,892	3,049,542	623,817	396,447	123,376
1973-74	13,430,198	4,842,106	8,588,092	953,161	679,192	3,396,308	3,738,896	3,717,263	945,378	2,711,720	21,933
1974-75*	5,149,441	2,603,518	2,545,923	427,599	510,056	607,401	1,793,936	1,194,618	615,831	incomplete	incomplete
Total 10 Yrs.	74,700,189	30,670,908	44,029,281	7,272,800	4,806,241	15,328,388	18,659,835	23,009,671	5,623,254	4,167,907	5,461,219

Year	Government Research	Government Other	Total
1971-72	976,534	788,056	1,764,590
1972-73	1,243,605	620,602	1,864,207
1973-74	1,087,309	648,476	1,735,785
1974-75	(Incomplete)		

*11 months

APPENDIX B

SOUTHERN METHODIST UNIVERSITY
CURRENT UNRESTRICTED REVENUE & EXPENDITURES

(000's Omitted)

Fiscal Year	Revenue	Expenditures	[1]Indicated Surplus (Deficit)	Unrestricted Gifts to Operations
1965-66	13,621	13,584	37	1,204
1966-67	16,319	16,149	170	1,456
1967-68	18,155	18,420	(265)	1,922
1968-69	19,892	21,658	(1,766)	1,747
1969-70	23,811	24,904	(1,093)	2,101
1970-71	26,931	27,917	(986)	2,870
1971-72	27,906	27,312	594	2,688
1972-73	30,305	30,295	10	2,824
1973-74	33,204	32,734	470	3,578
Preliminary 1974-75	34,982	37,078	(2,096)	2,983
	245,126	250,051	(4,925)	23,373

1. Deficits for Years 1968 - 1971 are largely offset by realizing gains on investments or reserves.

SOUTHERN METHODIST UNIVERSITY
TUITION AND FEES CHARGED OUR STUDENTS

1965 - 1975

Year	Per Semester Tuition	Per Semester Fees	Total 2 Semesters
1965-66	500.00	51.50	1,103.00
1966-67	600.00	51.50	1,303.00
1967-68	600.00	51.50	1,303.00
1968-69	600.00	70.00	1,340.00
1969-70	700.00	75.00	1,550.00
1970-71	800.00	75.00	1,750.00
1971-72	900.00	75.00	1,950.00
1972-73	900.00	80.00	1,960.00
1973-74	1,000.00	100.00	2,200.00
1974-75	1,100.00	125.00	2,450.00
1975-76	1,100.00	125.00 30.00*	2,510.00

*Added Utilities Fee

STATEMENT OF ROBERT BEGGAN
Vice President, Fund Raising, Labor, and Corporate Division
United Way of America

July 30, 1975

I am Robert Beggan, Vice President of the Fund Raising, Labor and Corporate Division of United Way of America.

United Way of America is the national association of local United Way fund raising and planning organizations. These organizations raised over one billion dollars ($1,038,995,000) in 1974 for the support of 37,000 local, state and national health, welfare and recreation services which serve over 34 million families. As the largest annual charitable fund raising effort in this country and therefore the world, the United Way is vitally concerned about tax policy as it affects charity.

The United Way human service delivery system depends upon charitable dollars for its survival, In order to merely keep pace with inflation, we must double the amount we are presently raising in the next ten years.

Specifically, I wish to comment on minimum tax proposals as these affect the support of charitable organizations.

We were very pleased with the Secretary Simon's assurance to the members of the Committee that the Administration has not advocated any change in the tax treatment on the appreciation involved in property gifts to charity, and is not advocating such change.

In this regard, the inclusion of the unrealized appreciation in deductible property gifts as an item of preference income for purposes of the minimum tax would adversely affect charity since it would reduce the present incentive to make such gifts. We would point out that:

1. The donor receives no income from such a transaction and should not, therefore, be taxed on the unrealized appreciation given to charity.

2. Charity, and those it serves, receive the full fair-market value of the property and the donor should not be penalized for foregoing the personal benefit that would accrue if he or she did not make the charitable gift.

3. A tax imposed on any part of a charitable gift to a publicly supported charity would be a radical departure from the long-honored tradition of not taxing charitable acts.

We were pleased to hear Secretary Simon's endorsement of the modifications this Committee made last fall in the MTI proposal with respect to charitable contributions. We urge the Committee to hold to that position should it decide to adopt MTI in place of the present minimum tax on preference income.

Charities have never been opposed to a minimum tax in principle. They believe that every person must meet his fair responsibility for the support of the government.

Yet, we must oppose those proposals which, either by design or inadvertence, affect support of charitable organizations so vital to the welfare of our nation.

Statement of Professor Daniel I. Halperin

University of Pennsylvania

Law School

Summary of Testimony

While I recognize opinion to the contrary, I do not believe that the charitable contribution deduction is justified as a means of measuring true net income. There is certainly no technical justification for the failure to tax appreciation on gifts of property.

Thus, if the Committee chooses to retain these provisions as an incentive to private giving (which, in some form, I believe, is justified), they are presumptive candidates for inclusion in a minimum tax, if the minimum tax has the goal of subjecting at least one-half of an individual's economic income to tax at the regular progressive rates.

Such a minimum tax may be intended to recapture part of the windfall to the taxpayer from the failure to apply a correct definition of net income. However, if it is believed that the taxpayer passes the benefits on, for example, by increasing his charitable contributions, the justification for a minimum tax is less clear. It may be required to alleviate public unhappiness with tax equity on the theory that the lack of advantage to the taxpayer is not demonstrable and, in any event, the public insists on significant actual payments of tax.

Therefore, if the Committee believes that the benefits of the charitable deduction to taxpayers are passed on in the form of higher contributions to charity and that the public accepts the charitable deduction as a legitimate part of an income tax, there may be a justification for allowing the deduction in computing the base for the minimum tax, as the Committee tentatively decided last year.

A consideration to the contrary is that the present law favors giving by high income individuals. Thus, as the marginal tax bracket increases,

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relatively less sacrifice is required in order to obtain the opportunity to direct funds, that otherwise would be paid in taxes, to one's favorite charities. Results are obtainable which are irreconcilable with the notion that charitable contributions require personal sacrifice. I believe that this situation in part explains the limit on the charitable deduction to 50% of Adjusted Gross Income and could support a rule which would say that you could not direct money to charity unless you were already paying taxes on one-half of your economic income. This position would support including charitable deductions within the minimum tax.

In any event, I would recommend treating the amount of appreciation on gifts of property as a preference (if my first choice of taxing it in full is not followed).

Any belief that the present economic situation makes changes in the charitable deduction inappropriate could be met by a delay in the effective date.

Charities may be arguing that anything else to the contrary, it is inappropriate to include charitable contributions within a minimum tax because the nature of the motivation for giving indicates the likelihood of a large drop in gifts far in excess of any revenue to be gained. I would hope that the Committee, before acting on this supposition, would insist on careful documentation of this assertion and that it would weigh the potential loss in terms of tax equity and public confidence in the income tax against the loss of donations to charity.

STATEMENT OF DANIEL I. HALPERIN

* * *

My name is Daniel I. Halperin and I am a Professor at the University of Pennsylvania Law School. I appear here today at the request of the committee to give my views on the application of the Minimum Tax to charitable contributions.

Charitable Contributions and Minimum Tax

In order to talk intelligently about the desirability of including charitable contributions within the scope of a minimum tax, one must come to some conclusion not only about the objections to and the justification for the charitable contribution, but also about the case for adoption and extension of a minimum tax. Unfortunately, there is no uniformity of opinion about either of these questions. Thus, it seems necessary to discuss the interaction of the two provisions under various assumptions relating to each.

The Case for Charitable Deductions

> "The current deductibility of charitable gifts in the calculation of taxable income has been both sharply criticized and strongly defended. The supporters argue that the deduction is needed to stimulate private expenditures on worthwhile activities that produce substantial benefits that do not accrue to the individual donors. The critics reply that the current system is unfair because it makes the donor's net personal cost per dollar of gift much lower for high income individuals than for individuals with lower income."1/

I assume everyone would agree that the charitable deduction has some effect on the total amount of private giving. It is also undeniable that many non-profit institutions are in serious financial straits. Thus, unless there is a corresponding increase in direct appropriations, a change in the deduction which reduces the benefits to contributors to certain institutions will also reduce the funds available to such institutions, almost certainly requiring a curtailment of present programs. Of course, there can be no assurance of an offsetting increase in government funds, but even if there were, there is a substantial body of opinion

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1/ Feldstein, The Income Tax & Charitable Contributions: Part II, XXVIII, Natl. Tax J. 209 (June 1975).

which holds that there are significant advantages to private decision-making as opposed to leaving the entire choice concerning organizations and causes to support to our legislative bodies.

What supporters of the deduction sometimes refuse to face up to, however, is that such arguments by themselves do not support the status quo or any particular set of rules. Donations to charity will be increased, almost certainly to the point of eliminating financial difficulty, by a law offering any individual $150 if he will give $100 to charity. Yet, there is obviously no support for such a proposal. Nor do I suspect is there support for a proposal to make the payment $99, indicating that the existence of financial detriment to the individual making the gift, as opposed to monetary gain, is insufficient. What then are the reasons for the charitable deduction?

Some have urged that the income tax should be imposed only upon the amount available for private consumption. Money given to charity is turned into public goods, shared by the community, and even if the donor obtains satisfaction from the gift, this form of consumption, because it does not preclude enjoyment by others, is somehow different.[2/] "If we are not willing to tax a man on income he could have earned, but did not (because he chose leisure time and decreased income ...), we should not tax him on income he earned but chose not to keep by voluntarily giving it to a public charity."[3/]

2/ Andrews, Personal Deduction in an Ideal Income Tax, 86 Harv. L. Rev. 309 (1972). See also, Bittker, The Propriety & Vitality of a Federal Income Deduction for Private Philanthropy in Tax Impacts on Philanthropy, T.I.A. (1972). But see McDaniel, Federal Matching Grants for Charitable Contributions, 27 Tax L. Rev. 377 (1972).

3/ Tax Reform & The Crisis of Financing Higher Education, A Report of the Association of American Universities in Hearings before the Committee on Ways & Means on General Tax Reform, 93rd Cong., 1st Sess., Part 14 at 5538, 5551 (Apr. 9, 1973).

This argument does not justify exclusion from income of the appreciation in property donated to charity and some supporters of the charitable deduction will urge a change in this result.[4/] The defenders of the status quo, when they are not merely voicing the proposition that the exclusion of appreciation is an effective incentive (which, as I have indicated above, is also true of a lot of things they would not support), seem to argue that it is illogical to compare a charitable gift to a sale of the property. They argue that the donation is purely voluntary and if it were not made the property might be held to death, in which case the appreciation would likewise not be taxed.[5/]

It seems clear, at least to me, that the failure to tax appreciation at some point is wrong and we should repeal the present escape at time of death. We certainly should not look to it as an analogy to justify all sorts of other tax avoidance results. Moreover, a charitable gift is clearly distinguishable from merely holding property in that the donation of the property enables avoidance of tax on income that is kept and used for personal enjoyment. This is so, because to the extent that appreciation is not taxed, the charitable deduction can be used to offset retained income.

Therefore, I believe that there is no technical explanation, drawn from the nature of the income tax, for the appreciated property rules. I also find it difficult to accept the argument that a gift to charity reflects a decline in consumption. The income is available for consumption and, since the donor selects the recipient of his bounty,

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4/ See Andrews, supra n. 2 at 372.

5/ See e.g. Hearings, supra n. 3, Part 14 at 5528.

actually consumed, certainly in the form of satisfaction from the enjoyment of the gift by others, but also, in many cases, more directly, as when one gives to his own church or school, to the museum he likes to visit or to his favorite symphony orchestra. I am persuaded that the charitable deduction results in an exclusion of income from taxation just as certainly as percentage depletion or the exclusion of interest on state and local bonds. Therefore, the case for the current rules lies not on technical grounds but on the acceptance of an incentive for charitable gifts.

The Case For an Incentive

Whole-hearted acceptance of the benefits to society of plural decision-making does not in itself justify favorable tax rules. One must also believe that, at least with high progressive rates draining the assets of the well-to-do, in the absence of tax or other governmental incentives, the charitable sector will not be supported by private money to the optimum extent. I am not in a position to make an expert judgment on the question, but I will take it as given that the majority of Americans support this proposition.

It seems, however, it would be the greatest of accidents if a tax deduction, not justified by the nature of the income tax, produced the right kind of incentive. Nevertheless, if the desirability of an incentive is accepted, as I believe it is, there has to be some presumption in favor of the status quo, particularly in light of the substantial support for a charitable deduction on more technical grounds. Despite this presumption, periodic reexamination of the operation of the tax incentive for charitable giving is desirable, just as it is with other governmental expenditures, to make sure it continues to be in accord with national

priorities for the use of limited governmental resources.

Among the factors to be taken into account in judging the propriety of continuing the present tax advantages to charitable giving are the efficiency of these provisions in producing additional donations and the effect of the charitable deduction on inter-personal equity.

A recent study indicates that the charitable deduction as a whole produces more in additional contributions than is lost in tax revenue.[6/] I do not have the expertise to evaluate the conclusion, but this Committee should attempt to reach the best judgment it can on this question both as a whole and with respect to various aspects of the deduction.

In any event, even if one concurs in this conclusion as to all aspects of current law, there is still the question of equity.

The Equity of the Charitable Deduction

The charitable deduction enables a taxpayer to divert funds, otherwise headed into the Treasury, to the charity he or she selects. Individual decision-making is, of course, the very reason for the incentive, but it is noteworthy that we do not allocate this power of decision as we do the vote.

In the first place, you must owe taxes; that is, you can decide how to spend it only if you were going to be the source of the tax money. Secondly, you must be willing to send some of your own funds to the same organization.

While some measure of individual sacrifice is purportedly required, how much depends upon the tax bracket. Thus, a taxpayer in the 20%

6/ Feldstein, The Income Tax & Charitable Contributions: Part I, XXVIII Natl. Tax J. 81 (Mar. 1975).

bracket must spend $400 of his own money (80% (100 - 20%) of the total gift) to get the right to allocate $100 of tax-designated dollars, while an individual in the 70% bracket need spend only $42.85 (30% (100 - 70%) of the total gift) to allocate $100.

If appreciated property is involved, and the alternative of sale is accepted, the out-of-pocket cost can be as little as zero. This will be true for taxpayers in the 70% bracket as long as the basis of the contributed property is approximately 15% or less of the value.[7/] For such a taxpayer, the personal sacrifice will only be about 10% of the gift when the basis of the donated property is 40% of value. In the case of property with a zero basis, there would be no out-of-pocket cost if a taxpayer were subject to a marginal rate higher than $66^{2}/3\%$.

These results cannot be reconciled with the notion that individual sacrifice is required. On the other hand, if individual sacrifice is not to be a prerequisite to redirection of tax payments, why can't I write the Treasury that, because of my high tax payments, I have no appreciated or other property to give away, but just the same I'd like them to send $100 of my money to the United Fund.

As has been frequently noted, the present system of plural decision-making results in a redirection of tax funds to charities favored by the well-to-do, primarily educational institutions, hospitals and cultural organizations, rather than those entities which would be chosen by the

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7/ These examples assume that the alternative tax on capital gains is absorbed by other sales during the year producing at least $50,000 of gain.

less well-off. Schools and hospitals can be said to be of benefit to all of us whether we are direct beneficiaries or not, but I wonder if the same can be said of museums and symphony orchestras. I would guess that these institutions are to a significant extent "consumed" by their supporters and, in any case, not by the poor. Other "charitable" endeavors may have even less widespread benefits.

A tax credit, in lieu of a deduction, would presumably result in a redirection of funds, possibly primarily to religious organizations.8/ Perhaps a credit mechanism could be designed which would not have this result, at least as to public charities, but certainly that it is not the criteria that would ideally be utilized in developing a credit. Notions of fairness or equity should prevail, and if this results in less money for organizations, you and I prefer, that is the price of democracy.

There is clearly a dilemma here and I feel fortunate that today's subject does not require me to offer a solution. Perhaps, one can say that Congress (even if it were not inhibited by constitutional restraints on aid to religion) would not deviate from the present dispersion of tax funds by categories (if it were to disallow the deduction, actually collect the added taxes and then appropriate it), and it is better to leave the choice of the organizations which will benefit to private decision-making. This would counter the seemingly undemocratic nature of the present system.

To sum up, I do not believe the charitable deduction can be supported by reference to the nature of an income tax. The need for an incentive for individual contributions to charitable organizations is

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8/ Feldstein, supra note 1.

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widely accepted, but there has to be some logic behind the incentive. Not every provision which would encourage donations would be supported. The difficulty of getting agreement as to a proper incentive is an argument for retaining the status quo. Thus, I am not sure I would change the present deduction even though I have great difficulty with a situation which enables high income taxpayers to direct tax money to charity with relatively little personal sacrifice. I am persuaded, however, that the exemption of income on appreciated property, which has no support on technical grounds, is too inequitable to be retained.

The question considered in what follows is whether a minimum tax can mitigate any inequities in the charitable deduction.

Role of the Minimum Tax

The present minimum tax is an uneasy compromise between two approaches to a minimum tax which have been advanced.9/

The Treasury, under several Presidents, has consistently supported a comparative tax under which a taxpayer would be required to pay a minimum tax at the regular progressive rates on at least one-half of a broader concept of income, approximating economic income (or coming as close to economic income as was deemed possible, mechanically or politically).

The Senate Finance Committee in 1969 substituted a flat 5% tax on preference income in excess of a $30,000 exemption. This additive tax

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9/ For a more detailed discussion from which the summary is partially drawn, see Statement of Paul McDaniel in Panel Discussions before the Committee on Ways & Means on General Tax Reform, 93rd Cong., 1st Sess., Part 6 at 711 (Feb. 20, 1973).

applied regardless of how much tax a taxpayer paid on his other income. As such, it represents a low rate of tax on items, such as the excluded one-half of capital-gain income, which would otherwise be exempt and a kind of a rough interest charge with respect to those preference items which result in deferral rather than an exemption of income.

The existing minimum tax structure, by permitting a deduction from tax preferences of the amount of regular income tax, bears some similarity to the comparative approach since this deduction has the effect of recognizing that the taxpayer is not completely avoiding tax. However, it is closer to the additive approach in that the existing tax can apply even though the taxpayer has not excluded one-half of his economic income from tax. More significant, the flat tax rate of 10% falls far short of the Treasury proposals which, since they taxed one-half of an expanded income base, had the effect of applying progressive rates up to 35% (one-half of the present highest tax rate).

The additive form of the minimum tax focuses on items of income and suggests the belief that there should be no income completely exempt from tax. If Congress wishes to favor certain kinds of income, it should reduce the tax on this income, but should not completely eliminate it. While this may reduce the intended incentive effect of a preference provision, it is the minimum required for the tax laws to be viewed as equitable. It should be noted, however, that this result could probably be accomplished more directly by making income only partially exempt or by reducing the amount of accelerated depreciation which is allowed.

The comparative form, on the other hand, focuses on individuals rather than items of income and suggests that all persons should pay tax at the regular rates on at least one-half of their economic income.

The existence of tax shelters and other incentives for economic and social behaviour makes it possible for individuals to avoid paying tax on all their income and Congress does not wish to entirely eliminate this situation. It, thus, turns to a minimum tax to extract some payment from the wealthy, which amount will be accepted as fair by the public at large or at least close enough to being fair to retain sufficient confidence in the equity of our tax laws to prevent our self-assessment system from collapsing.[10/]

The need for a comparative minimum tax may depend upon whether or not tax incentives are efficient in operation. Thus, existing tax preferences are generally supported as incentives to certain behaviour, principally investment in certain activity, such as oil and real estate. Even assuming that given national priorities, such incentives make sense, opponents of tax preferences argue that present tax rules are inefficient because, for example, they increase the return on certain investments beyond what is needed to achieve the desired level of investment. This would mean that the revenue loss to the Treasury, in part, provides windfalls to investors rather than aid to the intended beneficiaries. For example, the tax loss from failure to tax interest on state and city bonds is not entirely passed on in the form of lower interest payments to local governments but is in part retained by investors in such bonds.

10/ There could be more tangible support for this form of minimum tax, but I know of no study which considers such issues. For example, it is possible that the supposed need for incentives to invest is no longer present, at least to the same degree, if the top tax rate were reduced to 35% as it is under the minimum tax proposal. On another tack, can it be asserted that the response to an elimination of preferences would be an overall reduction of rates so that the individual who now pays tax on half of his economic income is coming close to paying his fair share?

On the other hand, as stated above, in the case of charitable contributions, many believe that the tax savings are more than passed on in the form of increased contributions. Supporters of other tax preferences argue that a similar result occurs in their case. Under the latter hypothesis, the taxpayer is a mere conduit for funnelling benefits from the Treasury to the ultimate beneficiary. The taxpayer, himself, would be no worse off if the tax preference were repealed, or if he shifted to another fully-taxed investment because the increase in tax burden would be offset by a corresponding increase in pre-tax return.

Most proponents of a minimum tax probably do not accept this description as reflective of reality and would argue that the minimum tax is needed to recapture some of the investor windfall described.

Nevertheless, the comparative form of minimum tax could be justified even if the tax incentives were efficient in operation. Thus, such efficiency and the lack of advantage to the taxpayer is too uncertain to be demonstrable. Public acceptance of tax equity demands some meaningful direct payment of tax not merely an indirect tax through acceptance of a reduced rate of return.[11/]

Charitable Contributions and the Minimum Tax

Proposals

The present minimum tax has no effect on charitable contributions despite various Administration proposals that would have affected charity in one form or another. Thus, the 1968 Treasury proposals suggested

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11/ It may also be possible that the need for special investment incentives is less urgent once the top marginal rate is reduced to 35% as it would be for those subject to a minimum tax.

the inclusion of untaxed appreciation on charitable gifts as a preference for minimum tax purposes and an Allocation of Deductions proposal under which charitable contributions (and other itemized deductions) would be disallowed in the ratio that income excluded from tax bears to the sum of such excluded income and taxable income.12/

The foregoing was also the basic thrust of the Nixon administration's original proposals for a Limit on Tax Preferences and Allocation of Deductions.13/ However, before the Senate Finance Committee, the Administration withdrew its support for the inclusion of untaxed appreciation as a preference.14/

In 1973, the Treasury proposed a new form of minimum tax known as MTI which called for a tax on at least 50% of an expanded base (not including untaxed appreciation on charitable gifts) from which only limited personal deductions, not including charitable contributions, would be allowed.15/ MTI is thus a comparative minimum tax which treats the charitable deduction as resulting in tax exempt income.

The tentative decision of this Committee, however, was to allow charitable contributions in computing the base for the minimum tax and this modification was accepted by Secretary Simon in his recent testimony.

12/ Tax Reform Studies & Proposals, U.S. Treasury Dep't., Joint Publication of Committee on Ways & Means & Committee on Finance at 133 (Feb. 5, 1969).

13/ Hearings on the Subject of Tax Reform before Committee on Ways & Means, 91st Cong., 1st Sess., Part 14 at 5483 (1969).

14/ Hearings on H.R. 13270 before the Senate Committee on Finance, 91st Cong., 1st Sess., part 1 at 499 (1969).

15/ Hearings, supra n. 3, part 18 at 6985 (April 30, 1973).

Policy Arguments Based on Nature of Minimum Tax and Charitable Contributions

The denial of charitable deductions in computing the base for a minimum tax could rest on the notion that the deduction reduces taxable income below economic income and everyone should pay tax on at least one-half their economic income.

Alternatively, one may urge some limits on the charitable deduction as a means of restricting, within reasonable bounds, the bias toward charities favored by high income individuals. A minimum tax could conceivably be more appropriate in this regard than the present 50% limit.

The arguments for and against these propositions will now be more fully developed.

Although there is not a universal acceptance of this proposition among tax technicians, I believe that the charitable deduction results in an exclusion from income just as percentage depletion or the special treatment of capital gain. Thus, if the minimum tax reflects the belief that everyone should pay tax on at least one-half their economic income, the treatment of charitable deductions under MTI proposed by the Treasury in 1973 is logical if the charitable deduction results in a windfall to the contributor. Moreover, as stated above, the minimum tax could still be appropriate, even if the full amount of tax savings were passed on in increased contributions.

However, if the taxpayer actually does increase his contributions by the full amount of the tax savings, he arguably obtains no windfall to be captured by the minimum tax. The justification for the minimum tax in this situation is the desire to alleviate public unhappiness with the inequity of the tax law. Thus, there may be no need to include in

its base a provision which is efficient in operation and which, in the view of the public, does not result in improper tax avoidance. Perhaps, the charitable deduction falls in this class because of its widespread use and because many believe it fits within the technical definition of income.

On the other hand, it may be argued that the benefits of the charitable contribution deduction cannot be completely passed on by contributors in the manner that investors in would do if the tax shelter resulted in lower prices. This is so because the taxpayer-donor, not the operation of the market, selects the ultimate beneficiary.

It should be noted that the limitation of the charitable deduction to 50% of Adjusted Gross Income is intended to preclude the transfer of all the tax you otherwise would pay, in the absence of the deduction, to the charitable institution of your choice. Some portion must be paid to the Treasury. This seems particularly appropriate in light of the bias toward the charitable choice of the high income individual. Utilizing the base of adjusted gross income seems inadequate for this purpose since the charitable deduction could, in combination with other deductions, completely wipe out tax liability. It would be better to limit the charitable deduction to 50% of taxable income before the deduction.

MTI suggests, on the other hand, that one should not be able to divert any part of his tax liability to charity unless he is already paying tax on 50% of his economic income. There seems to be widespread acceptance of the need for a limit on the charitable deduction so that

no one individual could completely favor charity in lieu of paying taxes even if he did sacrifice all of his current income. A minimum tax may be appropriate for this purpose. Thus, if the efficiency of the deduction is given, I am unable to reach a conclusion at this time as to whether charitable deductions should be included in MTI. But, it seems clear to me it would be useful to generate some discussion of whether the limit on the deduction should be in terms of potential tax liability on economic income or only in terms of taxes actually payable after consideration of all exclusions and deductions other than the charitable deduction.

In any event, the case for inclusion of untaxed appreciation within MTI seems clear, and it is surprising that the Treasury has failed to propose it.

Extraneous Policy Arguments

Assume that after consideration of the foregoing arguments concerning the nature of the minimum tax one has determined that, on balance, the minimum tax base should include untaxed appreciation on charitable gifts and, perhaps, should not permit a deduction for charitable contributions, are there other reasons which should give one pause?

Secretary Simon stated that this Committee's decision to put charitable contributions outside the scope of MTI was appropriate in light of the dire financial position in which inflation has left so many private charities. Whether or not one agrees with the Secretary's conclusion, it seems clear it represents a temporary respite rather than permanent salvation.

Can more fundamental objections be raised? I sense an argument that it is inappropriate to include charitable contributions within a

minimum tax because the nature of the motivation for giving indicates that MTI , as proposed in 1973, would reduce charitable giving in an amount much greater than the revenue involved and, in any event, would result in a delay as the taxpayer attempts to assess the impact of the charitable gift on his minimum tax liability.16/ In part, this fear derives from the description of charity as a "voluntary" act which apparently is intended to mean that the taxpayer will invest in tax shelters first and then determine the amount of his charitable contribution after assessing the amount of his preference income.

Unfortunately, I do not have the experience with large donors to assess the validity of such fears, but I would urge this Committee to seek a more explicit explanation rather than acting on the basis of the generalities that have thus far been advanced. Moreover, it is essential to weigh the potential loss in terms of tax equity and public confidence in the income tax against the loss of donations to charity.

16/ See e.g. Hearings, supra n. 3, part 15 at 6227.

PUBLIC HEARINGS ON TAX REFORM
BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS
(94th Congress - 1st Session)
July 30, 1975

A B S T R A C T

A large measure of the economic distress of the United States is the direct consequence of a mistake in measuring capital gain and loss in federal income tax schedules. The injury appears as a direct property tax on capital expenditures. It has diminished the national capital base in a sum not less than 115 billions of dollars and reduced net income tax revenue by almost 30 billions of dollars.

A second factor contributing to the recession and inflation is an additional loss of capital resulting from the deferral of capital expense deductions to the year in which the related asset is sold.

Amendment of the Internal Revenue Code to end the mismeasurement and to begin current capital expensing will contribute to real capital growth and, over the long term, will increase Treasury revenue in a noninflationary mode.

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THE HONORABLE MR. ULLMAN AND MEMBERS OF THE COMMITTEE :

I am Leslie H. Baker, Jr., addressing the Committee as an individual. I represent no other citizen or association.

P A R T 1

THE TAX ON CAPITAL EXPENDITURES

THE MISTAKEN COMPUTATION :

A mistaken tax on capital expenses is built into the federal income tax system because capital gain and loss are mismeasured. The error affects both individuals and corporations.

The expression used by the Internal Revenue Service to determine gain or loss from the sale of each capital asset is :

GROSS SALE PRICE - COST = GAIN, (LOSS) (Equ. 1)

also written as

GROSS SALE PRICE - (PURCHASE PRICE + EXPENSE) = GAIN, (LOSS)

Neither of the expressions of Equation 1 is a true mathematical equation. While the GROSS SALE PRICE and the GAIN are measures of property value ...

the COST is not. The term, COST, is generated by the addition of the PURCHASE PRICE and the EXPENSE incurred at the time of purchase, to which is added all further expenses connected with the ownership and sale.

That addition is meaningless. It defies the basic algebraic axiom which limits the use of a single number to the measuring of a single quality or characteristic. It destroys the identity of the equity value of the property and the money paid as expense. That single number measures the equity (property owned) and the expense (property formerly owned until paid to a broker). Can the owner sell the equity ? Can he sell the expense ?

That addition of something owned to nothing owned is comparable to the 3rd grade addition of 6 apples to 1 orange to obtain 7 fruit. The resultant population of fruit is neither apples nor oranges.

Further positive proof of the mistake becomes evident on examination of the cost accounts of the willing buyer and willing seller and the income account of the broker. The three accounts measure more property value after a transaction than before, even though all exchanges were -- by agreement -- equal.

The end result of this mistaken addition is an excessive tax proportional to the capital expenses. It produces the following distortions to the tax assessment :

(1) The seller-taxpayer pays a tax on the sum of capital expenses when there is net loss of any term.

(2) The seller-taxpayer pays a tax on one-half the sum of expenses when long term gain is realized.

(3) If capital loss is reported, the capital loss carryover mistakenly includes the sum of expenses incurred.

(4) Currently prorated depreciation allowances mistakenly accelerate real property depreciation in proportion to the expenditures included in the COST on which the depreciation schedule was established.

(5) The current capital loss allowance for individuals (up to $1,000 per year) is mistakenly consumed by the component of expenses apparent in the allowed deduction. The long term loss treatment instituted in 1970 permanently destroys 50% of an expense component in any allowance that is claimed.

<u>THE CORRECT COMPUTATION</u> :

Capital gain or loss is correctly computed from the following equation :

GROSS SALE PRICE - ADJUSTED COST = GAIN, (LOSS) (Equ. 2)

also written as ...

GROSS SALE PRICE - PURCHASE PRICE = GAIN, (LOSS)

This testimony is concerned only with the adjustment of the COST for the expenditures; there are other proper purposes for adjusting the COST which are not related to expenses.

With respect to expenditures, the COST is ADJUSTED by subtracting the total of expenses from the expenses in the cost account ... including the last expense paid, the EXPENSE of sale. All of the expense notations would properly have appeared in a dual entry accounting system of the following form :

	C O S T	
Property Description	PURCHASE PRICE	EXPENSES
100 shares XYZ stock	$5,000	$100 Buy $100 Sell
ADJUSTMENT AFTER SALE		-$200
ADJUSTED COST	$5,000	

In the same tax return, the expenses which have been subtracted from the COST are also subtracted from the tax liability because they are entered among itemized deductions in the basic return. The requirement that all additions to income and itemized deductions from income be maintained in one-to-one correspondence with source dollars is called the wholeness doctrine, and it is discussed in a very clear presentation in Merten's LAW OF FEDERAL INCOME TAXATION, Volume 3A, Section 21.01 .

Less than 20% of the estimated 115 billions of dollars injury to the base of capital results from the direct tax assessment. The greatest injury is the loss of post-tax appreciation caused by the destruction of capital to the direct tax. The total economic damage escalates on a year-by-year basis and is described by the compound interest formula :

$$\text{TOTAL LOSS} = \text{INITIAL TAX LOSS} \times (1 + \text{ANNUAL YIELD})^{\text{YEARS}} \qquad \text{(Equ. 3)}$$

Depending upon the owner's preferred mode of investment, the TREASURY LOSS may appear annually as by income from interest or dividends ... or it may appear as a total in the year of sale as from an item in capital account. In Chart 1 it is presented as an annual loss solely that it may be related to an annual post-tax yield from the sum invested. The post-tax yield is shown as 6.75% per annum after the application of a 25% income tax rate on the parent sum of 9% per annum. Note how rapidly the Treasury loss increases after the break-even term of 23 years.

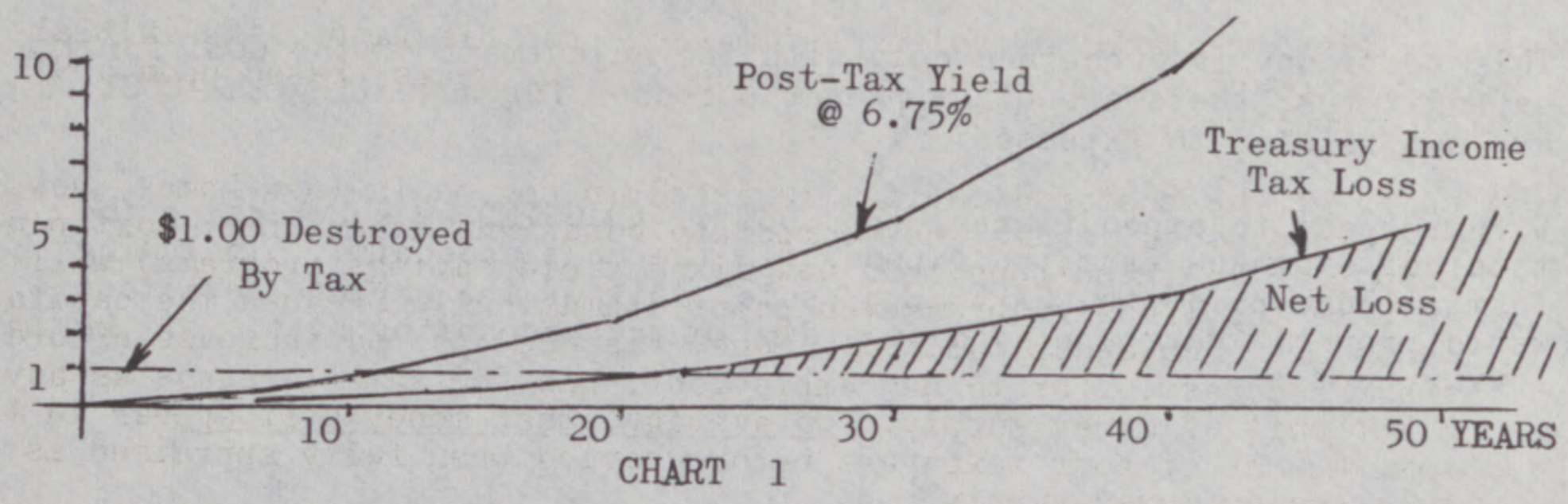

CHART 1

EFFECT ON TREASURY REVENUE :

Because the tax is not an income tax, it is not bounded by the conventional provisions of an income tax system. Treasury revenue is not reduced in one-to-one correspondence to sums which should be restored to taxpayers. On the contrary, over the long term, Treasury revenue sustains the same character of loss as taxpayer capital. After a period which this testimony describes as the Treasury breakeven term, the Treasury revenues are seriously reduced because of the error.

The 15 to 20 billions of dollars taken by the Treasury by the mismeasurement in the 60 year history of the tax system would otherwise have produced about 45 billions of dollars in normal income tax revenue. It is true, however, that the actual compound interest extension of Treasury loss was enlarged by the economic distortions of the Depression of 1929-1933 and of World War 2; hopefully, these would not be repeated in a succeeding 60 year period.

Restoration of revenue to the Treasury is not nearly so long delayed as is presented in Chart 1. The reasons are :

(1) If the tax accounting were corrected, the taxpayers would know of that correction during the initial period in which the change would be effective. Anticipation of the disappearance of that sum from the immediate tax computation would permit its use in an investment program during that first year ... to earn taxable income or begin a period of capital gain. This consideration would advance the Treasury breakeven date by one year after an initial restoration of revenue of about 2% based upon annual increments of income.

(2) The Congress does not now prescribe a clear formula for taxing real gain rather than indicated gain and, in fact, this is impossible with an inflationary monetary policy. Therefore, the sums restored to taxpayers whose subsequent investment was in existing equities (old real estate, issued stock and bonds) would simply reprice those properties in proportion to the returned capital. That increment of value appreciation would, itself, become subject to the income tax assessment on sale of the associated assets.

This "second tax" would diminish the apparent loss of Treasury revenue by the same decimal fraction which averages the tax rate on the affected taxpayers.This report has used a terminal tax rate of 25% to assure

conservative treatment of dollar estimates. In this range, the initial Treasury recovery is advanced by as much as four years, based upon a 9% pretax annual gain or yield.

(3) Units of the restored capital invested in new media (new homes, new corporate stock issues, new corporate bonds and debentures, most pension plan contributions, and new fixed yield savings programs) will advance the Treasury breakeven point dramatically because the capital funds are soon decapitalized. Money disposed to the increase of ordinary incomes ... or to new employment, has the same leverage as any other unit of money supply. On average, that money will appear in the tax returns of four taxpayers before having been fully appraised as outstanding money supply.

If the average tax rate on the four incomes to report that receipt is 20%, the initial net Treasury loss is also reduced to 20%. Note that this makes no allowance for the reduction of otherwise Treasury emergency aid appropriations which terminate with the increase of employment to produce the 80% initial recovery of Treasury loss.

Chart 2 presents the approximate effects of paragraphs (1), (2), and (3) above. Each is shown independently as if resulting from a 9% annual pretax yield examined as ordinary income and subject to an exemplary 25% income tax rate. Paragraph (3) recoveries are not compromised by the holding period of the recovering sellers. However, paragraph (2) results will be dependent upon the reinvestment medium and the term of holding.

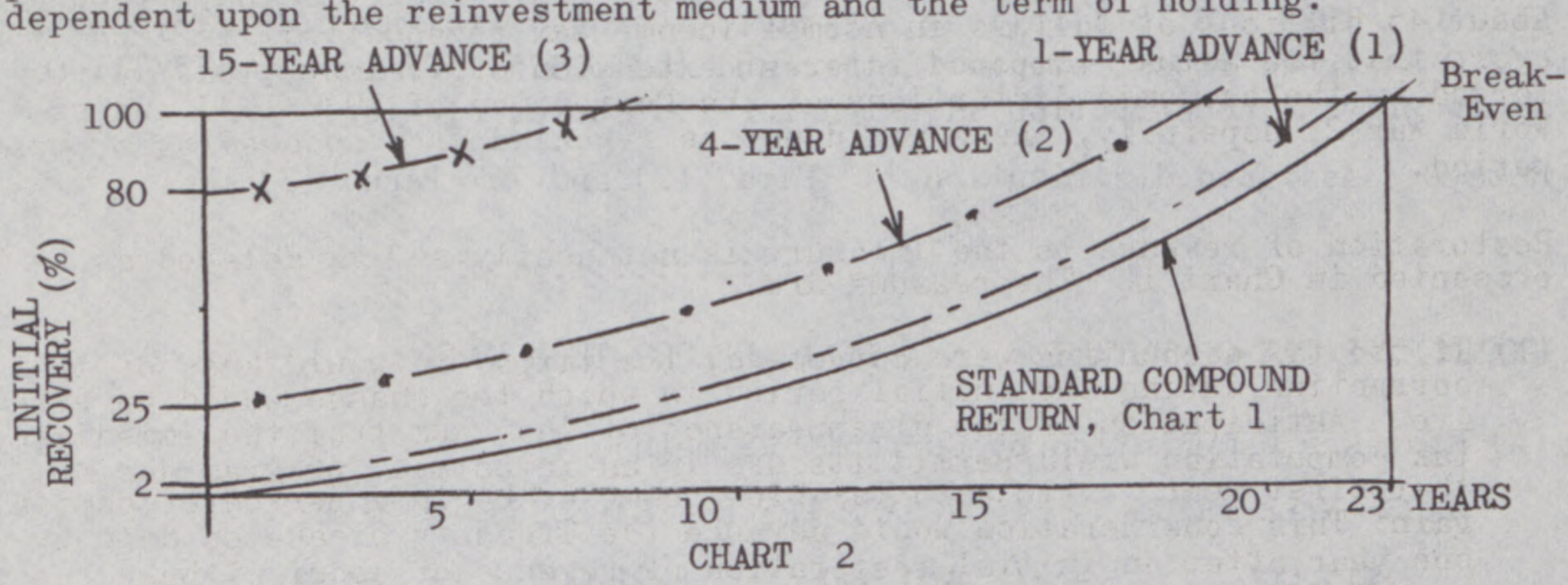

CHART 2

The projections of Chart 2 are quite conservative because no allowance is made for any tax on investment programs of employees who saved from their wages and salaries earned from the fund decapitalization associated with paragraph (3) applications.

Further, the treatment of this section makes no appraisal of the beneficial reduction of pressure on all Treasury requirements from the counterinflationary effect of money supply increases from earned sources. Paragraph (3) applications resist inflation and restore some flexibility to Federal Reserve Board authority.

The following table presents an estimate of taxpayer benefits and initial and ultimate Treasury recovery.

RESTORED FROM SALE OF	ANNUAL TAXPAYER BENEFITS	ANNUAL TREASURY LOSS	BREAK-EVEN
Stocks; bonds; commodity futures; undepreciated loss auctions	$700,000,000 (Note A)	$460,000,000 (Note B)	18 years
Old residential; capital land; undepreciated commercial real estate; sales of businesses	$1,700,000,000 (Note C)	$570,000,000 (Note D)	12 years
T O T A L S	$2,400,000,000	$1,030,000,000	16 years

Note A : 1973 U.S. Statistical Abstract, p.232/T370 with assigned 2.5 gross revenue factor; p.460/T735 with assigned ratio 4:1 securities + 1:1 unlisted + 1:1 commodities with assigned .70 loss factor.

Note B : Assigned distribution 80% Para.(2) and 20% Para.(3)

Note C : 1973 U.S. Statistical Abstract, averaged from(a) p.235/T375 with 2.0 assigned gross revenue factor, and (b) p.325/T527 less p.675/T1140 new private construction adjusted for 1.6% buyer closing.

Note D : Assigned distribution 25% Para. (2) and 75% Para. (3)

::::::::::::::::::::::::

EXAMPLE OF TAX COMPUTATION ON A TYPICAL LONG-TERM GAIN :

(A) Mistaken Computation by Current IRS method :

GROSS SALE PRICE - (PURCHASE PRICE + EXPENSE) $\neq$ GAIN

$15,000 - ($10,000 + $1,000) $\neq$ $4,000

Taxable Income $\neq \frac{\text{L.T. GAIN}}{2} \neq \frac{\$4,000}{2} \neq \$2,000$ WRONG

(B) Correct Cumputation by Adjusting Cost and Itemizing Deductions :

GROSS SALE PRICE - (PURCHASE PRICE) = GAIN

$15,000 - ($10,000) = $5,000

Effective Net Taxable Income $= \frac{\text{L.T. GAIN}}{2} - \text{EXPENSE}$ RIGHT

$= \frac{\$5,000}{2} - \$1,000 = \$1,500$

The apparently "extra" $500 taxable income in Example A is generated from numbers measuring expense disbursements ... yet is entered as a component of income on Tax Forms 1040 or 1120. Can a disbursement ever increase the income ?

In summary, it is seen that the money paid as EXPENSE ... ie. $1,000 was responsible for $1,000 of gross income as reported by the broker and for an additional $500 as mistakenly reported by the seller.

A similar computation made for returns reporting either short term losses or long term losses will reveal an even heavier burden. In those examples, the broker still reports $1,000 income ... yet the seller is also taxed on the entire $1,000 expense notation provided he has a taxable income in that tax period. The tax on that seller is increased because a component of his income is not offset in any way by a net subtraction of the $1,000 expense payment. That subtraction has been mistakenly deferred as an element of capital loss carryover which may or may not be offset against gain in future years.

It is important to note the conceptual error of equating expenses with true loss of equity value as reflected from willing buyer-willing seller price negotiations. There is not less property owned from the paying of an expense; the ownership has simply passed from the payer to the broker in total willingness. The expense decapitalization takes place in a single exchange between payer and broker.

Conversely, true capital loss results because all of the parties to two transactions have collectively agreed that there is less property value after a sale than existed after the prior purchase. Capital loss necessitates two exchanges ... not one.

Note that an injury -- in the event of loss -- is frequently borne by home sellers who have no future transactions against which to anticipate a following capital gain offset. Loss to those taxpayers is permanent; while other taxpayers should not subsidize their judgments as to home equity value ... it is unthinkable to burden them with a further loss resulting from a numeric mistake when, had they made a gain ... that numerical loss would have been halved.

DISASTEROUS EFFECTS OF THE MISTAKE :

(1) The error tax destroys capital ... increases unemployment ... reduces gross national product ... and depletes Treasury revenue. It severely pressures various emergency aid programs and the normal servicing of the Social Security Program.

(2) Over the long term, it unbalances Treasury revenue on income from capital gain, thus displacing that element of the income tax burden onto wage-earners and self-employed.

(3) The tax error intensifies sympathy for inflation of the money supply. The chain reaction of capital values seeking to counter the erosion caused by that inflation again increases the tax on indicated gains, further accelerating the capital erosion.

This form of the erosion is borne most severly by low and middle-income

taxpayers whose rate is simultaneously being increased as their indicated gains are increased from inflation. Unfortunately, the higher tax is also borne by all other ordinary income which became mixed with capital income to establish that taxpayers initial rate.

Conversely, the wealthy individual and corporate taxpayer ... while sustaining the same erosion of true asset value ... have reached a fixed rate plateau and are not simultaneously increasing their tax rate as the loss to expense treatment increases. The obvious result of the rate variance is to penalize the home seller, the occasional stock trader, and the investor in mutual funds more than the wealthy trader in securities.

(4) The mistaken tax biases the liquidity in all open auction markets with exactly the same compression of volume and spread between bid-ask prices as would accompany equal increases in trading commissions.

(5) The tax on expenses --- being computed from fixed percentages related to purchase and sale prices -- has been made independent of income. Thus, any dollar amount of that tax becomes a greater and greater percentage of the final taxable income as the income becomes <u>smaller</u>. This reversal of the intent of an escalated income tax system ends in the absurdity that the seller-taxpayer reporting net loss sustains a tax on his expenses at double the level imposed on a taxpayer netting long term gain.

(6) Inflation which directly results from the tax induces an increase in interest rates in all money markets. It influences the high cost of money for new corporate bonds and debentures, municipal bonds, and it is critical to the high cost of mortgages in the real estate and home building industries. The injury is dual because those higher interest rates burden normal Treasury revenue because the interest payments are direct tax deductions to the payers.

(7) The mistaken identification of expenses as elements of capital loss carryover skews the tax liability adversely to the interests of the investors who make the wiser choices of investment media; this result subsidizes failure and penalizes success. It is important to understand that the future offset of an element of loss carryover is claimable regardless of whether a tax was paid in the years of carryover accrual.

Thus, the wealthy individual trader whose income may be solely from capital transactions can safely modify his tax rate toward zero in year-end portfolio adjustments ... even, if he so chooses ... to the extent of reporting net loss for the sake of carryover deductions the following year. While the advantage is not ordinarily sufficient to justify the reporting of loss <u>deliberately</u>, it can become such advantage when the seller's total expenses begin to compare with his true equity gain or loss position.

Observe that this advantage is denied the low or middle income taxpayer whose tax rate remains at the level set by ordinary income as he may seek year-end capital account improvements.

<u>JUDICIAL TREATMENT OF THE ERROR</u> :

This testimony does not solicit any interference between the legislative department and the judicial department. It seeks merely the observance that the

judiciary is empowered to bring effect to past legislation ... but the legislature may at any time amend its own Acts to alter the framework within which judgments were entered.

The witness is plaintiff-appellant-petitioner in LESLIE H. BAKER, JR. vs. UNITED STATES OF AMERICA, No. C4-2222, United States District Court for the Northern District of Texas (summary judgment favoring the United States entered without hearing December 10, 1974); No. 75-1274, United States Court of Appeals for the Fifth Circuit (affirmed on summary calendar June 13, 1975); and the cause is now on notice of appeal to the United States Supreme Court.

The circumstances of the judgment are :

FACTS : The Department of Justice has admitted to the accounting and computational errors alleged in the complaints and as presented in this testimony. The admissions were affirmed on summary judgment by the trial court and upheld on affirmance by the appellate court.

LAW : The trial court and the appellate court have concluded that the gain or loss is to be computed according to the immediate Code provisions, and holding that the COST is the basis for that gain or loss. Both courts have withheld conclusions of law on plaintiff's pleadings that such tax is not constitutional pursuant to the 16th Amendment.

The witness asks that this Committee and its legal staff examine the language of the immediate Tax Code to determine whether the will of the legislature may have inadvertently commanded that the correct tax liability be computed from incorrect measurements of the gain or loss from the sale of property. This would appear particularly appropriate in light of the fact that the often cited landmark Supreme Court decision, HELVERING v. WINMILL, 305 U.S. 79, holding that capital expenses may not be deducted from income, was handed down with regard to the tax liability of a complainant who had made no tax claims concerning transactions in a capital account.

P A R T 2

DESTRUCTION OF CAPITAL VALUE BY DEFERRAL OF EXPENSE DEDUCTIONS

GENERAL :

A second serious erosion of the capital base occurs because tax credit for expense accountability is deferred to the year the related asset is sold. While independent of the injury discussed in PART 1, it becomes apparent in the same tax return.

There are two destructions of capital value from this deferral :

(1) The dollar value of the deferred expense deduction is continually eroded by inflation according to

$$\text{INFLATION LOSS} = \text{EXPENSE} \times \text{TAX RATE} \left[1 - \frac{1}{(1 + \text{INFLATION RATE})^{\text{YEARS}}} \right] \qquad \text{(Equ. 4)}$$

(2) Capital, effectively trapped in the cost accounting notation, could otherwise be invested ... either for further capital gain or ordinary income. That loss is expressed as

$$\text{INVESTMENT LOSS} = \text{EXPENSE} \times \text{TAX RATE} \left[(1 + \text{YIELD})^{\text{YEARS}} - 1 \right] \quad \text{(Equ. 5)}$$

The total erosion of the capital value of the deduction is the sum of Equations (4) and (5). In addition, there is a parallel loss of Treasury revenue which is expressed as

$$\text{TREASURY LOSS} = \text{INVESTMENT LOSS} \times \left[\frac{1}{2(N-1)} \right], \quad \text{(Equ. 6)}$$

where $\frac{1}{N}$ is the mean tax rate expressed as a common fraction or fraction with a decimal denominator ... and the 2 appearing in the denominator conveys a single long-term investment.

All of the capital loss and Treasury revenue loss computed from equations (4), (5), and (6) could be restored by amendment to the Internal Revenue Code so that all capital expenditures are claimed as itemized deductions in the year when paid.

The Committee will observe that Code amendment authorizing such current deduction will simultaneously end all of the capital destruction of PART 1 and PART 2.

While there is no equivalence between the tax liability of a current return and the liability in a future return, the prospective capital conservation and increased Treasury revenue may be approximated by use of a deferral period typical of specific long term investments:

DATA COMMON TO EXAMPLES :

Average Tax Rate	25%
Average Inflation Rate	5%/Year
Pretax Investment Return	6%/Year

Example 1 (TRADES IN LISTED SECURITIES) :

Annual Gross Purchase	$200 Billions
Average Purchase Commission	1%
Term of Ownership	7 Years

INFLATION LOSS :	$145,000,000/ Year
INVESTMENT LOSS :	$250,000,000/ Year
T O T A L :	$395,000,000/ Year
TREASURY LOSS :	$ 42,000,000/ Year

Example 2 (HOME SALES) :

No. of Homes sold	3.5 million/Yr.
Average Gross Purchase Price ...	$35,000
Initial Buyer Expense	1.6% Purch. Pr.
Term of Ownership	10 Years

INFLATION LOSS :	$195,000,000/ Year
INVESTMENT LOSS :	$880,000,000/ Year
T O T A L :	$1,075,000,000/ Year
TREASURY LOSS :	$145,000,000/ Year

Because these approximations are based upon a typical term of deferral until the property is sold, the recaptured capital value appears to offer benefit only to a seller. However, when the expenses are currently deducted ... the capital conservation is to both buyers and sellers.

For that reason, current expense deduction would be of particular benefit to the real estate and home building industries. Not only would such provision restore one billion dollars to the capital community from which those buyers and builders seek financing, but ... in terms of a home purchaser who would eventually pay out his mortgage, the ultimate savings to such buyer contracting a 9% mortgage for 35 years would be sufficient value to discharge about two full years of monthly payments. Such knowledge on the part of a home buyer would relieve a considerable element of the buyer indecision regarding the purchase of a home.

SUMMARY :

It is evident that specific property exchanges are made more difficult when the tax formula induces pricing variations which place a different burden on the buyer than on the seller. Under the present method of expensing, the buyer is not immediately concerned with the tax credit for the paying of expenses ... but the seller is. The effect is a difference in the viewpoint of buyer and seller as to what the final auction price will be for a property which appears the same to both. This effect is a bias against the liquidity of that unique, one-property marketplace.

This effect becomes magnified each time that same unit of property is sold, and that magnification is expanded according to the compound interest formula for the expense burden shouldered each time the property is sold. This ever increasing spread on the sellers target "breakeven price" always acts to widen the gap between buyer bid and seller offer.

The seriousness of this difference between the buyer's perspective and the seller's perspective for a typical home sale can best be understood when it is understood that most home sales are of fractional equities ... not fully owned property. Suppose that a home is sold two additional times in a 20 year period. In terms of the effect of the tax loss of PARTS 1 and 2 of this petition ... the capital loss to the mistaken tax has already become more important to the seller than the inflationary rise in equity has become to the buyer.

Thus, the natural interest of buyer and seller in that unique property has been made so divergent that there is hardly any common ground for an initiative price proposal. The realtor must try to work around this artificial difference in value perspective ... while being fair to both parties in terms

of the true ownership of both parties. Yet without the tax on expenditures, the Treasury would still collect the same tax revenue to which it was justly entitled from both of the additional sales. Therefore, this peculiar tax on expenses stalls out home sales and commercial real estate sales with devastating effect for two reasons, (1) the seller's burden is amplified with each and every sale of a unique property with the increase mounting exponentially, and (2) the sale of a fractional equity additionally magnifies the effect of the contribution of the mistaken tax.

The same type of problem situation exists in the open auction stock markets except that the circumstances are modified in several ways which reduce its relative severity : (1) there is nothing unique about the character of any 100 share lot of stock to compel prolonged buyer attention to specific assets, (2) many stocks are yielding sufficient ordinary income from dividends to the effect of reducing awareness of the capital erosion to a tax, and (3) fractional ownership of listed securities is ordinarily 50% or greater, whereas real property may be considerably less.

The most critical consideration of the tax on capital expenditures is its accounting for almost 40% of the inflation of the money supply since 1914. While this has been disasterous to all long term interest rates in money markets, it does not compel such continuing high rates of interest because the recapitalization incident to the removal of this tax would soon counter the apparent continuing demand for additional inflation. The measure of this reduced interest rate requirement demands empirical development as the inflation rate may be slowed.

RECOMMENDATIONS

(1) Amendment to immediate Sections 1012, 1011, 1016, and 165 to provide for 100% itemized deduction of all expenses in the year of sale of the related asset for expenses incurred before January 1, 1975.

(2) Amendment to the Code to provide for 100% itemized deduction of all expenses in the year when paid for all items paid on or after January 1, 1975.

(3) Amendment to the Code to specify that all expenses incident to private home purchases are recognized as capital expenses in the year when paid.

(4) Amendment to the Code to specify that all expenses resident in a depreciation schedule prior to January 1, 1975, will remain elements of that schedule.

Respectfully submitted this 30th day of July, 1975.

Leslie H. Baker, Jr.

Leslie H. Baker, Jr.
1417 Lincoln Avenue
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TAX REFORM - TOPICAL OUTLINE

Charles O. Galvin

Before the Committee on Ways and Means

House of Representatives

July 30, 1975

I. Early Efforts Concerning Tax Reform

II. The Work of the Special Committee on Substantive Tax Reform of the Section of Taxation of the American Bar Association 1962-1964

III. The American Bar Foundation-Southern Methodist University Pilot Studies in Substantive Tax Reform (1969)

IV. The Commission to Revise the Tax Structure, Reforming the Federal Tax Structure (Fund for Public Policy Research, 1973)

A. This report provided a detailed statistical analysis on what the income tax base would be under the following assumptions:

____Inclusion in income of cash and cash equivalent items of income such as interest on state and local securities, social security, unemployment benefits, and veterans benefits in excess of cost, scholarships and fellowships, other transfer payments, employee benefits, and the like.

____Elimination of nonbusiness deductions and exemption deductions with certain modifications in the case of major medical expenses and major casualty losses.

____Inclusion of imputed income on owner occupied dwellings.

____Inclusion or deduction of the increase or decrease in net asset values, including real estate, and all tangible and intangible personal property.

____Elimination of the corporate tax and the inclusion of corporate income in the shareholders' income tax base.

____Elimination of the estate and gift tax and the inclusion

of estates and gifts in the recipients' income tax base.

____Taxation of the family as a unit.

B. Effect of Proposals on the Rate Structure

The foregoing proposals increase the base from approximately $407 billion to $881 billion using 1971 as the subject year. All the actual revenues derived in 1971 from the individual income tax, corporate tax, and estate and gift taxes could have been derived from a single income tax with rates ranging from 4-54%.

C. Effect of the Commission Proposals on Unemployment and the Path of the Gross National Product

V. A Plea for the Creation of a Bipartisan Commission to do Research on the Tax System as a Basis for Long-range Tax Reform

Form a national Commission on Federal Tax Reform with two members from the Senate, one from each of the two major parties; two members from the House, one from each of the two major parties; two economists with a principal specialty in taxation and public finance, two lawyers specializing in federal taxation, two representatives from the academic community who have written and taught in the area of federal taxation, and three members from the public at large, one of whom shall be designated as Chairman. Each of the houses of Congress will select its own representatives, and the remaining nine will be selected by the President, giving due regard to the maintenance of a balance of political, social and economic positions.

Sufficient appropriations would be made on a continuing basis to provide the staff work for data retrieval and analysis to update and extrapolate from the work already financed in the private section.

The Commission would file an annual report with the Congress.

Oral Statement

TAX REFORM

Charles O. Galvin
Before the Committee on Ways and Means
July 30, 1975

Mister Chairman:

My name is Charles O. Galvin. My address is School of Law, Southern Methodist University, Dallas, Texas 75275.

For many years I have been an active member of the Section of Taxation of the American Bar Association. I have served as Chairman of its Committee on Legal Research, Chairman of its Committee on Exempt Organizations, Chairman of its Special Committee on Substantive Tax Reform, and have also served as a member of the Council of the Section. I have practiced, taught and written in the field of the law of Federal taxation for almost 30 years. In my supplemental statement, I have reviewed the prior efforts of the Ways and Means Committee, the Joint Committee on the Economic Report, and other groups in calling the attention of the public to the need for a sound and equitable system of taxation in the United States.

I have also described in my supplemental statement the important work of the Section of Taxation of the American Bar Association in substantive tax reform. In the period from 1962-64 the Section for the first time used some of the best talent of its practitioners and academicians on a special committee on Substantive Tax Reform. That Committee set the stage for the first organized effort of a professional association of lawyers who specialized in taxation to explore in depth a broadened tax base and significant proposals for simplification. Appropriate recommendations for a major study were made by the Section to the Board of Governors of the American Bar Association, and as a result, a special committee of the American Bar

Foundation was organized to present the project to the American Bar Foundation for financial support.

In conjunction with Southern Methodist University, the American Bar Foundation did sponsor a pilot project: Studies in Substantive Tax Reform, which was published and widely distributed in 1969. This project was intended to demonstrate the potentialities for substantial reduction in the rate structure and major simplification that could be achieved with the broadest possible income tax base. Because this project was only a demonstration (it had only a budget of about $25,000) the base broadening proposals and the possibilities for simplification were not explored to the fullest. Nevertheless, the publication did demonstrate how the skills of the tax lawyer and economic analysist could be combined with the important component of computer technology to provide a mass of important basic data from which rational tax policy choices could be made. The statistics of income were used for the year 1964 and on the basis of two models which were formulated, it was demonstrated that the existing tax base could be increased by 209 per cent in the case of one model and 217 per cent in the case of the other model, and a trial rate structure of 10 to 40 per cent was applied to these models to produce the same revenue that was actually produced in 1964 from the existing system.

Following the publication of these studies in 1969, the Fund for Public Policy Research in Washington was sufficiently attracted by the results to fund another major further extension of the work of Data Retrievals, statistical compilations and legal and economic analysis. These results were published

just two years ago in 1973 in the volume: Reforming the Federal Tax Structure, by the Commission to Revise the Federal Tax Structure of the Fund for Public Policy Research. This had a series of base broadening proposals together with proposals for the integration of the corporate income tax in the individual income tax base and the integration of the estate and gift taxes in the individual income tax base. These findings were presented together with an extensive analysis of the effect on the various adjusted gross income groups and demonstrated the effect of each base broadening proposal on each group.

A rate structure was presented of 4 per cent on taxable incomes of $3000 and over up to 54 per cent on taxable incomes of $100,000 and over. The remarkable aspect of this study was that it proved that all the actual revenue that was obtained for the test year, 1971, could have been obtained with practical base broadening and tax simplification proposals and a low graduated rate structure. And this assumed the complete elimination of the corporate tax and estate and gift taxes from the system.

The Commission also devised several econometric models to show the effect of its proposals on corporate growth, on agriculture, and on housing. These demonstrate that a broad based tax system with substantial simplification in structure, would much more nearly achieve the vertical and horizontal equity that we all seek and would produce a healthier economic climate for full employment and national growth.

It is interesting to note that at the time that these studies were proceeding through the American Bar Association and through

this independent study of the Fund for Public Policy Research the Canadian government had been successful in appointing a Royal Commission known as the Carter Commission which employed a staff of experts and professionals in the various disciplines to do for Canada what we had done on a more limited basis with respect to the United States tax system. If one reads the Carter Commission report, one is singularly struck by the comparability of the recommendations for the Canadian system with what should be the recommendations for the American system to achieve reform and simplification.

Therefore, Mr. Chairman, I propose the formation of a National Commission on Federal Tax Reform with two members from the Senate, one from each of the two major parties; two members from the House, one from each of the two major parties; with two economists, with a principal specialty in taxation and public finance; two lawyers specializing in federal taxation; two representatives from the academic community who have written and taught in the area of Federal Taxation; and three members from the public at large, one of whom should be designated as the chairman. Each of the houses of Congress would select its own representatives and the remaining nine would be selected by the President, giving due regard for a maintenance of balance of political, social and economic positions.

If the Congress wishes to benefit particular taxpayers, or stimulate particular industries, or reallocate resources for particular projects, these efforts are far better done on the expenditure, or appropriation, side of the budget rather

than on the revenue side. The system, instead of being further complicated by new provisions for credits and deductions and extensions of the tax system over a different specific transactions, should be simplified and the base broadened and then the funds thus generated could be used for whatever special purposes the Congress may from time to time determine. The kind of study that I am proposing would build on and update the significant work already formed on a non partisan basis in the private sector.

Only in this way, Mr. Chairman, can the legislative work of your committee be productively and fruitfully employed for the benefit of all the people of our nation. What more fitting way to celebrate the 200th birthday of the nation than to use our best minds and resources in creating for countless years ahead a national system of revenue measures for a sound and vital free economy.

Supplemental Statement

TAX REFORM

Charles O. Galvin

Before the Committee on Ways and Means

House of Representatives

Wednesday, July 30, 1975

Mr. Chairman, my name is Charles O. Galvin. My address is School of Law, Southern Methodist University, Dallas, Texas, 75275. I hold the degree of Juris Doctor from the Northwestern University School of Law in Chicago and the Doctor of the Science of Law degree from the Harvard Law School in Cambridge, Massachusetts. I also hold the Master of Business Administration degree from Northwestern and have a Certified Public Accountant's Certificate from the State of Texas. I have practiced, taught and written in the field of the law of Federal taxation for almost 30 years.

For many years, I have been an active member of the Section of Taxation of the American Bar Association. I have served as Chairman of its Committee on Legal Research, Chairman of its Committee on Exempt Organizations, Chairman of its Special Committee on Substantive Tax Reform, and I have also served as a member of the Council of the Section. I have been actively involved in several major national projects on tax reform, and it is with respect to them that I wish to make a brief summary which leads to the principal recommendation of this

statement.

I. Early Efforts Concerning Reform

From 1913 until the 1930's, the income tax was not of sufficiently broad application to evoke any general critical analysis and discussion. Following World War II, however, individuals and business organizations evinced greater concern about the tax. Although economists had been writing about different kinds of taxes for a number of years, it was not until after World War II that legal scholars began to give increasingly greater attention to the subject. Indeed, prior to World War II, only a few law schools offered a separate course in Federal taxation, and the offering of multiple courses in taxation in the curricula of law schools did not emerge until the late forties and early fifties. During this period, the two disciplines, law and economics, went their separate ways. Economists wrote on the shifting and incidence of taxes, on the effect of different kinds of taxes on allocation of resources, and on the development of economic models in which tax factor were significant. Legal scholars were largely concerned with technical analysis of taxing statutes and decisions and critiques of the tax impact on various business and investment patterns. Thus, the emphasis in economic writing was on macroeconomic analysis; in legal writing the emphasis was on the application of the rapidly developing tax law to real or hypothesized cases.

In the fifties the Joint Committee on the Economic Report and the House Committee on Ways and Means inaugurated multidisciplinary

discussions of tax policy for the future. Lawyers, economists, accountants, businessmen, and others were invited to participate as public witnesses to make their presentations concerning tax policy, not from any particular organizational or institutional position, but rather from the standpoint of the general national welfare. In addition, representatives from industry and trade associations were invited to present the views of their respective groups. As a result, the formal papers, panel discussions and colloquies between Committee members and witnesses filled many volumes.[1] These efforts constituted the first major broad-scale assault on tax reform. In this connection, it is interesting to observe the similarity of positions stated in much of this material: the rate structure of the income tax is too highly progressive, the tax is so complicated as to jeopardize compliance and administration, taxes on bunched income should be alleviated by averaging devices, vertical and horizontal equity should be sought for, and so on.

II. The Work of the Special Committee on Substantive Tax Reform of the Section of Taxation of the American Bar Association, 1962-1964

It was against this background that the Section of Taxation of the American Bar Association undertook a major effort in substantive tax reform beginning in 1962. Previously this Section, one of the largest of the

1. See Joint Committee on the Economic Report, Federal Tax Policy for Economic Growth and Stability (84th Cong., 1st Sess., 1956); Hearings on General Revenue Revision Before the Committee on Ways and Means, (84th Cong., 2d Sess., 1958); House Committee on Ways and Means, Tax Revision Compendium (3 vols.; 86th Cong., 1st Sess., 1960); House Committee on Ways and Means, Panel Discussion on Income Tax Revision (86th Cong., 1st Sess., 1960).

American Bar Association, had concentrated on the study and development of proposed technical amendments to the Internal Revenue Code and the regulations thereunder. Working through its committees, the Section had through the years contributed the skill of able tax practitioners toward the task of proposed improvements in the law, regulations, and administrative rulings. Probably no other area of Federal or state legislation has had any greater concentration of professional competence in legal research and analysis. It seemed appropriate, therefore, that the energies of this Section should be directed to substantive tax reform as it had been to proposals for technical amendments to legislation and improvement in tax administration.

Accordingly, the Special Committee on Substantive Tax Reform of the Section of Taxation was organized in 1962; it was composed of practitioners and academicians of long-standing at the tax bar who gave of their time and talent to this new and most important project, for this was the first time that a group of private practitioners had undertaken to consider broad and fundamental changes in tax policy.

In April 1963, the Committee transmitted a report and accompanying resolution to the Board of Governors of the American Bar Association.[2]

The resolution, which was adopted in May 1963,[3] recited the need for substantial revision to broaden the tax base, reduce the income tax rates,

2. "Resolutions on Substantive Tax Reform," 16 American Bar Association Taxation Section Annual Report (1963), pp. 4-5.

3. "Report of the Board of Governors," 88 Annual Report of the American Bar Association (1963), pp. 468-470.

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simplify the technical provisions, simplify administration, and ease the burden of compliance.

The resolution then approved the following action:

> 1. The continuance of inquiry and research by appropriate committees of the Section of Taxation leading to the objectives of establishing a fair and equitable tax system, broadening the tax base, and providing incentives for work and investment, and
>
> 2. The consideration of specific measures designed to achieve the objectives in paragraph 1, which would have the effect of -
>
> (a) insuring that every person able to do so pay in taxes his fair share of the cost of government;
>
> (b) including in gross income items not now included and curtailing special benefits and personal nonbusiness deductions;
>
> (c) establishing with respect to individual incomes a graduated rate structure with a maximum rate of approximately 40 percent;
>
> (d) establishing with respect to corporate incomes a rate structure which would tax corporate incomes not in excess of the maximum rate on individual incomes;
>
> (e) ameliorating or eliminating the double taxation of corporate income, and
>
> (f) modifying the estate and gift tax structure in the interest of simplification, greater fairness and equity, and consistency with the income tax.

By early 1964, the Committee had delineated nineteen areas of inquiry and requested the Treasury Department to supply certain statistical data with respect to them.[4] The Committee was aware that these items were

4. "Report of the Special Committee on Substantive Tax Reform," 17 American Bar Association Taxation Section Annual Report (1964), pp. 277, 282.

only a beginning, but it believed that the data which would be accumulated concerning them would provide important insights into the general problem and suggest further areas of exploration. As a first trial rate structure, the Committee proposed an individual tax rate schedule of 10 to 40 percent. The nineteen items related generally to broadening the income tax base.

Economists frequently allude to a concept of income consistent with what is known as the Haig-Simons definition; that is, that between two points of time, income consists of net accretions to wealth, or power of consumption, plus the value of transfers of wealth and the market value of rights exercised in consumption.[5] To be wholly compatible with the Haig-Simons definition, many more items would have to be considered than were suggested by the Committee for analysis. The ones selected were those for which data were reasonably accessible and would constitute a basis for an experiment. The Committee emphasized that the entire project was not undertaken for the purpose of taking a position on any one item or combination of items but solely for the purpose of demonstrating by extensive statistical analysis what the results of base broadening might be.

The Committee set the stage for the first organized effort of the bar to explore in depth a broadened tax base. It was aware, however, that a group of lawyers working as volunteers on a professional project could not hope to gather the relevant statistical data and make the necessary detailed analysis without a full-time working staff. Appropriate recommendations to this effect were made to the Section of Taxation and the Board of

5. R. Haig, "The Concept of Income--Economic and Legal Aspects," in R. Haig (ed.), The Federal Income Tax (1921), p. 7; H. Simons, Personal Income Taxation (1938), pp. 61-62.

Governors, and, as a result a Special Committee of the American Bar Association was organizaed to present the project to the American Bar Foundation.[6] A pilot project sponsored by the American Bar Foundation and Southern Methodist University was the result.

III. The American Bar Foundation - Southern Methodist University Pilot Studies in Substantive Tax Reform (1969)

This project was intended to demonstrate the simplification that could be achieved and what the tax rate structure might be with the broadest possible income base. Because this project was only a demonstration and because of the constraint of limited resources available for computer analysis and data retrieval (the total budget was only $25,000), the broadening of the tax base was not explored to the fullest. Nevertheless, the studies demonstrated that the skills of the tax lawyer and the economic analyst could be combined with the important component of computer technology to provide a mass of raw data from which rational tax policy choices could be made.[7] The statistics of income for the fiscal year 1964 were used as a base. Two separate base broadening models were constructed: one model demonstrated an increase from the actual 1964 base of $230.4 billion to $481.6 billion, a base broadening increase of $251.2 billion, or an increase over the existing base of 209 percent. The other model demonstrated an increase from the actual base of $230.4 billion to $501.3 billion,

6. "Report of the Special Committee on Substantive Tax Reform," 90 Annual Report of the American Bar Association (1965), p. 555.

7. Studies in Substantive Tax Reform (Published Jointly by the American Bar Foundation and Southern Methodist University, Arthur Willis, editor, pp. i-xv; 1-183. Chicago, 1969).

a base broadening increase of $270.9 billion, or an increase over the existing base of 217 percent. A model tax rate table was constructed from 10 to 40 percent which would have yielded for 1964 the same actual revenue as the existing tax system produced in that year. This project was a demonstration of the kind of dramatic possibilities which could be produced from such intensive analysis in depth. We intended that the project would elicit interest in a much larger privately sponsored effort. This hope was realized by the funding of further research by the Fund for Public Policy Research.

IV. The Commission to Revise the Tax Structure, Reforming the Federal Tax Structure (Fund for Public Policy Research, 1973)

The fund for Public Policy Research was sufficiently attracted by the results of the pilot project of the American Bar Foundation and Southern Methodist University to fund a major further extension of the work of data retrieval, statistical compilations and legal and economic analysis. These results were published in the volume: Reforming the Federal Tax Structure published by the Commission to Revise the Federal Tax Structure of the Fund for Public Policy Research in 1973.[8]

A. The recommendations contained in this report proposed the following changes in the tax base:

1. Include the following cash and cash equivalent items of income presently excluded: interest on state and local

8. Reforming the Federal Tax Structure (Commission to Revise the Tax Structure, Fund for Public Policy Research, pp. i-xv; 1-272. Washington, 1973).

securities; social security, unemployment compensations, and veterans benefits in excess of cost; scholarships and fellowships, health, disability and accident benefits in excess of cost; death benefits paid on life insurance policies in excess of cost.

2. Include the value of the following employee fringe benefits presently excluded: employer contributions on behalf of employees for social security, group life insurance, hospital, surgical, medical and disability insurance, and retirement benefits; the annual earnings of employee pension, profit sharing and other retirement plans; other fringe benefits such as merchandise discounts, free meals and lodging, recreational activities.

3. Eliminate certain of the nonbusiness deductions and deductions for exemptions presently allowable. These would include nonbusiness deductions and exemption deductions for the individual and his dependents except medical expenses in excess of 5 percent of adjusted gross income and casualty losses in excess of 5 percent of adjusted gross income. Adjusted gross income would be regarded as the same as under present law, i. e., generally, net trade or business income. All trade or business expenses and expenses in connection with earned income and property held for investment would be allowed.

4. Include income imputed to the individual in the following forms: interest on life insurance, rent on owner-occupied dwellings; interest subsidies on loans to college students.

5. Include the increase or decrease in the value of assets owned by the taxpayer between the beginning of the taxable year and the end of such year.

6. Under the Commission Proposal, the income presently being taxed to corporation would be included in the individual income tax base of the corporate shareholders. There are various ways in which this could be done; however, for purposes of its report, the Commission attributed corporate income to shareholders on the basis of the (1) dividends received, plus or minus the (2) annual appreciation or depreciation in value of the corporate stock. In this latter regard, it was assumed that the retained earnings or losses of the corporation are reflected in the stock values,

whereas, in actuality, of course, the annual change in stock value may be more or less than corporate net profits or losses.

7. The annual value of gifts and estates presently subject to gift and estate taxes were added to the individual income tax base of the transferees.

8. The Commission used the family as the tax unit. The family was assumed to be the husband and wife and their eligible dependents, or a single person. An eligible dependent is defined as a child living in the family household who is less than 18 years of age and not married, or 18 years of age or over and less than 26 who is attending school full-time and is not married.

The first $500 of earned income of each eligible dependent would be excluded from the income of the family unit. Income splitting between spouses would not be allowed; a single return would be required from each family; and the same rate schedules were used for each family unit so constructed as defined above.

Intrafamily transfers (gifts, inheritances, etc.) would not be recognized as income at the time of the transfer. However, upon leaving the family unit, the individual would then recognize as income the value of property when it was transferred to him while he was a member of the family unit.

In a family unit in which the husband worked and the wife did not, the Commission used a credit equal to the tax on the first $3,000 of taxable income. In a family unit in which both the husband wife work, an additional credit was allowed computed at the lowest tax rate (4 percent) times the lesser of the wife's earned income or $2,000.

B. The effect of the Commission Proposals on the tax system:

On the base established by these base broadening proposals, the Commission established a rate structure of 4 to 54 percent. This assumed the elimination of all corporate taxes and all estate and gift taxes. Thus, the Commission demonstrated that the revenue received

from the individual income tax, the corporate tax and the estate and gift tax system could be derived from one single individual income tax base with a rate structure from 4 to 54 percent. Such a system would be more equitable than the present system and would provide neutrality in its effect on business and investment decision making. The report demonstrated the substantial simplification which could be achieved under such a system.

C. The effect of the Commission Proposals on the economy:

The Commission devised several econometric models to show the effect of its proposals on the corporate community, on agriculture and on housing. These models demonstrate that a broad based tax system with more nearly achieved vertical and horizontal equity will produce a healthier economic climate for full employment and national growth.

V. A Plea for the Creation of a Bipartisan Commission to do Research on the Tax System as a Basis for Long Range Tax Reform

The foregoing summary of major privately sponsored projects on tax reform indicate why a thorough ongoing research is necessary if real, substantive tax reform and tax simplification is to be accomplished.

During the 1960's, our sister democracy, Canada, undertook a major study of tax reform. A Royal Commission, known as the Carter Commission, prepared for the Canadian Parliament and all the people of Canada an excellent statement of goals to achieve tax reform in Canada.[9]

9. Report of the Royal Commission on Taxation (Ottawa, Canada, 1966).

Sôme excerpts from that report echo well what our own concerns should be.

> 1. The present system does not afford fair treatment for all Canadians. People in essentially similar circumstances do not bear the same taxes. People in essentially different circumstances do not bear appropriately different tax burdens.
>
> 2. Canadians are less well off than they could be because there are fewer goods and services available than could be provided with the more efficient use of labor, capital and natural resources. The present tax system has contributed to this unfortunate result in two ways:
>
> (a) It needlessly distorts the distribution of productive goods and services;
>
> (b) It fails to compensate where it could for some nontax barriers to the efficient allocation of productive goods and services;
>
> 3. The fiscal system has not been used as effectively as it could have been used to maintain full employment, contain inflationary increases in the price level, and encourage Canadian ownership and control of Canadian industry.[10]

To those who would have difficulty in adjusting to new concepts, the Carter Commission stated:

> We hope Canadians will accept the challenge implicit in our recommendations. And there can be no doùbt that our recommendations constitute a great challenge. Preconceived opinions about taxation are deeply and firmly held. Many will find it extremely difficult to take a new look at old questions. Because some facts cannot be readily ascertained, honest differences of opinion are inevitable. There is a danger that the debate about these minor factual questions will divert attention from the major issues.[11]

The Carter Commission committed itself to the Haig-Simons definition as follows:

> We are completely persuaded that taxes should be allocated according to the changes in the economic power of individuals

10. Ibid., Vol. 1 at 2.
11. Id. at 2.

> and families. If a man obtains increased command over goods and services for his personal satisfaction we do not believe it matters, from the point of view of taxation, whether he earned it through working, gained it through operating a business, re-received it because he held property, made by selling property or was given it by a relative. Nor do we believe it matters whether the increased command over goods and services was in cash or in kind. Nor do we believe it matters whether the increase in economic power was expected or unexpected, whether it was a unique or recurrent event, whether the man suffered to get the increase in economic power or it fell in his lap without effort.[12]

The Royal Commission was generously provided for and operated independently with a staff of paid professionals. Its recommendations provide a useful model for a major program of interdisciplinary research in Federal taxation. The Canadians spent substantial sums on the Carter Report, and we should do no less.

RECOMMENDATION

I recommend the formation of a National Commission on Federal Tax Reform with two members from the Senate, one from each of the two major parties; two members from the House, one from each of the two major parties; two economists with a principal specialty in taxation and public finance, two lawyers specializing in Federal taxation, two representatives from the academic community who have written and taught in the area of Federal taxation, and three members from the public at large, one of whom shall be designated as Chairman. Each of the houses of Congress will select its own representatives, and the remaining nine will be selected by the President, giving due regard to the maintenance of a balance of political, social and economic positions.

12. Id. at 9-10.

VI. Conclusion

If the Congress wishes to benefit particular taxpayers or industries or investments with special provisions, this is far better done on the expenditure, or appropriation side of the budget, rather than the income side.[13] The funds required for a major ongoing study for the Congress would be the wisest investment the Congress could make in providing the data for testing the validity of numerous alternative proposals, and the results would be of invaluable benefit to our entire national community.

How much more effective such an effort would be than hastily devised band aid measures which only further confuse the law, make compliance and administration more difficult, and foster even greater inequities in the taxing system.

13. Surrey, "Tax Incentives as a Device for Implementing Government Policy: A Comparison with Direct Government Expenditures," 88 Harv. L. Rev. 705 (1970).

TESTIMONY OF EUGENE M. LERNER

CHAIRMAN OF THE FINANCE DEPARTMENT, NORTHWESTERN UNIVERSITY

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

WASHINGTON, D. C., WEDNESDAY, JULY 30, 1975

Mr. Chairman and Members of this Committee, my name is Eugene M. Lerner. I am Chairman of the Finance Department of the Graduate School of Management of Northwestern University.

I want to speak in favor of two proposed changes in tax legislation. These changes will enable firms to raise new equity more effecitvely and strengthen their balance sheets. I believe that the adoption of these proposals will stimulate capital spending, increase productivity, and raise employment. The two proposals are:

(1) to permit dividends on preferred stock to be tax exempt, and

(2) to permit investors to defer the payment of taxes on dividends they choose to reinvest in a company until the shares so acquired are sold

These proposals would be of value to all firms; and I urge that firms in every sector of the economy be permitted to take advantage of the benefits that the proposals would afford. However, to provide a specific background for my remarks, I would like to refer to telephone and electric companies. The importance of these industries to the overall productivity of the nation is clear to all. Moreover, this industry will require

substantial investments in plant and equipment in the immediate future and unless firms can increase their equity positions, they will encounter difficulties in raising the required funds.

Utilities are net borrowers: they do not generate enough funds internally to cover dividends and make the needed capital expenditures. For example, in 1973, six out of six telephone holding companies, 41 out of 43 flow-through electric companies and 61 out of 62 normalized utilities used more funds for plant and equipment outlays and dividends than they generated from internal sources. (See Table 1) Consequently, it is of vital importance that utilities continue to enjoy the confidence of the financial community so that they can continue to attract capital.

The facts are however that over the years, the financial health of utilities has deteriorated. Since 1970, Standard and Poors has lowered the credit ratings of 97 major utilities. Moreover, the pace of the deterioration is accelerating. In 1974 alone, the ratings of 37 companies were lowered.

One measure of the deteriorating financial health of the utilities is indicated by the trend of interest coverage. Interest coverage is the ratio of profits before interest and taxes to total interest payments. This measure shows the potential shrinkage in earnings that can take place before the return to the bondholder becomes jeopardized. In 1969, only 16 of 43 flow-through electric companies had an interest coverage ratio of less than three; by 1973, 37 of 43 companies were below three. In the case of normalized electrics, the corresponding numbers are six and 22, i.e. the number of electric companies with questionable coverage increased almost fourfold from 1969 to 1973.

The facts then are that huge investment requirements and weak balance sheets characterize the utility industry. What rational and practical policies can be adopted to correct this situation?

Two proposals are offered that will immediately allow corporations to meet their financial needs, improve balance sheet relationships, and raise the financial integrity of these utility firms. These proposals allow dividends on preferred stock to be tax deductible, and dividends on common stock to be reinvested at the shareholder's option with taxes deferred. Taxes at the capital gains rate will be paid only when the shares so acquired are sold. The former proposal has been put forth by President Ford and the latter proposal has been introduced into the Ways and Means Committee of the House by Representative Ullman (Democrat, Oregon).

The proposal to allow corporations the option of issuing tax deductible preferred stock calls for the creation of a new financial instrument. This preferred stock would be like debt in that the dividend payments on the instrument are tax deductible to the firm. It would be like equity, however, in that the issue has no maturity and is subordinated to debt. Recipients of the dividends would pay taxes on the income, and the 85 per cent tax exclusion for corporate buyers would not be applicable.

Issuers of the new preferred securities would use the instruments to reduce their short-term indebtedness, strengthen their balance sheet, and improve their liquidity. As a result, I believe that the firms will make new capital expenditures which in turn will lead to a rise in employment.

The new preferred stock offers major long-run advantages to both the issuer and purchaser. The benefits to the issuer are as follows:

- A new source of needed equity capital at a cost substantially lower than other equity alternatives.

- An opportunity to reduce debt ratios because the preferred issue is an equity issue.
- A new degree of flexibility in raising funds.
- Improved earnings, cash flow, and return on common equity.

The proposed common stock dividend reinvestment plan would have similar effects; i.e., it would provide another means of increasing the equity base of the issuing corporation and it would furnish significant benefits to the investor.

Many corporations now offer a dividend reinvestment plan. In some firms, the participation rate is as high as 15 per cent of all shareholders. These shareholders reinvest now only because it is convenient and brokerage charges are nominal. The participating shareholder must now pay taxes on funds he never receives. An indication of how much money could be raised by implementing this proposal is provided by mutual funds; their reinvestment ratio is on the order of 30 per cent. Some mutual funds report reinvestment rates as high as 96 per cent. If a positive incentive were provided to the shareholder, firms seemingly could meet a substantial portion of their additional equity requirements through this route.

The inflation that our economy has been experiencing over the past several years is a tax. For a corporation, inflation is a tax on capital. Profits are overstated because historical cost accounting measures do not adequately recognize that replacement costs are far in excess of original costs. To correct this problem at least partially, it is certainly appropriate for the taxing authorities to permit faster depreciation rates or larger investment credits. But neither of these tax changes reaches the root of

the financial plight of the modern firm -- the inadequate equity base to meet capital needs.

An advantage of the dividend reinvestment program and the preferred dividend program is that they will immediately improve the equity position and cash flow and thereby the financial integrity of the corporation. With improved balance sheets, corporations are better able to assume the risks associated with capital expenditures.

These two proposals would help all companies to appeal to a wider and more diverse shareholder base with differences in income and with various tax situations. The programs complement each other because the new preferred would help investors who seek safety and high-dividend yield, whereas the dividend reinvestment proposal assists those who seek capital appreciation.

National leaders have recognized the merit in both proposals. President Ford urged that one proposal be adopted and Representative Ullman the other. Both of these proposals deserve widespread support and both should be implemented. I urge that this Committee and the Congress take action to this affect.

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Table I

THE NUMBER OF COMPANIES REPORTING POSITIVE AND NEGATIVE DIFFERENCES BETWEEN INTERNAL SOURCES AND INTERNAL USES OF FUNDS

	6 Telephone Holding Companies		43 Electrics - Flow-Through		62 Electrics Normalized	
	Positive	Negative	Positive	Negative	Positive	Negative
1969	0	6	1	42	7	55
1970	0	6	1	42	5	57
1971	0	6	1	42	8	54
1972	0	6	3	40	5	58
1973	0	6	2	41	1	61

Table 2

TIMES INTEREST EARNED

6 Telephone Holding Companies

	1969		1970		1971		1972		1973	
	Number	Cumulative Total	Number	Cumulative Total	Number	Cumulative Total	Number	Cumulative Total	Number	Cumulativ Total
.0 - .9	0	0	0	0	0	0	0	0	0	0
1.0 - 1.9	0	0	1	1	0	0	0	0	0	0
2.0 - 2.9	2	2	1	2	2	2	3	3	3	3
3.0 - 3.9	3	5	3	5	4	6	3	6	3	6
4.0 - 4.9	0	5	1	6	0	6	0	6	0	6
5.0 - 5.9	0	5	0	6	0	6	0	6	0	6
6 & over	1	6	0	6	0	6	0	6	0	6

TIMES INTEREST EARNED

43 Electrics - Flow Through

	1969		1970		1971		1972		1973	
	Number	Cumulative Total	Number	Cumulative Total	Number	Cumulative Total	Number	Cumulative Total	Number	Cumulative Total
0 - .9	0	0	0	0	0	0	0	0	0	0
1.0 - 1.9	0	0	2	2	2	2	2	2	4	4
2.0 - 2.9	16	16	23	25	30	32	29	31	33	37
3.0 - 3.9	17	33	14	39	11	43	12	43	6	43
4.0 - 4.9	5	38	4	43	0	43	0	43	0	43
5.0 - 5.9	4	42	0	43	0	43	0	43	0	43
6 & over	1	43	0	43	0	43	0	43	0	43

Table 2 (continued)

62 Electrics - Normalized

	1969		1970		1971		1972		1973	
	Number	Cumulative Total	Number	Cumulative Total	Number	Cumulative Total	Number	Cumulative Total	Number	Cumulative Total
0 - .9	0	0	0	0	0	0	0	0	0	0
1.0 - 1.9	0	0	0	0	0	0	0	0	5	5
2.0 - 2.9	6	6	19	19	23	23	20	20	22	27
3.0 - 3.9	26	32	22	41	20	43	27	47	21	48
4.0 - 4.9	12	44	11	52	13	56	11	58	10	58
5.0 - 5.9	11	55	8	60	4	60	4	62	3	61
6 & over	7	62	2	62	2	62	0	62	1	62

Statement of

Robert L. Payton

Hofstra University, Hempstead, N.Y.

Mr. Chairman, my name is Robert L. Payton. I am president of Hofstra University in Hempstead, Long Island, and I also serve as chairman of the Public Affairs Committee of the Commission of Independent Colleges and Universities of the state of New York.

It was not clear precisely which panel I should appear before, and I ask your indulgence if I present remarks that the Committee might expect to hear in another context. In any event, I will be brief.

I am here to plead the case for tax relief for middle income families struggling to pay steadily rising college tuition. I have compressed the reasons for this recommendation into the following arguments:

(1) There are two sectors of higher education in the United States. One sector is called "public," is supported almost entirely by tax revenues, charges low tuition, and is managed by government agencies. The second sector is called "independent" (we reject the term "private" as misleading), is supported largely by tuition income, charges high tuition as a consequence, and although supervised by the state is managed independently.

(2) Public policy implies that access to higher education in the United States has become a right. The primary basis for exclusion is that of academic ability. In practical terms, higher education is mandatory for all citizens who seek to achieve or retain middle or upper income levels in the economy.

(3) Because tax subsidies permit them to charge low tuition, the public institutions do not discriminate on economic grounds. Because the independent colleges and universities depend on tuition for most of their income, however, they <u>are</u> forced to discriminate on economic grounds. Independent colleges turn away large numbers of students who cannot afford to pay high tuition, students who are in every other way fully acceptable for admission.

(4) Although public colleges depend on tax revenues and independent colleges depend on tuition income paid by students, both sectors of higher education are enrollment dependent. Colleges and universities do not exist without students to teach.

(5) Enrollment demand in the public colleges is based on low tuition, in large part. In all areas where low tuition colleges compete for students with high tuition colleges, enrollments have shifted from the latter institutions to the former. In New York State, the shift has been from one-third public to two-thirds public in fifteen years.

(6) This is not simply a New York problem, but New York may serve as an example. There are more than 50,000 empty seats for undergraduates in the independent college classrooms of New York State. Tuition averages $2800 in those institutions. Tuition averages $750 in the public colleges. The <u>cost</u> of educating each student averages about $3500. Therefore, the cost of educating 50,000 students in New York is $175 million a year. Independent college tuition would produce $140 million of that in tuition income. Public college tuition would produce only $37.5 million. By the shift of 50,000 students from the

independent to the public colleges we have given up about $140 million in voluntary income and added about $137.5 million to the tax burden of the state.

(7) It is not surprising that students are transferring from independent colleges to public colleges to benefit from low tuition, nor is it surprising that state governments are going broke trying to make up the difference.

(8) The primary burden of the costs of higher education has fallen on the middle income family. The shift of students from these families into the public colleges has led to pressure for still further expansion at the same time that the number of vacant seats and classrooms in the private colleges has increased.

(9) It should also be noted that students from upper income families attending low tuition public colleges receive a subsidy of the cost of their education that has the effect of a tax credit. Middle income students attending independent colleges and paying high tuition suffer a tax penalty because they are not now eligible for subsidy, either in the form of a tax credit or a tax deduction.

This is the briefest way that I can state the problem. Now, if I may, I will indicate possible solutions of particular interest to this Committee:

(1) The simplest, quickest, and least costly way to arrest this ominous trend and to stabilize enrollments is by tax relief.

(2) The fairest way to achieve tax relief is by tax credit.

(3) All tuition should be treated alike, as it is in the public colleges. Tax credit should be available for all forms

of tuition -- for undergraduate, graduate, part-time and full-time students.

(4) A "means test" should apply to all who receive subsidy for their education. If no "means test" is applied to students in the public colleges, there should be no means test for students in the independent colleges.

(5) Viewed from a national perspective, almost all students are expected to pay at least some part of the cost of their education. For that reason, we propose that a floor be established below which tax credits do not apply.

(6) Because some institutions may wish to provide special programs that require high tuition, we believe that there should be a ceiling above which tax credits do not apply.

(7) Separate minimum and maximum levels of tuition should perhaps be established for public colleges, so that their tuitions are not arbitrarily raised to divert the present cost burden from the states to the federal government.

These actions would stabilize enrollments in higher education. They would insure the continuation of the diversity that has been a principal source of strength of our system. We could also expect a continuation of the substantial voluntary contributions to higher education that have helped both sectors of higher education.

Most importantly, we would have retained the greatest measure of freedom of choice for the middle income student. For the first time in years decisions of these students will be made once again primarily on academic rather than economic grounds.

FULL STATEMENT

of

Robert L. Payton

The United States has a long tradition of two sectors of higher education. That tradition is now in serious jeopardy, and by default we may see it come to an end in the next decade.

The problem is not a matter of cosmetics but one of basic issues. If we understand more clearly what those issues are, we are more likely to deal with the substance than with the surface of the matter.

In the work of the Commission of Independent Colleges and Universities in the State of New York during the past months, we have tried to define the issues and to touch on possible solutions.

First, a matter of definitions:

The broad field of higher education is divided into two sectors. One is made up of institutions that are managed by state or local governments and receive the bulk of their income from tax revenues allocated by legislatures.

The other sector, for the most part older, is made up of colleges and universities that are supervised by state agencies --in New York it is the body called the Board of Regents--but managed independently by boards of trustees. They receive modest amounts of State support.

Although I will refer to the two sectors with the familiar names "public" and "independent," please bear in mind that each serves the public interest and is accountable to public agencies.

The majority of our colleges and universities are still in the independent sector, but the great expansion of public education has resulted in two-thirds of all students being enrolled in public institutions. As of last fall, almost eight million students were enrolled in public colleges, compared to 2,300,000 in independent institutions.

The two sectors have each expanded in recent years because of the fundamental change in our attitudes toward higher education. College education is no longer thought of as a luxury for the well-to-do, or as a "cultural advantage" for a small part of our society: it has become a necessity for individuals in all social and economic classes. It is also, of course, an essential source of trained manpower for our changing, complex society.

We have come to the conclusion that everyone who is academically qualified to do college work should have access to college, given the motivation to seek the opportunity.

By establishing new public colleges everywhere and by encouraging the rapid expansion of higher education generally, state legislatures have established a public policy that says:

1. It is in the public interest to provide higher education for all who are qualified to pursue it.
2. No one should be excluded from access to higher education on <u>economic grounds</u>.

This policy has been supported by generous programs to encourage the expansion of college campuses and to increase enrollments. Low-interest loans and outright grants have resulted in the construction of many billions of dollars in new campus buildings. Entire constituencies have been added to the traditional pool of college-going students.

Programs have been established, and supplemented by federal aid, to insure that students of low income have equal opportunity to pursue their academic training beyond the high school. Many states provide direct financial assistance to the colleges as well as to students.

Public policy has created a system of two sectors, and a system that is open to all who are academically qualified.

We have now entered a period of crisis, arising from several sources. The first is inflation, the second is a decline in the numbers of students graduating from high school, a third is the resulting competition for enrollments, and a fourth is the distortion of the way education is paid for.

I won't bore you with details about the impact of inflation on education costs, nor that enrollments of full-time undergraduates will decline; that has been accepted in most quarters of higher education.

Because <u>all</u> colleges and universities are dependent for their survival on enrollments, the competition within and between the two sectors of higher education has increased sharply.

Finally, this competiton is grossly distorted by the fact that all of the students in public institutions are heavily subsidized, while most of the students in independent institutions have to pay most of their own way.

In terms directly related to the concerns of this Committee, the students in public colleges and universities receive a significant financial incentive--anywhere from 70 to 100 per cent of the cost of their education is paid for. They need to be concerned only about a small portion charged them in tuition, and about other collateral costs.

Students in the independent colleges, however, have to pay the bulk of the costs in the form of tuition, as well as the collateral costs. A simple chart will dramatize the "gap" between public and independent college tuitions through the years:

Tuition and Fees

	Public	Independent	Difference
1935-36	$116	$ 313	$ 197
1955-56	202	712	510
1974-75	627	2,880	2,253

Source: American Council on Education, 1974 Fact Book

There results an economic incentive to seek out education in public colleges and an economic penalty--because tuition is not deductible in any form--for those who seek out education in independent colleges.

Independent colleges, serving the public interest and with a public mandate, are compelled to discriminate against prospective students on economic grounds by charging high tuition. Students are often forced to seek places in public institutions which require payment of very low tuition.

The public institutions are thus sustained by a wholly artificial "demand" which their relatively low tuition charges encourage. On the other hand, the tuition-dependent independent colleges are forced to raise tuitions to meet inflation--thus perpetuating the gap between the two sectors.

Individuals seek educational opportunity on the basis of price rather than program. The action of free choice and decision by students is lost. In a short period of time, American higher education will consist of one sector, governmentally controlled, and--in my opinion--suffering from many of the same profound weaknesses of the monopolistic public system of elementary and secondary education.

The problem now facing our young people and their families is the awful burden of high tuition. Even students in public colleges, paying only a few hundred dollars a year in tuition, often complain about the burden, yet many of these students are from middle and upper income families. In 1973, 55 per cent of the freshmen in four-year public institutions came from families with incomes of $15,000 or less. It may surprise you that 51 per cent of the freshmen in the independent sector come from that same income bracket.

What of the students now paying tuitions of $2500, $3000, indeed even $4000 a year? One can imagine the burden of that cost on the middle income family. What if more than one child attends college, or seeks education beyond the bachelor's degree?

The fact is that the full cost of education cannot be passed on to students. Some low income students will need heavy subsidy, others less, but practically all students will need some help.

Public policy has been expressed by legislative decision to set public college tuition at about $500 for undergraduates. (The range is from zero to $800 a year; $500 is an average.)

Public policy does not differentiate tuition charges; the same amount is charged whatever the family income. The cost to the student at a public college is $500 a year even if the family income is $100,000 a year. There is no "means test."

Public policy assigns a means test, however, to students attending the independent colleges. Anyone earning over

$25,000 in total family income in New York is essentially ineligible for assistance from the state -- or from the college itself. Federal programs are even more restrictive. Under BEOG, for example, there is practically no aid available to the family of $15,000 income.

Students in the independent colleges, therefore, use up the family savings, work part-time, and borrow money -- to pay tuition that wouldn't be charged if they were in public institutions.

Is there any wonder more and more students are demanding low tuition? Is there any question at all that high tuition institutions will be forced to close because of this artificial price gap?

I will indicate possible solutions of particular interest to this Committee:

(1) The simplest, quickest, and least costly way to arrest this ominous trend and to stabilize enrollments is by tax relief.

(2) The fairest way to achieve tax relief is by tax credit.

(3) All tuition should be treated alike, as it is in the public colleges. Tax credit should be available for all forms of tuition -- for undergraduate, graduate, part-time and full-time students.

(4) A "means test" should apply to all who receive subsidy for their education. If no "means test" is applied to students in the public colleges, there should be no means test for students in the independent colleges.

(5) Viewed from a national perspective, almost all

students are expected to pay at least some part of the cost of their education. For that reason, we propose that a floor be established below which tax credits do not apply.

(6) Because some institutions may wish to provide special programs that require high tuition, we believe that there should be a ceiling above which tax credits do not apply.

(7) Separate minimum and maximum levels of tuition should perhaps be established for public colleges, so that their tuitions are not arbitrarily raised to diver the present cost burden from the states to the federal government.

The results:

(1) Stabilization of enrollments in the two sectors of higher education. An end to wasteful expansion of one sector in the face of empty classrooms in the other.

(2) An improvement of quality resulting from rational competition among colleges based on the academic merits of each.

(3) Continued voluntary support of education by tuitions paid by students in non-governmental colleges.

(4) Encouragement of continued voluntary contributions to higher education.

(5) Most importantly, freedom of choice for all qualified students, and finally,

(6) The preservation of the strongest and most vigorous system of mass higher education achieved by any nation in the world.

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